

March 13, 2014

Dear Investor:

Enclosed are Inova Health System's 2013 Audited Consolidated Financial Statements and Other Supplementary Information Relating to the IHS Obligated Group. Management discussion and analysis is also enclosed for the years ended December 31, 2013 and 2012.

We appreciate your interest in Inova Health System. If we can provide any other information, please let me know.

Sincerely,

Paula Sherman  
Director, Financial Reporting  
(703) 289-2455  
[Paula.sherman@inova.org](mailto:Paula.sherman@inova.org)

Attachments

**Inova Health System**  
**Management's Discussion and Analysis of Results of Operations and Financial Position**  
**As of and for the Year Ended December 31, 2013**

**Introduction**

Inova Health System ("IHS") is a not-for-profit health care system serving Northern Virginia, Washington, D.C. and parts of Maryland, and offers a comprehensive array of services at multiple access points. IHS includes five hospitals with over 1,700 acute care beds to provide inpatient services, and provides other outpatient health services including emergency and urgent care, senior services, home care, mental health and blood donor services. Services range from health promotion and disease prevention to the most advanced treatment services, with specialty distinction in a number of areas, including cardiology, neuroscience, orthopedics, women's and children's services and cancer care. IHS' mission is to provide quality care and improve the health of the diverse communities it serves. Since December 2012, IHS has owned and operated *INTotal Health*, a Medicaid health plan licensed in Virginia with approximately 55,000 members. The health plan, formerly known as Amerigroup Virginia, was renamed effective July 1, 2013.

The following discussion and analysis provides information that IHS management believes is relevant to an assessment and understanding of IHS' results of operations and financial position. This analysis should be read in conjunction with IHS' financial statements for the years ended December 31, 2013 and 2012. The discussion and analysis focuses on IHS as a whole, which management believes provides a fair description and analysis, in all material respects, of the Obligated Group's results of operations and financial condition, insofar as the Obligated Group accounted for approximately 87.8% of total operating revenues and 98.9% of unrestricted net assets of IHS as of and for the year ended December 31, 2013.

**Results of Operations as of and for the Years ended December 31, 2013 and 2012**

***Operating Revenues.*** Total operating revenues for IHS for the year ended December 31, 2013 were \$2.5 billion, up 7.5% over the comparable period in 2012. That increase was mainly attributable to premium revenue in the amount of \$178.4 million from the operations of *INTotal Health*, a Medicaid health plan acquired in December 2012. Net patient service revenue of \$2.3 billion decreased 0.3% over the comparable period in 2012 primarily due to lower delivery and surgical volumes, and a \$25.5 million increase in the provision for bad debts. A considerable portion of the increase in bad debts was attributable to the installation of new clinical and patient accounting software (discussed in the next section). Other operating revenue includes approximately \$13.3 million in Medicare EHR incentive payments in 2013.

***Operating Expenses.*** Total operating expenses for the year ended December 31, 2013 were \$2.4 billion, an increase of 11.7%, over the comparable period in 2012. Most of this increase is related to medical claims and administrative costs associated with the Medicaid health plan mentioned above. The remaining increase is primarily attributable to the implementation of new IT applications.

IHS has undertaken several major projects to enhance its information technology capabilities, including the implementation of electronic health record technology and revenue cycle systems provided by Epic Systems Corporation (the “Epic Applications”). The implementation was completed in approximately eight months. Significant costs associated with the design and implementation of the Epic Applications have been capitalized; however, other costs, such as end-user training and backfill salaries and post-implementation costs have been and will continue to be expensed as incurred. For the year ended December 31, 2013, IHS incurred \$95.0 million of operating expenses related to the implementation of the Epic Applications compared to \$49.4 million in expenses for the comparable period in 2012. As of December 31, 2013, all five of IHS acute care hospitals have gone live on the Epic Applications (clinical and revenue cycle) as well as physician practices and most of its ambulatory sites.

Depreciation and amortization expense increased 21.2% primarily due to amortization of Epic Applications and additional depreciation related to the completion of Fairfax Hospital’s new South Patient Tower, which opened in January 2013.

***Operating Income.*** Operating income for IHS was \$131.8 million or 5.2% of total operating revenues for the year ended December 31, 2013, as compared to \$205.7 million, or 8.7% of total operating revenues, for the comparable period in 2012. Operating income in 2013 and 2012 included \$7.3 million and \$7.2 million, respectively, of losses attributable to debt refinancing and interest rate swap restructuring. The operating cash flow margin of IHS was 13.0% for 2013, as compared to 16.1% for the comparable period in 2012.

**Investment Performance and Other Non-Operating Activity.** The following table shows gains on investments redesignated as trading and the components of investment income and other, net from IHS' consolidated statements of operations for the years ended December 31, 2013 and 2012 along with unrealized gains on investments and interest rate swaps (dollars in thousands).

<b>Description</b>	<b>2013</b>	<b>2012</b>
Interest and other income, net	\$ 50,512	\$ 53,606
Gains in fair market value of interest rate swaps	10,416	11,904
Realized gains	176,371	115,466
Other than temporary declines in fair market value of Investments	(17,191)	(20,658)
Other	(9,533)	(3,109)
<i>Investment income and other, net</i>	<u>\$ 210,575</u>	<u>\$ 157,209</u>
Net gains on investments redesignated as trading	\$ 320,136	\$ -
Unrealized (losses)/gains on investments, net	\$ 122,692	\$ 137,292
Reclassification of unrealized gains on investments redesignated as trading	(320,136)	-
Change in fair value of effective hedging interest rate swaps	<u>25,776</u>	<u>(991)</u>
Total investment and swap related activity	\$ 359,043	\$ 293,510

On December 31, 2013, IHS changed the classification of certain investments from available for sale to trading. Accordingly, cumulative unrealized gains of \$320.1 million were reclassified from below excess of revenues over expenses to the non-operating revenue section within the consolidated statements of operations and changes in net assets.

### **Financial Position as of December 31, 2013**

**Current Assets and Liquidity.** IHS' unrestricted cash and investments at December 31, 2013 were \$3.7 billion, of which \$1.2 billion represented investments that could not be liquidated within 3 days. In addition to its unrestricted cash position at December 31, 2013, IHS had \$242.9 million of Series 2012A, B, and C bond proceeds available to fund current and future construction projects.

**Investments.** The following table summarizes the asset allocation for the Strategic Fund and the Capital Fund, which together comprised the Plant Replacement and Expansion Fund and the Construction Projects Fund as of December 31, 2013 (dollars in thousands):

<b>Asset Class</b>	<b>Amount</b>	<b>%</b>
<b><u>Strategic Fund</u></b>		
Cash and cash equivalent	\$69,008	2.0%
Global bonds	249,658	7.3
Core bonds	398,234	11.7
Domestic equity	233,526	6.9
Global equity	805,186	23.7
Hedge fund / fund of funds	557,671	16.4
Opportunistic	202,600	6.0
Inflation sensitive	569,830	16.7
	<u>3,085,713</u>	<u>90.7</u>
<b><u>Capital Fund</u></b>	<u>317,784</u>	<u>9.3</u>
<b><u>Total</u></b>	<u><u>\$3,403,497</u></u>	<u><u>100.0%</u></u>

The global bonds and core bonds are fixed income instruments and are typically investment quality with maturities ranging from one year to 30 years. Equity investments can be domestic or global, and are typically exchange traded stocks. The Opportunistic asset class is primarily private debt, while Inflation sensitive assets include REITs, private real estate, and tactical positions in commodities and other assets.

IHS maintains a special portfolio comprised of limited maturity, high quality bonds (Capital Fund). This fund was established to ensure that IHS would have sufficient liquidity to complete critical construction projects in the event of a major financial market disruption.

**Property, Plant and Equipment.** Capital expenditures were \$365.0 million for the year ended December 31, 2013, including \$143.5 million related to the Inova Fairfax Hospital 2015 project (as described below), \$51.4 million related to the Epic Applications project, \$80.9 million related to major projects for other facilities, and \$62.2 million related to acute care equipment replacement and minor renovations.

At the end of 2013, IHS had expended approximately 50% of its \$1.1 billion of board approved hospital related construction projects funds. The largest capital project is currently underway and involves a new patient tower; new women's and pediatric hospital; extensive renovation to the hospital's main patient tower; and extensive infrastructure and site work on the Inova Fairfax Hospital campus (the "IFH 2015 Project"). Original plans for the IFH 2015 Project call for an investment of approximately \$850.0 million through 2016, of which \$342.7 million has been spent as of December 31, 2013. Because of the favorable construction market for buyers, the IFH 2015 Project is anticipated to be completed for \$810.0 million. As of December

31, 2013, IHS had proceeds of \$242.9 million from the 2012A, B, and C financing available to pay costs of these and other projects.

All planned capital expenditures are regularly evaluated based upon business need, economic conditions and IHS' financial position. IHS management currently anticipates that capital expenditures will be financed with a combination of operating cash flow, existing cash reserves, donations and tax-exempt borrowing. The actual undertaking of any construction project or equipment purchase program contemplated by IHS is dependent upon a number of factors, including receipt of appropriate Certificates of Public Need from the Virginia Department of Health and subject to changes in the methods and requirements pertaining to the delivery of necessary health care services.

***Debt Structure and Liability Management.*** At December 31, 2013, total long-term debt outstanding was \$1.4 billion, or 25.6% of capitalization.

In December 2013, the IHS Obligated Group refunded a portion of its variable rate demand obligations under Series 1988ABCD, 2000, 2005A and 2005C with mandatory redemptions in years 2018-2023 totaling \$79.5 million. These bonds were refunded to fixed rate serial bonds and directly purchased by TD Bank, N.A.

IHS maintains a taxable commercial paper ("CP") program under which it is authorized to borrow and have outstanding from time to time up to \$100 million of short term debt having maturity dates from one to 270 days. IHS maintains a self-liquidity program to fund the purchase of any CP that is not remarketed. As of December 31, 2013, the amount of CP outstanding was \$100 million, which is included in notes payable and other liabilities in the current liabilities section of the balance sheet.

IHS also maintains unsecured lines of credit with two large commercial banks in a combined available principal amount of \$87.5 million. There were no amounts outstanding on these credit lines as of December 31, 2013.

In 2013, IHS terminated \$132.0 million notional amount of fixed payer swaps with three different counterparties. As of December 31, 2013, IHS had \$100.0 million notional amount of fixed payer swaps with a fair value of \$(22.8) million.

In October 2013, IHS extended its standby bond purchase agreement with JPMorgan Chase Bank, N.A. for the Series 2005C-1 bonds through October 21, 2016.

***Pension Settlement.*** As part of an overall pension de-risking strategy, IHS offered a lump sum buyout to all retirees receiving annuities of less than \$500 per month. IHS then purchased insurance annuities for those beneficiaries electing to continue receiving monthly payments. As a result of these transactions, IHS recognized a non-recurring settlement loss of \$3.4 million. The transactions triggered an updated actuarial valuation of plan assets and Projected Benefit Obligation, which resulted in an increase in the plan's funded status of \$15.7 million, with a prepaid pension asset balance of \$54.5 million as of December 31, 2013.

***Investments in Joint Venture.*** In June 2012, IHS entered into an agreement with Aetna to establish Innovation Health plans ("IHealth"), a jointly owned (50/50) licensed health plan

serving Northern Virginia. IHealth commenced operations in July 2013. IHealth provides employers and consumers access to more affordable, coordinated and integrated health care in the region. IHS has made capital contributions to this venture totaling \$28.5 million to date.

In March 2013, IHS entered into an agreement with Children’s National Medical Center to establish Pediatric Specialists of Virginia (“PSV”), a multi-specialty pediatric physician organization in Northern Virginia. PSV will make pediatric specialty care more convenient for children and families in the area. The following specialties are provided by PSV: Gastroenterology, Nephrology, Genetics, Hematology/Oncology and Orthopedics. PSV commenced operations on September 30, 2013. IHS made initial in-kind and cash contributions totaling \$5.1 million.

**Commitments.** In July 2013, IHS and Valley Health System, a not-for-profit health system based in Winchester, Virginia (“Valley”), announced a collaborative alliance to work together to improve the continuity of care to the patients they serve through closer operational, technological and clinical integration, particularly in the areas of clinical research, information technology, population health and selected clinical services. In order to facilitate the objectives of this strategic relationship, IHS is extending its Epic Applications to Valley and assisting Valley with the implementation of these systems. It is the intent of the parties that Valley reimburse IHS for any costs incurred in extending its Epic Application to Valley in this manner.

Under the agreement with Children’s National Medical Center to establish PSV, IHS anticipates additional capital contributions to this joint venture totaling approximately \$10.0 million to be contributed over a five year period.

## Other Financial Information

The following are selected financial indicators for IHS as of and for the years ended December 31, 2013 and 2012:

<b>Financial Indicator</b>	<b>2013</b>	<b>2012</b>
Operating Margin <sup>1</sup>	5.2%	8.7%
Operating Cash Flow Margin <sup>2</sup>	13.0%	16.1%
Net Days in Accounts Receivable <sup>3</sup>	40.2	45.2
Days in Unrestricted Cash <sup>4</sup>	598.6	596.8
Unrestricted Cash to Debt <sup>5</sup>	2.5x	2.3x
Debt Service Coverage <sup>6</sup>	8.1x	8.9x

1 Operating income divided by Operating Revenue

2 (Operating income plus interest expense, depreciation and amortization expense) divided by Operating Revenue

3 Net Patient Receivables divided by Three-Month Average Daily Net Patient Revenue

4 (Cash and Short-Term investments plus Unrestricted cash reserves and Unrestricted LT Investments) divided by (Operating Expenses less depreciation, amortization expense and loss on extinguishment of debt and termination of swaps)

5 (Cash and Short-Term investments plus Unrestricted cash reserves plus Unrestricted LT Investments) divided by (Debt-current portion plus Debt-long-term portion)

6 Income Available for Debt Service (annualized) divided by Long-Term Debt Service Requirement



INOVA HEALTH SYSTEM



**Audited Consolidated  
Financial Statements and  
Other Supplementary Information  
Relating to the IHS Obligated Group**

**Fiscal Year Ended  
December 31, 2013**

**Inova Health System**  
**Audited Consolidated Financial Statements**  
**and Other Supplementary Information**  
**Relating to the IHS Obligated Group**  
**December 31, 2013 and 2012**

Audited Consolidated Financial Statements

Report of Independent Auditors.....	1
Consolidated Balance Sheets.....	2
Consolidated Statements of Operations and Changes in Net Assets.....	3
Consolidated Statements of Cash Flows.....	4
Notes to Consolidated Financial Statements.....	5-32

Other Supplementary Information

Report of Independent Auditors on Other Supplementary Information.....	33
Consolidated Balance Sheets.....	34
Consolidated Statements of Operations.....	35
Consolidated Statement of Cash Flows.....	36

## Report of Independent Auditors

The Board of Trustees  
Inova Health System

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

### Management's Responsibility for the Financial Statements

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

### Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the 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 financial statements referred to above present fairly, in all material respects, the consolidated financial position of Inova Health System at December 31, 2013 and 2012, and the consolidated results of its operations and changes in net assets, and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

*Ernst & Young LLP*

March 13, 2014

**Inova Health System**  
**Consolidated Balance Sheets**  
**December 31, 2013 and 2012**  
(In thousands)

	<u>2013</u>	<u>2012</u>
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 252,679	\$ 216,672
Assets whose use is limited		
By board for plant replacement and expansion	228,870	250,010
Patient accounts receivable (less allowance for doubtful accounts: 2013 - \$102,090 ; 2012 - \$77,160)	250,250	273,386
Third-party settlements	1,946	3,646
Other current assets	92,306	89,469
<b>Total Current Assets</b>	<u>826,051</u>	<u>833,183</u>
<b>Property, Equipment and Leasehold Interests, net (Note 5)</b>	1,498,627	1,305,524
<b>Assets Whose Use Is Limited (Notes 6, 7, 14)</b>		
Held by bond trustee	251,602	408,546
By board for plant replacement and expansion	3,085,713	2,566,686
By board for construction projects	317,784	490,043
By donor	87,813	80,435
For professional liability	84,078	74,321
For health plan liability	12,037	11,994
	<u>3,839,027</u>	<u>3,632,025</u>
Less amounts required to meet current obligations	(228,870)	(250,010)
<b>Total Assets Whose Use Is Limited</b>	<u>3,610,157</u>	<u>3,382,015</u>
<b>Other Assets</b>		
Investments in and receivables from affiliates (Note 8)	37,493	10,368
Prepaid pension asset (Note 13)	54,534	22,688
Goodwill and other intangible assets (Note 10)	72,844	73,268
Other long-term assets	24,731	22,860
<b>Total Other Assets</b>	<u>189,602</u>	<u>129,184</u>
<b>TOTAL ASSETS</b>	<u><u>\$ 6,124,437</u></u>	<u><u>\$ 5,649,906</u></u>
<b>LIABILITIES AND NET ASSETS</b>		
<b>Current Liabilities</b>		
Accounts payable and accrued expenses	\$ 194,731	\$ 190,998
Accrued salaries, wages and benefits	105,951	120,291
Third-party settlements	52,528	53,711
Notes payable and other liabilities	142,924	120,711
Current portion of long-term debt (Note 11)	258,359	279,056
<b>Total Current Liabilities</b>	<u>754,493</u>	<u>764,767</u>
<b>Non-current Liabilities</b>		
Long-term debt, less current portion (Note 11)	1,127,972	1,140,331
Post employment health care benefits	-	-
Interest rate swap liability (Note 12)	22,841	62,390
Estimated professional and other insurance liabilities (Note 14)	32,775	35,597
Other non-current obligations	55,232	53,961
<b>Total Non-current Liabilities</b>	<u>1,238,820</u>	<u>1,292,279</u>
<b>Net Assets</b>		
Unrestricted	4,019,846	3,501,970
Temporarily restricted	72,029	55,666
Permanently restricted	39,249	35,224
<b>Total Net Assets</b>	<u>4,131,124</u>	<u>3,592,860</u>
<b>TOTAL LIABILITIES AND NET ASSETS</b>	<u><u>\$ 6,124,437</u></u>	<u><u>\$ 5,649,906</u></u>

See notes to consolidated financial statements.

**Inova Health System**  
**Consolidated Statements of Operations and Changes in Net Assets**  
**For the Years Ended December 31, 2013 and 2012**  
(In thousands)

	<u>2013</u>	<u>2012</u>
<b>Operating Revenues</b>		
Net patient service revenue	\$ 2,385,675	\$ 2,366,520
Provision for bad debts	(118,518)	(93,059)
Net Patient Service Revenue less Provision for Bad Debts	<u>2,267,157</u>	<u>2,273,461</u>
Premium revenue	181,489	13,992
Other operating revenue	90,773	74,064
Total Operating Revenues	<u>2,539,419</u>	<u>2,361,517</u>
<b>Operating Expenses</b>		
Salaries and benefits	1,140,158	1,141,195
Other operating expenses	923,749	822,749
Medical claims	138,212	10,975
Depreciation and amortization	170,931	141,030
Interest	27,293	32,659
Loss on extinguishment of debt and swap termination	7,319	7,216
Total Operating Expenses	<u>2,407,662</u>	<u>2,155,824</u>
<b>Operating Income</b>	<b>131,757</b>	<b>205,693</b>
<b>Non-Operating Revenues (Expenses)</b>		
Investment income and other, net (including other-than-temporary impairment losses: 2013 - \$17,191 ; 2012 - \$20,658)	210,575	157,209
Net gains on investments redesignated as trading	320,136	-
Excess of Revenues Over Expenses	<u>662,468</u>	<u>362,902</u>
Unrealized gains on investments, net	122,692	137,292
Reclassification of unrealized gains on investments redesignated as trading	(320,136)	-
Change in fair value of effective hedging interest rate swaps	25,776	(991)
Net assets released from restriction for purchase of equipment and land rights	17	681
Change in plan assets and benefit obligations of pension	25,567	9,442
Other	1,492	(3,771)
Increase in Unrestricted Net Assets	<u>517,876</u>	<u>505,555</u>
<b>Temporarily Restricted Net Assets</b>		
Gifts and bequests	23,192	12,804
Restricted investment income	961	780
Unrealized gain on investments, net	88	71
Net assets released from restriction	(7,116)	(7,076)
Other	(762)	386
Increase in Temporarily Restricted Net Assets	<u>16,363</u>	<u>6,965</u>
<b>Permanently Restricted Net Assets</b>		
Gifts and bequests	120	66
Restricted investment income (loss)	2,080	(272)
Unrealized gain on investments, net	1,169	2,961
Other	656	(107)
Increase in Permanently Restricted Net Assets	<u>4,025</u>	<u>2,648</u>
Increase in Net Assets	538,264	515,168
Net Assets, Beginning of Year	<u>3,592,860</u>	<u>3,077,692</u>
<b>NET ASSETS, END OF YEAR</b>	<b><u>\$ 4,131,124</u></b>	<b><u>\$ 3,592,860</u></b>

See notes to consolidated financial statements.

**Inova Health System**  
**Consolidated Statements of Cash Flows**  
**For the Years Ended December 31, 2013 and 2012**  
(In thousands)

	<b>2013</b>	<b>2012</b>
<b>Operating Activities</b>		
Change in net assets	\$ 538,264	\$ 515,168
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Depreciation and amortization	170,931	141,030
Change in plan assets and benefit obligations of pension	(25,567)	(9,442)
Net realized and unrealized (losses) gains on investments	16,466	(256,496)
Net gains on investments redesignated as trading	(320,136)	-
Other-than-temporary declines in fair market value of investments	17,191	20,658
Change in fair value of interest rate swaps	(24,655)	(1,968)
Equity investment losses (earnings)	3,994	(3,835)
Decrease in accounts receivable and third-party settlements, net	24,836	13,158
Increase in accounts payable and other current liabilities	24,760	16,920
(Decrease) increase in accrued salaries, wages and benefits	(14,281)	10,503
Increase in pension asset	(6,279)	(22,688)
(Decrease) increase in post employment health care benefits	(1,607)	9,009
(Decrease) increase in estimated professional liability and other deferred liability items	(2,743)	8,149
Restricted contributions received	(23,312)	(12,870)
Restricted interest and dividend income	(3,041)	(508)
Other	(5,054)	(14,827)
<b>Net Cash Provided by Operating Activities</b>	<b>369,767</b>	<b>411,961</b>
<b>Investing Activities</b>		
Capital expenditures	(365,037)	(287,923)
Investments in and advances to joint ventures and affiliates	(31,122)	3,099
Acquisition of INTotal Health, LLC	-	(82,087)
Purchases of marketable securities	(2,101,457)	(3,088,098)
Proceeds from sale of marketable securities	2,180,934	2,591,884
Other	4,736	341
<b>Net Cash Used in Investing Activities</b>	<b>(311,946)</b>	<b>(862,784)</b>
<b>Financing Activities</b>		
Restricted contributions received	23,312	12,870
Restricted interest and dividend income	3,041	508
Principal payments on long-term debt	(30,340)	(25,647)
Proceeds from issuance of long-term debt	79,530	609,542
Refunding of long-term debt	(79,530)	(170,040)
Swap termination and modification payments	(14,894)	(8,945)
Other	(2,933)	(4,339)
<b>Net Cash (Used in) Provided by Financing Activities</b>	<b>(21,814)</b>	<b>413,949</b>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>36,007</b>	<b>(36,874)</b>
Cash and cash equivalents at beginning of year	216,672	253,546
<b>CASH AND CASH EQUIVALENTS AT END OF YEAR</b>	<b>\$ 252,679</b>	<b>\$ 216,672</b>

See notes to consolidated financial statements.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

## **1. Nature of Operations**

**Organization:** Inova Health System (“IHS”) is an integrated, not-for-profit health care delivery system that owns, operates and manages clinical, educational, research and hospital facilities located in Northern Virginia, serving Northern Virginia, the Washington, D.C. metropolitan area and contiguous counties in Virginia and Maryland. The principal line of business for IHS is the delivery of acute care hospital services at five hospitals located in Northern Virginia. IHS also operates an integrated network of health services including ambulatory care, home health care, senior services, assisted living and other health related services. IHS formed a Population Health division in 2013 that operates INTotal Health, a Medicaid health maintenance organization (“HMO”), a Program of All-Inclusive Care for the Elderly and other related businesses.

## **2. Summary of Significant Accounting Policies**

**Basis of Presentation:** The financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”). The preparation of financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

**Principles of Consolidation:** The IHS consolidated financial statements include the accounts of the Inova Health System Foundation (the “Foundation”); Inova Health Care Services (“IHCS”); Loudoun Hospital Center (“LHC”); Inova Holdings, Inc. (“IHI”); and their majority-owned subsidiaries and controlled affiliates. All material intercompany accounts and transactions have been eliminated in consolidation.

The Foundation is a tax-exempt, non-stock corporation, which controls its affiliated corporations through its authority to appoint the governing boards of the tax-exempt, non-stock affiliates or its stock ownership. The Foundation also supports and maintains the programs, services, and facilities of IHS’ health care delivery system in part through the solicitation, receipt, administration, and distribution of philanthropic gifts on behalf of its tax-exempt affiliates. INTotal Health, LLC (“INTotal”), a wholly-owned subsidiary of the Foundation, is a Medicaid HMO licensed and authorized to do business in Virginia.

IHCS is a tax-exempt, non-stock corporation that serves the health care needs of the community by establishing, maintaining and operating hospital and health care facilities, programs, and other shared and integrated health care delivery arrangements. IHCS operates the following facilities, among others: Inova Fairfax Hospital (“Fairfax”); Inova Mount Vernon Hospital (“Mount Vernon”), Inova Fair Oaks Hospital (“Fair Oaks”) and Inova Alexandria Hospital (“Alexandria”). IHCS also provides and manages the clinical, non-hospital facilities and programs whose services include senior services, assisted living facilities, addiction treatment services for adults and adolescents, outpatient rehabilitation services, urgent care and other outpatient health care services.

LHC is a tax-exempt, non-stock corporation that serves the health care needs of Loudoun County, Virginia, and surrounding areas. In addition to Inova Loudoun Hospital (“Loudoun”), LHC operates Loudoun Nursing and Rehabilitation Center, Loudoun Healthcare Foundation and other health care and related facilities.

IHI is a wholly owned subsidiary of the Foundation and is the parent holding company for various taxable entities within IHS including Technical Dynamics Inc., a biomedical equipment maintenance and engineering company. IHI and its subsidiaries operate facilities providing a variety of health care and support services to patients and to affiliated health care providers.

Effective January 1, 2013, following a legal reorganization, the IHS consolidated statements are comprised of the Foundation, IHCS, and LHC. Alexandria Health Services Corporation (“AHSC”) and Inova Health System Services (“IHSS”) were merged into IHCS and no longer exist as separate legal entities. In addition, IHCS became the owner of IHSS’ interest in McLean Assisted Living and the other affiliates of IHSS became operating divisions with IHCS. The reorganization did not have a material impact on the consolidated financial position or results of operations for IHS.

**Cash and Cash Equivalents:** Cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less. Cash equivalents are valued at cost, which approximates fair value.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**2. Summary of Significant Accounting Policies (continued)**

**Patient Accounts Receivable:** Patient accounts receivable include charges for amounts due from all patients less allowances for the excess of established charges over the payments to be received on behalf of patients covered by Medicare, Medicaid and other insurers. IHS has a self-insured discount policy whereby uninsured patients receive a discount for services rendered. The discount percentage is based on amounts generally billed for commercially insured patients for the same services. Discounts to uninsured patients are classified as a deduction from revenue. The provision for bad debts is recognized when providing an allowance for uncollectible accounts.

All operating entities of IHS treat emergency patients regardless of their ability to pay. Non-emergency medically necessary care is provided virtually without restriction at all IHS tax-exempt operating entities. A patient is classified as a charity patient based upon established IHS policies that consider patient income levels and available assets. Since IHS does not pursue collection of amounts that qualify as charity care, they are deducted from gross revenue. The provision for bad debts includes unpaid accounts of patients who fail to provide required income and asset documentation to IHS. Guidelines used by IHS in determining charity care may differ from guidelines used by certain state or federal agencies.

**Assets Whose Use Is Limited:** Assets whose use is limited include board-designated funds for the acquisition of property and equipment, funds restricted by donors for charitable purposes, funds to cover self-insurance and medical claim liabilities, and trustee-held assets for the retirement of long-term liabilities and the funding of certain capital projects.

**Investments and Investment Income:** Investments in equity securities with readily determinable fair values and all investments in debt securities held by Northern Trust, IHS' custodian, are designated as trading securities effective December 31, 2013. Investment income (including realized gains and losses on investments, unrealized gains and losses on trading securities, interest, and dividends) is included in excess of revenues over expenses unless such earnings are subject to donor-imposed restrictions. Investment income restricted by donor stipulations is reported as an increase in temporarily restricted net assets. Unrealized gains and losses on investments classified as other-than-trading are reported as a change in unrestricted net assets and, in accordance with relevant accounting literature, are excluded from excess of revenues over expenses.

On December 31, 2013, IHS changed the classification of certain investments from available for sale to trading. Accordingly, cumulative unrealized gains of \$320.1 million were reclassified from changes in unrestricted net assets to the non-operating revenue section within the consolidated statements of operations and changes in net assets. The redesignation to trading had no impact on the total change in net assets or total assets at December 31, 2013.

**Fair Value Measurements:** IHS evaluates assets and liabilities subject to fair value measurements on a recurring basis to determine the appropriate level in which to classify them for each reporting period. See Note 7.

**Property, Equipment and Leasehold Interests:** Property and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable assets, and is computed using the straight-line method. The general range of useful lives is three to twenty-five years for land improvements, ten to forty years for buildings, fixed equipment, and leasehold improvements, and three to twenty years for major movable equipment. Software and other IT equipment are included in major movable equipment with useful lives of three to five years. Equipment under capital lease obligations is amortized using the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the consolidated statements of operations and changes in net assets. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. Repairs and maintenance are expensed as incurred.

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

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**2. Summary of Significant Accounting Policies (continued)**

**Interest Rate Swap Agreements:** IHS has entered into interest rate swap agreements to manage the net exposure to interest rate changes related to its borrowings and to manage its overall borrowing costs. For designated cash flow hedges, the change in its fair value is recorded as a change in other unrestricted net assets. For interest rate swaps not designated or qualifying as hedges, changes in fair value are recorded in investment income and other, net. See Note 12.

**Temporarily and Permanently Restricted Net Assets:** Temporarily restricted net assets are those whose use by IHS has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by IHS in perpetuity.

**Donor-restricted Gifts:** Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. Contributions received are reported as either temporarily or permanently restricted assets if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the accompanying consolidated statements of operations and changes in net assets as net assets released from restriction. Donor-restricted contributions whose restrictions are met within the same year as received and contributions received where no restrictions were stipulated are reflected as unrestricted contributions reported in the accompanying consolidated financial statements as other operating revenue.

**Investments in and Receivables from Affiliates:** IHS makes investments in corporations and other forms of businesses. Investments where less than 20% of the ownership interest is held by IHS, and IHS does not exert significant influence over the investee, are accounted for using the cost method. Investments where 20% to 50% of the voting common stock is owned by IHS as well as certain partnership and limited liability company investments are accounted for using the equity method. The equity method is also applied to investments in which IHS owns less than 20% of the ownership interest but can exert significant influence over the investee. See Note 8.

**Goodwill and Other Intangible Assets:** Financial Accounting Standard Board ("FASB") guidance requires business combinations to be accounted for using the acquisition method of accounting and it also specifies the types of acquired intangible assets that are required to be recognized and reported separately from goodwill. Goodwill represents the excess of cost of acquisition over the fair value of net assets acquired. Other intangible assets primarily represent the values assigned to subscriber bases, provider and hospital networks, and trademarks. Goodwill and other intangible assets with indefinite lives are not amortized but are tested for impairment at least annually. In compliance with FASB ASC Topic 350, "Intangibles – Goodwill and Other," IHS performed an annual impairment assessment of its goodwill and other indefinite lived intangible assets at the reporting level as of October 1, 2013. IHS utilizes the income approach to value the equity of the reporting unit for determining the fair value of goodwill. IHS utilizes the excess earnings method of the income approach to value its indefinite lived intangible assets. See Note 10.

**Premium Revenue:** IHS records premium revenues based on premium information from each government agency with whom they contract to provide services. Premiums are due monthly and are recognized as revenue during the period in which IHS is obligated to provide service to members. Premium payments from contracts with government agencies are based on eligibility lists produced by the government agencies.

**Medical Claims Liability:** IHS incurs medical claims expenses on behalf of its members and establishes an accrual for amounts billed and not paid and an estimate of costs incurred for unbilled services provided. The estimated liability for unbilled services is based principally on historical payment patterns using actuarial techniques. Changes in assumptions for medical costs caused by changes in actual experience could cause these estimates to change in the near term.

**Meaningful Use of Certified Electronic Health Record ("EHR") Technology Incentive Payments:** The Health Information Technology for Economic and Clinical Health ("HITECH") Act established incentive payments under the Medicare and Medicaid programs for certain healthcare providers that use certified EHR technology. The Medicare and Medicaid EHR programs provide financial incentives for the "meaningful use" ("MU") of certified EHR technology to improve patient care. To receive an EHR incentive payment, providers have to show that they are "meaningfully using" their EHRs by meeting

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**2. Summary of Significant Accounting Policies** (continued)

thresholds for a number of objectives established by the Centers for Medicare & Medicaid Services (“CMS”). Providers must attest to CMS that applicable meaningful use criteria have been met. Compliance with meaningful use criteria is subject to audit by the federal government or its designee. Incentive payments are subject to retrospective adjustments in a future period as the payments are calculated using the Medicare cost report data that is subject to audit. Financial penalties will become effective in 2015 for failure to meet these objectives.

IHS elected the grant accounting method for recognition of revenue from EHR incentive payments. Grant revenue is recognized when there is reasonable assurance that the grant will be received and that the organization will comply with the conditions attached to the grant. Once reasonable assurance is obtained the revenue can be recognized ratably across the compliance period. The IHS hospitals recognized \$13.3 million in Year One MU revenue for the year ended December 31, 2013. MU revenue is recorded as other operating revenue in the accompanying consolidated statements of operations and changes in net assets. At December 31, 2013, Management did not believe adequate reliable information was available to make a determination of reasonable assurance that the hospitals would be able to successfully demonstrate compliance with the conditions for Year Two reporting. Therefore IHS did not record an accrual as of December 31, 2013 for estimated EHR incentive payments under the Act’s Year Two reporting period.

**Income Taxes:** The Foundation, IHCS, and LHC, are not-for-profit corporations and have been determined to be exempt from Federal income tax under the provisions of section 501(c)(3) of the Internal Revenue Code. IHI and its subsidiaries are taxable organizations. Deferred income taxes are provided for all significant timing differences between revenues and expenses reported for financial statement and for tax purposes. Management annually reviews its tax positions and has determined that there are no material uncertain tax positions that require recognition in the consolidated financial statements.

Effective on the acquisition date INTotal was converted to a single member LLC and expected to be treated as a disregarded entity for federal income tax purposes and therefore take on the exemption of and be reported under the Foundation. Following the acquisition it was determined that since INTotal is an insurance entity it is considered a per se corporation and therefore requires its own exemption and filings. IHS applied for exemption in 2013 and is confident the application will be accepted retroactive to the acquisition date.

**Risk Factors:** IHS’ ability to maintain and/or increase future revenues could be adversely affected by: (i) the growth of managed care organizations promoting alternative methods for health care delivery or payment of services, such as discounted fee for service networks and capitated fee arrangements; (ii) increased competition from other hospital facilities and integrated health care delivery systems in IHS’ service areas, including health maintenance organizations (HMOs) and other entities providing health care services to the population which IHS presently serves; (iii) new statutory, legal or regulatory requirements, or structural, operational or payment changes to the health care industry, resulting from the enactment and implementation of the Patient Protection and Affordable Care Act and other similar health care reform measures, (iv) proposed and/or future changes in the laws, rules, regulations and policies relating to the definition, activities, and/or taxation of non-profit tax-exempt entities; (v) future legislation, regulation or other actions by federal, state and local governments and their agencies which may impose requirements or continue the trend toward more restrictive limitations on reimbursement for health care services; (vi) future legislation or adverse trends affecting the costs related to professional liability coverage; (vii) the future of Virginia’s Certificate of Need (CON) program, where future deregulation could result in the entrance of new competitors, or future additional regulation may eliminate IHS’ ability to expand new services; (viii) changes in general and local economic conditions which could influence patients’ ability to pay for services or the adequacy of patients’ health insurance coverage; (ix) a potential shortage of qualified nurses and other skilled health care professionals in the local employment market; (x) the future renewal of IHS’ Medicaid HMO contracts that renew annually which drive the majority of IHS’ premium revenue; and (xi) changes in general and local economic conditions which could cause volatility in capital and debt markets and may impose limitations to timely access to debt markets.

**Reclassification:** Certain prior year balances have been reclassified to be consistent with the current year presentation.

**Subsequent Events:** IHS has evaluated subsequent events for recognition and disclosure through March 13, 2014, the date the financial statements were available for issuance.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**3. Net Patient Service Revenue**

Net patient service revenue is reported at estimated net realizable amounts from patients, third-party payers and others for services rendered. IHS 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 who do not qualify for charity care, IHS recognizes revenue on the basis of discounted (or negotiated) rates for services rendered as provided by policy. On the basis of historical experience, a portion of IHS' uninsured patients will be unable or unwilling to pay for the services provided. Thus, IHS records a provision for bad debts related to uninsured patients in the period the services are provided. Patient service revenue, net of contractual allowances and discounts and after the provision for bad debts, is recognized from these major payer sources for the years ended December 31, 2013 and 2012 (in thousands) as follows:

	<b>2013</b>	<b>2012</b>
Gross Patient Revenue	\$4,840,431	\$4,616,514
Deductions:		
Medicare and Medicaid allowances	(1,226,952)	(1,093,929)
Other discounts and allowances	(995,462)	(895,174)
Charity care	(232,342)	(260,891)
Net Patient Service Revenue	2,385,675	2,366,520
Less: Provision for Bad Debts	(118,518)	(93,059)
<b>Total</b>	<b><u>\$2,267,157</u></b>	<b><u>\$2,273,461</u></b>

Significant portions of IHS' services are provided under agreements with the respective patients' health insurance carriers. The following summarizes the sources of gross revenue for acute care hospital services for the years ended December 31, 2013 and 2012:

	<b>2013</b>	<b>2012</b>
Managed care and commercial	51.0%	51.3%
Medicare	30.9	30.3
Medicaid	9.8	8.4
Uninsured	8.3	10.0
<b>Total</b>	<b><u>100.0%</u></b>	<b><u>100.0%</u></b>

IHS agreements with third-party payers provide for payments to IHS at amounts different from its established rates. A summary of the payment arrangements with major third-party payers follows:

- *Managed Care and Commercial Payers:* Under managed care and commercial insurance plans, IHS is typically reimbursed for services provided under various contractual arrangements on a discounted fee, per diem or case rate basis. Patients covered by these types of contractual arrangements are obligated to pay IHS any copayments or deductible amounts required pursuant to the provisions of their managed care plans.
- *Medicare:* Inpatient acute (operating and capital), non-acute (psych, skilled nursing, rehab, and home health) and outpatient services provided to Medicare beneficiaries are paid at prospectively determined rates. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Ultimately, Medicare reimbursement also takes other factors into consideration such as medical education costs, disproportionate share payments, transplant costs and bad debts which are reimbursed at tentative rates with final settlement determined after submission and audit of the annual cost reports. IHS' classification of patients under the Medicare program and the appropriateness of their admission may be subject to independent review by a peer review organization.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**3. Net Patient Service Revenue (continued)**

- *Medicaid:* The Medicaid program is administered by the Department of Medical Assistance Services (DMAS) of the Commonwealth of Virginia, pursuant to federal and state laws and regulations. DMAS receives funding for program expenditures from both the federal government and the Commonwealth of Virginia. Federal and state laws or regulations may affect limits on Medicaid payment. For inpatient Medicaid and other state programs, IHCS, and LHI are reimbursed on an all payer-diagnostic related groups based prospective payment system. Outpatient reimbursement for Medicaid patients is paid on a percentage of allowable costs.

Patient accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectability of accounts receivable, IHS analyzes its past history and identifies trends for each of its major payer sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. Management regularly reviews data about these major payer sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts. For receivables associated with services provided to patients who have third-party coverage, IHS analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts, if necessary. For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), IHS records a provision for bad debts in the period of service on the basis of its past experience. The difference between the standard rates (or discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

Beginning in late 2012 and over the course of 2013, IHS converted to a new, fully integrated electronic medical record (EMR) system known as EpicCare. With the system-wide implementation of EpicCare, all scheduling, registration, billing and clinical data are in one centralized database available to clinicians and business users at every location of care throughout IHS. The decrease in Charity Care deductions and the increase to the Provision for Bad Debts in 2013 as compared to 2012 are the result of some classification differences between EpicCare and the old system; however, when taken together the differences are largely offset. IHS also made a change to its charity care and uninsured discount policy effective October 1, 2013 which resulted in an increase to the self pay discount percentage.

Net patient service revenue also includes estimated retroactive adjustments resulting from future audits, reviews and investigations. Retroactive adjustments are considered in 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 are made known or as years are no longer subject to such audits, reviews and investigations. Retroactive adjustments in excess of amounts previously estimated have had some effect on net patient service revenue for 2013 and 2012 as IHS has experienced increased retrospective review activity by both governmental and non-governmental payers. Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is a reasonable possibility that recorded estimates will change by a material amount in the near term.

**4. Charity Care and Other Community Benefits**

IHS provides healthcare services to patients who meet certain criteria under its charity care policy without charge (or at amounts less than the established rates). Since IHS does not pursue collection of amounts that qualify as charity care, such amounts are not reported as net patient service revenue. The amounts reported as charity care represent the cost of rendering such services based on the cost to charge ratio for each hospital. Various government programs provide for the indigent, including Medicaid recipients. These programs provide a percentage of reimbursement for qualifying patients; however, payment is typically below the cost of those services.

In addition to charity and uncompensated care, IHS provides benefits to the broader community. These services include health screenings and other health-related services, training health professionals, education and prevention services, family support programs, direct donations, costs of performing medical research and costs associated with providing free clinics and community services.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**4. Charity Care and Other Community Benefits** (continued)

IHS' estimated costs of providing services to the poor and broader community as of December 31, 2013 and 2012 are as follows (in thousands):

	<b>2013</b>	<b>2012</b>
Charity care	\$105,282	\$119,696
Unpaid cost of state programs to financially disadvantaged persons	70,537	64,339
Community health programs	25,148	25,394
Medical education and research	30,633	24,583
<b>Total community benefits, at cost</b>	<b>\$231,600</b>	<b>\$234,012</b>

**5. Property, Equipment and Leasehold Interests**

The components of property, equipment and leasehold interests, at cost, and the related accumulated depreciation were as follows at December 31, 2013 and 2012 (in thousands):

	<b>2013</b>	<b>2012</b>
Land and land improvements	\$168,049	\$140,504
Buildings, fixed equipment and leasehold improvements	1,688,142	1,505,061
Major movable equipment	1,146,431	1,022,494
	3,002,622	2,668,059
Less: Accumulated depreciation and amortization	1,763,351	1,599,339
	1,239,271	1,068,720
Construction-in-progress	259,356	236,804
<b>Total</b>	<b>\$1,498,627</b>	<b>\$1,305,524</b>

**6. Investments**

On December 31, 2013, IHS changed the designation of certain investments to trading from available for sale and those investments now designated as trading are excluded from the table below for 2013. IHS' investments consisted of trading securities totaling \$2,016,847 and \$0 (in thousands), equity method investments totaling \$1,066,758 and \$936,530 (in thousands), and the investments held as available for sale securities totaling \$755,422 and \$2,695,495 (in thousands) as of December 31, 2013 and 2012, respectively. Net open trades related to trading securities were (\$1.6) million for 2013 and \$0 for 2012.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

**6. Investments** (continued)

Details of investments held as available for sale securities in assets whose use is limited as of December 31, 2013 and 2012 are as follows (in thousands):

	<b>2013</b>		<b>2012</b>	
	<b>Cost</b>	<b>Fair Value</b>	<b>Cost</b>	<b>Fair Value</b>
Cash and cash equivalents	\$372,588	\$372,803	\$400,529	\$400,892
U.S. government and agency securities	149,523	146,956	231,429	231,922
Corporate and other bonds				
- Corporate and other bonds	1,459	1,579	406,653	412,473
- Other government securities	-	-	50,758	51,931
Equity securities				
- Domestic	19	14	275,127	359,698
- International	-	-	236,497	304,841
Mutual fund				
- Equity	13,585	17,061	202,294	237,339
- Fixed income and other	6,289	6,332	552,630	573,542
Alternative investments				
- Private equity	691	281	-	-
- Private debt	24,345	28,120	24,000	24,239
- Private real estate	157,986	182,276	90,455	98,618
<b>Total</b>	<b>\$726,485</b>	<b>\$755,422</b>	<b>\$2,470,372</b>	<b>\$2,695,495</b>

IHS records investment values on a trade-date basis. Amounts for sales and purchases of securities unsettled as of the balance sheet date are included net in the fair value amounts disclosed above in the appropriate asset class. Open sales totaled \$0.2 million and \$0.5 million as of December 31, 2013 and 2012, respectively. Open purchases totaled \$0.2 million and \$45.2 million as of December 31, 2013 and 2012, respectively.

Investments are carried at estimated fair value. Realized gains and losses from sales of investments are reflected in income for the period in which they occur. The average cost of the investment sold is used to determine the realized gain or loss. Interest and dividend income is reported net of investment-related expenses of \$11.6 million in 2013 and \$11.4 million in 2012.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

**6. Investments (continued)**

Investment returns for the years ended December 31, 2013 and 2012 are summarized as follows (in thousands):

	<b>2013</b>	<b>2012</b>
Interest and dividend income	\$50,204	\$53,408
Net realized gains	179,720	116,172
Gain on investments redesignated as trading	320,136	-
Other than temporary declines in fair value of investments	(17,191)	(20,658)
Net unrealized (losses) gains	(196,187)	140,324
<b>Total</b>	<b>\$336,682</b>	<b>\$289,246</b>

  

	<b>2013</b>	<b>2012</b>
Included in investment income and other, net		
- Income from investments, net	\$140,862	\$88,258
- Income from equity method investments, net	68,830	60,156
Gain on investments redesignated as trading	320,136	-
(Decrease) increase in unrestricted net assets	(197,444)	137,292
Increase in temporarily restricted net assets	1,049	851
Increase in permanently restricted net assets	3,249	2,689
<b>Total</b>	<b>\$336,682</b>	<b>\$289,246</b>

Over the past several years, the investment market has experienced significant volatility. Management continually reviews its investment portfolio and evaluates whether declines in the fair value of securities should be considered other-than-temporary. All investment holdings managed by third-party investment managers with fair value less than cost were considered other-than-temporarily impaired. These holdings were among the investments that IHS redesignated as trading securities on December 31, 2013. IHS has the intent and ability to hold investments in certain alternative investment vehicles whose fair values may be less than cost, and these securities are evaluated to determine whether declines in the fair value of securities should be considered other-than-temporary. During the years ended December 31, 2013 and 2012, IHS recognized a loss for other-than-temporary declines in the fair market value of investments of approximately \$17.2 million and \$20.7 million, respectively.

As of December 31, 2013, IHS held 6 investment positions with unrealized losses that are considered to be temporary in nature as summarized in the following table (in thousands):

<b>Description of Securities</b>	<b>Less than Twelve Months</b>		<b>Twelve Months or Longer</b>		<b>Total</b>	
	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>
Equity securities	\$10	\$(1)	\$ -	\$(5)	\$10	\$(6)
Alternative investments	5,337	(1,354)	-	-	5,337	(1,354)
<b>Total</b>	<b>\$5,347</b>	<b>\$(1,355)</b>	<b>\$ -</b>	<b>\$(5)</b>	<b>\$5,347</b>	<b>\$(1,360)</b>

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**6. Investments** (continued)

As of December 31, 2012, IHS held 105 investment positions with unrealized losses that are considered to be temporary in nature as summarized in the following table (in thousands):

Description of Securities	Less than Twelve Months		Twelve Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government securities	\$12,640	\$(5)	\$ -	\$ -	\$12,640	\$(5)
Corporate and other bonds	129,284	(1,149)	27,980	(553)	157,264	(1,702)
Equity securities	24,061	(444)	2,167	(123)	26,228	(567)
<b>Total</b>	<b>\$165,985</b>	<b>\$(1,598)</b>	<b>\$30,147</b>	<b>\$(676)</b>	<b>\$196,132</b>	<b>\$(2,274)</b>

**7. Fair Value Measurements**

Fair value is the price that would be received to sell an asset or paid to transfer a liability, or the exit price, in an orderly transaction between market participants at the measurement date. ASC Topic 820, “*Fair Value Measurement*,” establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy distinguishes between market participant assumptions based on independent sources (observable inputs classified within Levels 1 and 2) and the reporting entity’s own notions about market participant assumptions (unobservable inputs classified within Level 3). Transfers into and out of all levels of the fair value hierarchy are reflected at end-of-period fair value.

The fair value levels are as follows:

- Level 1 inputs utilize unadjusted quoted prices in active markets for identical assets or liabilities that IHS has the ability to access at the measurement date.
- Level 2 inputs are other observable inputs for the assets or liabilities, either directly or indirectly. These may include quoted prices for similar assets and liabilities in active markets, interest rates, foreign exchange rates and yield curves that are observable at commonly quoted intervals.
- Level 3 inputs are unobservable inputs for the assets or liabilities, which are typically based on an entity’s own assumptions, as there is little, if any, related market activity.

Fair value level assignment for assets and liabilities is based on the lowest level input that is significant to the fair value measurement in its entirety. IHS’ assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the assets and liabilities.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**7. Fair Value Measurements** (continued)

The following tables present IHS' assets and liabilities measured at fair value on a recurring basis as of December 31, 2013 and 2012, respectively (in thousands). Certain assets such as open purchases and sales do not have fair values classified within a level in the valuation hierarchy. Alternative investments which are over 3% of the fund's value and whose ownership interest is considered to be more than minor are accounted for under the equity method of accounting. As a result, these are excluded from fair value tables below.

	<b>December 31, 2013</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets:</b>				
Cash and cash equivalents	\$432,044	\$432,044	\$ -	\$ -
U.S. government and agency securities	289,026	-	289,026	-
Corporate and other bonds				
- Corporate and other bonds	159,136	-	159,136	-
- Other government securities	13,578	-	13,578	-
Equity securities				
- Domestic	490,793	490,793	-	-
- International	320,675	320,675	-	-
Mutual fund				
- Equity	265,643	265,643	-	-
- Fixed Income and other	592,286	592,286	-	-
Alternative investments				
- Private equity	281	-	-	281
- Private debt	28,120	-	-	28,120
- Private real estate	182,276	-	177,113	5,163
<b>Total assets</b>	<b>\$2,773,858</b>	<b>\$2,101,441</b>	<b>\$638,853</b>	<b>\$33,564</b>
<b>Liabilities:</b>				
Interest rate swap liabilities	\$(22,841)	\$ -	\$(22,841)	\$ -
<b>Total liabilities</b>	<b>\$(22,841)</b>	<b>\$ -</b>	<b>\$(22,841)</b>	<b>\$ -</b>

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

**7. Fair Value Measurements (continued)**

	<b>December 31, 2012</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Assets:				
Cash and cash equivalents	\$445,514	\$445,514	\$ -	\$ -
U.S. government and agency securities	231,922	-	231,922	-
Corporate and other bonds				
- Corporate and other bonds	412,473	-	412,473	-
- Other government securities	51,931	-	51,931	-
Equity securities				
- Domestic	359,698	356,901	2,797	-
- International	304,841	304,841	-	-
Mutual fund				
- Equity	237,339	237,339	-	-
- Fixed Income and other	573,542	573,542	-	-
Alternative investments				
- Private debt	24,239	-	-	24,239
- Private real estate	98,618	-	98,618	-
<b>Total assets</b>	<b>\$2,740,117</b>	<b>\$1,918,137</b>	<b>\$797,741</b>	<b>\$24,239</b>
Liabilities:				
Interest rate swap liabilities	\$(62,390)	\$ -	\$(62,390)	\$ -
<b>Total liabilities</b>	<b>\$(62,390)</b>	<b>\$ -</b>	<b>\$(62,390)</b>	<b>\$ -</b>

The fair value of IHS' securities is determined by management using third-party service providers utilizing various methods dependent upon the specific type of investment except for Level 3 investments. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Where significant inputs, including benchmark yields, broker-dealer quotes, issuer spreads, bids, offers, the LIBOR curve and measures of volatility, are used by these third-party dealers or independent pricing services to determine fair values, the securities are classified within Level 2.

Assets utilizing Level 1 inputs include: cash and cash equivalents, exchange-traded equity securities, equity and fixed income mutual funds.

Assets and liabilities utilizing Level 2 inputs include: U.S. government and agency securities, common collective trust funds, derivatives, corporate, convertible, and municipal bonds, collateralized mortgage obligations, certain mortgage-backed securities, asset-backed securities, and foreign government issued securities. Certain assets fair valued using net asset value ("NAV") are also classified as Level 2 in accordance with ASU 2009-12, "Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)". IHS entered into interest rate swap agreements in conjunction with the issuance of variable rate bonds. The swap contracts are valued using models based on readily observable market parameters for all substantial terms of the contract. See Note 12 for additional information.

Assets utilizing Level 3 inputs include: limited partnership interests in private debt, private real estate and private equity alternative investment funds where IHS' ownership percentage is currently less than 3% of the funds' values. Private debt funds invest in distressed debt and other value oriented investments. Valuation of the funds' exchange-traded holdings is based on quoted prices while that of the over-the-counter securities is based on last reported bid and ask prices. Illiquid holdings in the funds are priced by broker quotations, the market approach, discounted cash flow or recent transaction price. Private real estate fund invests in real estate, real estate related and other financial instruments through a variety of investment vehicles domestically and abroad. Valuation of the fund's exchange-traded holdings is based on quoted prices

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

**7. Fair Value Measurements (continued)**

while that of over-the-counter securities is based on last reported bid and ask prices. Illiquid holdings in the fund are priced by one or a combination of the income capitalization and sales comparison approaches. Private equity fund predominantly invests in large U.S. leverage buyouts. Investments are valued at their market prices if market quotations are readily available. The fund's management applies consistent valuation methodologies based on best available information in the absence of observable market prices. The valuation process may incorporate fund management's own assumptions and involves a significant degree of judgment. Management uses the fund manager's valuation report in assessing the fair value. NAV is used as a practical expedient in determining the fair value of IHS' interest in the fund. Management validates the assessment based on the fund's audited financial statements, when they become available.

The following table summarizes certain characteristics of the alternative investments which are valued using NAV as of December 31, 2013 and 2012 (in thousands):

Fund	2013		2012		Investment Strategy	Liquidity Restrictions	Remaining Commitment
	Level 2	Level 3	Level 2	Level 3			
Private equity	\$ -	\$281	\$ -	\$ -	Fund seeks to make privately negotiated equity or equity-related investments, focusing on leveraged buyout transactions primarily in the U.S.	Closed ended fund with 10 year term; renewal option up to two one-year terms.	\$74.3 million
Private debt	-	352	-	-	Funds seeks substantial long-term capital appreciation, as well as current income, by acquiring, holding and disposing of, directly or indirectly through one or more intermediate entities, investments which are generally being made in emerging market stressed, distressed and other value-oriented investments.	Closed ended fund with 10 year term; automatic renewal up to 15 years; additional one-year extensions by approval of 2/3 consent.	\$5.7 million
Private debt	-	27,768	-	24,239	The fund seeks capital appreciation by investing mainly in distressed debt and other value oriented investments.	Eighteen-month investment period for 50% of the commitment, and a 3-year investment period (starting from closing) for anything not withdrawn at the end of the 18 months.	N/A
Private real estate	-	5,163	-	-	Fund seeks substantial long-term capital appreciation, as well as current income, by acquiring, holding, remediating, managing, leasing, operating, maintaining, improving, developing, redeveloping, renovating, financing, refinancing, transferring and disposing of, directly or indirectly through one or more intermediate entities, real estate, real estate related and other financial instruments.	Closed ended fund with 10 year term; automatic renewal up to 15 years; additional one-year extensions by approval of 2/3 consent.	\$9.0 million
Private real estate	60,967	-	-	-	Fund invests in core and value added properties.	90 days written notice thereafter.	N/A
Private real estate	116,146	-	98,618	-	Fund invests in income producing real property, seeking high current income and capital preservation with a low risk, low leverage core approach. The real estate portfolio consists of multi-family, industrial, retail and office properties in targeted metropolitan areas within the continental U.S.	Quarterly with 45 days notice.	N/A
	<u>\$177,113</u>	<u>\$33,564</u>	<u>\$98,618</u>	<u>\$24,239</u>			

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

**7. Fair Value Measurements** (continued)

The following table provides a reconciliation of the beginning and ending balances of items measured at fair value that used significant unobservable inputs (Level 3) (in thousands):

	<u>Private Equity</u>	<u>Private Real Estate</u>	<u>Private Debt</u>	<u>Total Level 3 Investments</u>
<b>Balance at January 1, 2012</b>	\$ -	\$15,334	\$ -	\$15,334
Unrealized gains relating to instruments still held at the reporting date	-	774	239	1,013
Purchases	-	37,323	24,000	61,323
Transfers out of Level 3	-	(53,431)	-	(53,431)
<b>Balance at December 31, 2012</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$24,239</b>	<b>\$24,239</b>
Unrealized gains (losses) relating to instruments still held at the reporting date	(411)	102	3,536	3,227
Purchases	692	-	345	1,037
Transfers into Level 3	-	5,061	-	5,061
<b>Balance at December 31, 2013</b>	<b>\$281</b>	<b>\$5,163</b>	<b>\$28,120</b>	<b>\$33,564</b>

Unrealized gains related to instruments still held at the reporting date are reported in unrealized gain (loss) on investments, net under unrestricted, temporarily restricted and permanently restricted net assets in the consolidated statements of operations and changes in net assets. IHS' ownership percentage exceeded 3% in the private real estate fund in 2012 and was transferred out of Level 3. In 2013, the fund decreased below the threshold and was transferred into Level 3 as the equity method of accounting ceased to apply.

**8. Investments in Affiliates**

IHS makes strategic investments in corporations and other forms of businesses. IHS accounts for investments with 20% to 50% ownership under the equity method of accounting and includes IHS' net equity interest in investments in and receivables from affiliates in the consolidated balance sheets. Investments with less than 20% ownership are accounted for using the cost method.

IHS invested in a joint venture with Aetna that established Innovation Health plans ("IHealth"), a licensed health plan serving Northern Virginia. IHealth commenced operations in July 2013. IHealth provides employers and consumers access to more affordable, coordinated and integrated health care in the region. IHS holds a 50% interest in IHealth.

Other equity investments include Pediatric Specialists of Virginia, LLC ("PSV"), a multi-specialty pediatric physician organization in Northern Virginia established jointly with Children's National Medical Center in 2013; Genetics & IVF Institute ("GIVF"), one of the largest fully integrated specialized providers of infertility treatment and genetic services; and Potomac Inova Healthcare Alliance, LLC ("PIHA"), a venture with Potomac Hospital Corporation which provides diagnostic and treatment options for patients with cancer. As of December 31, 2013, IHS holds 50%, 33% and 50% ownership in these investments, respectively.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**8. Investments in Affiliates (continued)**

IHS' ownership in significant nonconsolidated entities and the amounts included in IHS' consolidated financial statements as of December 31, 2013 and 2012 are as follows (in thousands):

	<b>Carrying Value</b>		<b>Equity In Earnings</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
IHealth	\$23,532	\$1,500	\$(4,968)	\$ -
Other investments accounted for under equity method	11,826	8,372	974	3,835
Investments accounted for under cost method	2,135	496	-	-
Total investments in affiliates	<u>\$37,493</u>	<u>\$10,368</u>	<u>\$(3,994)</u>	<u>\$3,835</u>

The summarized financial positions and results of operations for investments accounted for under the equity method as of and for the years ended December 31, 2013 and 2012 are as follows (in thousands) (unaudited):

	<b>2013</b>	<b>2012</b>
Total Assets	\$101,171	\$44,893
Total Liabilities	25,150	15,905
Net Assets	76,021	28,988
 Total revenues, net	 73,643	 66,930
(Deficit) Excess of revenue over expenses	(563)	(14,780)

Certain differences exist between IHS' investment carrying value and the underlying equity of the investee companies principally due to a deferred tax liability recorded related to the non-cash capital contributions.

**9. Acquisition of INTotal Health, LLC**

On December 1, 2012, IHS completed the acquisition of INTotal, formerly known as Amerigroup Virginia, Inc., a Medicaid HMO licensed and authorized to do business in Virginia. INTotal serves approximately 55,000 members who receive Temporary Assistance for Needy Families, Children's Health Insurance and Supplemental Security Income/Aged, Blind and Disabled benefits through its Medallion II and Family Access to Medical Insurance Security programs. The acquisition of INTotal is expected to enable IHS to improve care through appropriate utilization and care management measures and by enhancing access of Medicaid patients to IHS' unique wellness and health management programs. Through this transaction, IHS acquired all outstanding common shares of INTotal for a total purchase price of approximately \$89.7 million in cash.

Initial disclosures in the 2012 financial statements were preliminary because the valuation of the goodwill and intangible assets was not finalized at the report issuance date. The following disclosures are updated to reflect the final purchase price and valuation of the assets and liabilities.

Of the \$89.7 million total adjusted purchase price, the fair value of the assets acquired and liabilities assumed are as follows (in millions):

Cash and cash equivalents	\$ 6.4
Current assets	14.6
Property and equipment	1.3
Assets whose use is limited	11.9
Goodwill and identifiable intangible assets	69.6
Notes payable and other liabilities	<u>(14.1)</u>
<b>Net assets acquired</b>	<b><u>\$ 89.7</u></b>

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**9. Acquisition of INTotal Health, LLC (continued)**

The operating results of INTotal have been included in the consolidated income statements of IHS since December 1, 2012, the acquisition date. The revenue and net income attributable to INTotal for the year ended December 31, 2012 was \$13.9 million and \$0.5 million, respectively (prior to intercompany eliminations). The following unaudited pro forma condensed consolidated results of operations assume the INTotal acquisition occurred on January 1, 2012 (in millions):

	<b>Year Ended December 31, 2012 (unaudited)</b>
Pro forma operating revenues	\$ 2,509
Pro forma operating income	213

The 2012 profoma operating income amounts in the above table have been adjusted to exclude approximately \$1.6 million of acquisition related expenses. However, there were no pro forma adjustments made to reflect potential operating efficiencies or synergies. Accordingly, the combined pro forma financial information is for comparative purposes only and is not necessarily indicative of the results that IHS would have experienced if the INTotal acquisition had actually occurred on January 1, 2012 and do not reflect any intercompany eliminations. IHS recorded approximately \$1.6 million of acquisition related costs that were included in other operating expenses in the consolidated statements of operations and changes in net assets during the year ended December 31, 2012.

**10. Goodwill and Intangible Assets**

The majority of goodwill and intangible assets pertain to the December 1, 2012 acquisition of INTotal. A summary of goodwill and intangible assets for the years ended December 31, 2013 and 2012 is as follows (in thousands):

	<b>2013</b>	<b>2012</b>	<b>Estimated Useful Life (Years)</b>
Provider Network	\$10,500	\$10,500	20
Customer Relations	9,900	9,900	10
Medicaid License	21,300	21,300	Indefinite
Other	2,283	1,965	6
	43,983	43,665	
Accumulated amortization	(1,967)	(239)	
Total intangibles, net	42,016	43,426	
Goodwill	30,828	29,842	
Total intangible assets and goodwill, net	\$72,844	\$73,268	

Amortization expense of intangible assets was \$1.7 million, and \$0.03 million, for the years ended December 31, 2013 and 2012 respectively. Based upon the current amount of intangibles subject to amortization, the estimated amortization expense for each of the succeeding five years is \$1.6 million. IHS noted no impairment for 2013 as the fair value of the goodwill and indefinite lived intangible assets exceeded the carrying value.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

**11. Long-Term Debt**

	(in thousands)	
	December 31,	
	<u>2013</u>	<u>2012</u>
<b>Long-term Debt of the IHS Obligated Group:</b>		
1988A,B,C,D Variable Rate Demand Obligation Revenue Bonds; maturing 10/1/25; monthly interest at a variable rate and maximum of 15.0%	\$11,700	\$ 37,600
1993A Hospital Revenue Refunding Bonds; maturing 8/15/23; semi-annual interest at a fixed rate of 2.75% to 5.25%	68,450	73,605
2000 Variable Rate Demand Health Care Revenue Bonds; maturing 1/1/30; monthly interest at a variable rate and maximum of 12.0%	30,300	49,300
2005A Health Care Revenue Bonds; maturing 5/15/35; monthly interest at a variable rate and maximum of 12.0%	109,730	111,420
2005C Health Care Revenue Bonds; maturing 5/15/26; monthly interest at a variable rate and maximum of 12.0%	18,610	51,550
2009A Health Care Revenue Bonds; maturing 5/15/35; semi-annual interest at a fixed rate of 3.0% to 5.5%	264,805	268,815
2009C Health Care Revenue Bonds; maturing 5/15/25; semi-annual interest at a fixed rate of 2.0% to 5.0%	57,915	61,150
2010A-2 Health Care Revenue Bonds; maturing 5/15/39; monthly interest at a variable rate	95,000	95,000
2011 Health Care Revenue Bonds; maturing 8/1/2017; monthly interest at a fixed rate of 1.8%	33,299	42,381
2012A Health Care Revenue Bonds; maturing 5/15/42; semi-annual interest at a fixed rate of 3.0% to 5.0%	285,870	290,000
2012B Health Care Revenue Bonds; maturing 5/15/42; semi-annual interest at a fixed rate of 3.0% to 5.0%	60,000	60,000
2012C Health Care Revenue Bonds; maturing 5/15/42; monthly interest at a variable rate and maximum of 12.0%	143,705	145,000
2012D Health Care Revenue Bonds; maturing 5/15/29; semi-annual interest at a fixed rate of 3.0% to 5.0%	70,395	70,395
2013 Health Care Revenue Bonds; maturing 12/1/23; monthly interest at a fixed rate of 2.15%	79,530	-
Promissory Note Payable to Bank of America; maturing 3/29/13; monthly interest at a variable rate	-	313
Total Long-term Debt of the IHS Obligated Group	<u><b>1,329,309</b></u>	<u><b>1,356,529</b></u>
Less: Current Portion of Long-term Debt	(255,116)	(275,934)
Net Original Issue Premium	38,367	41,083
Net Long-term Debt of the IHS Obligated Group	<u><b>\$1,112,560</b></u>	<u><b>\$1,121,678</b></u>
<b>Long-term Debt of Non-Obligated IHS Affiliates:</b>		
Promissory Note Payable to GMAC Commercial Mortgage Bank; maturing 4/1/16; monthly interest at a fixed rate of 6.26%	11,752	12,095
Promissory Note Payable to Cardinal Bank; maturing 11/24/15; monthly interest at a fixed rate of 3.89%	1,404	2,099
Promissory Note Payable to Cardinal Bank; maturing 6/16/16; monthly interest at a fixed rate of 3.79%	2,510	3,417
Promissory Note Payable to Cardinal Bank; maturing 7/28/2016; monthly interest at a fixed rate of 3.2%	2,683	3,663
Promissory Note Payable to Cardinal Bank; maturing 9/21/2015; monthly interest at a fixed rate of 2.75%	202	313
Promissory Note Payable to Cardinal Bank; maturing 3/12/2015; monthly interest at a fixed rate of 2.25%	104	188
Total Long-term Debt of Non-Obligated IHS Affiliates	<u><b>18,655</b></u>	<u><b>21,775</b></u>
Less: Current Portion of Long-term Debt	(3,243)	(3,122)
Net Long-term Debt of Non-Obligated IHS Affiliates	15,412	18,653
<b>Total Net IHS Long-term Debt</b>	<u><b>\$1,127,972</b></u>	<u><b>\$1,140,331</b></u>

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**11. Long-Term Debt** (continued)

The preponderance of IHS' debt is tax-exempt revenue bonds issued under a Master Trust Indenture, which defines the obligated subsidiaries and affiliates under the bonds. The Members of the IHS Obligated Group consist of the Foundation, IHCS and LHC. The financial statements presented for the Obligated Group include only their accounts, which includes their investment interest in controlled, affiliated entities, but does not include in the revenues, expenses, assets or liabilities of the Obligated Group the revenues, expenses, assets or liabilities of any of those controlled, affiliated entities.

On December 4, 2013, the IHS Obligated Group refunded a portion of its variable rate demand obligations ("VRDOs") under Series 1988ABCD, 2000, 2005A and 2005C with mandatory redemptions in years 2018-2023 totaling \$79.5 million. These bonds were refunded to fixed rate serial bonds and directly purchased by TD Bank, N.A.

On December 20, 2012, the Industrial Development Authority issued \$70.4 million of Series 2012D bonds for the benefit of the IHS Obligated Group to advance refund one tranche of the Series 2009A Bonds which totaled \$75.04 million maturing in 2029. This particular tranche was callable in May 2014. The Series 2012D were sold at a premium of \$10.6 million. A loss of \$6.7 million was recognized related to the advance refunding.

On September 10, 2012, the mandatory tender date for the Series 2010A-2 bonds held by TD Bank, N.A. was extended from May 2, 2015 to September 1, 2021.

On August 23, 2012, the Industrial Development Authority issued \$495 million of Series 2012A, B and C bonds for the benefit of the IHS Obligated Group to finance approximately \$400 million of capital projects and to currently refund \$95 million of Series 2010A-1 bonds. The Series 2012A, B and C bonds are comprised of three series: \$290 million of fixed rate serial and term bonds (Series 2012A), \$60 million of fixed rate 10-year maturity bonds (Series 2012B) and \$145 million of variable rate bonds (Series 2012C). These series of bonds were sold at a premium of \$33.0 million. A loss of \$0.5 million was recognized related to the refinancing of the 2010A-1 bonds.

On August 23, 2012, the IHS Obligated Group converted \$55.7 million of existing Series 2005A-2 variable rate bonds that were in a daily interest rate mode with a JPMorgan Chase Bank, N.A. Stand-by Bond Purchase Agreement ("SBPA") to a weekly interest rate mode with an IHS self-liquidity pledge.

Losses recognized for early extinguishment of debt relate to the write-off of unamortized costs as well as the excess of amounts transferred to escrow over the principal amount of debt outstanding (representing interest).

IHS Obligated Group debts are secured by an interest in all funds held by the Bond Trustee for purposes of debt service, construction and equipment acquisition. Each Member of the IHS Obligated Group covenants that it will not pledge or grant a security interest in (except as may be otherwise provided in the Master Trust Indenture) any of its property. The Master Trust Indenture for the IHS Obligated Group requires that certain minimum financial ratios be met. IHS is in compliance with the financial ratio requirements.

IHS estimates the December 31, 2013 and 2012 fair value of its long-term debt, based on mid-market estimate, a market bid and/or ask, or any other price or estimate within a market spread, to be approximately \$1,372 million and \$1,485 million, respectively, compared with the face value of approximately \$1,386 million and \$1,419 million, respectively. The fair value of all financial instruments other than investments and debt is estimated by management to approximate or equal their reported carrying value.

The interest rate on the variable rate bonds ranged between 0.03% and 0.31% in 2013 and 0.03% and 0.38% in 2012. The variable rate bonds include an optional tender feature that allows the bond holder to tender the bonds on any daily or weekly interest payment date. The 2012C bonds, in the seven month window VRDO mode are subject to mandatory tender for purchase 210 days after tender notice. As such, both the variable and seven month window VRDO bonds are classified as current liabilities, except for those supported by certain liquidity arrangements as described below.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**11. Long-Term Debt** (continued)

IHS maintains SBPAs and Letters of Credit (“LOC”) to support the optional tender features on the VRDO bonds excluding the 2005A-2 bonds. The liquidity providers are summarized as follows (in thousands):

<b>Liquidity Provider</b>	<b>Bond Series</b>	<b>Amount</b>	<b>Expiration Date</b>
Branch Bank & Trust Company	2000	\$30,300	12/31/2015
TD Bank	2005A-1	54,865	4/30/2016
JP Morgan	2005C-1	9,305	10/21/2016
Northern Trust	1988ABCD and 2005C-2	21,005	5/2/2015
<b>Total</b>		<b><u>\$115,475</u></b>	

In the event of a failed remarketing, the banks are obligated to extend credit to purchase the tendered bonds. The banks may subsequently remarket the bonds and if the bonds are not remarketed, they are subject to mandatory redemption in quarterly installments by IHS. Certain SBPAs and LOCs include a provision which specifies re-payment of advances made by the bank will begin in the 13th calendar month after the bonds are acquired by the bank. This provision ensures that tendered bonds do not become an obligation for IHS for at least one year. Accordingly, the underlying debt is not classified as current liabilities except for principal amounts due within twelve months.

The tender feature of the 2012C Bonds and certain variable rate bonds requires IHS to maintain current assets of \$228.9 million and \$250.0 million as of December 31, 2013 and 2012, respectively, to provide for redemption of the tendered bonds. These assets are included in the current portion of assets whose use is limited.

The promissory note payable to GMAC Commercial Mortgage Bank is secured by a mortgage on the property of McLean Assisted Living, LLC, a joint venture between IHCS (60% equity interest) and Health Care REIT, Inc. (40% equity interest). The note is guaranteed by Sunrise/Inova McLean Assisted Living, LLC. The entire amount of the obligation is consolidated in the accompanying consolidated balance sheets.

Costs incurred in the issuance or conversion of long-term debt are deferred and amortized over the life of the related debt using the principal balance outstanding method.

All bonds are subject to mandatory sinking fund redemption and to earlier redemption under certain circumstances as defined in the respective bond indenture agreements. Maturities of long-term debt for the five years succeeding December 31, 2013 are as follows (in thousands):

	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>Thereafter</b>	<b>Total</b>
Scheduled Maturities	\$30,809	\$31,528	\$41,353	\$27,004	\$30,720	\$959,000	\$1,120,414
Bonds under remarketing agreement and subject to mandatory tender	227,550	-	-	-	-	-	227,550
<b>Total</b>	<b><u>\$258,359</u></b>	<b><u>\$31,528</u></b>	<b><u>\$41,353</u></b>	<b><u>\$27,004</u></b>	<b><u>\$30,720</u></b>	<b><u>\$959,000</u></b>	<b><u>\$1,347,964</u></b>

Interest income from the trustee held funds relating to construction projects qualifying for interest capitalization was offset against related bond interest expense and capitalized to such projects. Amounts capitalized were approximately \$3.6 million for 2013 and approximately \$0.9 million for 2012.

IHS incurred interest expense of \$44.0 million and \$40.0 million in 2013 and 2012, respectively, which approximates amounts paid. Interest amounts capitalized was \$16.7 million and \$7.4 million in 2013 and 2012, respectively.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**11. Long-Term Debt** (continued)

In 2012, a portion of the 2009A Health Care Revenue Bonds which were callable in 2014 with principal outstanding in the amount of \$75.04 million, were defeased. Proceeds from the 2012D bonds were transferred to an irrevocable escrow account and invested in State and Local Government Securities, the principal and interest from which is sufficient to retire the bonds on the call date. At December 31, 2013, the principal outstanding of these defeased bonds was \$75.04 million.

In 2002, the 1993B AHSC Medical Facility Revenue Refunding Bonds, with principal outstanding in the amount of \$5.6 million, were defeased. Cash was transferred to an irrevocable escrow account and invested in State and Local Government Securities, the principal and interest from which is sufficient to retire the bonds at maturity. At December 31, 2013, the principal outstanding of these defeased bonds was \$0.6 million.

In December 2010, IHS issued \$100 million of taxable commercial paper ("CP") under a program authorized for borrowings up to \$100 million with maturity dates from one to 270 days. Proceeds from this issuance were used for a variety of working capital requirements. IHS maintains a self-liquidity program that would be used to repurchase any CP that is not remarketed. All outstanding CP is included in notes payable and other liabilities in the current liabilities section of the accompanying consolidated balance sheets. As of December 31, 2013 and 2012, the amount of CP outstanding was \$100 million.

IHS has two unsecured bank lines of credit available in the amount of \$37.5 million and \$50.0 million with a variable interest rate of LIBOR plus 0.50%. No amount was outstanding at either December 31, 2013 or 2012. IHS had outstanding bank letters of credit guaranteeing payment to different beneficiaries amounting to \$0.6 million at December 31, 2013 and 2012.

**12. Derivative Financial Instruments**

IHS entered into interest rate swap agreements in order to hedge the variability of cash flows related to changes in market interest rates on underlying variable rate debt. The swap agreements effectively converted the variable rate debt to a fixed rate for the remaining life of the outstanding debt. These swap agreements initially qualified and were designated as cash flow hedges, and the effectiveness of the hedges was periodically evaluated. The effective portion of the change in fair value of the swap agreements was reported on the accompanying statements as a change in unrestricted net assets, and the ineffective portion was recorded in investment income and other, net. The effective hedges' maturity dates ranged from years 2030 to 2035.

Beginning in 2008, previously hedging swaps no longer qualified as cash flow hedges because the underlying debt was refinanced with debt with fixed interest rates. Beginning as of the date the hedges were discontinued, changes in the fair value of these swap agreements are recorded in investment income and other, net, and the accumulated losses as of the date the hedges were discontinued, but not previously recognized in income, will be amortized and recorded as investment income and other, net, as future interest payments occur. During 2014, \$0.5 million is expected to be reclassified into earnings.

In 2013, three swap agreements were terminated. In 2012, two swap agreements were recouped to lower fixed payer rates. In 2013, with the termination of the swap agreements, a loss of \$9.1 million related to accumulated losses in fair value of the swaps was recognized in the consolidated statements of operations and changes in net assets.

Each of the swap agreements includes a credit support provision which requires the posting of collateral with the counterparty for liability positions in excess of specified thresholds. At December 31, 2013 and 2012, no collateral was held by the counter-parties.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

**12. Derivative Financial Instruments** (continued)

The following table provides a summary of the notional value and fair value positions of derivative instruments as well as their reporting location in the consolidated balance sheets at December 31, 2013 and 2012 (in thousands):

	<b>Balance Sheet Location</b>	<b>2013</b>		<b>2012</b>	
		<b>Notional</b>	<b>Fair Value</b>	<b>Notional</b>	<b>Fair Value</b>
<b>Interest rate swap agreements:</b>					
Designated as cash flow hedges	Non-current Liabilities	\$ -	\$ -	\$107,085	\$(21,166)
Not designated as hedges	Non-current Liabilities	100,000	(22,841)	125,000	(41,224)
<b>Total</b>		<b>\$100,000</b>	<b>\$(22,841)</b>	<b>\$232,085</b>	<b>\$(62,390)</b>

The following table presents gains and losses in the consolidated statements of operations and changes in net assets for the years ended December 31, 2013 and 2012 (in thousands):

<b>Interest Rate Swaps Designated as Cash Flow Hedges</b>	<b>Statements of Operations and Changes in Net Assets</b>	<b>2013</b>	<b>2012</b>
Unrealized gains (losses) – effective portion	Change in fair value of effective hedging interest rate swaps	\$14,076	\$(1,597)
Unrealized gains – ineffective portion	Investment income and other, net	-	4,946
Realized losses - termination	Loss on extinguishment of debt and swap termination	(7,090)	-
<b>Interest Rate Swaps Not Designated as Cash Flow Hedges</b>			
Unrealized gains	Investment income and other, net	\$16,387	\$7,564
Unrealized losses - amortization of discontinuance of cash flow hedges	Investment income and other, net	(534)	(606)
Realized losses - termination	Investment income and other, net	(1,996)	-

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**13. Retirement Obligations**

The IHS Retirement Income Plan (the "IHS Plan") is a defined benefit pension plan that covers substantially all full-time employees of IHS.

The reconciliation of the beginning and ending balances of the projected benefit obligation and the fair value of plan assets for the years ended December 31, 2013 and 2012 and the accumulated benefit obligation at December 31, 2013 and 2012 is as follows (in thousands):

	<u>2013</u>	<u>2012</u>
Projected Benefit Obligation:		
Beginning of year	\$709,673	\$652,586
Service cost	23,555	24,745
Interest cost	25,495	23,822
Actuarial (gain) loss	(62,571)	45,593
Benefits payments	(90,514)	(37,073)
<b>End of year</b>	<b><u>\$605,638</u></b>	<b><u>\$709,673</u></b>
Fair Value of Plan Assets:		
Beginning of year	\$732,361	\$651,511
Actual return on plan assets	(15,675)	75,923
Employer contributions	34,000	42,000
Benefits payments	(90,514)	(37,073)
<b>End of year</b>	<b><u>\$660,172</u></b>	<b><u>\$732,361</u></b>
<b>Funded status at end of year</b>	<b><u>\$54,534</u></b>	<b><u>\$22,688</u></b>
	<u>2013</u>	<u>2012</u>
Amounts recognized in the consolidated balance sheets consist of:		
Noncurrent assets	\$54,534	\$22,688
Amounts recognized in Unrestricted Net Assets consist of:		
Prior service cost (credit)	\$(1,811)	\$(1,625)
Actuarial loss	37,297	62,678
Accumulated benefit obligation:		
End of year	\$590,034	\$690,754
Net periodic benefit cost:		
Service cost	\$23,555	\$24,745
Interest cost	25,495	23,822
Expected return on plan assets	(31,271)	(30,317)
Amortization of prior service cost	186	1,210
Recognized actuarial loss	5,001	6,309
Recognized settlement (gain)/loss	4,755	1,910
<b>Net periodic benefit cost</b>	<b><u>\$27,721</u></b>	<b><u>\$27,679</u></b>

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**13. Retirement Obligations (continued)**

For the year ended December 31, 2013, IHS recognized an increase in unrestricted net assets related to the change in plan assets and benefit obligations of the pension plan of approximately \$25.6 million. The increase resulted mainly from an increase in the discount rate used to calculate the pension obligation, offset by investment returns on plan assets. For the year ended December 31, 2012, IHS recognized an increase in unrestricted net assets related to the change in plan assets and benefit obligations of the pension of approximately \$9.4 million. The increase resulted from higher than expected investment earnings on plan assets and a reduction in benefits paid.

As part of an overall pension risk management strategy, IHS offered a lump sum buyout to all retirees receiving annuities of less than \$500 per month. IHS then purchased insurance annuities for those beneficiaries electing to continue receiving monthly payments. As a result of these transactions, IHS recognized a settlement loss of \$3.4 million included in salaries and benefits on the consolidated statements of operations and changes in net assets. The transactions triggered an updated actuarial valuation of plan assets and Projected Benefit Obligation, which resulted in an increase in the plan's funded status of \$15.7 million.

The prior service credit and actuarial loss included in unrestricted net assets related to the pension plan which is expected to be recognized in net periodic pension cost during the year ending December 31, 2014 are \$0.3 million and \$3.3 million, respectively. No plan assets are expected to be returned to IHS for the year ending December 31, 2014.

<u><b>Additional Information</b></u>	<u><b>2013</b></u>	<u><b>2012</b></u>
<u><b>Assumptions:</b></u>		
Weighted-average assumptions used to determine benefit obligations at December 31:		
Discount rate	4.61%	3.66%
Rate of compensation increase	3.50%	3.50%
Weighted-average assumptions used to determine net periodic benefit costs for years ended December 31:		
Discount rate	3.66%	3.77%
Rate of compensation increase	3.50%	3.50%
Expected long-term return on plan assets	4.50%	4.70%

The assumed expected long-term return on plan assets is based on current and expected future asset allocations and long-term historic and expected future investment returns and is consistent with assumptions used by plans of similar size.

The overall financial objectives for the plans' assets are (1) to provide funds for the timely payment of the plan's obligations and (2) to produce an investment rate of return that improves the overall funding status of the Plan consistent with the first objective. The investment objective of the plan seeks to strike a balance between higher returns and controlling funding status volatility. To achieve its objectives, the plan's assets were allocated 98% to cash and fixed income investments and 2% to alternative investment strategies based on market value as of December 31, 2013. The plan's allocation to fixed income investments is structured in part to match the expected stream of future benefit payments in order to minimize funding volatility risk, and to assure a return in excess of the interest crediting rate forecast for the cash balance portion of the plan.

The fair value of IHS' Plan assets is determined by management using third-party service providers utilizing various methods dependent upon the specific type of investment. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Where significant inputs, including benchmark yields, broker-dealer quotes, issuer spreads, bids, offers, the LIBOR curve and measures of volatility, are used by these third-party dealers or independent pricing services to determine fair values, the assets are classified within Level 2. Assets utilizing Level 3 inputs include certain limited partnership interest in alternative investment funds where the valuation is based on the fund's underlying investments as reported by the funds' managers.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**13. Retirement Obligations (continued)**

The following tables present the IHS Plan's assets measured at fair value aggregated by the level in the fair value hierarchy within which those measurements fall as of December 31, 2013 and 2012 (in thousands):

	<b>December 31, 2013</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Cash and cash equivalents	\$4,290	\$3,834	\$ 456	\$ -
Common/collective trusts	4,627	-	4,627	-
U.S. government securities	49,016	-	49,016	-
Corporate and other bonds				
- Corporate and other bonds	161,130	-	161,130	-
- Asset-backed securities	101,760	-	101,760	-
- Other government securities	34,795	-	34,795	-
Mutual fund				
- Fixed Income	293,286	293,286	-	-
Alternative investments				
- Hedge funds of funds	8,044	-	-	8,044
- Private debt	3,224	-	-	3,224
<b>Total</b>	<b>\$660,172</b>	<b>\$297,120</b>	<b>\$351,784</b>	<b>\$11,268</b>

	<b>December 31, 2012</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Cash and cash equivalents*	\$(13,727)	\$(18,656)	\$4,929	\$ -
Common/collective trusts	22,112	-	22,112	-
U.S. government securities	93,271	-	93,271	-
Corporate and other bonds				
- Corporate and other bonds	137,529	-	137,529	-
- Asset-backed securities	68,748	-	68,748	-
- Other government securities	33,925	-	33,925	-
Mutual fund				
- Fixed Income	376,229	376,229	-	-
Alternative investments				
- Hedge funds of funds	10,535	-	-	10,535
- Private debt	3,739	-	-	3,739
<b>Total</b>	<b>\$732,361</b>	<b>\$357,573</b>	<b>\$360,514</b>	<b>\$14,274</b>

\*Cash and cash equivalents included open sales of \$9.7 million and open purchases of \$34.0 million as of December 31, 2012, causing the Level 1 balance to be negative. Cash and cash equivalents in the retirement portfolio consist of commercial papers and short-term U.S. Treasury bills, which are considered Level 2.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**13. Retirement Obligations (continued)**

The following table summarizes certain characteristics of investments which are valued using NAV (in thousands):

<u>Fund</u>	<u>2013</u>		<u>2012</u>		<u>Investment Strategy</u>	<u>Liquidity Restrictions</u>
	<u>Level 2</u>	<u>Level 3</u>	<u>Level 2</u>	<u>Level 3</u>		
Hedge fund of funds	\$ -	\$8,044	\$ -	\$10,535	Hedge fund of funds which seeks to achieve long term, non-market directional returns with low volatility relative to stocks by utilizing a variety of defensive hedge fund strategies.	Winding down; no regular liquidity <sup>(1)</sup>
Private debt	-	3,224	-	3,739	Mezzanine finance investments. Seek high current return and long-term capital appreciation, emphasizing fundamental credit analysis with a bias toward risk control. Focus on middle-market transactions which are sourced from the firm's relationships in the private equity community.	Winding down; at least quarterly distributions at general partner's discretion; term ends in 2015
Common/ collective trust	4,627	-	22,112	-	Investment vehicle for cash reserves. It seeks to offer a competitive rate of return through a portfolio of high-grade, short term, money market instruments. Principal preservation is the primary objective, with liquidity management also emphasized to provide for redemption of units on any business day. Admissions and withdrawals may be made daily at a constant \$1.00 net asset value.	N/A
	<u>\$4,627</u>	<u>\$11,268</u>	<u>\$22,112</u>	<u>\$14,274</u>		

<sup>(1)</sup>This fund has suspended redemption since December 2008 due to a significant decrease in liquidity in the underlying funds in which it is invested. In September 2009, this fund announced a restructuring plan under which the IHS Plan chose to liquidate its holdings. The fund will wind down over the next 2-4 years. Redemptions occur periodically as excess cash is accumulated. Since the restructuring began, the IHS Plan has received eleven distributions totaling \$17.7 million as of March 13, 2014.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**13. Retirement Obligations (continued)**

The following table provides a reconciliation of the beginning and ending balances of items measured at fair value that used significant unobservable inputs (Level 3) (in thousands):

	<b>Hedge Fund of Funds</b>	<b>Private Debt</b>	<b>Private Real Estate</b>	<b>Total Level 3 Investments</b>
Balance at January 1, 2012	\$12,409	\$5,497	\$9,544	\$27,450
Actual return on plan assets				
Related to assets still held	645	1,112	-	1,757
Related to assets sold during the period	-	-	426	426
Sales	-	-	(9,970)	(9,970)
Settlements	(2,519)	(2,870)	-	(5,389)
<b>Balance at December 31, 2012</b>	<b>\$10,535</b>	<b>\$3,739</b>	<b>\$ -</b>	<b>\$14,274</b>
Actual return on plan assets				
Related to assets still held	709	410	-	1,119
Settlements	(3,200)	(925)	-	(4,125)
<b>Balance at December 31, 2013</b>	<b>\$8,044</b>	<b>\$3,224</b>	<b>\$ -</b>	<b>\$11,268</b>

IHS plans to contribute \$31.5 million to the IHS Plan in 2014.

IHS' expected future benefit payments, which reflect expected future service as appropriate, are as follows (in thousands):

<b>Fiscal Year</b>	<b>Pension</b>
2014	\$32,971
2015	35,456
2016	36,669
2017	38,578
2018	39,047
2019 to 2023	216,823

IHS also maintains a Retiree Medical Plan ("Retiree Health Plan") which provides benefits to certain retirees and certain active employees who met age and length of service requirements as of September 1, 1993. The projected benefit obligation was \$9.9 million and \$11.5 million as of December 31, 2013 and 2012, respectively. The current portion of the Retiree Health Plan liability is recorded in accrued salaries, wages and benefits and the noncurrent portion is recorded in other non-current obligations in the consolidated balance sheets.

IHS also sponsors the Inova Health System Retirement Savings Plan ("401K Plan") that covers the same groups covered under the IHS Plan. Employees may contribute to the 401K Plan and IHS may contribute to this plan in varying amounts. Defined contribution benefit expense was \$18.7 million and \$21.2 million in 2013 and 2012, respectively.

**14. Professional and Other Insurance Liabilities**

IHS maintains coverage for professional and general liability through claims-made policies issued by InovaCap, LLC ("InovaCap"). InovaCap is a wholly owned captive insurance company domiciled in Vermont. Because InovaCap is a wholly owned subsidiary of IHS, its assets, liabilities, revenues and expenses are fully consolidated in the accompanying financial statements.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**14. Professional and Other Insurance Liabilities (continued)**

InovaCap retains risk of \$2.1 million per claim and \$19 million in annual aggregate for professional liability. Additional risk is reinsured in umbrella forms through Lloyds of London, other European companies, Zurich North American, and CNA, together providing limits of \$50 million per claim, and \$50 million in the aggregate, in excess of the InovaCap retention. The consolidated balance sheets at December 31, 2013 and 2012 include an accrued liability of \$31.9 million and \$35.6 million, respectively, based on actuarial estimates of payments to be made under its professional liability insurance programs for known claims, as well as for estimated losses on unfiled claims, which relate to events occurring in 2013 and prior years. The liabilities are discounted at 2.0% and 1.6% at December 31, 2013 and 2012, respectively.

On September 30, 2013, InovaCap was reorganized as a protected cell sponsored captive insurance company and issued a professional liability policy to PSV. No assets, liabilities, revenues or expenses have been recognized related to this transaction as of December 31, 2013.

In addition, InovaCap assumed reinsurance obligations ceded by Aetna Health Inc. and Aetna Life Insurance Company ("Aetna affiliates") related to certain Medicare Advantage health benefit insurance plans and products issued by the Aetna affiliates. The reinsurance arrangement was entered into to take advantage of business opportunities until licensure of Innovation Health was completed, as defined in the Master Relationship agreement between Inova and Aetna's parent company. As of December 31, 2013, InovaCap recorded a liability of \$0.9 million for reinsurance of the health plan obligations.

Assets held by InovaCap of \$84.1 million and \$74.3 million at December 31, 2013 and 2012, respectively, are restricted by statute from being transferred to another subsidiary or obligated for any other purpose and accordingly are included as assets whose use is limited in the consolidated balance sheets.

**15. Fairfax County Leases**

The land upon which the majority of Inova Fairfax Hospital and the entirety of Inova Mount Vernon Hospital are located and the related buildings and equipment are leased to IHS by the Board of Supervisors of Fairfax County, Virginia ("County"), under an agreement that was partially amended in 2010 (the "County Lease"). The 2010 agreement included sale of property whereby a portion of the Inova Fairfax Hospital campus land was taken out of the County Lease and ownership of that land was conveyed to IHS. There is also land owned by IHS, off-site of the hospital campus that was conveyed to Fairfax County. Effective as of December 3, 2010, the 2010 agreement extends the County Lease for the residual land for a term of 99 years and, thus, the County Lease now expires in December 2109. Under the County Lease, the property and equipment leased from the County are recorded as leasehold interests at the cost to construct or acquire. Upon termination of the County Lease, such property, including leasehold improvements and equipment will revert to the County, subject to all related long-term liabilities of IHS incurred to finance the construction and acquisition of such property, buildings and equipment.

The County Lease also requires IHS to set aside funds in an amount at least equal to the depreciation expense on the related leasehold interests. Such funds may be expended by IHS for major repairs or alterations, construction of or additions to buildings, or the purchase or replacement of equipment. IHS' Board of Trustees has also designated additional funds for the purpose of plant expansion.

The terms of the County Lease outline an indigent care policy to assure all individuals in the County have access to medically necessary care. Patients' payment obligations under the policy are determined using a sliding income scale which is based on the federal poverty guidelines. During the term of the County Lease, IHS has agreed to notify the County of any intent to incur additional debt in excess of \$1 million. IHS has also agreed to notify the County of any intent to enter into contractual agreements for the management or operation of Inova Fairfax Hospital or Inova Mount Vernon Hospital by persons other than IHS, or any intent to change hospital rates.

**Inova Health System**  
**Notes To Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**16. Other Leases**

IHS leases equipment, office space and certain facilities. Included in the operating expenses of IHS are lease expenses of approximately \$24.0 million and \$20.0 million in 2013 and 2012, respectively. Future minimum payments under non-cancellable operating leases with initial or remaining terms of one year or more consisted of the following at December 31, 2013 (in thousands):

	<u>Operating Leases</u>
2014	\$19,103
2015	15,840
2016	14,331
2017	12,812
2018	11,898
Thereafter	22,691
Total lease payments	<u>96,675</u>
Less: minimum lease income from non-cancellable subleases	<u>(27,773)</u>
<b>Total</b>	<b><u>\$68,902</u></b>

**17. Other Commitments and Contingencies**

IHS has entered into several contracts for the acquisition of equipment and for the construction of facilities. Future commitments under these contracts at December 31, 2013 were approximately \$289.0 million. IHS currently anticipates that these projects will be financed with a combination of bond proceeds, funds generated from earnings and donations. These projects include expansion and renovation of Alexandria, Loudoun, Fair Oaks, Mt. Vernon, and Fairfax hospitals and Lorton Healthplex facilities.

Under the agreement with Children's National Medical Center to establish PSV, IHS anticipates additional capital contributions to this joint venture totaling approximately \$10 million to be paid over a five year period.

On July 2, 2013, IHS and Valley Health System, a not-for-profit health system based in Winchester, Virginia ("Valley"), announced a collaborative alliance to work together to improve the continuity of care to the patients they serve through closer operational, technological and clinical integration, particularly in the areas of clinical research, information technology, population health and selected clinical services. In order to facilitate the objectives of this strategic relationship, IHS intends to extend its EpicCare software to Valley and assist Valley with the implementation of these systems. It is the intent of the parties that Valley reimburses IHS for any costs incurred in extending EpicCare to Valley in this manner.

IHS is subject to various legal claims and contingencies arising in the ordinary course of its business. While the outcomes of such matters are uncertain, management believes that their ultimate resolution will not have a material adverse effect on IHS' financial position or on the changes in its net assets or cash flows.

**18. Functional Expenses**

IHS provides various health care services to patients within its geographic region. Operating expenses related to providing these services for the years ended December 31, 2013 and 2012 are as follows (in thousands):

	<u>2013</u>	<u>2012</u>
Health care services	\$2,053,758	\$1,817,822
General and administrative	353,904	338,002
<b>Total</b>	<b><u>\$2,407,662</u></b>	<b><u>\$2,155,824</u></b>



Ernst & Young LLP  
Westpark Corporate Center  
8484 Westpark Drive  
McLean, VA 22102

Tel: +1 703 747 1000  
Fax: +1 703 747 0100  
ey.com

## Report of Independent Auditors on Other Supplementary Information

The Board of Trustees  
Inova Health System

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

*Ernst & Young LLP*

March 13, 2014

**Inova Health System Obligated Group**  
**Consolidated Balance Sheets**  
**December 31, 2013 and 2012**  
(In thousands)

	<u>2013</u>	<u>2012</u>
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 208,750	\$ 191,413
Assets whose use is limited		
By board for plant replacement and expansion	228,870	250,010
Patient accounts receivable less allowance for doubtful accounts	239,967	260,995
Third-party settlements	1,946	3,646
Other current assets	66,190	73,877
<b>Total Current Assets</b>	<u>745,723</u>	<u>779,941</u>
<b>Property, Equipment and Leasehold Interests, net</b>		
Land and land improvements	155,111	136,869
Buildings, fixed equipment and leasehold improvements	1,644,885	1,459,163
Major movable equipment	1,118,086	991,927
	<u>2,918,082</u>	<u>2,587,959</u>
Less allowances for depreciation and amortization	(1,719,725)	(1,555,347)
	<u>1,198,357</u>	<u>1,032,612</u>
Construction-in-progress	254,342	236,685
<b>Total Property, Equipment and Leasehold Interests, net</b>	<u>1,452,699</u>	<u>1,269,297</u>
<b>Assets Whose Use Is Limited</b>		
Held by bond trustee	251,602	408,546
By board for plant replacement and expansion	3,085,167	2,565,844
By board for construction projects	317,784	490,043
By donor	74,925	67,528
	<u>3,729,478</u>	<u>3,531,961</u>
Less amounts required to meet current obligations	(228,870)	(250,010)
<b>Total Assets Whose Use Is Limited</b>	<u>3,500,608</u>	<u>3,281,951</u>
<b>Other Assets</b>		
Investments in and receivables from affiliates	149,566	108,191
Prepaid pension asset	54,534	22,688
Other long-term assets	66,526	33,308
<b>Total Other Assets</b>	<u>270,626</u>	<u>164,187</u>
<b>TOTAL ASSETS</b>	<u>\$ 5,969,656</u>	<u>\$ 5,495,376</u>
<b>LIABILITIES AND NET ASSETS</b>		
<b>Current Liabilities</b>		
Accounts payable and accrued expenses	\$ 179,895	\$ 171,679
Accrued salaries, wages and benefits	101,332	114,464
Third-party settlements	52,319	53,326
Notes payable and other liabilities	122,478	105,468
Current portion of long-term debt	255,117	275,934
<b>Total Current Liabilities</b>	<u>711,141</u>	<u>720,871</u>
<b>Non-current Liabilities</b>		
Long-term debt, less current portion	1,112,559	1,121,678
Interest rate swap liability	22,841	62,390
Estimated professional and other insurance liabilities	16,556	18,359
Other non-current obligations	40,919	40,769
<b>Total Non-current Liabilities</b>	<u>1,192,875</u>	<u>1,243,196</u>
<b>Net Assets</b>		
Unrestricted	3,975,832	3,458,015
Temporarily restricted	56,928	43,668
Permanently restricted	32,880	29,626
<b>Total Net Assets</b>	<u>4,065,640</u>	<u>3,531,309</u>
<b>TOTAL LIABILITIES AND NET ASSETS</b>	<u>\$ 5,969,656</u>	<u>\$ 5,495,376</u>

NOTE: The Obligated Group consists of Inova Health System Foundation, Inova Health Care Services and Loudoun Hospital Center, and the financial statements presented for the Obligated Group includes only their accounts, which includes their investment interest in controlled, affiliated entities, but does not include in the revenues, expenses, assets or liabilities of the Obligated Group the revenues, expenses, assets or liabilities of any of those controlled, affiliated entities.

**Inova Health System Obligated Group**  
**Consolidated Statements of Operations and Changes in Unrestricted Net Assets**  
**For the Years Ended December 31, 2013 and 2012**  
(In thousands)

	<u>2013</u>	<u>2012</u>
<b>Operating Revenues</b>		
Net patient service revenue	\$ 2,265,313	\$ 2,216,796
Provision for bad debts	(116,600)	(91,318)
<b>Net Patient Service Revenue Less Provision for Bad Debts</b>	<u>2,148,713</u>	<u>2,125,478</u>
Other operating revenue	81,492	67,856
<b>Total Operating Revenues</b>	<u>2,230,205</u>	<u>2,193,334</u>
<b>Operating Expenses</b>		
Salaries and benefits	1,074,150	1,072,362
Other operating expenses	854,171	766,541
Depreciation and amortization	162,559	133,900
Interest	26,082	30,935
Loss on extinguishment of debt and swap termination	7,319	7,216
<b>Total Operating Expenses</b>	<u>2,124,281</u>	<u>2,010,954</u>
<b>Operating Income</b>	<b>105,924</b>	<b>182,380</b>
<b>Non-operating Revenues (Expenses)</b>		
Investment income and other, net	235,094	183,153
Net gains on investments redesignated as trading	305,554	-
<b>Excess of Revenues Over Expenses</b>	<u>646,572</u>	<u>365,533</u>
Unrealized gains on investments, net	117,859	133,485
Reclassification of unrealized gains on investments redesignated as trading	(305,554)	-
Change in fair value of effective hedging interest rate swaps	25,776	(991)
Change in plan assets and benefit obligations of pension	25,567	6,834
Net assets released from restriction for purchase of equipment and land rights	17	599
Net asset transfer due to merger	12,794	-
Other	(5,214)	(682)
<b>Increase in Unrestricted Net Assets</b>	<u><u>\$ 517,817</u></u>	<u><u>\$ 504,778</u></u>

NOTE: The Obligated Group consists of Inova Health System Foundation, Inova Health Care Services and Loudoun Hospital Center, and the financial statements presented for the Obligated Group includes only their accounts, which includes their investment interest in controlled, affiliated entities, but does not include in the revenues, expenses, assets or liabilities of the Obligated Group the revenues, expenses, assets or liabilities of any of those controlled, affiliated entities.

**Inova Health System Obligated Group**  
**Consolidated Statements of Cash Flows**  
**For the Years Ended December 31, 2013 and 2012**  
(In thousands)

	<u>2013</u>	<u>2012</u>
<b>Operating Activities</b>		
Change in net assets	\$ 534,331	\$ 511,892
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	162,559	133,900
Change in plan assets and benefit obligations of pension	(25,567)	(6,834)
Transfer of assets and liabilities due to merger	(12,600)	-
Net realized and unrealized losses (gains) on investments	9,005	(252,009)
Net gains on investments redesignated as trading	(305,554)	-
Other than temporary declines in market value of investments	17,172	20,617
Change in fair value of interest rate swaps	(24,655)	(1,968)
Equity investment earnings	(10,905)	(19,318)
Decrease in accounts receivable and third-party settlements	24,892	8,890
Increase in accounts payable and other current liabilities	22,630	14,206
(Decrease) increase in accrued salaries, wages and benefits	(14,263)	9,467
Increase in prepaid pension asset	(6,279)	(22,688)
(Decrease) increase in post employment health care benefits liability	(1,607)	6,401
(Decrease) increase in estimated professional liability and other deferred liability items	(105)	8,790
Restricted contributions received	(20,025)	(9,798)
Restricted interest and dividend income	(2,413)	(371)
Increase in intangibles and other long-term assets	(15,311)	(13,328)
<b>Net Cash Provided by Operating Activities</b>	<u>331,305</u>	<u>387,849</u>
<b>Investing Activities</b>		
Capital expenditures	(344,890)	(284,865)
Investments in and advances to joint ventures and affiliates	(30,649)	18,078
Acquisition of INTotal Health, LLC	-	(88,450)
Purchases of marketable securities	(2,081,257)	(3,071,307)
Proceeds from sale of marketable securities	2,163,118	2,582,551
Other	2,318	(5,374)
<b>Net Cash Used in Investing Activities</b>	<u>(291,360)</u>	<u>(849,367)</u>
<b>Financing Activities</b>		
Restricted contributions received	20,025	9,798
Restricted interest and dividend income	2,413	371
Principal payments on long-term debt	(27,219)	(22,270)
Proceeds from issuance of long-term debt	79,530	608,952
Refunding of long-term debt	(79,530)	(170,040)
Swap termination and modification payments	(14,894)	(8,945)
Other	(2,933)	(4,339)
<b>Net Cash (Used in) Provided by Financing Activities</b>	<u>(22,608)</u>	<u>413,527</u>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<u>17,337</u>	<u>(47,991)</u>
Cash and Cash Equivalents at Beginning of Year	191,413	239,404
<b>CASH AND CASH EQUIVALENTS AT END OF YEAR</b>	<u><u>\$ 208,750</u></u>	<u><u>\$ 191,413</u></u>

NOTE: The Obligated Group consists of Inova Health System Foundation, Inova Health Care Services and Loudoun Hospital Center, and the financial statements presented for the Obligated Group includes only their accounts, which includes their investment interest in controlled, affiliated entities, but does not include in the revenues, expenses, assets or liabilities of the Obligated Group the revenues, expenses, assets or liabilities of any of those controlled, affiliated entities.