



**ST. CHARLES HEALTH SYSTEM, INC.**

Consolidated Financial Statements  
and Supplementary Schedules

December 31, 2013 and 2012

(With Independent Auditors' Report Thereon)

# ST. CHARLES HEALTH SYSTEM, INC.

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KPMG LLP  
Suite 3800  
1300 South West Fifth Avenue  
Portland, OR 97201

## **Independent Auditors' Report**

The Board of Directors  
St. Charles Health System, Inc.:

We have audited the accompanying consolidated financial statements of St. Charles Health System, Inc., which comprise the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

### ***Management's Responsibility for the Consolidated Financial Statements***

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with U.S. generally accepted accounting principles; 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.

### ***Auditors' Responsibility***

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the 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 auditors consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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

### ***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly in all material respects, the financial position of St. Charles Health System, Inc. as of December 31, 2013 and 2012, and the results of its operations and its cash flows for the years then ended, in accordance with U.S. generally accepted accounting principles.



***Other Matter***

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplemental information included in schedules I and II is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

**KPMG LLP**

Portland, Oregon  
March 18, 2014

**ST. CHARLES HEALTH SYSTEM, INC.**

Consolidated Balance Sheets

December 31, 2013 and 2012

<b>Assets</b>	<b>2013</b>	<b>2012</b>
Current assets:		
Cash and cash equivalents	\$ 9,440,000	27,017,000
Assets limited as to use, current portion	7,734,000	7,671,000
Patient accounts receivable, net of reserves for uncollectible accounts of \$23,588,000 and \$16,492,000 at December 31, 2013 and 2012, respectively	89,219,000	61,990,000
Other receivables, net	15,753,000	9,706,000
Supplies inventory	10,305,000	8,935,000
Prepaid expenses and other current assets	7,418,000	7,225,000
Total current assets	139,869,000	122,544,000
Assets limited as to use, net of current portion	308,418,000	259,098,000
Property and equipment, net	223,842,000	211,063,000
Other assets	12,497,000	13,051,000
Total assets	\$ 684,626,000	605,756,000
<b>Liabilities and Net Assets</b>		
Current liabilities:		
Accounts payable	\$ 24,627,000	19,023,000
Accrued liabilities	40,982,000	35,579,000
Estimated third-party payor settlements payable, net	5,467,000	5,058,000
Deferred revenue	366,000	349,000
Current portion of long-term obligations	12,471,000	9,707,000
Total current liabilities	83,913,000	69,716,000
Long-term obligations, net of current portion	145,509,000	156,723,000
Other liabilities	8,290,000	3,929,000
Total liabilities	237,712,000	230,368,000
Net assets:		
Unrestricted, SCHS	434,560,000	367,414,000
Unrestricted, noncontrolling interests	4,315,000	2,959,000
Temporarily restricted	6,556,000	3,581,000
Permanently restricted	1,483,000	1,434,000
Total net assets	446,914,000	375,388,000
Total liabilities and net assets	\$ 684,626,000	605,756,000

See accompanying notes to consolidated financial statements.

**ST. CHARLES HEALTH SYSTEM, INC.**

## Consolidated Statements of Operations

Years ended December 31, 2013 and 2012

	<b>2013</b>	<b>2012</b>
Operating revenues:		
Net patient service revenue prior to provision for bad debts	\$ 559,028,000	504,986,000
Provision for bad debts	27,779,000	24,216,000
Net patient service revenue	531,249,000	480,770,000
Other revenue	25,684,000	24,367,000
Total operating revenues	556,933,000	505,137,000
Expenses:		
Salaries and wages	233,361,000	198,999,000
Employee benefits	72,843,000	65,034,000
Professional fees	38,896,000	36,205,000
Depreciation and amortization	29,853,000	31,175,000
Interest	12,171,000	13,020,000
Medical supplies, drugs, and other	157,874,000	139,783,000
Total expenses	544,998,000	484,216,000
Excess of revenues over expenses from operations	11,935,000	20,921,000
Other income (losses):		
Investment income, net	41,971,000	27,421,000
Contribution from Mountain View Hospital District	16,796,000	—
Other, net	1,641,000	107,000
Total other income, net	60,408,000	27,528,000
Excess of revenue over expenses	72,343,000	48,449,000
Gain on discontinued operations	—	2,499,000
Net assets released from restriction for capital	81,000	516,000
Capital contributions	341,000	43,000
Other transfers	(611,000)	(20,000)
Distributions	(3,652,000)	(2,424,000)
Increase in unrestricted net assets	\$ 68,502,000	49,063,000

See accompanying notes to consolidated financial statements.

**ST. CHARLES HEALTH SYSTEM, INC.**

Consolidated Statements of Changes in Net Assets

Years ended December 31, 2013 and 2012

	<b>Unrestricted – SCHS</b>	<b>Unrestricted noncontrolling interests</b>	<b>Temporarily restricted</b>	<b>Permanently restricted</b>	<b>Total</b>
Net assets at December 31, 2011	\$ 318,617,000	2,693,000	3,662,000	1,375,000	326,347,000
Excess of revenue over expenses	45,759,000	2,690,000	—	—	48,449,000
Gain on discontinued operations	2,499,000	—	—	—	2,499,000
Restricted contributions	—	—	1,760,000	—	1,760,000
Net assets released from restriction	516,000	—	(1,978,000)	—	(1,462,000)
Other transfers	(20,000)	—	2,000	18,000	—
Distributions	—	(2,424,000)	—	—	(2,424,000)
Other changes in net assets	43,000	—	135,000	41,000	219,000
Change in net assets	48,797,000	266,000	(81,000)	59,000	49,041,000
Net assets at December 31, 2012	367,414,000	2,959,000	3,581,000	1,434,000	375,388,000
Excess of revenue over expenses	67,335,000	5,008,000	—	—	72,343,000
Restricted contributions	—	—	3,449,000	—	3,449,000
Net assets released from restriction	81,000	—	(1,222,000)	—	(1,141,000)
Other transfers	(611,000)	—	611,000	—	—
Distributions	—	(3,652,000)	—	—	(3,652,000)
Capital contributions	341,000	—	—	—	341,000
Other changes in net assets	—	—	137,000	49,000	186,000
Change in net assets	67,146,000	1,356,000	2,975,000	49,000	71,526,000
Net assets at December 31, 2013	\$ 434,560,000	4,315,000	6,556,000	1,483,000	446,914,000

See accompanying notes to consolidated financial statements.

**ST. CHARLES HEALTH SYSTEM, INC.**

Consolidated Statements of Cash Flows

Years ended December 31, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Cash flows from operating activities:		
Increase in net assets	\$ 71,526,000	49,041,000
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	29,853,000	31,524,000
Net gain on investments	(33,539,000)	(20,440,000)
Gain on sale of property and equipment	(223,000)	(3,384,000)
Accretion of debt obligation	211,000	313,000
Restricted contributions	(954,000)	(1,760,000)
Contribution from Mountain View Hospital District	(13,651,000)	—
Distributions to noncontrolling owners	3,652,000	2,424,000
Changes in certain operating assets and liabilities:		
Patient accounts receivable	(24,026,000)	14,782,000
Other receivables, net	(5,507,000)	(2,784,000)
Supplies inventory	(1,370,000)	430,000
Other assets	(2,698,000)	(2,325,000)
Accounts payable	5,936,000	(2,154,000)
Accrued liabilities	5,403,000	3,781,000
Estimated third-party payor settlements payable, net	1,115,000	1,509,000
Deferred revenue	17,000	(719,000)
Other liabilities	4,361,000	(770,000)
Net cash provided by operating activities	<u>40,106,000</u>	<u>69,468,000</u>
Cash flows from investing activities:		
Purchases of investments	(32,968,000)	(90,992,000)
Proceeds from sales and maturities of investments	17,124,000	56,197,000
Distributions received from joint ventures	3,059,000	2,655,000
Proceeds from sale of property and equipment	786,000	3,064,000
Purchases of property and equipment	<u>(29,788,000)</u>	<u>(21,706,000)</u>
Net cash used in investing activities	<u>(41,787,000)</u>	<u>(50,782,000)</u>
Cash flows from financing activities:		
Payments on long-term obligations	(13,198,000)	(9,482,000)
Proceeds from restricted contributions	954,000	1,760,000
Distributions paid to noncontrolling owners	<u>(3,652,000)</u>	<u>(2,424,000)</u>
Net cash used in financing activities	<u>(15,896,000)</u>	<u>(10,146,000)</u>
Net (decrease) increase in cash and cash equivalents	(17,577,000)	8,540,000
Cash and cash equivalents at beginning of year	<u>27,017,000</u>	<u>18,477,000</u>
Cash and cash equivalents at end of year	\$ <u>9,440,000</u>	<u>27,017,000</u>
Supplemental disclosures:		
Cash paid for interest	\$ 12,304,000	13,108,000
Change in property and equipment in accounts payable	(1,149,000)	(553,000)
Increase in notes receivable upon disposition of property and equipment	—	2,904,000

See accompanying notes to consolidated financial statements.



## **ST. CHARLES HEALTH SYSTEM, INC.**

### Notes to Consolidated Financial Statements

December 31, 2013 and 2012

#### **(1) Business, Organization, and Summary of Significant Accounting Policies**

##### **(a) *Business and Organization***

St. Charles Health System, Inc. (SCHS or the Corporation) is an Oregon nonprofit corporation that operates a healthcare delivery system, which includes four hospitals in Central Oregon: St. Charles Bend, St. Charles Redmond, St. Charles Madras, and Pioneer Memorial Hospital in Prineville (PMH), as well as several other lines of healthcare-related businesses. Effective January 1, 2013, SCHS assumed substantially all of the assets and operations of Mountain View Hospital District (MVHD), and assumed substantially all of their liabilities, resulting in the creation of St. Charles Madras as discussed in note 1(b). Prior to 2013, SCHS provided management services to MVHD including strategic support, management personnel, and information technology support. SCHS provides healthcare and healthcare-related services primarily to residents in Central, Southeastern, and Eastern Oregon. In addition, SCHS is the sole member of Cascadia Insurance Company, Inc. (CICI), a captive insurance company domiciled in Hawaii, established for the purpose of providing malpractice insurance coverage for SCHS. Effective June 30, 2013, CICI was dissolved and the Corporation began contributing actuarially determined amounts to a self-insurance trust established to fund estimated ultimate losses. SCHS is also the sole member of St. Charles Management Services Organization LLC (SCMSO), a limited liability company that provides billing services to physicians and medical clinics. These healthcare businesses and subsidiaries, along with the Corporation's home office, form the obligated group. The assets of any one are available for the satisfaction of debts of the others within the obligated group (subject to certain contractual limitations).

The St. Charles Foundation, Inc. (SCF), an Oregon nonprofit corporation, was established to engage in and conduct charitable, educational, and scientific activities and to raise funds in support of SCHS. The Corporation is the sole member of SCF, and SCF is included in the consolidated financial statements of SCHS but is not a member of the obligated group. The net assets of SCF are reported as unrestricted, temporarily restricted, or permanently restricted, according to donor or legal restrictions, in the accompanying consolidated financial statements.

SCHS also has a controlling interest in Cascade Medical Imaging, LLC (CMI). CMI is a limited liability corporation whose two members are SCHS (70% ownership interest) and Central Oregon Radiology Associates, P.C. (CORA) (30% ownership interest). CMI provides positron emission tomography (PET) scanning, computer-assisted tomography (CT) scanning, nuclear medicine, mammography, and picture archiving and communications system (PACS) services in Central, Southeastern, and Eastern Oregon. CMI has been consolidated into the financial statements of SCHS but is not part of the obligated group.

##### **(b) *Mountain View Hospital District Asset Purchase***

On January 1, 2013, SCHS assumed the operations and substantially all of the assets of MVHD, located in Madras, Oregon, in exchange for the assumption of substantially all of MVHD's liabilities and payment of certain outstanding MVHD debt obligations. The financial position and results of operations of St. Charles Madras have been included in the consolidated financial statements of the Corporation since that date. The facility was renamed St. Charles Madras and SCHS continues to offer substantially the same healthcare services to the community of Madras and the surrounding Jefferson County area.

## ST. CHARLES HEALTH SYSTEM, INC.

### Notes to Consolidated Financial Statements

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The transaction has been accounted for as an acquisition under ASC 958-805, *Not-for-Profit Entities – Business Combinations*. No consideration was paid by the Corporation to acquire the net assets of St. Charles Madras. The fair value of the assets acquired in excess of the liabilities assumed, resulted in an inherent contribution of MVHD to the Corporation of approximately \$16,796,000. The inherent contribution is unrestricted and included in other income in the accompanying consolidated statement of operations.

The following table summarizes the fair value estimates of the St. Charles Madras assets and liabilities assumed as of January 1, 2013:

Cash assumed	\$ 3,145,000
Tangible assets assumed, net of cash	18,230,000
Liabilities assumed	<u>(4,579,000)</u>
Inherent contribution	<u>\$ 16,796,000</u>

The following are the financial results of St. Charles Madras included in the Corporation's 2013 consolidated statement of operations since January 1, 2013 through the fiscal year-end:

Total revenues	\$ 25,776,000
Deficit of revenues over expenses from operations	(1,494,000)
Deficit of revenues over expenses	(1,516,000)

The following pro forma financial information presents the Corporation's results as if MVHD had been consolidated as of the beginning of fiscal 2012:

	2012	
	Actual	Pro forma
Net patient service revenue	\$ 480,770,000	507,370,000
Excess of revenues over expenses from operations	20,921,000	21,703,000
Excess of revenues over expenses	27,528,000	25,536,000
Total assets	605,756,000	620,650,000

(c) ***Principles of Consolidation***

The accompanying consolidated financial statements include the accounts and transactions of SCHS, CICI, SCMSO, SCF, and CMI. All material intercompany accounts and transactions have been eliminated in consolidation.

(d) ***Estimates***

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of

## ST. CHARLES HEALTH SYSTEM, INC.

### Notes to Consolidated Financial Statements

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revenue, income, gains, expenses, and losses during the reporting period. Actual results could differ from those estimates. The significant estimates in the Corporation's consolidated financial statements include accounts receivable allowances, third-party payor settlement liabilities, valuation of investments, liabilities related to self-insurance programs, and the contribution from MVHD.

**(e) *Cash and Cash Equivalents***

Cash and cash equivalents consist of petty cash and cash in demand bank accounts. Amounts held in demand bank accounts are often in excess of Federal Deposit Insurance Corporation (FDIC) coverage levels.

**(f) *Assets Limited as to Use***

Assets limited as to use primarily consist of assets internally designated for future capital acquisitions and operating purposes (over which SCHS retains control and may, at its discretion, subsequently use for other purposes), assets held by a trustee under bond indenture agreements and temporarily and permanently restricted funds held by SCF. Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value based on quoted market prices in the accompanying consolidated financial statements.

The investment in the Oregon Community Foundation (OCF) represents a beneficial interest in a recipient organization. SCHS established an interest in OCF by contributing funds to its investment portfolio. The value of this interest is then adjusted at a rate proportional to its investment returns obtained by OCF on their investment portfolio. SCHS recognizes their interest in the net assets of OCF and adjusts that interest for its share of the change in the value of the investment portfolio using a method that is similar to the equity method of accounting for investments in common stock.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values of this investment. Furthermore, while SCHS believes that its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

Investment income or loss (including interest, dividends, realized gains and losses, and unrealized gains and losses) is included in the excess of revenue over expenses unless the income or loss is restricted by donor or law.

Trading securities are debt and equity securities that are bought and held principally for the purpose of selling them in the near term. The Corporation classifies all of its investments in internally designated assets as trading securities, based on the nature of trading activity in its portfolio by the Corporation's investment manager.

As of December 31, 2013 and 2012, the Corporation had investments in equity and fixed-income mutual funds, corporate stock and obligations, U.S. government agency and treasury securities, commercial paper, and an interest in the OCF. Management believes that the Corporation's credit risk with respect to these investments is minimal due to the diversity of the individual investments and the financial strength of the entities, which have issued the securities or instruments. However,

## ST. CHARLES HEALTH SYSTEM, INC.

### Notes to Consolidated Financial Statements

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due to changes in economic conditions, interest rates, and common stock prices, the fair value of the Corporation's investments can be volatile. Consequently, the fair value of the Corporation's investments can significantly change in the near term as a result of such volatility.

**(g) Patient Accounts Receivable, Allowance for Doubtful Accounts, and Other Receivables**

The collection of receivables from third-party payors and patients is SCHS' primary source of cash and is critical to its operating performance. When SCHS provides care to patients, it does not require collateral; however, it maintains an estimated allowance for doubtful accounts. Additionally, SCHS adjusts accounts receivable balances to estimated collectible balances based on the terms of contracts in place with third-party payors. The primary collection risks relate to uninsured patient accounts and patient accounts for which the primary insurance payor has paid, but patient responsibility amounts (generally deductibles and copayments) remain outstanding. The allowance for doubtful accounts is estimated based upon SCHS' historical collection experience, the age of the patient's account, management's estimate of the patient's economic ability to pay, and the effectiveness of collection efforts. Patient accounts receivable balances are routinely reviewed in conjunction with historical collection rates and other economic conditions that might ultimately affect the collectibility of patient accounts when considering the adequacy of the amounts recorded in the allowance for doubtful accounts. Actual write-offs have historically been within management's expectations. Significant changes in payor mix, business office operations, economic conditions, or trends in federal and state governmental healthcare coverage could affect SCHS' collection of patient accounts receivable, cash flows, and results of operations.

SCHS' write-offs of accounts receivable for which patients have financial responsibility were \$16,793,000 and \$19,041,000 in fiscal 2013 and 2012, respectively. Total bad debt expense, which is a reduction in deriving net patient service revenue, for the years ended December 31, 2013 and 2012 was \$27,779,000 and \$24,216,000, respectively. The Corporation also maintains an allowance for doubtful accounts for third-party payors, which has been determined based on historical bad debt expense on those account types.

Significant concentrations of gross patient accounts receivable as of December 31, 2013 and 2012 were approximately as follows:

	2013	2012
Medicare and Medicare managed care contracts	30%	26%
Medicaid and Oregon Health Plan (OHP)	13	13
Commercial and managed care insurance	36	35
Self-pay	21	26
	100%	100%

**(h) Supplies Inventory**

Supplies inventory is recorded at the lower of cost (first-in, first-out method) or market.

## ST. CHARLES HEALTH SYSTEM, INC.

### Notes to Consolidated Financial Statements

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(i) ***Property and Equipment***

Property and equipment acquisitions are recorded at cost. Donated property and equipment items are recorded on the basis of estimated fair value at the date of donation. Improvements and replacements of property and equipment are capitalized. Maintenance and repairs are charged to expense as incurred.

Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Assets under capital lease obligations are amortized using the straight-line method over the shorter period of the lease term or the estimated useful life of the asset. Such amortization is included in depreciation expense in the accompanying consolidated financial statements. Net interest costs incurred on borrowed funds during the period of construction of capital assets are capitalized as a component of the cost of acquiring those assets. Estimated useful lives are as follows:

Land improvements	5–25 years
Buildings and fixed equipment	5–40 years
Furniture and moveable equipment	3–20 years

Contributions of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, the Corporation reports expirations of donor restrictions as support when the donated or acquired long-lived assets are placed in service.

(j) ***Long-Lived Assets***

Management reviews property and equipment and other long-term assets, as appropriate, for possible impairment whenever events or circumstances indicate the carrying amount of such assets may not be recoverable. If there is an indication of impairment, management would prepare an estimate of future cash flows (undiscounted and without interest charges) expected to result from the use of the asset and its eventual disposition. If these cash flows were less than the carrying amount of the asset, an impairment loss would be recognized to write down the asset to its estimated fair value.

(k) ***Contributions and Grants***

Unrestricted donations and grants are recorded as other operating revenue. Donor-restricted contributions and grants are recorded as additions to the appropriate class of restricted net assets. When capital expenditures are made consistent with the purpose intended by the donor, a transfer is made from temporarily restricted net assets to unrestricted net assets. If restricted amounts are expended for operations, the amounts are recorded as other revenues in the accompanying consolidated statements of operations.

(l) ***Other Assets***

Other assets include SCHS' investments in various related entities, which are not consolidated. SCHS consolidates such investees if it owns a majority of the investee's stock, is the sole member of the investee, or controls a majority voting interest in the investee's board of directors and has an

## **ST. CHARLES HEALTH SYSTEM, INC.**

### **Notes to Consolidated Financial Statements**

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economic interest in such investee. If SCHS owns 50% or less of the voting stock of an investee and can exercise significant influence over the investee's operating and financial policies (generally presumed to be when SCHS owns more than 20% of the voting stock of the investee), SCHS accounts for such investments under the equity method of accounting, whereby SCHS records its proportionate share of the investee's income or loss in the consolidated statements of operations and records distributions received from the investee as a reduction in the related investment balance. If SCHS cannot exercise significant influence over the investee's operating and financial policies (generally presumed to be when SCHS owns less than 20% of the voting stock of the investee), SCHS accounts for such investments at cost and records dividends or distributions from the investee as other income when received.

**(m) *Unamortized Bond Discount***

Unamortized bond discount, a component of long-term obligations, is amortized to interest expense over the term of the related bonds using the effective-interest method.

**(n) *Net Patient Service Revenue***

SCHS has agreements with third-party payors that provide for payments at amounts different from established rates. Payment arrangements include prospectively determined rates per discharge, outpatient case rates, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts due and determined to be collectible from patients, third-party payors, and others for services rendered and includes estimates for potential retroactive revenue adjustments under reimbursement agreements with third-party payors. Such estimates are adjusted in future periods as final settlements are determined.

A significant portion of SCHS' services are provided to Medicare, Medicaid, and Oregon Health Plan (OHP) patients under contractual arrangements. Inpatient acute care services rendered by SCHS to Medicare, Medicaid, and OHP program beneficiaries are generally reimbursed at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors (i.e., Medicare severity-diagnosis related groups or MS-DRGs). Such payments include a capital cost component and may be greater or less than the actual charges for services. Most outpatient services related to Medicare beneficiaries are reimbursed prospectively under the ambulatory payment classifications methodology. Home health services related to Medicare beneficiaries are reimbursed under a prospective payment system methodology. OHP outpatient services are reimbursed based on a percentage of charges. SCHS is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after audits of SCHS' annual cost reports by the Medicare fiscal intermediary and Medicaid. St. Charles Bend's and St. Charles Redmond's cost reports have been audited and final settled by the Medicare fiscal intermediary and Medicaid through December 31, 2011.

St. Charles Madras and PMH are "critical access hospitals" (CAH) for Medicare and Medicaid program purposes. As CAHs, St. Charles Madras and PMH cannot operate more than 25 beds, and the average length of stay for acute care patients cannot exceed 96 hours. As CAHs, St. Charles Madras and PMH are reimbursed for Medicare and Medicaid inpatient and outpatient services under a cost-reimbursement methodology. PMH's cost reports have been audited and final settled by the Medicare fiscal intermediary and Medicaid through December 31, 2011. St. Charles Madras' cost

## **ST. CHARLES HEALTH SYSTEM, INC.**

### **Notes to Consolidated Financial Statements**

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reports have been audited and final settled by the Medicare fiscal intermediary and Medicaid through June 30, 2011. Prior to being acquired by SCHS, St. Charles Madras had a June 30 fiscal year-end.

The laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that estimated third-party payor settlements payable, net, will change by a material amount in the near term. Net patient service revenue was increased by approximately \$1,386,000 and \$4,243,000 for the years ended December 31, 2013 and 2012, respectively, as a result of final settlements of prior years cost reports and revisions of estimates for prior years cost report settlements.

SCHS has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations to provide medical services to subscribing participants. The basis for payment to SCHS under these agreements includes prospectively determined rates per discharge, discounts from established charges, prospectively determined fee schedules, and certain capitated per member per month payment arrangements.

#### **(o) *Charity Care***

SCHS provides services without charge, or at amounts less than its established rates, to patients who meet the criteria of its charity care policy. SCHS' criteria for the determination of charity care include the patient's—or other responsible party's—annual household income, number of people in the home and claimed on taxes, assets, credit history, existing medical debt obligations, and other indicators of the patient's ability to pay. Generally, those individuals with an annual household income at or less than 100% of the Federal Poverty Guidelines (the Guidelines) qualify for charity care under SCHS' policy. In addition, SCHS provides discounts on a sliding scale to those individuals with an annual household income of between 100% and 300% of the Guidelines. Since SCHS does not pursue collection of amounts determined to qualify as charity care, those amounts are not reported as net patient service revenue. The cost of the services and supplies furnished under the charity care policy for the years ended December 31, 2013 and 2012, net of subsidies, was approximately \$18,039,000 and \$16,634,000, respectively. The Corporation uses a ratio of cost to charges based on the direct and indirect costs and gross charges of SCHS to estimate the cost of providing this charity care. The cost to charge ratio is developed separately for each facility by using certain analysis tools. The weighted average cost to charge ratio used in this determination was 47.1% and 46.0% for the years ended December 31, 2013 and 2012, respectively. The amount of subsidies received by SCHS for providing charity care for the years ended December 31, 2013 and 2012 was approximately \$966,000 and \$1,143,000, respectively.

#### **(p) *Consolidated Statements of Operations***

For purposes of presentation, transactions deemed by management to be ongoing, major, or central to the provision of healthcare services are reported as operating revenue and expenses. SCHS' income from investments in healthcare-related joint ventures recorded on the equity method of accounting is reported as other operating revenue. Peripheral or incidental transactions are reported as other income (losses).

The performance indicator for the accompanying consolidated statements of operations is excess of revenue over expenses. Changes in unrestricted net assets, which are excluded from the excess of

## **ST. CHARLES HEALTH SYSTEM, INC.**

### **Notes to Consolidated Financial Statements**

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revenue over expenses, consistent with industry practice, include the change in net assets released from restrictions used for purchases of property and equipment, contributions for property and equipment, distributions to noncontrolling interest, discontinued operations of Airlink, refer to note 11, and net asset transfers.

#### **(q) State of Oregon Provider Tax**

Effective July 1, 2004, the State of Oregon instituted a provider tax on certain qualifying hospitals. SCHS recorded provider taxes of approximately \$19,507,000 and \$15,708,000 for the years ended December 31, 2013 and 2012, respectively, which are included in medical supplies, drugs, and other expense in the accompanying consolidated statements of operations. The increase in the 2013 tax is attributed primarily to increased gross charges and provider tax rate changes instituted in April 2013 and October 2013 by the State of Oregon. In addition, SCHS has entered into an agreement with the Oregon Association of Hospitals and Health Systems (OAHHS), which provides that all payments owed to SCHS related to beneficiaries of the Oregon Medical Assistance Program are to be remitted directly to OAHHS. OAHHS aggregates these payments, returning a portion to SCHS. The remaining funds are pooled by OAHHS with like amounts received on behalf of other hospitals subject to the provider tax, and OAHHS redistributes such funds to qualifying hospitals on a quarterly basis. The estimate of the amount of receipts via the quarterly redistribution process from OAHHS for the years ended December 31, 2013 and 2012 matches the annual amounts of taxes paid, which is reflected as a component of net patient service revenue in the accompanying consolidated statements of operations.

#### **(r) Income Taxes**

The Corporation has received a determination letter from the Internal Revenue Service (IRS) stating that it is exempt from federal income tax under Section 501(a) of the Internal Revenue Code as an organization described in Section 501(c)(3) of the Internal Revenue Code. It is management's belief that none of its activities have produced material unrelated business income, and that SCHS continues to be operated in a manner that qualifies it for tax-exempt status.

Accounting principles generally accepted in the United States of America require SCHS' management to evaluate tax positions taken by the Corporation and recognize a tax liability (or asset) if the Corporation has taken an uncertain position that more likely than not would not be sustained upon examination by the IRS. Management has analyzed tax positions taken by the Corporation and has concluded that as of December 31, 2013, there are no uncertain positions taken or expected to be taken that would require recognition of a liability (or asset) or disclosure in the financial statements. The Corporation is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress. The Corporation's management believes it is no longer subject to income tax examinations for years prior to 2010.

#### **(s) Reclassifications**

Certain reclassifications have been made to prior year amounts to conform to the current year presentation.



**ST. CHARLES HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

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**(2) Assets Limited as to Use**

The composition of assets limited as to use as of December 31, 2013 and 2012 is set forth in the following table. Investments are carried at fair value.

	<u>2013</u>	<u>2012</u>
Internally designated for capital acquisitions:		
Equity mutual funds	\$ 216,388,000	179,111,000
Fixed-income mutual funds	66,759,000	57,773,000
Total internally designated for capital acquisitions	<u>283,147,000</u>	<u>236,884,000</u>
Internally designated for operating purposes:		
Cash and cash equivalents	738,000	727,000
Equity mutual funds	1,910,000	385,000
Fixed-income mutual funds	573,000	307,000
Corporate stock	11,000	—
Corporate obligations	—	271,000
U.S. government agency and treasury securities	—	3,938,000
Cash surrender value of life insurance	269,000	248,000
Total internally designated for operating purposes	<u>3,501,000</u>	<u>5,876,000</u>
Total internally designated	<u>286,648,000</u>	<u>242,760,000</u>
Held by trustee:		
Cash and cash equivalents	9,223,000	7,671,000
Equity mutual funds	1,682,000	—
Government agencies	9,787,000	—
Corporate obligations	1,474,000	10,132,000
Total held by trustee	<u>22,166,000</u>	<u>17,803,000</u>
Board designated endowment:		
Investment in Oregon Community Foundation	1,551,000	1,448,000
Donor restricted – temporarily:		
Cash and cash equivalents	—	16,000
Equity mutual funds	2,543,000	1,827,000
Fixed-income mutual funds	1,694,000	1,465,000
Donor restricted – permanently:		
Investment in Oregon Community Foundation	768,000	717,000
Cash and cash equivalents	17,000	15,000
Equity mutual funds	410,000	363,000
Fixed-income mutual funds	355,000	355,000
Total assets limited as to use	<u>316,152,000</u>	<u>266,769,000</u>
Less portion reported as current	<u>(7,734,000)</u>	<u>(7,671,000)</u>
Total assets limited as to use, net of current portion	<u>\$ 308,418,000</u>	<u>259,098,000</u>

# ST. CHARLES HEALTH SYSTEM, INC.

## Notes to Consolidated Financial Statements

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Investment income, net, consisted of the following for the years ended December 31, 2013 and 2012:

	<b>2013</b>	<b>2012</b>
Interest and dividend income	\$ 8,432,000	6,874,000
Realized gains on sales of securities, net	2,096,000	107,000
Unrealized gains (losses) on trading securities, net	31,443,000	20,440,000
Investment income, net	<u>\$ 41,971,000</u>	<u>27,421,000</u>

SCHS maintains investments with OCF. The investments are used solely to support the endowments of SCHS, and are recorded as a beneficial interest by SCHS, in accordance with the provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 958-20, *Not-for-Profit Entities – Financially Interrelated Entities*, regarding financially interrelated not-for-profit entities. The investments, which represent an endowment fund that is legally owned by the OCF, primarily include equity securities and fixed-income investments. SCHS' investment in the OCF is recorded based on their initial contribution to the OCF, adjusted for subsequent changes. All earnings of the investments held by the OCF, less investment management fees charged by the OCF, are allocated by OCF, and are recorded by SCHS as investment earnings in the consolidated statements of operations, within the appropriate category of net assets based on related donor restrictions. Earnings consist of interest, dividends, realized gains and losses, and changes in unrealized gains and losses. Funds held by OCF may be distributed once per quarter, subject to approval by the OCF board of directors.

### (3) Property and Equipment

Property and equipment consisted of the following at December 31, 2013 and 2012:

	<b>2013</b>	<b>2012</b>
Land and improvements	\$ 16,335,000	15,313,000
Buildings and fixed equipment	263,457,000	249,962,000
Furniture and movable equipment	153,138,000	178,870,000
	432,930,000	444,145,000
Less accumulated depreciation	<u>(226,769,000)</u>	<u>(240,172,000)</u>
	206,161,000	203,973,000
Construction in progress	17,681,000	7,090,000
Property and equipment, net	<u>\$ 223,842,000</u>	<u>211,063,000</u>

Construction in progress includes costs incurred in connection with various construction projects and costs incurred related to the acquisition and implementation of various software applications. As of December 31, 2013, management estimates that the remaining cost to complete the construction projects is approximately \$45,286,000, and the remaining cost to complete the software acquisitions and implementations is approximately \$14,928,000.

# ST. CHARLES HEALTH SYSTEM, INC.

## Notes to Consolidated Financial Statements

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### (4) Restricted Net Assets

Restricted net assets are held by SCF and are those whose use has been limited by donor-imposed restrictions to a specific time period and/or purpose. SCF also holds funds that are not donor restricted for a specific purpose and are distributed to SCHS in amounts and in periods determined by SCF's board of directors, which are included in unrestricted net assets. SCF's temporarily restricted net assets are distributed to SCHS or other recipients for the purposes specified by the donors. SCF's permanently restricted net assets consist of the principal amount of contributions accepted by SCF with the stipulation from donors that the principal be maintained in perpetuity and only the income from investments thereof be expended to support SCF's general activities or restricted purposes, as stipulated by the respective donors.

During 2013 and 2012, net assets were released from donor restrictions by SCHS incurring operating expenses satisfying the restricted purpose of approximately \$1,141,000 and \$1,462,000, respectively, and are included in other revenue. Further, approximately \$81,000 and \$516,000 were released from restriction to SCHS for capital expenditures made during 2013 and 2012, respectively.

Temporarily and permanently restricted net assets are available for the following purposes at December 31, 2013 and 2012:

	<u>2013</u>	<u>2012</u>
Temporarily restricted:		
Education and research	\$ 755,000	796,000
Indigent care	210,000	150,000
Patient care operating activities	1,706,000	1,531,000
Purchase of property and equipment	3,885,000	1,104,000
Net assets, temporarily restricted	<u>\$ 6,556,000</u>	<u>3,581,000</u>
Permanently restricted:		
Education and research	\$ 447,000	447,000
Indigent care	1,036,000	987,000
Net assets, permanently restricted	<u>\$ 1,483,000</u>	<u>1,434,000</u>

SCF has adopted investment and spending policies for endowment assets to provide a predictable stream of funding to programs supported by its endowment and to maintain the value of the endowment assets. Asset allocation is reviewed annually with respect to: i) SCF's tolerance for risk based on its financial condition and need for cash from investments to support operations; ii) expected asset class return, risk, and correlation characteristics; and iii) changes in accounting guidance, tax law, or other restrictions.

SCF's spending practices are intended to comply with donor's wishes and meet all applicable laws and regulations. Spending must be for a purpose that is consistent with the documented intent of the donor, and may not exceed the amounts annually determined by the SCF's board of directors. Factors that are considered in addressing the annual spending allocation are: i) market value of the fund relative to the principal of the gift and ii) the level of spending in prior years.

# ST. CHARLES HEALTH SYSTEM, INC.

## Notes to Consolidated Financial Statements

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From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or Uniform Prudent Management of Institutional Funds Act (UPMIFA) requires SCF to retain as a fund of perpetual duration. Deficiencies of this nature are reported as a reduction to unrestricted net assets and are excluded from the performance indicator.

SCF follows the guidance in the UPMIFA in determining the net asset classification of all donor-restricted endowment funds. In accordance with board policy, assets classified as permanent endowments in accordance with donor intent are only utilized for current period expenditures to the extent that earnings on the endowment exceed the original fair value of the donation. To the extent earnings on endowment funds exceed identified expenditures on which to apply those earnings, the earnings are classified as temporarily restricted net assets. As of December 31, 2013 and 2012, unspent earnings on endowment funds totaling \$304,000 and \$215,000, respectively, were included in temporarily restricted net assets.

### (5) Debt Agreements

Long-term obligations consisted of the following at December 31, 2013 and 2012:

	<u>2013</u>	<u>2012</u>
Hospital Facility Authority of Deschutes County Oregon (the Authority) Hospital Revenue Refunding Bonds Series 2008 (the 2008 Bonds)	\$ 102,040,000	103,460,000
The Authority Hospital Revenue Bonds Series 2005B (the 2005B Bonds)	45,675,000	46,600,000
Wells Fargo Bank and Wells Equipment Finance Notes Payable	1,827,000	1,151,000
GE Healthcare Financial Notes Payable	—	635,000
Siemens Financial Services Equipment leases	513,000	—
U.S. Bancorp Technology Leasing Master Lease	—	4,976,000
Bend Ortho Building Associates Lease	8,879,000	8,760,000
Banc of America Leasing Healthcare Finance	277,000	1,901,000
Other	238,000	508,000
Less unamortized discount on bonds, net	<u>(1,469,000)</u>	<u>(1,561,000)</u>
Total long-term obligations	157,980,000	166,430,000
Less current portion	<u>(12,471,000)</u>	<u>(9,707,000)</u>
Long-term obligations, net of current portion	<u>\$ 145,509,000</u>	<u>156,723,000</u>

In December 2008, the Authority issued the 2008 Bonds in the amount of \$103,460,000. The proceeds of the 2008 Bonds were primarily used to advance refund the 2005A Bonds, make the termination payment related to a swap agreement, and establish a debt service reserve fund. The 2008 Bonds bear interest at rates ranging from 5.500% to 8.250% payable semiannually each January 1 and July 1 and require annual principal payments each January 1 (including mandatory redemptions) ranging from \$1,470,000 in 2014 to \$12,000,000 in 2038. The 2008 Bonds maturing on and after January 1, 2020 are subject to optional redemption prior to maturity, at the option of the Authority (such option shall be exercised at the request of the Corporation), at par, plus accrued interest.

## **ST. CHARLES HEALTH SYSTEM, INC.**

### Notes to Consolidated Financial Statements

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In December 2005, SCHS entered into agreements with the Authority, whereby the Authority issued the 2005B Bonds in the amount of \$51,800,000 (the 2005B Bonds). The proceeds from the 2005B Bonds were primarily used to finance certain capital additions and improvements at St. Charles Bend and St. Charles Redmond. The 2005B Bonds bear interest at rates ranging from 4.000% to 5.375% payable semiannually each January 1 and July 1 and require annual principal payments each January 1 (including mandatory redemptions) ranging from \$1,000,000 in 2014 to \$7,150,000 in 2035.

Under the terms of the agreements (the 2005B Agreement) between SCHS and the Authority related to the 2005B Bonds, SCHS has (1) collateralized the 2005B Bonds with SCHS' gross receivables (as defined in the 2005B Agreement) and (2) obtained bond insurance which unconditionally guarantees payment of principal and interest on the 2005B Bonds. Under the terms of the agreement (the 2008 Agreement) between SCHS and the Authority related to the 2008 Bonds, SCHS has (1) collateralized the 2008 Bonds with SCHS' gross receivables (as defined in the 2008 Agreement) and (2) agreed to grant a leasehold deed of trust on the St. Charles Bend main hospital building and related improvements to the trustee for the 2008 Bonds (the Trustee), as well as entered into a 50-year ground lease related to the underlying land for this property with the Trustee. Additionally, SCHS has agreed to not create or allow any other mortgage, pledge, or security in SCHS' facilities, except as permitted in the Agreements; maintain certain reserve funds with a trustee; and meet certain financial ratios on an annual basis.

In July 2007, SCHS entered into a lease agreement with U.S. Bancorp Technology Leasing (the U.S. Bancorp Master Lease Agreement) to partially finance the acquisition and implementation of an information system. All obligations under this U.S. Bancorp Master Lease Agreement were paid off in 2013.

The Bend Ortho Building Associates lease represents a lease of an approximately 30,000-square-foot building that expires on December 31, 2014, with two 5-year renewal options. Under this agreement, SCHS has the option to purchase the building on December 31, 2014 – or at the end of either of the subsequent renewal periods – at a price determined based on a formula that includes the net operating income of the building and a capitalization rate, all as defined in the lease agreement. In addition, the lessor has the right at any time during the lease term (including renewals) to require SCHS to purchase the building at a price using this same formula. Under the terms of the lease, SCHS is required to make monthly payments of approximately \$68,000. Additionally, SCHS incurs annual interest expense, representing the accretion of the obligation, in order to have the purchase obligation under the lease properly recorded. SCHS has notified the lessor of its intent to exercise the purchase option at the end of the initial term and expects the lessor to require SCHS to purchase the building prior to December 31, 2014, therefore the purchase amount is included in the current portion of long-term liabilities as of December 31, 2013.

In September 2003, SCHS entered into a sublease agreement with the Authority, whereby the Authority financed the construction of a central utility plant and related energy management systems (the Plant) for St. Charles Bend with a lease agreement with Banc of America Healthcare Finance (B of A) (collectively, the B of A Master Lease and Sublease Agreement). Under the terms of the B of A Master Lease and Sublease Agreement, SCHS is required to make monthly payments of \$140,000 through March 2014, including interest at 4.65%. Upon receipt of the final scheduled lease payment, B of A shall terminate and release its security interest in the Plant to SCHS. SCHS has the option to purchase the Plant at any time during the term of the B of A Master Lease and Sublease Agreement by paying the remaining lease

# ST. CHARLES HEALTH SYSTEM, INC.

## Notes to Consolidated Financial Statements

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payments, plus a 1.00% prepayment penalty multiplied by the number of years remaining in the term of the lease.

Notes and leases payable to Wells Fargo Bank, Wells Equipment Finance, Siemens Financial Services, and GE Healthcare Financial represent various equipment financing arrangements, generally at CMI. The notes bear interest ranging from 3.50% to 6.41%, mature at various times from 2015 to 2018, and are secured by equipment.

Scheduled principal repayments on long-term debt and payments on capital lease obligations are as follows:

	<b>Long-term debt</b>	<b>Capital lease obligations</b>
2014	\$ 3,154,000	10,363,000
2015	3,122,000	178,000
2016	3,124,000	147,000
2017	3,130,000	44,000
2018	3,181,000	—
Thereafter	134,069,000	—
	<u>\$ 149,780,000</u>	<u>10,732,000</u>
Less amount representing interest under capital lease obligations		<u>(1,063,000)</u>
		<u>\$ 9,669,000</u>

The above described debt instruments carry various financial covenants that the Corporation is required to measure on an annual basis.

As of December 31, 2013 and 2012, SCHS had a \$5,000,000 and \$3,000,000, respectively, unsecured line-of-credit agreement with U.S. Bank. There were no amounts outstanding under this line-of-credit agreement at December 31, 2013 or 2012. Borrowings outstanding under this line-of-credit agreement bear interest at the greater of the U.S. Bank's prime rate plus 0.50% or 3.75%. The line of credit expires on November 30, 2014.

Interest cost incurred during the years ended December 31, 2013 and 2012 was \$12,171,000 and \$13,038,000, respectively. No interest expense or interest income was capitalized during the years ended December 31, 2013 and 2012.

### (6) Commitments and Contingencies

#### (a) Operating Leases

SCHS leases office space and equipment under operating lease agreements, which expire at various dates through 2026. Certain of these lease agreements contain renewal options. A portion of the leased office space has been subleased to unrelated third parties. In addition, effective January 1, 2008, SCHS leased the land, buildings, and equipment of PMH (the PMH Lease) and the lessor is

## ST. CHARLES HEALTH SYSTEM, INC.

### Notes to Consolidated Financial Statements

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Pioneer Memorial Hospital. As of December 31, 2013, future minimum rental commitments for the five years subsequent to and thereafter, under noncancelable operating lease agreements, that have initial or remaining lease terms in excess of a year were as follows:

2014	\$	5,975,000
2015		5,254,000
2016		3,393,000
2017		2,901,000
2018		2,775,000
Thereafter		<u>14,866,000</u>
Total minimum lease payments		35,164,000
Less total minimum sublease rentals		<u>(476,000)</u>
	\$	<u><u>34,688,000</u></u>

Included in the commitments above are lease payments required under the PMH Lease. Such payments vary by year based on PMH's future required debt and lease payments that were in effect as of January 1, 2008. Such future minimum lease payments total approximately \$7,505,000 and decrease from approximately \$607,000 in 2014 to approximately \$170,000 in 2026 (at which time, all currently outstanding PMH debt and lease payments will have been paid). In addition, the PMH Lease requires SCHS to annually invest a minimum of \$200,000 toward capital purchases and renovations at PMH through the term of the lease (2031), plus certain additional amounts based on PMH's operating results. The PMH Lease may be terminated by either party with 24-month notice as described in the lease. Additionally, the PMH Lease was amended to provide for early termination if SCHS builds a replacement hospital facility in Prineville, Oregon, which is currently planned for completion in 2015.

Certain of the leases above are with related entities. As of December 31, 2013, the total future minimum rental commitments expected to be paid on these related entity leases aggregate approximately \$18,020,000.

Rent expense totaled \$7,292,000 and \$7,638,000 for the years ended December 31, 2013 and 2012, respectively, and is included in medical supplies, drugs, and other in the accompanying consolidated statements of operations.

#### **(b) Medical Malpractice Insurance**

Effective July 1, 2013, SCHS started a self-insurance program for malpractice and other general liability claims under which the Corporation contributes actuarially determined amounts to a trust to fund estimated ultimate losses. SCHS purchases excess insurance for claims exceeding \$500,000 per occurrence and \$3,000,000 annual in aggregate. Prior to that time SCHS was self-insured for malpractice and other general liability claims through Cascadia Insurance Company, Inc. (CICI), a captive insurance company wholly owned by SCHS. CICI provided coverage of SCHS' claims up to a \$500,000 per occurrence limit and a \$3,000,000 annual aggregate limit, and SCHS purchased excess insurance for claims exceeding such limits. CICI's coverage for SCHS was retroactive to

## ST. CHARLES HEALTH SYSTEM, INC.

### Notes to Consolidated Financial Statements

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occurrences since July 1, 2004 reported after July 1, 2005. Under SCHS' policy with CICI, medical malpractice claims reported by SCHS to CICI during the policy period were covered; however, any medical malpractice claim that was incurred but not reported (IBNR) to CICI during the policy period is not covered. Upon dissolution of CICI as of June 30, 2013 the liability for all claims covered by CICI was transferred to SCHS.

Based on an actuarial valuation, the Corporation, including CICI, has recorded estimated liabilities for IBNR medical malpractice claims, which, along with deductibles on reported claims, aggregated \$5,832,000 and \$3,855,000 as of December 31, 2013 and 2012, respectively, and are included in other noncurrent liabilities in the accompanying consolidated balance sheets. Management believes that these estimated liabilities are adequate to cover actual ultimate expenses; however, the establishment of estimated liabilities for medical malpractice claims is an inherently uncertain process, and there can be no assurance that currently established liabilities will prove adequate. Subsequent actual experience could result in liabilities being too high or too low, which could positively or negatively impact the Corporation's reported consolidated operations in future periods.

(c) ***Self-Insurance***

SCHS is self-insured for medical, dental, and vision benefits provided to its employees for claims up to \$400,000 per employee. SCHS is also self-insured for state unemployment claims. SCHS recognizes self-insurance costs based on claims filed with its third-party administrators and estimates for IBNR claims. Management believes that adequate amounts have been accrued in the accompanying consolidated financial statements to cover any related potential losses.

(d) ***Risk Management***

In the ordinary course of business, the Corporation is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; and natural disasters. However, management believes that adequate commercial insurance coverage has been purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage for the years ended December 31, 2013 and 2012.

(e) ***Guaranties***

As of December 31, 2013, SCHS is a guarantor of the following loans of certain related entities:

Entity	Loan balances outstanding at December 31, 2013 (unaudited)	SCHS' guaranties	Loan expiration dates
Cascade Medical Buildings, LLC	\$ 20,537,000	10,268,000	April 2021
Heart Center of the Cascades, LLC	9,058,000	4,529,000	December 2015

In the opinion of management, the likelihood that SCHS will be required to make any payments under the guaranties is remote, and the estimated fair value of such guaranties is not significant to the



## **ST. CHARLES HEALTH SYSTEM, INC.**

### **Notes to Consolidated Financial Statements**

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accompanying consolidated financial statements; accordingly, no liability related to these guaranties has been recorded in the accompanying consolidated balance sheets.

#### **(f) *Regulations and Litigation***

The healthcare industry is subject to various laws and regulations from federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Government activity has remained high with respect to investigations and allegations concerning possible violations by healthcare providers of regulations, which could result in the expulsion from government healthcare programs, together with the imposition of significant fines and penalties, as well as significant repayments of patient services previously billed and collected. Management believes that the Corporation is in compliance with the fraud and abuse regulations, as well as other applicable government laws and regulations; however, compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time.

In addition, the Corporation becomes involved in litigation and other regulatory investigations arising in the ordinary course of business. After consultation with legal counsel, management believes that these matters will be resolved without causing a material adverse effect on the Corporation's future consolidated financial position or results of operations.

#### **(g) *Collective Bargaining Agreements***

Approximately 1% of SCHS employees, including nurses and certain professional employees, were covered under collective bargaining agreements at December 31, 2013 that will expire in 2014. An additional 24% are covered under contracts expiring beyond 2014.

#### **(7) *Retirement Plan***

Substantially all employees of SCHS are eligible to participate in SCHS' defined contribution retirement plan (the Plan). Under the Plan, SCHS matches each participant's contributions up to 6% of his or her salary. Employees are eligible to receive SCHS' matching contributions once they achieve at least 21 years of age, work 1,000 hours or more during the year, and have been continuously employed by SCHS for one year or more. SCHS' expense relating to the Plan during the years ended December 31, 2013 and 2012 was \$8,511,000 and \$7,516,000, respectively, and is included in employee benefits in the accompanying consolidated statements of operations.

# ST. CHARLES HEALTH SYSTEM, INC.

## Notes to Consolidated Financial Statements

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### (8) Other Related-Party Transactions

The following is a summary of SCHS' primary unconsolidated related-party investments at December 31, 2013 and 2012:

Entity	Basis of accounting	Ownership as of December 31, 2013	Investment balance included in the accompanying consolidated balance sheets		SCHS' share of income (loss) included in the accompanying consolidated statements of operations	
			December 31		2013	2012
			2013	2012		
CMB	Equity method	50%	\$ 939,000	680,000	380,000	313,000
CPH	Equity method	50	72,000	162,000	(90,000)	(87,000)
HCC	Equity method	50	(1,714,000)	(1,507,000)	118,000	(65,000)
CS	Equity method	50	525,000	662,000	1,461,000	1,274,000
SCAS	Equity method	49	—	—	—	—
COMRI	Equity method	33	539,000	565,000	976,000	1,209,000
SOLS	Equity method	28	655,000	622,000	46,000	82,000
IOC	Cost method	50	20,000	20,000	—	—
HF	Cost method	14	54,000	54,000	—	—

In addition to SCF, CICI, SCMSO, and CMI, SCHS has investments in the following related entities:

#### (a) Cascade Medical Buildings, LLC (CMB)

CMB is a limited liability company whose two members are SCHS (50% ownership interest) and Deschutes Medical Buildings, LLC (50% ownership interest). CMB was formed to build, own, and manage a medical office building on land leased from SCHS. SCHS rents approximately 9,950 square feet in this building. During the years ended December 31, 2013 and 2012, SCHS received member distributions of \$120,000 and \$395,000, respectively, from CMB. During each of the years ended December 31, 2013 and 2012, SCHS earned rental income from CMB of approximately \$155,000 under the land lease. During the years ended December 31, 2013 and 2012, SCHS incurred rent expense for facilities owned by CMB of \$274,000 and \$218,000, respectively.

#### (b) Cascade Property Holdings, LLC (CPH)

CPH is a limited liability company whose two members are SCHS (50% ownership interest) and Deschutes Medical Buildings, LLC (50% ownership interest). CPH owns bare land held for investment purposes in Bend, Oregon.

#### (c) Heart Center of the Cascades, LLC (HCC)

HCC is a limited liability company whose two members are SCHS (50% ownership interest) and CCC Real Properties, LLC (50% ownership interest). CCC Real Properties, LLC is owned by four physicians who are also employees of the Corporation. HCC was formed to build, own, and manage a medical building on land leased from SCHS. During the years ended December 31, 2013 and 2012, SCHS received member distributions of \$325,000 and \$30,000 from HCC, respectively. During the years ended December 31, 2013 and 2012, SCHS earned income from HCC of \$334,000 and \$362,000, respectively, under the land lease and from the provision of certain facility services.

## **ST. CHARLES HEALTH SYSTEM, INC.**

### **Notes to Consolidated Financial Statements**

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During the years ended December 31, 2013 and 2012, SCHS incurred rent expense related to a lease with HCC of \$1,166,000 and \$784,000, respectively.

HCC entered into an interest rate swap agreement in 2007 with KeyBank; the swap agreement was transferred to U.S. Bank in November 2010. The swap agreement is considered a cash flow hedge and has been deemed ineffective by management. As a result, the changes in fair value in the interest rate swap are included in excess of revenues over expenses. As of December 31, 2013 and 2012, HCC had a liability of \$1,203,000 and \$1,707,000, respectively, related to this swap agreement. SCHS recorded its share of the changes in the fair value of the swap agreement as a component of other, net in the accompanying consolidated statements of operations.

**(d) *Cascade Surgicenter, LLC (CS)***

CS is a limited liability company whose two members are SCHS (50% ownership interest) and Deschutes Surgicenter, LLC (50% ownership interest). CS was formed to own, operate, and manage an outpatient surgery center located in facilities owned by CMB. SCHS received member distributions of \$1,598,000 and \$1,085,000, respectively, from CS during the years ended December 31, 2013 and 2012. During the years ended December 31, 2013 and 2012, CS incurred rent expense for facilities owned by CMB of \$777,000 and \$777,000, respectively.

**(e) *St. Charles/AmSurg ASC Partners LLC (SCAS)***

SCAS is a limited liability company, created in July 2013, whose two members are SCHS (49% ownership interest) and AmSurg Holdings, Inc. (51% ownership interest). SCAS was formed to acquire, develop, own, and/or operate ambulatory surgery centers or other facilities in Central Oregon. SCAS had no operating activities for the year ended December 31, 2013.

**(f) *Central Oregon Magnetic Resonance Imaging, LLC (COMRI)***

COMRI is a limited liability company, which is owned by SCHS, CORA, and certain physicians. SCHS owns a one-third interest in COMRI. COMRI owns and operates three magnetic resonance imaging machines located in Bend and Redmond, Oregon. During the years ended December 31, 2013 and 2012, SCHS received member distributions of \$1,003,000 and \$1,145,000, respectively, from COMRI. During the years ended December 31, 2013 and 2012, SCHS charged COMRI \$392,000 and \$464,000, respectively, for certain staffing services, rent, and supplies. In addition, during the years ended December 31, 2013 and 2012, SCHS incurred professional fees expense of \$2,665,000 and \$2,629,000, respectively, for services rendered by COMRI. Included in accounts payable in the accompanying consolidated balance sheets are amounts due to COMRI for these services of \$16,000 and \$210,000, as of December 31, 2013 and 2012, respectively.

**(g) *Southern Oregon Linen Service (SOLS)***

SOLS is an Oregon cooperative corporation that provides laundry, linen, and uniform services to members of the cooperative. SCHS owns 28% of the outstanding common stock of SOLS, and St. Charles Bend, St. Charles Redmond, St. Charles Madras, and PMH utilize the laundry and linen services provided by this cooperative. SCHS received member distributions of \$14,000 and \$0, respectively, from SOLS during the years ended December 31, 2013 and 2012. SCHS incurred

## ST. CHARLES HEALTH SYSTEM, INC.

### Notes to Consolidated Financial Statements

December 31, 2013 and 2012

laundry and linen expense with SOLS of \$1,426,000 and \$1,176,000, for the years ended December 31, 2013 and 2012, respectively.

**(h) *Institute of the Cascades (IOC)***

IOC is a limited liability company whose two members are SCHS (50% ownership interest) and The Neuromusculoskeletal Center of the Cascades PC (NCC) (50% ownership interest). IOC provides administration and marketing to promote CMB, CSC, NCC, and SCHS.

**(i) *Health Futures (HF)***

Health Futures LLC (HF) is a limited liability company whose members participate in centralized administrative services in Oregon. SCHS owns approximately 14% of HF. Primarily SCHS benefits from group purchasing agreements. SCHS receives distributions from time to time that are treated as a reduction to purchases and not a return of capital, as they are the result of group purchasing agreements.

**(9) Functional Classification of Expenses**

Expenses on a functional basis for the years ended December 31, 2013 and 2012 were as follows:

	<b>2013</b>	<b>2012</b>
Healthcare services	\$ 432,488,000	389,629,000
General and administrative	112,510,000	94,587,000
	<u>\$ 544,998,000</u>	<u>484,216,000</u>

**(10) Fair Value Measurements**

The Corporation applies the provisions of FASB ASC Topic 820, *Fair Value Measurement* (ASC 820) for fair value measurements of financial assets and financial liabilities and for fair value measurements of nonfinancial items that are recognized or disclosed at fair value in the financial statements on a recurring basis. ASC 820 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The levels of the fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Corporation has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are unobservable inputs for the asset or liability.

The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest-level input that is significant to the fair value measurement in its entirety.

**ST. CHARLES HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

The following table presents assets and liabilities that are measured at fair value on a recurring basis at December 31, 2013:

<b>Fair value measurements at reporting date using</b>				
	<b>December 31,</b>			
	<b>2013</b>	<b>(Level 1)</b>	<b>(Level 2)</b>	<b>(Level 3)</b>
<b>Assets:</b>				
Assets limited as to use:				
Cash and cash equivalents	\$ 9,978,000	9,978,000	—	—
Equity mutual funds:				
Medium cap blend	8,642,000	8,642,000	—	—
Medium cap value	11,000	11,000	—	—
Medium cap growth	25,000	25,000	—	—
Small cap blend	217,000	217,000	—	—
Small cap value	8,584,000	8,584,000	—	—
Small cap growth	35,000	35,000	—	—
Large cap growth	19,979,000	19,979,000	—	—
Large cap balanced	58,487,000	58,487,000	—	—
Large cap value	19,656,000	19,656,000	—	—
Large cap blend	1,591,000	1,591,000	—	—
International growth	16,413,000	16,413,000	—	—
International value	16,697,000	16,697,000	—	—
International large cap	92,000	92,000	—	—
International balance	32,332,000	32,332,000	—	—
Market neutral	14,162,000	14,162,000	—	—
REIT sector	26,010,000	26,010,000	—	—
Fixed-income mutual funds:				
Treasury intermediate	40,822,000	40,822,000	—	—
Inv grade corp interm	14,586,000	14,586,000	—	—
Inv grade corp short	13,939,000	13,939,000	—	—
High-yield bond	17,000	17,000	—	—
International bond	17,000	17,000	—	—
Corporate stock	11,000	11,000	—	—
Corporate obligations	1,474,000	—	1,474,000	—
U.S. government agencies	9,787,000	—	9,787,000	—
Cash surrender value of life insurance	269,000	—	269,000	—
	<u>\$ 313,833,000</u>	<u>302,303,000</u>	<u>11,530,000</u>	<u>—</u>

# ST. CHARLES HEALTH SYSTEM, INC.

## Notes to Consolidated Financial Statements

December 31, 2013 and 2012

The following table presents assets and liabilities that are measured at fair value on a recurring basis at December 31, 2012:

Fair value measurements at reporting date using				
	December 31,			
	2012	(Level 1)	(Level 2)	(Level 3)
<b>Assets:</b>				
Assets limited as to use:				
Cash and cash equivalents	\$ 8,429,000	8,429,000	—	—
Equity mutual funds:				
Medium cap blend	6,882,000	6,882,000	—	—
Small cap blend	6,969,000	6,969,000	—	—
Large cap growth	15,889,000	15,889,000	—	—
Large cap balanced	45,966,000	45,966,000	—	—
Large cap value	15,843,000	15,843,000	—	—
Large cap blend	14,000	14,000	—	—
International growth	13,459,000	13,459,000	—	—
International value	13,621,000	13,621,000	—	—
International large cap	47,000	47,000	—	—
International balance	27,570,000	27,570,000	—	—
Market neutral	11,508,000	11,508,000	—	—
REIT sector	23,902,000	23,902,000	—	—
Money market	16,000	16,000	—	—
Fixed-income mutual funds:				
Treasury intermediate	35,828,000	35,828,000	—	—
Inv grade corp interm	12,278,000	12,278,000	—	—
Inv grade corp short	11,736,000	11,736,000	—	—
High-yield bond	58,000	58,000	—	—
Corporate obligations	10,403,000	—	10,403,000	—
U.S. government agencies	1,970,000	—	1,970,000	—
U.S. government treasuries	1,968,000	1,968,000	—	—
Cash surrender value of life insurance	248,000	—	248,000	—
	<u>\$ 264,604,000</u>	<u>251,983,000</u>	<u>12,621,000</u>	<u>—</u>

The fair value of long-term obligations is estimated using current market activity and discounted cash flow analysis and is considered a Level 2 measurement under ASC 820. The fair value and carrying amount of long-term obligations at December 31, 2013 and 2012 were as follows:

	2013		2012	
	Carrying amount	Fair value	Carrying amount	Fair value
Long-term obligations	\$ 157,980,000	175,428,000	166,430,000	197,752,000

**ST. CHARLES HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

**(11) Discontinued Operations**

Effective June 1, 2012, SCHS closed its emergency air ambulance transportation business “Airlink.” The closure included ceasing all air ambulance operations, transferring all Airlink membership program activities to a new provider and selling the aircraft used to provide the air ambulance transportation services. Airlink had distinct and identifiable assets, liabilities, and cash flows and was considered a component of SCHS. As a result, the closure of Airlink was reported as discontinued operations in these consolidated financial statements. The following table provides summary financial information for Airlink for the year ended December 31, 2012:

	<b>2012</b>
Operating revenues	\$ 2,915,000
Operating expenses	<u>4,109,000</u>
Operating loss	(1,194,000)
Gain on sale of assets	<u>3,693,000</u>
Gain on discontinued operations	<u><u>\$ 2,499,000</u></u>

**(12) Subsequent Events**

The Corporation has performed an evaluation of subsequent events through March 18, 2014, which is the date these consolidated financial statements were issued.

## **SUPPLEMENTARY SCHEDULES**



**ST. CHARLES HEALTH SYSTEM, INC.**  
Supplementary Schedule – Balance Sheet Information  
December 31, 2013 and 2012

Assets	Obligated group	Nonobligated group excluding St. Charles Foundation, Inc.	St. Charles Foundation, Inc.	Eliminating and reclassifying entries	2013	2012
Current assets:						
Cash and cash equivalents	\$ 6,908,000	630,000	1,902,000	—	9,440,000	27,017,000
Assets limited as to use, current portion	7,734,000	—	—	—	7,734,000	7,671,000
Patient accounts receivable, net of allowance	86,499,000	2,720,000	—	—	89,219,000	61,990,000
Other receivables, net	13,874,000	4,007,000	2,556,000	(4,684,000)	15,753,000	9,706,000
Supplies inventory	10,305,000	—	—	—	10,305,000	8,935,000
Prepaid expenses and other current assets	7,230,000	106,000	82,000	—	7,418,000	7,225,000
Total current assets	132,550,000	7,463,000	4,540,000	(4,684,000)	139,869,000	122,544,000
Assets limited as to use, net of current portion	299,967,000	721,000	7,730,000	—	308,418,000	259,098,000
Property and equipment, net	219,475,000	4,367,000	—	—	223,842,000	211,063,000
Other assets	35,315,000	6,842,000	—	(29,660,000)	12,497,000	13,051,000
Total assets	\$ 687,307,000	19,393,000	12,270,000	(34,344,000)	684,626,000	605,756,000
<b>Liabilities and Net Assets</b>						
Current liabilities:						
Accounts payable	\$ 27,786,000	753,000	—	(3,912,000)	24,627,000	19,023,000
Accrued liabilities	40,977,000	5,000	—	—	40,982,000	35,579,000
Estimated third-party payor settlements, net	5,467,000	—	—	—	5,467,000	5,058,000
Deferred revenue	1,138,000	—	—	(772,000)	366,000	349,000
Current portion of long-term obligations	11,746,000	725,000	—	—	12,471,000	9,707,000
Total current liabilities	87,114,000	1,483,000	—	(4,684,000)	83,913,000	69,716,000
Long-term obligations, net of current portion	144,229,000	1,280,000	—	—	145,509,000	156,723,000
Other liabilities	8,219,000	—	71,000	—	8,290,000	3,929,000
Total liabilities	239,562,000	2,763,000	71,000	(4,684,000)	237,712,000	230,368,000
Net assets:						
Unrestricted, SCHS	439,706,000	12,315,000	2,450,000	(19,911,000)	434,560,000	367,414,000
Unrestricted, noncontrolling interests	—	4,315,000	—	—	4,315,000	2,959,000
Temporarily restricted	6,556,000	—	6,863,000	(6,863,000)	6,556,000	3,581,000
Permanently restricted	1,483,000	—	2,886,000	(2,886,000)	1,483,000	1,434,000
Total net assets	447,745,000	16,630,000	12,199,000	(29,660,000)	446,914,000	375,388,000
Total liabilities and net assets	\$ 687,307,000	19,393,000	12,270,000	(34,344,000)	684,626,000	605,756,000

See accompanying independent auditors' report.

**ST. CHARLES HEALTH SYSTEM, INC.**  
Supplementary Schedule – Statement of Operations Information  
Years ended December 31, 2013 and 2012  
(Dollars in thousands)

	<b>Obligated group</b>	<b>Nonobligated group excluding St. Charles Foundation, Inc.</b>	<b>St. Charles Foundation, Inc.</b>	<b>Eliminating and reclassifying entries</b>	<b>2013</b>	<b>2012</b>
Operating revenue:						
Net patient service revenue prior to bad debt adjustments	\$ 547,391,000	31,867,000	—	(20,230,000)	559,028,000	504,986,000
Bad debt adjustments	27,779,000	—	—	—	27,779,000	24,216,000
Net patient service revenue	519,612,000	31,867,000	—	(20,230,000)	531,249,000	480,770,000
Other revenue	40,871,000	—	1,724,000	(16,911,000)	25,684,000	24,367,000
Total operating revenue	560,483,000	31,867,000	1,724,000	(37,141,000)	556,933,000	505,137,000
Expenses:						
Salaries and wages	227,967,000	5,394,000	469,000	(469,000)	233,361,000	198,999,000
Employee benefits	74,707,000	—	147,000	(2,011,000)	72,843,000	65,034,000
Professional fees	59,113,000	—	69,000	(20,286,000)	38,896,000	36,205,000
Depreciation	28,631,000	1,222,000	—	—	29,853,000	31,175,000
Interest	12,094,000	77,000	—	—	12,171,000	13,020,000
Medical supplies, drugs, and other	151,326,000	8,479,000	574,000	(2,505,000)	157,874,000	139,783,000
Total expenses	553,838,000	15,172,000	1,259,000	(25,271,000)	544,998,000	484,216,000
Operating income	6,645,000	16,695,000	465,000	(11,870,000)	11,935,000	20,921,000
Other income (losses):						
Investment income, net	41,311,000	—	485,000	175,000	41,971,000	27,421,000
Contribution from Mountain View Hospital District	16,796,000	—	—	—	16,796,000	—
Other, net	1,641,000	—	—	—	1,641,000	107,000
Total other income, net	59,748,000	—	485,000	175,000	60,408,000	27,528,000
Excess of revenue over expenses	66,393,000	16,695,000	950,000	(11,695,000)	72,343,000	48,449,000
Increase (decrease) in interest in net assets of St. Charles Foundation, Inc.	300,000	—	—	(300,000)	—	—
Gain on discontinued operations	—	—	—	—	—	2,499,000
Net assets released from restriction for use	81,000	—	—	—	81,000	516,000
Capital contributions	341,000	—	—	—	341,000	43,000
Transfers (to) from affiliated organizations	—	—	(611,000)	—	(611,000)	(20,000)
Distributions	8,521,000	(12,173,000)	—	—	(3,652,000)	(2,424,000)
Change in unrestricted net assets	\$ 75,636,000	4,522,000	339,000	(11,995,000)	68,502,000	49,063,000

See accompanying independent auditors' report.