

Partners HealthCare System, Inc. and Affiliates

**Consolidated Financial Statements
September 30, 2013 and 2012**

Partners HealthCare System, Inc. and Affiliates
Index
September 30, 2013 and 2012

	Page(s)
Report of Independent Auditors	1
Financial Statements	
Consolidated Balance Sheets	2
Consolidated Statements of Operations	3
Consolidated Statements of Changes in Net Assets	4
Consolidated Statements of Cash Flows	5
Notes to Consolidated Financial Statements	6–49



Independent Auditor's Report

To the Board of Directors of
Partners HealthCare System, Inc. and Affiliates

We have audited the accompanying consolidated financial statements of Partners HealthCare System, Inc. and its Affiliates (Partners HealthCare), which comprise the consolidated balance sheets as of September 30, 2013 and 2012 and the related consolidated statements of operations, changes in net assets and of cash flows for the years then ended.

Management's Responsibility for the Consolidated Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on the consolidated financial statements based on our 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 our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to Partners HealthCare'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 Partners HealthCare'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 Partners HealthCare System, Inc. and its Affiliates at September 30, 2013 and 2012, and the results of their operations, their changes in net assets and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

PricewaterhouseCoopers LLP

December 13, 2013

Partners HealthCare System, Inc. and Affiliates
Consolidated Balance Sheets
Years Ended September 30, 2013 and 2012

<i>(dollars in thousands)</i>	2013	2012
Assets		
Current assets		
Cash and equivalents	\$ 471,322	\$ 486,932
Investments	1,439,299	1,256,984
Collateral held under securities lending arrangements	229,400	105,985
Current portion of investments limited as to use	1,813,490	1,735,373
Patient accounts receivable, net of allowance for bad debts (2013 - \$104,044; 2012 - \$111,850)	813,384	775,918
Research grants receivable	109,708	121,758
Other current assets	326,751	273,668
Receivable for settlements with third-party payers	68,854	48,265
Total current assets	5,272,208	4,804,883
Investments limited as to use, less current portion	2,771,216	2,325,279
Long-term investments	957,100	890,097
Pledges receivable, net and contributions receivable from trusts, less current portion	165,095	168,096
Property and equipment, net	4,235,839	3,885,858
Other assets	499,442	548,768
Total assets	<u>\$ 13,900,900</u>	<u>\$ 12,622,981</u>
Liabilities and Net Assets		
Current liabilities		
Current portion of long-term obligations	\$ 361,249	\$ 293,322
Accounts payable and accrued expenses	690,946	603,013
Accrued medical claims and related expenses	121,833	-
Accrued compensation and benefits	623,352	612,607
Collateral due under securities lending arrangements	229,400	105,985
Current portion of accrual for settlements with third-party payers	36,052	44,759
Unexpended funds on research grants	160,668	171,136
Total current liabilities	2,223,500	1,830,822
Other liabilities		
Accrual for settlements with third-party payers, less current portion	87,787	7,861
Accrued professional liability	443,688	441,404
Accrued employee benefits	648,128	1,625,024
Interest rate swaps liability	232,005	398,340
Accrued other	158,468	196,911
	1,570,076	2,669,540
Long-term obligations, less current portion	3,097,280	2,839,940
Total liabilities	6,890,856	7,340,302
Commitments and contingencies		
Net assets		
Unrestricted	5,805,066	4,131,437
Temporarily restricted	792,769	777,012
Permanently restricted	412,209	374,230
Total net assets	7,010,044	5,282,679
Total liabilities and net assets	<u>\$ 13,900,900</u>	<u>\$ 12,622,981</u>

The accompanying notes are an integral part of these consolidated financial statements.

Partners HealthCare System, Inc. and Affiliates
Consolidated Statements of Operations
Years Ended September 30, 2013 and 2012

<i>(dollars in thousands)</i>	2013	2012
Operating revenue		
Net patient service revenue, net of provision for bad debts (2013 - \$102,409 ; 2012 - \$123,725)	\$ 6,769,743	\$ 6,828,189
Premium revenue	1,349,525	-
Direct academic and research revenue	1,242,819	1,176,002
Indirect academic and research revenue	351,630	362,595
Other revenue	632,322	614,551
Total operating revenue	<u>10,346,039</u>	<u>8,981,337</u>
Operating expenses		
Employee compensation and benefits	5,224,242	4,864,713
Supplies and other expenses	2,108,313	2,113,614
Medical claims and related expenses	1,061,630	-
Direct academic and research expenses	1,242,819	1,176,002
Depreciation and amortization	434,725	418,330
Interest	116,671	103,413
Asset impairment charge	-	114,356
Total operating expenses	<u>10,188,400</u>	<u>8,790,428</u>
Income from operations	<u>157,639</u>	<u>190,909</u>
Nonoperating gains (expenses)		
Income from investments	146,631	136,875
Change in fair value of nonhedging interest rate swaps	48,522	(11,881)
Gifts and other, net of fundraising and other expenses	(56,194)	(44,352)
Academic and research gifts, net of expenses	49,206	80,784
Contribution income - affiliates	254,205	-
Total nonoperating gains, net	<u>442,370</u>	<u>161,426</u>
Excess of revenues over expenses	<u>600,009</u>	<u>352,335</u>
Other changes in net assets		
Change in net unrealized appreciation on marketable investments	74,522	95,701
Change in fair value of hedging interest rate swaps	117,813	(11,258)
Funds utilized for property and equipment	57,224	62,679
Change in funded status of defined benefit plans	835,651	(700,088)
Other	(11,590)	192
Increase (decrease) in unrestricted net assets	<u>\$ 1,673,629</u>	<u>\$ (200,439)</u>

The accompanying notes are an integral part of these consolidated financial statements.

Partners HealthCare System, Inc. and Affiliates
Consolidated Statements of Changes in Net Assets
September 30, 2013 and 2012

<i>(dollars in thousands)</i>	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Net assets at October 1, 2011	\$ 4,331,876	\$ 783,798	\$ 337,913	\$ 5,453,587
Increases (decreases)				
Income from operations	190,909	-	-	190,909
Income (loss) from investments	136,875	2,980	(211)	139,644
Gifts and other	(44,352)	(10,104)	34,383	(20,073)
Academic and research gifts, net of expenses	80,784	-	-	80,784
Change in net unrealized appreciation on marketable investments	95,701	27,928	900	124,529
Change in fair value of interest rate swaps				
Nonhedging	(11,881)	-	-	(11,881)
Hedging	(11,258)	-	-	(11,258)
Funds utilized for property and equipment	62,679	(26,204)	-	36,475
Change in funded status of defined benefit plans	(700,088)	-	-	(700,088)
Other	192	(1,386)	1,245	51
Change in net assets	(200,439)	(6,786)	36,317	(170,908)
Net assets at September 30, 2012	4,131,437	777,012	374,230	5,282,679
Increases (decreases)				
Income from operations	157,639	-	-	157,639
Income from investments	146,631	10,158	163	156,952
Gifts and other	(56,194)	9,612	35,009	(11,573)
Academic and research gifts, net of expenses	49,206	-	-	49,206
Contribution income - affiliates	254,205	8,431	510	263,146
Change in net unrealized appreciation on marketable investments	74,522	23,802	802	99,126
Change in fair value of interest rate swaps				
Nonhedging	48,522	-	-	48,522
Hedging	117,813	-	-	117,813
Funds utilized for property and equipment	57,224	(36,246)	-	20,978
Change in funded status of defined benefit plans	835,651	-	-	835,651
Other	(11,590)	-	1,495	(10,095)
Change in net assets	1,673,629	15,757	37,979	1,727,365
Net assets at September 30, 2013	\$ 5,805,066	\$ 792,769	\$ 412,209	\$ 7,010,044

The accompanying notes are an integral part of these consolidated financial statements.

Partners HealthCare System, Inc. and Affiliates
Consolidated Statements of Cash Flows
September 30, 2013 and 2012

<i>(dollars in thousands)</i>	2013	2012
Cash flows from operating activities		
Change in net assets	\$ 1,727,365	\$ (170,908)
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Contribution income - affiliates	(263,146)	-
Change in funded status of defined benefit plans	(835,651)	700,088
Asset impairment charge, net of cash portion	-	112,379
Loss on refunding of debt	-	54
Change in fair value of interest rate swaps	(166,335)	23,139
Depreciation and amortization	434,725	418,330
Provision for bad debts	102,409	123,725
(Gain) loss on disposal of property	(848)	1,489
Net realized and change in unrealized appreciation on investments	(344,585)	(326,822)
Restricted contributions and investment income	(88,289)	(103,153)
Cash premium received upon issuance of bonds	-	22,181
Increase (decrease) in cash resulting from a change in		
Patient accounts receivable	(119,412)	(170,567)
Research grants receivable	12,050	5,452
Other current assets	(9,251)	18,350
Pledges receivable and contributions receivable from trusts	21,486	25,592
Other assets	45,892	(84,983)
Accounts payable and accrued expenses	46,244	54,184
Accrued medical claims and related expenses	917	-
Accrued compensation and benefits	(3,010)	55,269
Settlements with third-party payers	38,999	(62,638)
Unexpended funds on research grants	(10,468)	9,359
Accrued employee benefits and other	(208,806)	(304,956)
Net cash provided by operating activities	<u>380,286</u>	<u>345,564</u>
Cash flows from investing activities		
Purchase of property and equipment	(703,083)	(471,082)
Proceeds from sale of property	4,954	913
Purchase of investments	(2,314,810)	(1,955,070)
Proceeds from sales of investments	2,247,631	1,551,262
Cash acquired through affiliations	17,668	-
Net cash used for investing activities	<u>(747,640)</u>	<u>(873,977)</u>
Cash flows from financing activities		
Payments on long-term obligations	(112,715)	(44,366)
Proceeds from long-term obligations, net of financing costs	400,000	576,632
(Increase) decrease in auction rate securities holdings	(23,830)	30,000
Deposits into refunding trusts	-	(89,611)
Restricted contributions and investment income	88,289	103,153
Net cash provided by financing activities	<u>351,744</u>	<u>575,808</u>
Net (decrease) increase in cash and equivalents	(15,610)	47,395
Cash and equivalents		
Beginning of year	486,932	439,537
End of year	<u>\$ 471,322</u>	<u>\$ 486,932</u>

The accompanying notes are an integral part of these consolidated financial statements.

Partners HealthCare System, Inc. and Affiliates

Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(dollars in thousands)

1. Organization and Community Benefit Commitments

Partners HealthCare System, Inc. (PHS) is the sole member of The Massachusetts General Hospital (MGH), Brigham and Women's Health Care, Inc. (BWHC), NSMC HealthCare, Inc. (NSMC), Newton-Wellesley Health Care System, Inc. (NWHCS), Partners Continuing Care, Inc. (PCC), Partners International Medical Services, LLC (PIMS) and Neighborhood Health Plan, Incorporated (NHP). PHS appoints the two physicians who are the members of Partners Community HealthCare, Inc. (PCHI). The individual serving as the PHS President and Chief Executive Officer is the sole member of Partners Harvard Medical International, Inc. (PHMI). PHS, together with all of its affiliates, is referred to as "Partners HealthCare."

Partners HealthCare currently operates two tertiary and seven community acute care hospitals in Massachusetts, one facility providing inpatient and outpatient mental health services and four facilities providing inpatient and outpatient services in rehabilitation medicine and long-term care. Partners HealthCare also operates physician organizations and practices, a home health agency, nursing homes, and a graduate Level program for health professions. Partners HealthCare provides services to patients primarily from the Greater Boston area as well as New England and beyond. In addition, Partners HealthCare is a nonuniversity-based Non-profit private medical research enterprise and is a principal teaching affiliate of the medical and dental schools of Harvard University. Partners HealthCare also operates a licensed, not-for-profit managed care organization that provides health insurance products to the Medicaid, Commonwealth Care (a health insurance program for uninsured adults who meet income and other eligibility requirements) and commercial populations.

PHS is a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code (IRC). All affiliates of PHS, except for PCHI, PIMS, NHP and Newton-Wellesley Physician Hospital Organization, Inc. (NWPHO), are also tax-exempt organizations under Section 501(c)(3) of the IRC. NHP is a tax-exempt organization under Section 501(c)(4) of the IRC. Accordingly, no provision for income taxes related to these tax-exempt entities has been made. PCHI and NWPHO are taxable entities and PIMS is a single member LLC that is disregarded for income tax purposes. As of September 30, 2013, PCHI has available net operating loss carryforwards of approximately \$32,000 for income tax purposes, expiring in 2018 through 2033.

Community Benefit

Partners HealthCare's community benefit programs include working with communities to address a number of public health issues including racial disparities, alcohol and substance abuse among young people, infant mortality, domestic violence and cancer. Partners HealthCare provides economic opportunity for low income Boston residents by helping people advance into nursing and other healthcare careers through its public school partnerships and workforce development programs. In addition, twenty-one community health centers are licensed by or affiliated with Partners HealthCare entities and provide high quality, culturally competent primary care and access to Partners HealthCare's hospitals. Partners HealthCare invests in these health centers' infrastructure, programming and operation and also helps with relocation, renovation and other capital requirements.

The Massachusetts Attorney General's Community Benefits Guidelines direct health maintenance organizations and Non-profit acute care hospitals to prepare annual reports documenting the status and Level of their community benefit programs and initiatives. These annual reports serve the important purpose of providing the public with access to useful information about these programs

Partners HealthCare System, Inc. and Affiliates

Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(dollars in thousands)

and initiatives. Partners HealthCare files its report annually with the Massachusetts Attorney General. The report summarizes community benefit activities on a system-wide basis. In addition, each of the acute care hospitals within Partners HealthCare has a community benefit planning and service delivery structure and files separate community benefit reports. Partners HealthCare's nonacute care hospitals also file community benefit reports annually.

Uncompensated Care

Partners HealthCare provides care to all patients regardless of their ability to pay. The cost of providing that care is reflected in the statements of operations. The cost related to those patients for which Partners HealthCare receives either partial or no reimbursement for healthcare services provided is summarized as follows:

State Programs

Uncompensated Care

Free care services are partially reimbursed to acute care hospitals through the statewide Health Safety Net (HSN) established by the Massachusetts Health Care Reform Law (Chapter 58 of the Acts of 2006). A portion of the funding for the HSN is paid by hospitals through a statewide hospital assessment levied each year by the Massachusetts Legislature. All acute care hospitals in the state are assessed their share of this total statewide hospital assessment amount (\$160,000 in 2013 and 2012) based on each hospital's charges for private sector payers. Partners HealthCare's hospitals report this assessment as a deduction from net patient service revenue.

Hospitals are reimbursed for free care based on claims for eligible patients and eligible services that are submitted to and adjudicated by the HSN. Rates of payment are based on Medicare rates and payment policies. The HSN is projected to be under-funded by approximately \$78,118 and \$133,200 in 2013 and 2012, respectively, with approximately \$21,924 and \$36,400 in 2013 and 2012, respectively, allocated to Partners HealthCare's hospitals. This shortfall is allocated to hospitals based on their share of total statewide patient care costs. Each hospital's share of the overall state shortfall cannot exceed its total free care reimbursement. Hospitals with a high proportion of free care and government funding receive more favorable reimbursement, including limiting their shortfall allocation to no more than 15% of their payments for free care. In aggregate, Partners HealthCare's acute care hospitals received uncompensated care funding covering 54% of the estimated cost of free care provided in 2013 and 39% of the estimated cost in 2012, excluding the assessment.

Medicaid

Medicaid is a means-tested health insurance program jointly funded by state and federal governments. States administer the program and set rules for eligibility, benefits and provider payments within broad federal guidelines. The program provides health care coverage to low-income children and families, pregnant women, long-term unemployed adults, seniors and persons with disabilities. Eligibility is determined by a variety of factors, which include income relative to the federal poverty line, age, immigrant status and assets.

Medicaid payments to Partners HealthCare providers do not cover the full cost of services provided. In aggregate, reimbursement from Medicaid covered 59% and 57% of the estimated cost of services provided in 2013 and 2012, respectively. In addition, Medicaid premium revenue paid to NHP for the care of Medicaid patients enrolled in NHP did not cover the medical expense and administrative costs of care for these enrollees. In aggregate, the premium revenue paid to NHP by Medicaid was \$4,339, or 0.5%, less than the cost of care.

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

Federal Program

Medicare

Medicare is a federally sponsored health insurance program for people age 65 or older, under age 65 with certain disabilities and any age with end-stage renal disease. For many years, Medicare payments have not kept pace with increases in the cost of care provided at many hospitals. Additionally, payments to physicians have seen little or no increases over the past several years. Compounding this shortfall in payments is the shift of care from higher paying inpatient services to lower paying outpatient services.

Consequently, Medicare payments to Partners HealthCare also do not cover the full cost of services provided. In aggregate, reimbursement from Medicare covered 74% of the estimated cost of services provided in 2013 and 76% of the estimated cost of services provided in 2012.

For free care, Medicaid and Medicare, the total estimated cost of services provided by Partners HealthCare exceeded the net reimbursement received under these programs by \$1,085,938 and \$994,684 for the years ended September 30, 2013 and 2012, respectively. The estimated cost of services provided is either obtained directly from a costing system or based on an entity specific ratio of cost to gross charges. In the latter case, cost is derived by applying this ratio to gross charges associated with providing care to free care, Medicaid and Medicare patients. The following summarizes, by program, the cost of services provided, net reimbursement and cost of services in excess of reimbursement for each year:

	Years Ended September 30,	
	2013	2012
Cost of services provided		
Free care, including assessment payment to HSN of \$56,028 and \$53,550 in 2013 and 2012, respectively	\$ 163,326	\$ 165,303
Medicaid	755,114	723,157
Medicare	2,477,719	2,301,132
	<u>\$ 3,396,159</u>	<u>\$ 3,189,592</u>
Net reimbursement		
Free care	\$ 45,069	\$ 35,136
Medicaid	441,939	415,068
Medicare	1,823,213	1,744,704
	<u>\$ 2,310,221</u>	<u>\$ 2,194,908</u>
Cost of services in excess of reimbursement		
Free care	\$ 118,257	\$ 130,167
Medicaid	313,175	308,089
Medicare	654,506	556,428
	<u>\$ 1,085,938</u>	<u>\$ 994,684</u>

Partners HealthCare System, Inc. and Affiliates

Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(dollars in thousands)

Bad Debts

In addition to free care and inadequate funding from the Medicaid and Medicare programs, there are significant losses related to self-pay patients who fail to make payment for services rendered or insured patients who fail to remit co-payments and deductibles as required under the applicable health insurance arrangement. The provision for bad debts of \$102,409 in 2013 and \$123,725 in 2012 represents charges for services provided that are deemed to be uncollectible. The estimated cost of providing these services was approximately \$38,205 and \$39,936 for 2013 and 2012, respectively.

2. Summary of Significant Accounting Policies

Basis of Accounting

The accompanying consolidated financial statements have been prepared on the accrual basis of accounting and include the accounts of PHS and its affiliates. Significant interaffiliate accounts and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates are made in the areas of patient accounts receivable, research grants receivable, pledges receivable, investments, receivables and accruals for settlements with third-party payers, accrued professional liability, accrued compensation and employee benefits, interest rate swaps and accrued other.

Fair Value of Financial Instruments

The fair value of financial instruments approximates the carrying amount reported in the consolidated balance sheets for cash and equivalents, certain investments and investments limited as to use, collateral held and due under securities lending arrangements, patient accounts receivable, research grants receivable, accounts payable and interest rate swaps. More information can be found in Note 6, Fair Value Measurements.

Cash and Equivalents

Cash and equivalents represent money market and highly liquid debt instruments with a maturity at the date of purchase of three months or less. Most of Partners HealthCare's banking activity, including cash and equivalents, is maintained with several national banks and from time to time cash deposits exceed federal insurance limits. It is Partners HealthCare's policy to monitor these banks' financial strength on an ongoing basis and no losses have been experienced to date.

Investments

Investments in equity securities with readily determinable fair values and all investments in debt securities (marketable investments) are measured at fair value based on quoted market prices. The change in net unrealized appreciation on these marketable investments is excluded from excess of revenues over expenses.

Partners HealthCare System, Inc. and Affiliates

Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(dollars in thousands)

Alternative investments, including hedge funds and private equities, do not have readily ascertainable market values. Alternative investments are valued by the investment manager and assessed for reasonableness by management using the following methodology: investments in securities sold short or traded on a national securities exchange are valued based on quoted market prices; investments in securities that are not traded and restricted securities of public companies are valued based on amounts reported by the fund manager and evaluated by management. The reported value of these investments represents the amount Partners HealthCare would expect to receive if it liquidated its investments at the balance sheet date on a nondistressed basis. Investments in hedge funds, private equity, private debt and other private partnerships (collectively, private partnerships) for which Partners HealthCare owns more than 5% of the overall investment are generally recorded as equity method investments. The change in value of equity method investments is included in excess of revenues over expenses as a component of income from investments. All other investments are recorded at cost.

Income from investments (including realized gains and losses, change in value of equity method investments, interest, dividends and endowment income distributions) is included in excess of revenues over expenses unless the income or loss is restricted by donor or law. Income from investments is reported net of investment-related expenses.

Investments whose cost exceeds fair value are reviewed each quarter to determine whether these investments are other-than-temporarily impaired. Externally managed marketable investments with fair value below cost are considered to be other-than-temporarily impaired and, accordingly, the unrealized depreciation is recognized as realized losses through a write-down in the cost basis of these investments. All other investments are subject to a further review, which considers factors including the anticipated holding period for the investment and the extent and duration of below cost valuation. A similar write-down is recorded when the impairment on these investments has been judged to be other-than-temporary.

Depending on any donor-imposed restrictions on the underlying investments, the amount of the write-down is reported as a realized loss in either temporarily restricted net assets or in excess of revenues over expenses as a component of income from investments, with no adjustment in the cost basis for subsequent recoveries.

Partners HealthCare has an endowment spending policy for pooled endowment funds. A fixed distribution rate for spending is determined each year which will come from either income and/or net accumulated appreciation.

Investments Limited as to Use

Investments limited as to use primarily include assets whose use is contractually limited by external parties as well as assets set aside by the boards (or management) for identified purposes and over which the boards (or management) retain control such that the boards (or management) may, at their discretion, subsequently use such assets for other purposes. Certain investments corresponding to deferred compensation are accounted for such that all income and appreciation (depreciation) is recorded as a direct addition (reduction) to the asset and corresponding liability.

Partners HealthCare System, Inc. and Affiliates

Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(dollars in thousands)

Securities Loaned

Investments that have been loaned to another institution are reported as pledged assets within investments in the consolidated financial statements. Investments held by the custodian on behalf of Partners HealthCare as collateral on the securities lending transaction are also reported as assets on the balance sheet. Because the collateral must be returned in the future, a corresponding liability is also reported in the consolidated financial statements.

Derivative Instruments

Derivatives are recognized on the balance sheet at fair value. Partners HealthCare designates at inception whether the derivative contract is considered hedging or nonhedging for accounting purposes. For hedges, Partners HealthCare formally documents at inception all relationships between hedging instruments and hedged items, as well as its risk management objectives and strategies for undertaking various accounting hedges. Partners HealthCare uses its derivatives which are designated as hedging for accounting purposes as cash flow hedges. Cash flow hedges are used to minimize the variability in cash flows of interest-bearing liabilities or forecasted transactions caused by changes in interest rates. Changes in the fair value of derivatives designated for hedging activities that are highly effective as hedges are excluded from excess of revenues over expenses. Hedge ineffectiveness, if any, is recorded in excess of revenues over expenses. For nonhedging derivatives, changes in the fair value are recorded in excess of revenues over expenses.

Patient Accounts Receivable

Partners HealthCare receives payments for services rendered from federal and state agencies (under the Medicare and Medicaid programs), managed care payers, commercial insurance companies and patients. Patient accounts receivable are reported net of contractual allowances and reserves for denials, uncompensated care and doubtful accounts. The Level of reserves is based upon management's assessment of historical and expected net collections, business and economic conditions, trends in federal and state governmental and private employer health care coverage and other collection indicators.

Research Grants Receivable

Partners HealthCare receives research funding from departments and agencies of the U.S. Government, industry and corporate sponsors and other private sponsors. Research grants receivable include amounts due from these sponsors of externally funded research. These amounts have been billed or are billable to the sponsor, or in limited circumstances, represent accelerated spending in anticipation of future funding. Research grants receivable are reported net of reserves for uncollectible accounts.

Other Current Assets

Other current assets include prepaids, nonpatient and research receivables, premiums receivable, and reinsurance recoveries. Reinsurance recoveries, net of allowances as of September 30, 2013 were \$2,360.

Property and Equipment

Property and equipment is reported on the basis of cost less accumulated depreciation. Donated items are recorded at fair value at the date of contribution. All research grants received for capital are recorded in the year of expenditure as a change in unrestricted net assets. Property and equipment is reviewed for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. Depreciation of property and equipment is

Partners HealthCare System, Inc. and Affiliates

Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(dollars in thousands)

calculated by use of the straight-line method at rates intended to depreciate the cost of assets over their estimated useful lives, which generally range from three to forty years. Interest costs incurred on borrowed funds during the period of construction of capital assets are capitalized, net of any interest earned, as a component of the cost of acquiring those assets.

In March 2012, Partners HealthCare made a strategic decision related to a change in scope and direction for its clinical information systems. In making that decision, management reassessed information system projects currently underway, including a system-wide patient administrative system, and concluded that certain costs that had been capitalized no longer had future value. Accordingly, an impairment charge of \$114,356, which related to actual amounts incurred and capitalized in previous periods, was recorded in the year ended September 30, 2012.

Asset Retirement Obligations

Asset retirement obligations, reported in accrued other, are legal obligations associated with the retirement of long-lived assets. These liabilities are initially recorded at fair value and the related asset retirement costs are capitalized by increasing the carrying amount of the related assets by the same amount as the liability. Asset retirement costs are subsequently depreciated over the useful lives of the related assets. Partners HealthCare records changes in the liability resulting from the passage of time and revisions to either the timing or the amount of the original liability estimate. Partners HealthCare reduces these liabilities when the related obligations are settled.

Other Assets

Other assets consist of long-term receivables, deferred financing costs, intangible assets, prepaid ground rent, malpractice insurance receivables (Note 14), investments in healthcare related limited partnerships and benefit assets for over-funded defined benefit plans. Deferred financing costs are amortized over the terms of the related obligations. The carrying value of other assets is reviewed if the facts and circumstances suggest that it may be impaired.

Compensated Absences

In accordance with formal policies concerning vacation and other compensated absences, accruals of \$225,967 and \$205,957 were recorded as of September 30, 2013 and 2012, respectively.

Unexpended Funds on Research Grants

Research grants received in advance of corresponding grant expenditures are accounted for as a direct addition to investments limited as to use and unexpended funds on research grants.

Self-Insurance Reserves

Partners HealthCare is generally self-insured for employee healthcare, disability, workers' compensation and certain other employee benefits. These costs are accounted for on an accrual basis to include estimates of future payments for claims incurred prior to year end.

Net Assets

Permanently restricted net assets include the historical dollar amounts of gifts and the income and gains on such gifts which are required by donors to be permanently retained. Temporarily restricted net assets include gifts and the income and gains on permanently restricted net assets which can be expended but for which restrictions have not yet been met. Such restrictions include purpose restrictions where donors have specified the purpose for which the net assets are to be spent, or time restrictions imposed by donors or implied by the nature of the gift (capital projects, pledges to be paid in the future, life income funds) or by interpretations of law (gains available for

Partners HealthCare System, Inc. and Affiliates

Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(dollars in thousands)

appropriation but not appropriated in the current period). Unrestricted net assets include all of the remaining net assets of Partners HealthCare. More information can be found in Note 16, Restricted Net Assets.

Realized gains and losses are classified as unrestricted net assets unless they are restricted by the donor or law. Unless permanently restricted by the donor, realized gains and unrealized net appreciation on permanently restricted gifts are classified as temporarily restricted until appropriated for spending by Partners HealthCare in accordance with policies established by Partners HealthCare and the Massachusetts Uniform Prudent Management of Institutional Funds Act (UPMIFA). Net losses on permanently restricted endowment funds are classified as a reduction to unrestricted net assets until such time as the fair value of these funds exceeds historical cost.

Gifts and Grants

Unconditional promises to give cash and other assets to Partners HealthCare are reported at fair value at the date the promise is received. Conditional promises to give are recognized when the conditions are substantially met. 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. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted gifts in the accompanying financial statements.

Gifts of long-lived assets with explicit restrictions that specify use of assets and gifts of cash or other assets that must be used to acquire long-lived assets are reported as additions to temporarily restricted net assets if the assets are not placed in service during the year.

Grants and contracts normally provide for the recovery of direct and indirect costs, subject to audit. Partners HealthCare recognizes revenue associated with direct and indirect costs as direct costs are incurred. The recovery of indirect costs is based on predetermined rates for U.S. Government grants and contracts and negotiated rates for other grants and contracts.

Contributed Securities

Partners HealthCare's policy is to sell securities contributed by donors upon receipt, unless prevented from doing so by donor request. For the years ended September 30, 2013 and 2012, contributed securities of \$29,017 and \$23,853, respectively, were received and liquidated. Donors restricted the proceeds received from the sale of these contributed securities of \$4,553 and \$5,345 for long-term purpose for the years ended September 30, 2013 and 2012, respectively.

Statement of Operations

All activities of Partners HealthCare deemed by management to be ongoing, major and central to the provision of healthcare services, teaching, research activities and health insurance are reported as operating revenue and expenses. Other activities are deemed to be nonoperating and include unrestricted gifts (net of fundraising expenses), net change in unexpended academic and research gifts, change in fair value of nonhedging interest rate swaps, contribution income from affiliates (Note 3) and substantially all income (loss) from investments. Academic and research gifts largely consist of donor contributions (and the related investment income including realized gains and losses) designated to support the clinical, teaching or research efforts of a physician or department as directed by the donor. These gifts are reported as unrestricted, net of related support expenses, when donor restrictions are of a general nature that are inherent in the normal activities of the organization.

Partners HealthCare System, Inc. and Affiliates

Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(dollars in thousands)

Partners HealthCare recognizes changes in third-party payer settlements and other estimates in the year of the change in estimate. For the years ended September 30, 2013 and 2012, adjustments to prior year estimates resulted in an increase (decrease) to income from operations of (\$17,503) and \$111,169, respectively. The (\$17,503) decrease in income from operations for the year ended September 30, 2013 includes \$79,020 recorded as deferred revenue and more fully described below. The \$111,169 increase in income from operations for the year ended September 30, 2012 is comprised of \$48,290 in favorable settlements with commercial payers and \$62,879 in favorable settlements from government payers, including \$27,146 associated with Partners HealthCare's share of a Department of Health Services settlement to compensate hospitals nationwide for past underpayments related to an error in Medicare's "rural floor" budget neutrality adjustment.

Effective October 1, 2007, the Centers for Medicare and Medicaid Services (CMS) adopted the MS-DRG patient classification system (MS-DRGs) for inpatient services to better recognize severity of illness in Medicare payment rates for acute care hospitals. The adoption of MS-DRGs resulted in the expansion of the number of diagnosis related groups (DRGs), a system of classifying patients for purposes of inpatient reimbursement. By increasing the number of DRGs and more fully taking into account patients' severity of illness in Medicare payment rates for acute care hospitals, the use of MS-DRGs encourages hospitals to improve their documentation and coding of patient diagnoses. CMS has determined that the adoption of the MS-DRGs has increased aggregate payments to hospitals due to additional documentation and coding without a corresponding increase in actual patient severity of illness.

CMS is required by its enabling statute to maintain budget neutrality by prospectively adjusting the Medicare payment rate to eliminate the effect of changes in DRG classification that do not reflect real changes in case-mix. CMS requires Congressional authority, however, to recoup any overpayments made in prior years. In 2007, Congress granted CMS the authority to recoup overpayments made to hospitals in 2008 and 2009 resulting from increased coding and documentation, which CMS did through rate reductions in 2011 and 2012. Under the American Taxpayer Relief Act of 2012, Congress granted CMS the authority to recoup overpayments made to hospitals in 2010 through 2012 through rate reductions in 2014 through 2017.

In 2010, Partners HealthCare recorded the estimated overpayment amounts received in 2008 and 2009 of \$38,509 as deferred revenue and amortized this amount into net patient service revenue in 2011 and 2012 to offset the rate reductions. In 2013, Partners HealthCare recorded the estimated overpayment amounts received in 2010 through 2012 of \$79,020 as deferred revenue to be amortized into net patient service revenue in 2014 through 2017 to offset the rate reductions. Management believes this accounting treatment better reflects the financial impact of this rate methodology and more accurately presents the recognition of revenue. For the years ended September 30, 2013 and 2012, amortization of these overpayments amounted to \$0 and \$19,254, respectively.

The statement of operations include excess of revenues over expenses. Changes in unrestricted net assets which are excluded from excess of revenues over expenses include change in net unrealized appreciation on marketable investments, change in fair value of effective hedging interest rate swaps, contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for acquisition of such assets) and change in funded status of defined benefit plans.

Partners HealthCare System, Inc. and Affiliates

Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(dollars in thousands)

Net Patient Service Revenue

Partners HealthCare maintains agreements with CMS of the United States Department of Health and Human Services (DHHS) under the Medicare program, The Commonwealth of Massachusetts (the Commonwealth) under the Medicaid program and various managed care payers that govern payment for services rendered to patients covered by these agreements. The agreements generally provide for per case or per diem rates or payments based on discounted charges for inpatient care and discounted charges or fee schedules for outpatient care. Certain contracts also provide for payments that are contingent upon meeting agreed upon quality and efficiency measures.

Partners HealthCare recognizes patient service revenue associated with services provided to patients who have third-party payer coverage on the basis of contractual rates for the services rendered. For uninsured patients that do not qualify for charity care, Partners HealthCare recognizes revenue on the basis of its standard rates (subject to discounts) for services provided. On the basis of historical experience, a significant portion of Partners HealthCare's uninsured patients are unable or fail to pay for the services provided. Consequently, Partners HealthCare records a provision for bad debts related to uninsured patients in the period the services are provided. For the years ended September 30, 2013 and 2012, patient service revenue net of contractual allowances and discounts (before the provision for bad debts) is as follows:

	Years Ended September 30,	
	2013	2012
Patient service revenue (net of contractual allowances and discounts)		
Third-party payers	\$ 6,638,603	\$ 6,728,031
Uninsured patients	233,549	223,883
Total all payers	<u>\$ 6,872,152</u>	<u>\$ 6,951,914</u>

Net patient service revenue includes estimated retroactive revenue adjustments due to future audits, reviews and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews and investigations. Contracts, laws and regulations governing the Medicare, Medicaid and HSN programs (Note 1) and managed care payer arrangements are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. A portion of the accrual for settlements with third-party payers has been classified as long-term because such amounts, by their nature or by virtue of regulation or legislation, will not be paid within one year.

Partners HealthCare provides either full or partial charity care to patients who cannot afford to pay for their medical services based on income and family size. Charity care is generally available to qualifying patients for medically necessary services. Partners HealthCare reports certain bad debts related to emergency services as charity care. Charity care is reported at gross charges with an offsetting allowance, as there is no expectation of collection. Accordingly, there is no net patient service revenue related to charity care.

Partners HealthCare System, Inc. and Affiliates

Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(dollars in thousands)

Medical Claims and Related Expenses

NHP contracts with various community health centers, hospital-based primary care physician practices and other health care providers for the delivery of services to its members. NHP compensates these providers on a capitated, fee-for-service, or per diem basis.

The cost of contracted health care services is accrued in the period in which services are provided and include certain estimated amounts. The estimated liability for medical claims payable and related expenses is actuarially determined based on analysis of historical claims-paid experience, modified for changes in enrollment, inflation and benefit coverage. The liability for medical claims and related expenses represents the anticipated cost of claims incurred but unpaid at the balance sheet date. The estimates for claims expense may be more or less than the amounts ultimately paid when claims are settled. Such changes in estimates are reflected in the current period consolidated statements of operations.

In the normal course of business, NHP identifies and recoups overpayments through reductions in future payments made to providers and hospitals. Such overpayments are the result of, among other things, coordination of benefits and provider claim audits. For the year ended September 30, 2013, NHP identified approximately \$34,500 of recoveries related to claim overpayments made for both current-year and prior-year paid claims, which are reflected as a reduction to medical claims and related expenses in the accompanying consolidated statements of operations. At September 30, 2013, NHP's accounts receivable include \$2,270 relating to such overpayments.

Premium Revenue

Premiums are due monthly and recorded as earned during the period in which members are eligible to receive services. Premiums received prior to the first day of the coverage period are recorded as unearned premiums in accounts payable and accrued expenses.

Reinsurance

Reinsurance premiums are reported in medical claims and related expenses and reinsurance recoveries are reported as reductions in medical claims and related expenses.

Settlements

NHP contracts with the Executive Office of Health and Human Services (EOHHS) and certain providers based on historical and anticipated experience. These methods of reimbursement result in year-end settlements based on actual versus anticipated experience. Settlements payable also includes amounts for risk-sharing incentives, which are based on specific contractual provisions between NHP and these providers. The settlements are intended to include both reported and unreported incurred claims at September 30, 2013.

Premium Deficiency Reserve

NHP recognizes premium deficiency reserves based upon expected premium revenue, medical expense and administrative expense levels, and remaining contractual obligations using NHP's historical experience. Anticipated investment income is not included in the determination of premium deficiency reserves since its effect is deemed to be immaterial. As of September 30, 2013 the premium deficiency reserves total approximately \$6,493 and are included in accrued medical claims and related expenses in the accompanying consolidated balance sheets.

Partners HealthCare System, Inc. and Affiliates

Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(dollars in thousands)

Claims Adjustment Expenses

Claims adjustment expenses (CAE) are those costs expected to be incurred in connection with the adjustment and recording of health claims. NHP has recorded an estimate of unpaid CAE associated with incurred but unpaid claims, which is included in medical claims and related expenses in the accompanying consolidated financial statements. Management believes the amount of the liability for unpaid CAE at September 30, 2013, is adequate to cover NHP's cost for the adjustment and recording of unpaid claims; however, actual expenses may differ from those established estimates. Adjustments to the estimates for unpaid CAE are reflected in operating results in the period in which the change in estimate is identified (Note 9).

Other Revenue

Other revenue includes institutional revenue (for example, billing for services provided to other healthcare providers), royalties and management services.

Adoption of New Accounting Guidance

Partners HealthCare adopted new accounting guidance related to the classification of contributed securities in the consolidated statement of cash flows and retroactively applied the guidance to fiscal year 2012.

3. Acquisitions

NHP and Cooley Dickinson Health Care Corporation and Subsidiaries (CDHCC) contributed their net assets to Partners HealthCare on October 1, 2012 and July 1, 2013, respectively. As a result, Partners HealthCare recorded contribution income of \$263,146 reflecting the fair value of the contributed net assets of NHP of \$152,461 and of CDHCC of \$110,685 on their respective transaction dates. Of this amount, \$254,205 represents unrestricted net assets and is included as a nonoperating gain in the accompanying consolidated statements of operations and changes in net assets. Restricted contribution income of \$8,431 and \$510 was recorded within temporarily restricted net assets and permanently restricted net assets, respectively, in the accompanying consolidated statement of changes in net assets.

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

Assets, liabilities, and net assets assumed as of the acquisition dates are as follows:

	NHP	CDHCC	Total
Assets			
Cash and cash equivalents	\$ 12,461	\$ 5,207	\$ 17,668
Assets limited as to use and investments	230,551	131,057	361,608
Patient accounts receivable, net	-	20,463	20,463
Property plant and equipment	4,224	76,514	80,738
Other assets	56,202	7,056	63,258
Total assets acquired	<u>\$ 303,438</u>	<u>\$ 240,297</u>	<u>\$ 543,735</u>
Liabilities			
Accounts payable and accrued expenses	\$ 25,616	\$ 16,073	\$ 41,689
Accrued medical claims and related expenses	120,916	-	120,916
Accrual for settlements with third-party payers	-	11,631	11,631
Long-term debt	-	61,812	61,812
Accrued pension and post retirement benefits	-	25,205	25,205
Other liabilities	4,445	14,891	19,336
Total liabilities assumed	<u>150,977</u>	<u>129,612</u>	<u>280,589</u>
Net Assets			
Unrestricted	152,461	101,744	254,205
Temporarily restricted	-	8,431	8,431
Permanently restricted	-	510	510
Total net assets	<u>152,461</u>	<u>110,685</u>	<u>263,146</u>
Total liabilities and net assets	<u>\$ 303,438</u>	<u>\$ 240,297</u>	<u>\$ 543,735</u>

A summary of the financial results of NHP from the period October 1, 2012 through September 30, 2013 and of CDHCC from the period July 1, 2013 through September 30, 2013 that is included in the consolidated statements of operations and changes in net assets is as follows:

	NHP	CDHCC	Total
Total operating revenue	\$ 1,351,361	\$ 47,006	\$ 1,398,367
Total operating expenses	<u>1,332,641</u>	<u>50,385</u>	<u>1,383,026</u>
Income (loss) from operations	18,720	(3,379)	15,341
Nonoperating gains (expenses), net	<u>1,245</u>	<u>(12,802)</u>	<u>(11,557)</u>
Excess (deficit) of revenues over expenses	19,965	(16,181)	3,784
Pension related changes	-	2,255	2,255
Other changes	7,825	6,765	14,590
Increase (decrease) in unrestricted net assets	<u>\$ 27,790</u>	<u>\$ (7,161)</u>	<u>\$ 20,629</u>

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

A summary of the consolidated financial results of Partners HealthCare for the years ended September 30, 2013 and 2012, as if the transactions had occurred on October 1, 2012 is as follows (unaudited):

	2013	2012
Total operating revenue	\$ 10,501,763	\$ 10,433,477
Total operating expenses	10,331,840	10,229,669
Income from operations	169,923	203,808
Nonoperating gains	445,658	166,317
Excess of revenues over expenses	615,581	370,125
Pension related changes	851,141	(703,876)
Other changes	239,551	146,207
Increase / (decrease) in unrestricted net assets	\$ 1,706,273	\$ (187,544)

4. Levels of Capital and Surplus

On an annual basis, NHP is required to calculate its risk-based capital (RBC) and submit this calculation to the Massachusetts Department of Insurance (DOI). RBC is the minimum Level of capital deemed necessary for a managed care organization based upon the types of assets held and business written, calculated in accordance with the managed care organizations' RBC formula that was adopted by the National Association of Insurance Commissioners (NAIC). If an organization's Total Adjusted Capital, as defined, falls below RBC, the Insurance Commissioner is required to take actions considered necessary to protect policyholders and creditors. The annual calculation is done as of December 31, as that is NHP's fiscal and statutory year-end. Management believes that NHP's RBC exceeds the minimum levels. As of December 31, 2012 NHP's RBC was 309%. PHS has committed to maintain NHP's RBC at a minimum of 300%.

NHP's current contract with EOHHS requires NHP to maintain a minimum net worth and/or financial insolvency insurance in an amount equal to the Minimum Net Worth calculation as defined in Massachusetts General Law 176G, Section 25. At December 31, 2012, the minimum net worth requirement, as determined in accordance with EOHHS guidelines, was \$75,300. NHP's GAAP net worth was \$165,800 at December 31, 2012 and statutory net worth was \$160,300 at December 31, 2012. NHP's statutory net worth exceeds the EOHHS requirements by \$85,000 at December 31, 2012.

5. Investments and Investments Limited as to Use

Investments are either separately invested or included in pooled investment funds. The Partners HealthCare System Pooled Investment Accounts (Partnership) is structured as a single general partnership composed of four investment pools, with PHS and substantially all of its affiliates participating in the pools as partners. Each partner's interest in the Partnership is based on its underlying investments in one or more of the four separate pools. Amounts included in the investment pools are accounted for using the fair value method whereby each partner is assigned a number of units based on the fair value of the assets of a pool at the time of entry of the funds into the pool. Current fair value is used to determine the number of units allocated to additional amounts placed in a pool and to value withdrawals from a pool. Income from investments of the

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

pools, including realized gains and losses, is allocated on a unitized basis to a partner based on the partner's share of units in a pool.

The Partnership invests in private partnerships whose assets include equity, fixed income and other investments. As of September 30, 2013, the Partnership has unfunded commitments of approximately \$353,000 which will be drawn down by the various general partners over the next several years. The maximum annual drawdown is expected to be less than 2% of investments and investments limited as to use.

Investments and investments limited as to use are recorded in the balance sheet as follows:

	September 30,	
	2013	2012
Current assets		
Investments	\$ 1,439,299	\$ 1,256,984
Current portion of investments limited as to use	1,813,490	1,735,373
	<u>3,252,789</u>	<u>2,992,357</u>
Investments limited as to use, less current portion	2,771,216	2,325,279
Long-term investments	957,100	890,097
	<u>\$ 6,981,105</u>	<u>\$ 6,207,733</u>

Investments limited as to use consist of the following:

	September 30, 2013		September 30, 2012	
	Current Portion	Long-Term Portion	Current Portion	Long-Term Portion
Internally designated funds				
Reserved for capital expenditures	\$ 854,265	\$ -	\$ 804,234	\$ -
Unexpended academic and research gifts	-	2,331,946	-	1,932,845
Deferred compensation	-	191,726	-	167,397
Other	771,482	207,902	581,250	185,216
	<u>1,625,747</u>	<u>2,731,574</u>	<u>1,385,484</u>	<u>2,285,458</u>
Externally limited funds				
Unexpended funds on research	160,668	-	171,136	-
Contributions held for others	4,272	-	3,428	-
Professional liability trust fund	-	39,642	-	39,821
Held by trustees under debt and other agreements	22,803	-	175,325	-
	<u>187,743</u>	<u>39,642</u>	<u>349,889</u>	<u>39,821</u>
	<u>\$ 1,813,490</u>	<u>\$ 2,771,216</u>	<u>\$ 1,735,373</u>	<u>\$ 2,325,279</u>

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

Investments and investments limited as to use are reported at either fair value or on the equity or cost methods of accounting. The composition of these investments, segregated between pooled investments and those that are separately invested, is as follows:

	September 30, 2013			
	At Fair Value	On Equity Method	On Cost Method	Total
Pooled investments				
Invested cash equivalents	\$ 63,146	\$ -	\$ -	\$ 63,146
Separately managed investments	2,297,413	-	-	2,297,413
Mutual funds	607,991	-	-	607,991
Commingled funds	959,607	-	-	959,607
Private partnerships	-	722,516	1,628,480	2,350,996
	<u>3,928,157</u>	<u>722,516</u>	<u>1,628,480</u>	<u>6,279,153</u>
Separately invested				
Invested cash equivalents	145,057	-	488	145,545
Equities	12,273	-	14,247	26,520
U.S. Government and domestic fixed income securities	33,653	-	-	33,653
Mutual funds	359,306	-	327	359,633
Other	59,380	-	77,221	136,601
	<u>609,669</u>	<u>-</u>	<u>92,283</u>	<u>701,952</u>
	<u>\$ 4,537,826</u>	<u>\$ 722,516</u>	<u>\$ 1,720,763</u>	<u>\$ 6,981,105</u>

Separately managed investments include cash and equivalents of \$284,815, equities of \$660,847 and fixed income securities of \$1,351,751 as of September 30, 2013.

	September 30, 2012			
	At Fair Value	On Equity Method	On Cost Method	Total
Pooled investments				
Invested cash equivalents	\$ 50,258	\$ -	\$ -	\$ 50,258
Separately managed investments	2,165,550	-	-	2,165,550
Mutual funds	646,358	-	-	646,358
Commingled funds	522,574	-	-	522,574
Private partnerships	-	690,286	1,700,243	2,390,529
	<u>3,384,740</u>	<u>690,286</u>	<u>1,700,243</u>	<u>5,775,269</u>
Separately invested				
Invested cash equivalents	149,238	-	-	149,238
Equities	16,323	-	9,196	25,519
U.S. Government and domestic fixed income securities	5,169	-	-	5,169
Mutual funds	169,875	-	-	169,875
Other	9,194	-	73,469	82,663
	<u>349,799</u>	<u>-</u>	<u>82,665</u>	<u>432,464</u>
	<u>\$ 3,734,539</u>	<u>\$ 690,286</u>	<u>\$ 1,782,908</u>	<u>\$ 6,207,733</u>

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

Separately managed investments include cash and equivalents of \$281,109, equities of \$395,146 and fixed income securities of \$1,489,295 as of September 30, 2012.

For the private partnerships reflected in the balance sheet at cost, the difference (unrecorded net unrealized appreciation) between the value reported by the investment managers and the cost for these investments was \$745,013 and \$648,893 as of September 30, 2013 and 2012, respectively.

The fair value and gross unrealized depreciation of investments and investments limited as to use, with a fair value less than cost, that are not deemed to be other-than-temporarily impaired at September 30, 2013 are as follows:

	Less than 12 Months		12 Months or Greater	
	Fair Value	Gross Unrealized Depreciation	Fair Value	Gross Unrealized Depreciation
Pooled investments				
Separately managed investments	\$ 41,024	\$ (2,490)	\$ 14,410	\$ (263)
Commingled funds	316,899	(9,682)	153,011	(6,546)
	<u>357,923</u>	<u>(12,172)</u>	<u>167,421</u>	<u>(6,809)</u>
Separately invested				
Equities	-	-	695	(44)
U.S. Government and domestic fixed income securities	12,152	(111)	1,376	(794)
Mutual funds	41,562	(1,153)	-	-
External trusts	-	-	7,488	(1,787)
	<u>53,714</u>	<u>(1,264)</u>	<u>9,559</u>	<u>(2,625)</u>
	<u>\$ 411,637</u>	<u>\$ (13,436)</u>	<u>\$ 176,980</u>	<u>\$ (9,434)</u>

In addition, for certain private partnerships recorded at cost, gross unrealized depreciation amounted to \$21,559 as of September 30, 2013, with \$17,648 of that amount unrealized for 12 months or greater.

Based on management's quantitative and qualitative assessment, investments whose cost exceeds fair value are not considered to be other-than-temporarily impaired at September 30, 2013. Management believes these investments will recover their values and there is no intention to liquidate these positions.

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

Investment income and gains (losses) from cash and equivalents, investments (including long-term) and investments limited as to use are comprised of the following:

	Years Ended September 30,	
	2013	2012
Unrestricted		
Dividends, interest and other income	\$ 54,710	\$ 58,122
Endowment income distributions, net of reinvested gains	32,272	30,714
Net realized gains (losses) on investments		
Realized gains	267,110	158,560
Other-than-temporary impairment	(85,879)	(41,099)
Change in value of equity method investments	19,971	46,856
Recovery on endowment funds	893	2,324
Total investment activity included in excess of revenues over expenses	289,077	255,477
Change in net unrealized appreciation on marketable investments	74,522	95,701
Total unrestricted investment activity	363,599	351,178
Temporarily restricted		
Dividends and interest income	5,146	3,738
Endowment income distributions	(38,182)	(36,668)
Net realized gains (losses) on investments		
Realized gains	53,844	30,695
Other-than-temporary impairment	(15,351)	(6,709)
	5,457	(8,944)
Change in value of equity method investments	4,701	11,924
Change in net unrealized appreciation on marketable investments	24,695	30,252
Recovery on endowment funds	(893)	(2,324)
	28,503	39,852
Total temporarily restricted investment activity	33,960	30,908
Permanently restricted		
Dividends and interest income	(7)	47
Net realized gains (losses) on investments	170	(258)
Change in net unrealized appreciation on marketable investments	802	900
Total permanently restricted investment activity	965	689
	<u>\$ 398,524</u>	<u>\$ 382,775</u>

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

Investment income included in operating results and excess of revenues over expenses is comprised of the following:

	Years Ended September 30,	
	2013	2012
Investment income included in operations and reported in other revenue	\$ 11,816	\$ 10,997
Investment income included in nonoperating gains and reported in		
Income from investments	146,631	136,875
Academic and research gifts, net of expenses	<u>130,630</u>	<u>107,605</u>
Total investment activity included in excess of revenues over expenses	<u>\$ 289,077</u>	<u>\$ 255,477</u>

Securities Lending

The Partnership may lend securities to qualified financial institutions through a program administered by the Partnership custodian. All loans are callable at any time and are fully collateralized. Income is earned based on the collateral held and invested during the period of lending. Collateral requirements are 102% and 105% for domestic and foreign securities, respectively. The custodian continually monitors borrowers' creditworthiness and protects against borrower default through full indemnification. If a borrower failed to return a loaned security whose market value has increased over the amount in collateral, the custodian will cover the difference. The custodian will also cover operational losses, such as the failure of the borrower to make substitute dividend payments to the lender.

The fair value of loaned securities and related collateral at September 30, 2013 and 2012 is as follows:

	2013		2012	
	Loaned Securities	Collateral	Loaned Securities	Collateral
Equities, U.S. government, domestic and foreign fixed income securities	<u>\$ 223,389</u>	<u>\$ 229,400</u>	<u>\$ 102,785</u>	<u>\$ 105,985</u>

Income generated by the Partnership from securities lending arrangements was \$561 and \$490 for the years ended September 30, 2013 and 2012, respectively.

6. Fair Value Measurements

Fair value is defined 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 (also referred to as exit price). Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. In determining fair value, the use of various valuation approaches, including market, income and cost approaches, is permitted.

Partners HealthCare System, Inc. and Affiliates

Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(dollars in thousands)

Fair Value Hierarchy

A fair value hierarchy has been established based on whether the inputs to valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the reporting entity's assumptions about the inputs market participants would use. The fair value hierarchy requires the reporting entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. In addition, for hierarchy classification purposes, the reporting entity should not look through the form of an investment to the nature of the underlying securities held by an investee.

The hierarchy is described below.

- | | |
|---------|---|
| Level 1 | Valuations using quoted prices in active markets for identical assets or liabilities. Valuations of these products do not require a significant degree of judgment. Level 1 assets and liabilities primarily include debt and equity securities that are traded in an active exchange market. |
| Level 2 | Valuations using observable inputs other than Level 1 prices such as quoted prices in active markets for similar assets or liabilities; quoted prices for identical or similar assets or liabilities in markets that are not active; broker or dealer quotations; 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 primarily include debt securities with quoted prices that are traded less frequently than exchange-traded instruments as well as debt securities and derivative contracts whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. |
| Level 3 | Valuations using unobservable inputs that are supported by little or no market activity and are significant to the fair value of the assets or liabilities. Level 3 includes assets and liabilities whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques reflecting the reporting entity's assumptions about the assumptions market participants would use as well as those requiring significant management judgment. |

Valuation Techniques

Pooled investments (except for private partnerships, which are reported on either the equity method or cost method of accounting), separately invested cash equivalents, debt and equity securities, and collateral held under securities lending arrangements are classified within Level 1 or Level 2 of the fair value hierarchy as they are valued using quoted market prices, broker or dealer quotations, or other observable pricing sources. Certain types of investments are classified within Level 3 of the fair value hierarchy because they have little or no market activity and therefore have little or no observable inputs with which to measure fair value.

The valuation of interest rate swaps is determined using widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities.

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

The following tables summarize fair value measurements at September 30, 2013 and 2012 for financial assets and liabilities measured at fair value on a recurring basis:

	Fair Value Measurements Using			
	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Fair Value at September 30, 2013
Assets				
Pooled investments				
Invested cash equivalents	\$ 13,988	\$ 49,158	\$ -	\$ 63,146
Separately managed investments	1,483,585	813,828	-	2,297,413
Mutual funds	607,991	-	-	607,991
Commingled funds	-	959,607	-	959,607
	<u>2,105,564</u>	<u>1,822,593</u>	<u>-</u>	<u>3,928,157</u>
Separately invested				
Invested cash equivalents	145,048	9	-	145,057
Equities	9,760	2,513	-	12,273
U.S. Government and domestic fixed income securities	18,773	14,880	-	33,653
Mutual funds	359,306	-	-	359,306
Other	108	49,591	9,681	59,380
	<u>532,995</u>	<u>66,993</u>	<u>9,681</u>	<u>609,669</u>
	<u>\$ 2,638,559</u>	<u>\$ 1,889,586</u>	<u>\$ 9,681</u>	<u>\$ 4,537,826</u>
Collateral held under securities lending arrangements		<u>\$ 229,400</u>		<u>\$ 229,400</u>
Liabilities				
Interest rate swaps		\$ 232,005		\$ 232,005

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

	Fair Value Measurements Using			
	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Fair Value at September 30, 2012
Assets				
Pooled investments				
Invested cash equivalents	\$ 8,742	\$ 41,516	\$ -	\$ 50,258
Separately managed investments	1,270,525	895,025	-	2,165,550
Mutual funds	646,358	-	-	646,358
Commingled funds	-	522,574	-	522,574
	<u>1,925,625</u>	<u>1,459,115</u>	<u>-</u>	<u>3,384,740</u>
Separately invested				
Invested cash equivalents	149,238	-	-	149,238
Equities	14,027	2,296	-	16,323
U.S. Government and domestic fixed income securities	3,749	1,420	-	5,169
Mutual funds	169,875	-	-	169,875
Other	121	-	9,073	9,194
	<u>337,010</u>	<u>3,716</u>	<u>9,073</u>	<u>349,799</u>
	<u>\$ 2,262,635</u>	<u>\$ 1,462,831</u>	<u>\$ 9,073</u>	<u>\$ 3,734,539</u>
Collateral held under securities lending arrangements		\$ 105,985		\$ 105,985
Liabilities				
Interest rate swaps		\$ 398,340		\$ 398,340

For the years ended September 30, 2013 and 2012, the changes in the fair value of the assets measured using significant unobservable inputs (Level 3) were comprised of the following:

	2013	2012
Balances at beginning of year	\$ 9,073	\$ 10,383
Total gains (losses)		
Dividends and interest income	43	58
Realized gains on investments	463	597
Realized loss on investments	(8)	(16)
Change in net unrealized appreciation on investments	115	86
Purchases	170	9
Sales	(175)	(2,044)
Balances at end of year	<u>\$ 9,681</u>	<u>\$ 9,073</u>

The net unrealized gain on Level 3 investments held at September 30, 2013 was \$518.

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

7. Pledges Receivable and Contributions Receivable from Trusts

Pledges receivable represent unconditional promises to give and are net of allowances for uncollectible amounts. Pledges are recorded at the present value of their estimated future cash flows. Pledges collectible within one year are classified as other current assets, net of allowances, and total \$91,281 and \$109,766 as of September 30, 2013 and 2012, respectively. Estimated cash flows due after one year are discounted using published treasury bond and note yields that are commensurate with estimated collection risks. The blended discount rate was 0.8% and 0.4% for 2013 and 2012, respectively. Pledges are expected to be collected as follows:

	September 30,	
	2013	2012
Amounts due		
Within one year	\$ 111,141	\$ 128,865
In one to five years	140,842	136,811
In more than five years	11,084	18,418
Total pledges receivable	263,067	284,094
Less: Unamortized discount	4,715	2,566
	258,352	281,528
Less: Allowance for uncollectibles	29,857	29,452
Net pledges receivable	228,495	252,076
Contributions receivable from trusts	27,881	25,786
	<u>\$ 256,376</u>	<u>\$ 277,862</u>

8. Property and Equipment

Property and equipment consists of the following:

	September 30,	
	2013	2012
Land and land improvements	\$ 172,530	\$ 160,838
Buildings and building improvements	5,348,349	4,854,254
Equipment	1,348,621	1,276,372
Construction in progress	591,763	490,567
	7,461,263	6,782,031
Accumulated depreciation	(3,225,424)	(2,896,173)
Property and equipment, net	<u>\$ 4,235,839</u>	<u>\$ 3,885,858</u>

Depreciation expense for the years ended September 30, 2013 and 2012 was \$429,734 and \$415,593, respectively. Interest costs, net of interest earned, aggregating \$20,771 and \$16,754 were capitalized in 2013 and 2012, respectively.

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

For the years ended September 30, 2013 and 2012, fully depreciated assets with an original cost of \$241,091 and \$186,182, respectively, were written off.

9. Accrued Medical Claims and Related Expenses

These liabilities include estimates of expected trends in claims severity, frequency, and other factors, which could vary as the claims are ultimately settled. In establishing this reserve, management has utilized the services of actuaries to review the reasonableness of the reserves based principally upon the historical experience of NHP. As a result of changes in estimates of insured events in prior years and recoveries, the liability on claims existing on October 1, 2012, decreased \$26,081 in the year ended September 30, 2013. Decreases and increases of this nature occur as the result of claim settlements and recoveries during the current year and as additional information is received regarding individual claims, causing changes from the original estimates of the cost of these claims. Ongoing analysis of the recent loss development trends is also taken into account in evaluating the overall adequacy of the reserves. Amounts are in thousands in the following table:

	September 30, 2013
Balance at beginning of year	\$ 120,916
Less:	
Premium deficiency reserve	(9,552)
Medical loss ratio rebate payable	(202)
Accrual for claims adjustment expenses	(2,759)
Claim recoveries	(4,484)
Plus:	
Settlements payable, net	19,559
Net balance at beginning of year	<u>123,478</u>
Incurred related to	
Current year	1,242,333
Prior years	(26,081)
Total incurred	<u>1,216,252</u>
Paid related to	
Current year	1,103,374
Prior years	107,009
Total paid	<u>1,210,383</u>
Net balance at end of year	129,347
Plus:	
Premium deficiency reserve	6,494
Medical loss ratio rebate payable	4,701
Accrual for claims adjustment expenses	2,855
Claims recoveries	1,991
Less: Settlements payable, net	(23,555)
Balance at end of year	<u>\$ 121,833</u>

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

Medical claims and related expenses in the accompanying consolidated statements of operations include these amounts along with other nonclaims related costs. These nonclaims related expenses were for directly delivered services and medical cost risk sharing and incentives, totaling approximately \$13,181 for the year ended September 30, 2013.

10. Long-Term Obligations

Long-term obligations issued by PHS and its affiliates consist of the following:

	September 30,	
	2013	2012
Massachusetts Health and Educational Facilities Authority (Authority) Revenue Bonds		
Partners HealthCare System Series C, average fixed interest rate of 5.00%, final maturity in 2013	\$ -	\$ 3,960
Partners HealthCare System Series D, variable interest rate of 0.05% and 0.18% at September 30, 2013 and 2012, respectively, final maturity in 2038	92,005	103,500
Partners HealthCare System Series E, average fixed interest rate of 5.00%, final maturity in 2023	4,475	5,633
Partners HealthCare System Series F, issued in multiple subseries, average fixed interest rate of 5.00%, variable interest rate of 0.17% and 0.29% at September 30, 2013 and 2012, respectively, final maturity in 2040	371,618	378,097
Partners HealthCare System Series G, issued in multiple subseries, average fixed interest rate of 4.91%, variable interest rate of 0.19% and 0.36% at September 30, 2013 and 2012, respectively, final maturity in 2047	446,252	454,084
Partners HealthCare System Series H, variable interest rate of 0.11% and 0.16% at September 30, 2013 and 2012, respectively, final maturity in 2042	171,159	171,154
Partners HealthCare System Series I, issued in multiple subseries, average fixed interest rate of 4.77%, variable interest rate of 0.06% and 0.17%, at September 30, 2013 and 2012, respectively, final maturity in 2044	226,002	228,792
Partners HealthCare System Series J, average fixed interest rate of 5.00%, final maturity in 2039	473,742	491,118
Partners HealthCare System Series P, variable interest rate of 0.06% and 0.18% at September 30, 2013 and 2012, respectively, final maturity in 2027	150,000	150,000
Massachusetts Development Finance Agency (Agency) Revenue Bonds		
Partners HealthCare System Series K, issued in multiple subseries, average fixed interest rate of 4.74%, variable interest rate of 0.34% and 0.44% at September 30, 2013 and 2012, respectively, final maturity in 2046	434,063	434,775
Partners HealthCare System Series L, average fixed interest rate of 4.93%, final maturity in 2041	352,185	352,937
Partners HealthCare System Series 2007 taxable bonds, fixed interest rate of 6.26%, final maturity in 2037	100,000	100,000
Partners HealthCare System Series 2011 taxable bonds, fixed interest rate of 3.44%, final maturity in 2021	250,000	250,000
Partners HealthCare System 2012 Taxable Senior Notes, fixed interest rate of 4.11%, final maturity in 2052	400,000	-
Other obligations	6,798	7,125
Capital lease obligations	4,060	2,087
Total long-term obligations net of premiums and discounts	3,482,359	3,133,262
Less:		
Current portion	361,249	293,322
Auction rate securities held	23,830	-
	<u>\$ 3,097,280</u>	<u>\$ 2,839,940</u>

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

As of September 30, 2013 and 2012, respectively, Partners HealthCare was holding \$23,830 and \$0 of the Series F and Series G Revenue Bonds issued as auction rate securities (ARS). Although not legally extinguished, the bonds held by Partners HealthCare have been reflected as extinguished under generally accepted accounting principles.

Aggregate maturities and payments of long term obligations during the next five years and thereafter, and other amounts classified as current liabilities, are as follows:

	Scheduled Maturities	Bonds Supported by Partners HealthCare Liquidity	Total
2014	\$ 54,994	\$ 306,255	\$ 361,249
2015	56,614	-	56,614
2016	63,681	-	63,681
2017	64,529	-	64,529
2018	68,433	-	68,433
Thereafter	2,867,853	-	2,867,853
	<u>\$ 3,176,104</u>	<u>\$ 306,255</u>	<u>\$ 3,482,359</u>

The scheduled maturities represent annual payments as required under debt repayment schedules. The current portion of long-term obligations includes the payments scheduled to be made in 2014 along with variable rate bonds supported by Partners HealthCare liquidity. The variable rate bonds supported by self liquidity provide the bondholder with an option to tender the bonds to Partners HealthCare. Accordingly, these bonds are classified as a current liability.

The fair value of long-term obligations was \$3,559,469 and \$3,377,755 as of September 30, 2013 and 2012, respectively, and would be classified as Level 2. The carrying amount of the variable rate debt is a reasonable estimate of its fair value. The fair value of the fixed rate debt is estimated based on quoted market prices for the same or similar issues.

Interest expense approximates interest paid, net of capitalized interest, during the years ended September 30, 2013 and 2012.

Taxable Bonds

In December 2011, PHS issued \$250,000 of Partners HealthCare System Taxable Bonds Series 2011. The bond proceeds, net of issuance costs of \$1,632, were used to make a voluntary contribution to Partners HealthCare's defined benefit pension plans.

In November 2012, PHS issued \$400,000 of Partners HealthCare System Taxable Senior Notes. Proceeds from the notes were used to make a voluntary contribution to Partners HealthCare's defined benefit pension plans (\$200,000) and to finance certain capital projects (\$200,000).

Partners HealthCare System, Inc. and Affiliates

Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(dollars in thousands)

Agency Revenue Bonds

In January 2012, PHS issued \$331,320 of Partners HealthCare System Series L Revenue Bonds plus bond premium of \$22,181. The bond proceeds, net of issuance costs of \$3,056, were used to finance certain capital projects totaling \$260,834 and to refund a portion of Partners HealthCare System Series B Revenue Bonds (\$73,205), a portion of Partners HealthCare System Series C Revenue Bonds (\$5,279) and a portion of Partners HealthCare System Series E Revenue Bonds (\$11,127), all of which were issued as fixed rate bonds.

Partners HealthCare Series 2007, 2011 and 2012 taxable bonds, the Authority's Series D through J bonds and the Agency's Series K and L bonds and the Series P loan to PHS, (collectively, PHS Bonds) are uncollateralized general obligations of PHS supported by guarantees from BWHC, The Brigham and Women's Hospital, Inc. (BWH), MGH and The General Hospital Corporation (the General) which may be suspended under certain conditions.

PHS bond agreements contain certain covenants, including a minimum debt service coverage ratio and limitations on additional indebtedness and asset transfers.

Credit Agreement

Partners HealthCare maintains a \$150,000 Credit Agreement (the Agreement) that provides access to same day funds. Advances under the Agreement bear a variable rate of interest based on the London Interbank Offered Rate (LIBOR). There were no amounts outstanding under the Agreement as of September 30, 2013. The Agreement expires in June 2017.

11. Derivatives

Interest Rate Swaps

Partners HealthCare uses derivative financial instruments principally to manage interest rate risk and has entered into derivatives to lock in fixed rates for anticipated issuances and refundings of debt. By using derivative financial instruments to manage the risk of changes in interest rates, Partners HealthCare exposes itself to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contracts. When the fair value of a derivative contract is positive, the counterparty has a liability to Partners HealthCare, which creates credit risk. Partners HealthCare minimizes its credit risk by entering into derivative agreements with several counterparties and requiring the counterparty to post collateral for the benefit of Partners HealthCare based on the credit rating of the counterparty and the fair value of the derivative contract. When the fair value of a derivative contract is negative, Partners HealthCare has a liability to the counterparty and, therefore, it does not possess credit risk. Under certain circumstances Partners HealthCare may be required to post collateral for the benefit of the counterparty. Market risk is the adverse effect on the value of a financial instrument that results from a change in interest rates. The market risk associated with interest rate changes is managed by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken.

Partners HealthCare utilizes interest rate swaps to manage fluctuations in cash flows resulting from interest rate risk on certain of its variable rate revenue bonds. These bonds expose Partners HealthCare to variability in interest payments due to changes in interest rates. Management believes that it is prudent to limit the variability of its interest payments. To meet this objective and to take advantage of low interest rates, Partners HealthCare entered into various interest rate swap

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

agreements involving the exchange of fixed rate payments by Partners HealthCare for variable rate payments from several counterparties based on a percentage of LIBOR.

The following is a summary of the outstanding positions under these interest rate swap agreements at September 30, 2013:

Effective Date	Notional Amount	Maturity	Rate Paid	Rate Received	Hedging Status
5/1/03	\$ 150,000	7/1/35	4.40%	67% 1-month LIBOR	Nonhedging
7/1/03	16,800	7/1/15	5.11%	67% 6-month LIBOR	Hedging
7/1/05	150,000	7/1/40	3.63%	67% 1-month LIBOR	Nonhedging
7/1/05	46,200	7/1/25	5.11%	67% 6-month LIBOR	Hedging
7/1/07	150,000	7/1/42	3.46%	67% 1-month LIBOR	Nonhedging
7/1/09	100,000	7/1/44	3.71%	67% 1-month LIBOR	Hedging
7/1/11	100,000	7/1/46	3.74%	67% 1-month LIBOR	Hedging
7/1/13	100,000	7/1/48	3.80%	67% 1-month LIBOR	Nonhedging
7/1/15	100,000	7/1/50	3.80%	67% 1-month LIBOR	Hedging
7/1/17	100,000	7/1/52	3.74%	67% 1-month LIBOR	Hedging

Partners HealthCare designates its interest rate swaps that are used to minimize the variability in cash flows of interest-bearing liabilities or forecasted transactions caused by changes in interest rates as hedging instruments at the inception of each contract, with the intention of maintaining hedge accounting treatment over the term of the agreement. However, circumstances may arise whereby the variability in cash flows exceeds the threshold for hedging qualification or the structure of the bonds or the timing of the forecasted transaction is changed, resulting in de-designation of the hedge. Partners HealthCare de-designated \$550,000 of its interest rate swaps when they ceased to qualify for hedge accounting.

Hedging swaps are designated as cash flow hedges; accordingly, the change in fair value of the effective portion of the hedge is reflected as a change in unrestricted net assets and the ineffective portion of the hedge is reflected as a component of nonoperating gains (expenses) in the consolidated statements of operations. Nonhedging swaps are swaps that have been de-designated as hedges; accordingly, the change in fair value is recorded as a component of nonoperating gains (expenses) in the consolidated statements of operations.

The fair value of interest rate swaps is as follows:

Balance sheet location	September 30,	
	2013	2012
Derivatives designated as hedging instruments		
Interest rate swaps liability	\$ 99,868	\$ 223,788
Derivatives not designated as hedging instruments		
Interest rate swaps liability	132,137	174,552
	<u>\$ 232,005</u>	<u>\$ 398,340</u>

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

The effects of interest rate swaps on the consolidated statements of operations are as follows:

Statement of operations location	Amount of Gain (Loss) Recognized in Changes in Unrestricted Net Assets		Amount of Gain (Loss) Recognized in Excess of Revenues Over Expenses	
	Years Ended September 30,		Years Ended September 30,	
	2013	2012	2013	2012
Derivatives designated as hedging instruments				
Change in fair value of hedging interest rate swaps	\$ 116,995	\$ (12,076)	\$ -	\$ -
Amortization of swaption premiums	-	-	1,386	1,471
Hedge ineffectiveness	-	-	5,539	(2,830)
Derivatives not designated as hedging instruments				
Change in fair value of nonhedging interest rate swaps	-	-	42,415	(9,704)
Reclassification of net asset balance upon hedge de-designation	818	818	(818)	(818)
	<u>\$ 117,813</u>	<u>\$ (11,258)</u>	<u>\$ 48,522</u>	<u>\$ (11,881)</u>

Partners HealthCare's interest rate swaps contracts contain provisions that require collateral to be posted if the fair value of the swaps exceeds certain thresholds. The collateral thresholds reflect the current credit ratings issued by major credit rating agencies on Partners HealthCare's and the counterparty's debt. Declines in Partners HealthCare's or the counterparty's credit ratings would result in lower collateral thresholds and consequently the potential for additional collateral postings by Partners HealthCare or the counterparty. As of September 30, 2013 and 2012, the aggregate fair value of all interest rate swaps was a liability of \$232,005 and \$398,340, respectively, for which Partners HealthCare had posted collateral of \$22,663 and \$133,383, respectively. Partners HealthCare has established procedures to ensure that liquidity and securities are available to meet collateral posting requirements.

Upon the occurrence of certain events of default or termination events identified in the derivative contracts, either Partners HealthCare or the counterparty could terminate the contracts in accordance with their terms. Termination results in the payment of a termination amount by one party that attempts to compensate the other party for its economic losses. If interest rates at the time of termination are lower than those specified in the derivative contract, Partners HealthCare will make a payment to the counterparty. Conversely, if interest rates at such time are higher, the counterparty will make a payment to Partners HealthCare.

Derivatives - Other

Partners HealthCare also enters into options and futures primarily as hedges on securities and indices primarily related to foreign currency. Forward contracts are used as currency hedges. These agreements are limited in use and generally do not exceed one year and are included in separately invested investments.

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

12. Commitments

Leases

Partners HealthCare has capital and noncancelable operating leases for certain buildings and equipment. Minimum future lease commitments under noncancelable leases for the next five years and thereafter are as follows:

	Capital Leases	Operating Leases
2014	\$ 1,826	\$ 183,933
2015	1,184	166,514
2016	438	192,040
2017	437	125,774
2018	437	103,380
Thereafter	73	447,198
Total lease payments	<u>4,395</u>	<u>\$ 1,218,839</u>
Less: Amount representing interest	<u>335</u>	
Capital lease obligations at September 30, 2013	<u>\$ 4,060</u>	

Rental expense under operating leases approximated \$177,554 in 2013 and \$169,317 in 2012.

Construction Projects

BWH is constructing a building (the Brigham Building for the Future or BBF) and a parking garage (the Brigham Patient Parking project or BPP). The BBF will expand research and clinical space on the BWH campus, with a focus on the Neuroscience and Musculoskeletal programs, and increase flexibility for future campus redevelopment while allowing for lease consolidation. The associated land is leased to BWH by the Commonwealth through 2105. Phase 1 of the project, which involved the construction of two smaller facilities to be used by the Commonwealth, was completed in 2012. Phase 2 of the project, which involves the site preparation and construction of BBF, is ongoing. As of September 30, 2013, accumulated costs incurred related to the BBF approximated \$24,864 with approximately \$31,417 in outstanding construction contracts. Phase 2 costs are expected to be approximately \$499,000, with occupancy scheduled for late 2017.

BPP locates a 400 space parking facility under BWH's 15 Francis Street entrance. BPP mitigates a parking shortage on campus and also satisfies commitments to the community and regulators. BPP includes a "greening" landscaped park over the garage as required by the City of Boston. BPP's total project cost is expected to be approximately \$63,500. Construction is underway with accumulated costs of approximately \$30,410 as of September 30, 2013 and outstanding construction contracts of approximately \$25,207, with the garage opening scheduled for Spring 2014.

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

13. Pension and Postretirement Healthcare Benefit Plans

Substantially all employees of Partners HealthCare are covered under various noncontributory defined benefit pension plans and various defined contribution pension plans. In addition, certain affiliates provide subsidized healthcare benefits for retired employees on a self-insured basis, with the benefit obligation being partially funded. These retiree healthcare benefits are administered through an insurance company and are accounted for on the accrual basis, which includes an estimate of future payments for claims incurred.

Total expense for these plans consists of the following:

	Years Ended September 30,	
	2013	2012
Defined benefit plans	\$ 275,096	\$ 172,800
Defined contribution plans	139,973	131,781
Postretirement healthcare benefit plans	9,683	8,875
	<u>\$ 424,752</u>	<u>\$ 313,456</u>

Information regarding benefit obligations, plan assets, funded status, expected cash flows and net periodic benefit cost follows within this footnote.

Benefit Obligations

	Defined Benefit Pension Plans		Postretirement Healthcare Benefit Plans	
Change in benefit obligations	2013	2012	2013	2012
Benefit obligations at beginning of year	\$ 4,441,164	\$ 3,346,936	\$ 140,344	\$ 113,682
Service cost	245,002	190,453	6,293	4,730
Interest cost	191,652	184,042	5,036	5,561
Plan amendments	-	2,278	-	-
Actuarial (gain) loss	(610,840)	796,201	(15,268)	14,733
Benefits paid	(85,811)	(74,249)	(5,025)	(4,816)
Expenses paid	(4,019)	(4,497)	-	-
Employee contributions	52	-	6,949	6,454
Affiliation	83,355	-	-	-
Benefit obligations at end of year	<u>\$ 4,260,555</u>	<u>\$ 4,441,164</u>	<u>\$ 138,329</u>	<u>\$ 140,344</u>

The accumulated benefit obligation for all defined benefit pension plans at the end of 2013 and 2012 was \$4,025,049 and \$4,148,507, respectively.

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

	Defined Benefit Pension Plans		Postretirement Healthcare Benefit Plans	
	2013	2012	2013	2012
Weighted-average assumptions used to determine end of year benefit obligation				
Discount rate	5.05%	4.15%	3.15% - 5.05%	2.65% - 4.15%
Rate of compensation increase				
Professional staff	4.45%	4.45%	N/A	N/A
Other than professional staff	3.00% - 4.00%	3.00% - 3.50%	N/A	N/A
Healthcare cost trend rate for next year	N/A	N/A	6.50%	7.00%
Rate to which the cost trend rate is to decline	N/A	N/A	5.00%	5.00%
Year that rate reaches the ultimate trend rate	N/A	N/A	2017	2017

Assumed healthcare cost trend rates have a significant effect on the amounts reported for the healthcare plans. A one-percentage-point change in assumed healthcare cost trend rates would have the following effect:

	One-Percentage-Point Increase	One-Percentage-Point Decrease
Effect on postretirement benefit obligation	\$ 978	\$ (906)

Plan Assets

	Defined Benefit Pension Plans		Postretirement Healthcare Benefit Plans	
	2013	2012	2013	2012
Change in plan assets				
Fair value of plan assets at beginning of year	\$ 3,114,884	\$ 2,368,991	\$ 45,982	\$ 33,334
Actual return on plan assets	367,705	310,042	5,041	6,194
Employer contributions	474,857	514,597	3,814	4,816
Employee contributions	52	-	6,949	6,454
Benefits paid	(85,811)	(74,249)	(5,025)	(4,816)
Expenses paid	(4,019)	(4,497)	-	-
Affiliation	58,150	-	-	-
Fair value of plan assets at end of year	\$ 3,925,818	\$ 3,114,884	\$ 56,761	\$ 45,982

The assets of the defined benefit pension plans are aggregated in a single master trust (Master Trust) and managed as one asset pool. The investment objective for the Master Trust is to achieve the highest reasonable total return after considering (i) plan liabilities, (ii) funding status and projected cash flows, (iii) projected market returns, valuations and correlations for various asset classes and (iv) Partners HealthCare's ability and willingness to incur market risk.

Oversight of the management of Partners HealthCare's investable assets, including the Master Trust, is provided by the Investment Committee of the PHS Board of Directors. The Committee seeks to add incremental returns by manager selection and asset allocation (increasing/decreasing allocations within allowable ranges based on current and projected valuations). The Committee is supported by a professional staff, an outside investment consultant and a pension actuarial consultant.

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

Partners HealthCare utilizes a policy benchmark allocation that balances projected returns, correlations and volatility of various asset classes within the overall risk tolerance. The allocations are actively managed based on relative valuations among and within asset classes and the perceived ability of managers to outperform passive benchmarks. Exposure by asset class is the sum of the net exposures reported by each manager. Asset performance is monitored monthly and the portfolio is rebalanced if asset classes exceed explicit ranges.

The following table presents the capital allocations, reported exposures of the allocations and policy benchmarks by manager mandate within the Master Trust. Some managers, particularly real assets and less market sensitive managers, invest allocated capital among multiple policy benchmark asset classes.

	September 30, 2013			September 30, 2012		
	Dollars	Reported Exposures	Policy Benchmark	Dollars	Reported Exposures	Policy Benchmark
Global equity	\$ 177,304	4 %	3 %	\$ -	0 %	3 %
Traditional U.S. equity	549,170	14	12	435,240	14	12
Traditional foreign developed equity	500,323	13	12	303,320	10	12
Traditional emerging markets equity	494,358	13	12	346,731	11	12
Private equity	240,657	6	8	219,446	7	8
Real assets	343,265	9	9	321,706	10	9
Less market sensitive managers	1,271,823	32	33	1,005,007	32	33
Fixed income managers	348,918	9	11	483,434	16	11
	<u>\$ 3,925,818</u>	<u>100 %</u>	<u>100 %</u>	<u>\$ 3,114,884</u>	<u>100 %</u>	<u>100 %</u>

Inflation defensive strategies include investments in real estate assets, commodities, timber and inflation protection bonds. Other exposures include currency and volatility based strategies.

Within the Master Trust, assets are allocated to managers with investment mandates that may range from a single sub-asset class to very broad mandates; with restrictions that range from long-only to unconstrained; and with management structures ranging from separately managed funds to mutual/commingled funds to private partnerships. Less market sensitive managers employ absolute return, long/short equity and diversified strategies, which in the aggregate are expected to generate positive returns on a consistent basis. Investment risks (concentration, correlation, valuation, liquidity, leverage, mandate compliance, etc.) are measured at the manager Level as well as the pool level.

The postretirement healthcare benefit plans assets are commingled funds, with the objective of achieving returns to satisfy plan obligations and with a Level of volatility commensurate with Partners HealthCare's overall financial profile.

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

The following table presents plan assets, by form of ownership, as of September 30, 2013 and 2012 measured at fair value on a recurring basis using the fair value hierarchy defined in Note 6:

	Fair Value Measurements Using			Fair Value at September 30, 2013
	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Defined Benefit Pension Plans				
Invested cash equivalents	\$ 59,826	\$ -	\$ -	\$ 59,826
Separately managed investments	452,654	216,796		669,450
Mutual funds	472,768	-		472,768
Commingled funds	-	863,109		863,109
Private partnerships	-	996,926	863,739	1,860,665
	<u>985,248</u>	<u>2,076,831</u>	<u>863,739</u>	<u>3,925,818</u>
Postretirement Healthcare Benefit Plans				
Commingled funds	2,200	49,057	5,504	56,761
Total plan assets	<u>\$ 987,448</u>	<u>\$ 2,125,888</u>	<u>\$ 869,243</u>	<u>\$ 3,982,579</u>

	Fair Value Measurements Using			Fair Value at September 30, 2012
	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Defined Benefit Pension Plans				
Invested cash equivalents	\$ 5,053	\$ -	\$ -	\$ 5,053
Separately managed investments	463,234	173,667	-	636,901
Mutual funds	403,749	-	-	403,749
Commingled funds	-	351,562	-	351,562
Private partnerships	-	963,376	754,243	1,717,619
	<u>872,036</u>	<u>1,488,605</u>	<u>754,243</u>	<u>3,114,884</u>
Postretirement Healthcare Benefit Plans				
Commingled funds	3,748	38,924	3,310	45,982
Total plan assets	<u>\$ 875,784</u>	<u>\$ 1,527,529</u>	<u>\$ 757,553</u>	<u>\$ 3,160,866</u>

In evaluating the Level at which Partners HealthCare's private partnerships have been classified within the fair value hierarchy, management has assessed factors including, but not limited to price transparency, the ability to redeem these investments at net asset value at the measurement date, and the existence or absence of certain restrictions at the measurement date. Investments in private partnerships generally have limited redemption options for investors and, subsequent to final closing, may or may not permit subscriptions by new or existing investors. These entities may also have the ability to impose gates, lockups, and other restrictions on an investor's ability to

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

readily redeem out of their investment interest in the fund. At September 30, 2013 and 2012, certain private partnerships where Partners HealthCare has the ability and the right to redeem interests within the next twelve months have been classified as Level 2 investments in the plan assets fair value table.

During the years ended September 30, 2013 and 2012, the change in the fair value of the plan assets measured using significant unobservable inputs (Level 3) is comprised of the following:

	2013	2012
Balances at beginning of year	\$ 757,553	\$ 618,341
Total gains		
Dividends and interest income	3,787	2,984
Realized gains on investments	60,893	22,577
Realized losses on investments	-	(1,270)
Change in net unrealized appreciation on investments	27,932	28,244
Purchases	53,630	111,867
Sales	(34,552)	(26,043)
Transfers into Level 3	-	853
Balances at end of year	<u>\$ 869,243</u>	<u>\$ 757,553</u>

The net unrealized gain on Level 3 investments held at September 30, 2013 was \$248,430.

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

Funded Status

The funded status of the plans recognized in the balance sheet and the amounts recognized in unrestricted net assets follows:

	Defined Benefit Pension Plans		Postretirement Healthcare Benefit Plans	
	2013	2012	2013	2012
End of year				
Fair value of plan assets at measurement date	\$ 3,925,818	\$ 3,114,884	\$ 56,761	\$ 45,982
Benefit obligations at measurement date	(4,260,555)	(4,441,164)	(138,329)	(140,344)
Funded status	<u>\$ (334,737)</u>	<u>\$ (1,326,280)</u>	<u>\$ (81,568)</u>	<u>\$ (94,362)</u>
Amounts recognized in the balance sheet consist of				
Noncurrent assets	\$ -	\$ -	\$ 1,001	\$ 1,157
Current liabilities	(2,493)	(2,597)	(3,477)	(3,636)
Long-term liabilities	(332,244)	(1,323,683)	(79,092)	(91,883)
	<u>\$ (334,737)</u>	<u>\$ (1,326,280)</u>	<u>\$ (81,568)</u>	<u>\$ (94,362)</u>
Amounts not yet recognized in net periodic benefit cost and included in unrestricted net assets consist of				
Actuarial net loss (gain)	\$ 843,148	\$ 1,636,265	\$ 11,816	\$ 30,525
Prior service cost (credit)	11,007	13,192	(20)	(62)
	<u>\$ 854,155</u>	<u>\$ 1,649,457</u>	<u>\$ 11,796</u>	<u>\$ 30,463</u>
Amounts recognized in unrestricted net assets consist of				
Current year actuarial (gain) loss	\$ (707,747)	\$ 723,124	\$ (16,875)	\$ 11,026
Amortization of actuarial gain (loss)	(107,057)	(33,424)	(1,810)	(1,091)
Current year prior service cost (credit)	-	2,278	-	-
Amortization of prior service (cost) credit	(2,183)	(1,846)	21	21
	<u>\$ (816,987)</u>	<u>\$ 690,132</u>	<u>\$ (18,664)</u>	<u>\$ 9,956</u>

At the end of 2013 and 2012, the projected benefit obligation, accumulated benefit obligation and fair value of plan assets for pension plans with an accumulated benefit obligation in excess of plan assets were as follows:

	2013	2012
Accumulated benefit obligation in excess of plan assets		
Projected benefit obligation	\$ 3,042,196	\$ 4,441,164
Accumulated benefit obligation	2,943,202	4,148,507
Fair value of plan assets	2,791,146	3,114,884

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

Expected Cash Flows

Information about the expected cash flows for the defined benefit and postretirement healthcare benefit plans is as follows:

	Defined Benefit Pension Plans	Postretirement Healthcare Benefit Plans	
Expected employer contributions			
2014	\$ 184,241	\$ 6,235	
			Medicare Subsidy
Expected benefit payments (receipts)			
2014	\$ 178,929	\$ 6,520	\$ (285)
2015	198,388	7,128	(269)
2016	212,908	7,610	(249)
2017	230,138	8,158	(229)
2018	245,372	8,723	(209)
2019–2022	1,465,353	34,281	(756)

Net Periodic Benefit Cost

	Defined Benefit Pension Plans		Postretirement Healthcare Benefit Plans	
	2013	2012	2013	2012
Service cost	\$ 245,002	\$ 190,453	\$ 6,293	\$ 4,730
Interest cost	191,652	184,042	5,036	5,561
Expected return on plan assets	(270,798)	(236,965)	(3,435)	(2,486)
Amortization of				
Prior service cost (credit)	2,183	1,846	(21)	(21)
Actuarial net (gain) loss	107,057	33,424	1,810	1,091
Net periodic benefit cost	<u>\$ 275,096</u>	<u>\$ 172,800</u>	<u>\$ 9,683</u>	<u>\$ 8,875</u>

Amounts expected to be amortized from unrestricted net assets into net periodic benefit cost during the year ending September 30, 2014 are as follows:

	Defined Benefit Pension Plans	Postretirement Healthcare Benefit Plans
Actuarial net loss	\$ 44,182	\$ 118
Prior service cost (credit)	3,937	(20)

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

	Defined Benefit Pension Plans	Postretirement Healthcare Benefit Plans
Actuarial net loss	\$ 44,182	\$ 118
Prior service cost (credit)	3,937	(20)

	Defined Benefit Pension Plans		Postretirement Healthcare Benefit Plans	
	2013	2012	2013	2012
Weighted-average assumptions used to determine net periodic pension and postretirement cost				
Discount rate	3.70 % - 4.15 %	5.30 %	2.65 % - 4.15 %	4.15 % - 5.30 %
Expected return on plan assets	7.75 % - 8.00 %	8.25 %	7.50 %	7.50 %
Rate of compensation increase				
Professional staff	4.45 %	4.45 %	N/A	N/A
Other than professional staff	3.00 % - 4.00 %	3.00 % - 3.50 %	N/A	N/A
Healthcare cost trend rate for this year	N/A	N/A	7.00 %	7.50 %
Rate to which the cost trend rate is to decline	N/A	N/A	5.00 %	5.00 %
Year that rate reaches the ultimate trend rate	N/A	N/A	2017	2017

Partners HealthCare uses a long term return assumption which is validated annually by obtaining long term asset return, volatility and correlation projections for relevant asset class indexes; modifying volatility and correlations to reflect the actual historical experience of the active managers; calculating the expected return using benchmark weights and indexes; and comparing the return assumption to the sum of the expected return and the historical outperformance of the actual return versus the benchmark. Partners HealthCare regularly monitors the active risk of the Master Trust by a statistical regression of the return series of the actual portfolio to that of the policy benchmark.

Assumed healthcare cost trend rates have a significant effect on the amounts reported for the healthcare plans. A one-percentage-point change in assumed healthcare cost trend rates would have the following effect:

	One-Percentage-Point	
	Increase	Decrease
Effect on service and interest cost	\$ 51	\$ (48)

Partners HealthCare System, Inc. and Affiliates

Notes to Consolidated Financial Statements

September 30, 2013 and 2012

(dollars in thousands)

14. Professional Liability Insurance

Partners HealthCare insures substantially all of its professional and general liability risk on a claims-made basis in cooperation with other healthcare organizations in the Greater Boston area through a captive insurance company, Controlled Risk Insurance Company Ltd. (CRICO). PHS owns 10% of CRICO. The investment is accounted for on the cost basis of accounting. The policies cover claims made during their respective terms, but not those occurrences for which claims may be made after expiration of the policy, except for certain tail liabilities which CRICO has assumed on an occurrence basis through December 31, 2013. Management intends to renew its coverage on a claims-made basis and has no reason to believe that it will be prevented from such renewal.

Partners HealthCare follows the accounting policy of establishing reserves to cover the ultimate costs of medical malpractice claims, which include costs associated with litigating or settling claims. The liability also includes an estimated tail liability, established to cover all malpractice claims incurred but not reported to the insurance company as of the end of the year. The total malpractice liability of \$443,688 and \$441,404 at September 30, 2013 and 2012, respectively, is presented as accrued professional liability in the consolidated balance sheets. These reserves have been recorded on a discounted basis using an interest rate of 3.50% and 2.75% at September 30, 2013 and 2012, respectively.

Partners HealthCare also recognizes an insurance receivable from CRICO, at the same time that it recognizes the liability, measured on the same basis as the liability, subject to the need for a valuation allowance for uncollectible amounts. The insurance receivable of \$355,332 and \$351,382 at September 30, 2013 and 2012, respectively, is reported as a component of other assets in the consolidated balance sheets.

Management is not aware of any claims against Partners HealthCare or factors affecting CRICO that would cause the expense for professional liability risks to vary materially from the amount provided.

15. Concentration of Credit Risk

Financial instruments that potentially subject Partners HealthCare to concentration of credit risk consist of patient accounts receivable, research grants receivable, pledges receivable, certain investments and interest rate swaps.

Partners HealthCare receives a significant portion of its payments for services rendered from a limited number of government and commercial third-party payers, including Medicare, Medicaid, Blue Cross and Blue Shield of Massachusetts, Harvard Pilgrim Health Care and Tufts Health Plan. Research funding is provided through many government and private sponsors. Pledges receivable are due from multiple donors. Partners HealthCare assesses the credit risk for pledges based on history and the financial wherewithal of donors, most of which are individuals or organizations well known to Partners HealthCare.

Investments, which include government and agency securities, stocks and corporate bonds, and private partnerships and other investments are not concentrated in any corporation or industry or with any single counterparty. Alternative investments are less liquid than Partners HealthCare's other investments. The reported values of the alternative investments may differ significantly from

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

the values that would have been used had a ready market for those securities existed. These instruments may contain elements of both credit and market risk. Such risks include, but are not limited to, limited liquidity, absence of oversight, dependence upon key individuals, emphasis on speculative investments and nondisclosure of portfolio composition.

Partners HealthCare minimizes the credit risk it is exposed to under interest rate swap agreements by utilizing several counterparties and requiring the counterparties to post collateral for the benefit of Partners HealthCare when the fair value of the swap is positive. Partners HealthCare minimizes its counterparty risk by contracting with six counterparties, none of which accounts for more than 30% of the aggregate notional amount of the swap contracts.

16. Restricted Net Assets

Restricted net assets are available for the following purposes:

	September 30,	
	2013	2012
Temporarily restricted		
Charity care	\$ 99,808	\$ 95,576
Buildings and equipment	97,826	121,584
Clinical care, research and academic	595,135	559,852
	<u>\$ 792,769</u>	<u>\$ 777,012</u>
Permanently restricted		
Charity care	\$ 19,664	\$ 19,326
Buildings and equipment	2,433	2,433
Clinical care, research and academic	390,112	352,471
	<u>\$ 412,209</u>	<u>\$ 374,230</u>

Endowment

Partners HealthCare's endowment consists of over 1,000 individual funds established for a variety of purposes. The endowment includes both donor-restricted endowment funds and funds designated by the boards to function as endowment. As required by generally accepted accounting principles, net assets associated with endowment funds, including funds designated by the boards to function as endowment, are classified and reported as restricted or unrestricted based on the existence or absence of donor-imposed restrictions.

Partners HealthCare has interpreted UPMIFA as requiring the preservation of the value of the original gift of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, Partners HealthCare 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 that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by Partners HealthCare in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

UPMIFA, Partners HealthCare considers several factors in making a determination to appropriate or accumulate donor-restricted endowment funds. These factors include: the duration and preservation of the fund; the purposes of the organization and the donor-restricted endowment fund; general economic conditions; the possible effect of inflation and deflation; the expected total return from income and the appreciation of investments; other resources of the organization; and the investment policies of the organization.

Endowment Funds with Deficits

From time to time, the value of assets associated with individual donor-restricted endowment funds may fall below the value of the initial and subsequent donor gift amounts. When such endowment deficits exist, they are classified as a reduction to unrestricted net assets. Deficits of this nature reported in unrestricted net assets were \$338 and \$1,231 at September 30, 2013 and 2012, respectively. These deficits resulted from unfavorable market fluctuations that occurred after the investment of new permanently restricted contributions or subsequent endowment additions.

The following presents the endowment net asset composition by type of fund as of September 30, 2013 and 2012 and the changes in endowment assets for the years ended September 30, 2013 and 2012:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net asset composition by type of fund as of September 30, 2013				
Donor-restricted endowment funds	\$ (338)	\$ 468,273	\$ 397,472	\$ 865,407
Board-designated endowment funds	903,593	-	-	903,593
Total funds	<u>\$ 903,255</u>	<u>\$ 468,273</u>	<u>\$ 397,472</u>	<u>\$ 1,769,000</u>

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Changes in endowment net assets				
Endowment net assets at September 30, 2012	<u>\$ 853,737</u>	<u>\$ 433,316</u>	<u>\$ 359,985</u>	<u>\$ 1,647,038</u>
Investment return				
Investment income	4,067	4,799	2	8,868
Net realized and unrealized appreciation (depreciation)	<u>83,141</u>	<u>66,920</u>	<u>280</u>	<u>150,341</u>
Total investment return	87,208	71,719	282	159,209
Contributions	3,963	(202)	35,008	38,769
Appropriation of endowment assets for expenditure	(37,535)	(38,291)	-	(75,826)
Other changes	<u>(4,118)</u>	<u>1,731</u>	<u>2,197</u>	<u>(190)</u>
Total changes	<u>49,518</u>	<u>34,957</u>	<u>37,487</u>	<u>121,962</u>
Endowment net assets at September 30, 2013	<u>\$ 903,255</u>	<u>\$ 468,273</u>	<u>\$ 397,472</u>	<u>\$ 1,769,000</u>
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net asset composition by type of fund as of September 30, 2012				
Donor-restricted endowment funds	\$ (1,231)	\$ 433,316	\$ 359,985	\$ 792,070
Board-designated endowment funds	<u>854,968</u>	<u>-</u>	<u>-</u>	<u>854,968</u>
Total funds	<u>\$ 853,737</u>	<u>\$ 433,316</u>	<u>\$ 359,985</u>	<u>\$ 1,647,038</u>

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Changes in endowment net assets				
Endowment net assets at October 1, 2011	\$ 794,151	\$ 404,753	\$ 323,736	\$ 1,522,640
Investment return				
Investment income	3,808	3,868	56	7,732
Net realized and unrealized appreciation (depreciation)	85,996	62,513	561	149,070
Total investment return	89,804	66,381	617	156,802
Contributions	11,295	135	34,387	45,817
Appropriation of endowment assets for expenditure	(37,005)	(37,319)	-	(74,324)
Other changes	(4,508)	(634)	1,245	(3,897)
Total changes	59,586	28,563	36,249	124,398
Endowment net assets at September 30, 2012	\$ 853,737	\$ 433,316	\$ 359,985	\$ 1,647,038

Conditional Pledge

During 2009, the General signed an agreement (Ragon Agreement) with The Massachusetts Institute of Technology (MIT), The President and Fellows of Harvard College (Harvard) and The Phillip T. and Susan M. Ragon Foundation (Ragon Foundation) to establish the Phillip T. and Susan M. Ragon Institute (Ragon Institute) as a joint research center of the General, MIT and Harvard with the purpose of harnessing the potential of the immune response to combat and conquer human diseases, integrating biomedical research with emerging engineering technologies (with the main initial focus being the development of an AIDS vaccine) and educating and training scientists. The Ragon Foundation committed to provide funding for the Ragon Institute of \$100,000 over ten years through the General (as the administrative home for the Ragon Institute), beginning retroactively on January 1, 2008. The Ragon Foundation has the ability to slow, suspend or eliminate funding based on restrictions described in the Ragon Agreement. Additionally, any funding not paid by December 31, 2017 will no longer be due by the Ragon Foundation. Due to the conditions within the Ragon Agreement, funding is recognized when received, with no pledge receivable recorded for the balance of the commitment.

Through September 30, 2013, total funding of \$64,000 was received, with \$10,000 received for the year ended September 30, 2013, and total net expenses of \$48,662 were incurred, including \$10,331 for the year ended September 30, 2013. As of September 30, 2013, unspent funding of \$15,338 has been recorded as temporarily restricted net assets, to be released to unrestricted net assets after qualifying expenses have been incurred.

Partners HealthCare System, Inc. and Affiliates
Notes to Consolidated Financial Statements
September 30, 2013 and 2012

(dollars in thousands)

17. Functional Expenses

Total operating expenses by function are as follows:

	Years Ended September 30,	
	2013	2012
Healthcare services	\$ 6,577,800	\$ 6,449,354
Research and academic	1,594,449	1,538,597
Medical claims and related expenses	1,061,630	-
General and administrative	954,521	802,477
	<u>\$ 10,188,400</u>	<u>\$ 8,790,428</u>

18. Contingencies

Partners HealthCare is subject to complaints, claims and litigation which have risen in the normal course of business. In addition, Partners HealthCare is subject to reviews and investigations by various federal and state government agencies to assure compliance with applicable laws, some of which are subject to different interpretations. Governmental review of compliance by healthcare institutions, including Partners HealthCare, has increased.

19. Subsequent Events

Partners HealthCare has assessed the impact of subsequent events through December 13, 2013, the date the audited financial statements were issued. During this period, there were no subsequent events that require adjustment to the audited financial statements.