



COMBINED FINANCIAL STATEMENTS

Sierra Vista Regional Health Center, Inc. and Affiliates
Years Ended June 30, 2011 and 2010
With Report of Independent Auditors

Ernst & Young LLP

 **ERNST & YOUNG**

Sierra Vista Regional Health Center, Inc. and Affiliates

Combined Financial Statements

Years Ended June 30, 2011 and 2010

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Report of Independent Auditors

Board of Trustees
Sierra Vista Regional Health Center, Inc.

We have audited the accompanying combined balance sheets of Sierra Vista Regional Health Center, Inc. and Affiliates (the Company) as of June 30, 2011 and 2010, and the related combined statements of operations, changes in net assets, and cash flows for the years then ended. These combined financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these combined 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 combined financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the combined financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall combined financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the combined financial position of Sierra Vista Regional Health Center, Inc. and Affiliates at June 30, 2011 and 2010, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

August 24, 2011

Sierra Vista Regional Health Center, Inc. and Affiliates

Combined Balance Sheets

	June 30	
	2011	2010
Assets		
Current assets:		
Cash and cash equivalents	\$ 12,040,116	\$ 13,025,498
Short-term investments	4,536,652	3,912,883
Patient accounts receivable, net of allowance for doubtful accounts of \$2,822,000 and \$1,477,000 at June 30, 2011 and 2010, respectively	8,593,614	7,837,954
AHCCCS SAVE program receivable	764,737	1,570,087
Inventories	2,390,380	2,099,777
Current portion of assets whose use is limited	728,504	702,005
Prepaid expenses and other	1,994,828	2,564,238
Total current assets	31,048,831	31,712,442
Assets whose use is limited, net of current portion	3,184,383	3,183,414
Investments	44,894,204	34,609,886
Property and equipment, net	34,802,744	36,873,701
Deferred financing costs, net	540,195	605,595
Interests in affiliates/other	1,254,190	670,144
Total assets	\$ 115,724,547	\$ 107,655,182
Liabilities and net assets		
Current liabilities:		
Accounts payable and accrued expenses	\$ 4,205,335	\$ 5,139,861
Accrued compensation	3,810,337	3,863,422
Estimated third-party settlements	3,158,422	1,632,878
Current portion of long-term debt	1,147,979	1,389,805
Total current liabilities	12,322,073	12,025,966
Long-term debt, net of current portion	24,429,675	25,564,416
Professional and general liabilities and other	3,238,695	3,394,971
Total liabilities	39,990,443	40,985,353
Net assets:		
Unrestricted	75,531,382	66,501,261
Temporarily restricted	202,722	168,568
Total net assets	75,734,104	66,669,829
Total liabilities and net assets	\$ 115,724,547	\$ 107,655,182

See accompanying notes.

Sierra Vista Regional Health Center, Inc. and Affiliates

Combined Statements of Operations

	Year Ended June 30	
	2011	2010
Revenues:		
Net patient service revenue	\$ 96,183,264	\$ 97,698,585
Other operating revenue	1,187,023	1,382,914
Total revenues	97,370,287	99,081,499
Expenses:		
Salaries and wages	35,734,756	37,346,111
Employee benefits	8,095,803	7,497,793
Supplies, services, and other	33,448,412	34,753,686
Provision for doubtful accounts	4,192,925	2,685,398
Professional fees	2,781,107	2,197,557
Interest	1,830,633	1,910,876
Depreciation and amortization	6,200,886	6,531,300
Net loss on disposal of equipment	23,920	43,375
Total expenses	92,308,442	92,966,096
Operating income	5,061,845	6,115,403
Other income:		
Investment income	1,413,524	1,431,224
Net unrealized gains on investments	2,379,275	1,509,684
Other nonoperating revenue	157,584	187,103
Total other income	3,950,383	3,128,011
Excess of revenues over expenses	\$ 9,012,228	\$ 9,243,414

See accompanying notes.

Sierra Vista Regional Health Center, Inc. and Affiliates

Combined Statements of Changes in Net Assets

	Year Ended June 30	
	2011	2010
Unrestricted net assets:		
Excess of revenues over expenses	\$ 9,012,228	\$ 9,243,414
Net assets released from restrictions used for purchase of property and equipment	<u>17,893</u>	113,168
Increase in unrestricted net assets	9,030,121	9,356,582
Temporarily restricted net assets:		
Grants and contributions	52,047	54,255
Net assets released from restrictions used for purchase of property and equipment	<u>(17,893)</u>	(113,168)
Increase (decrease) in temporarily restricted net assets	34,154	(58,913)
Increase in net assets	9,064,275	9,297,669
Net assets, beginning of year	<u>66,669,829</u>	57,372,160
Net assets, end of year	<u>\$ 75,734,104</u>	\$ 66,669,829

See accompanying notes.

Sierra Vista Regional Health Center, Inc. and Affiliates

Combined Statements of Cash Flows

	Year Ended June 30	
	2011	2010
Operating activities		
Increase in net assets	\$ 9,064,275	\$ 9,297,669
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	6,200,886	6,531,300
Provision for doubtful accounts	4,192,925	2,685,398
Net loss on disposal of equipment	23,920	43,375
Amortization of bond discount	12,181	12,179
Net unrealized gains on investments	(2,379,275)	(1,509,684)
Changes in operating assets and liabilities:		
Patient accounts receivable	(4,948,585)	(2,350,961)
Inventories	(290,603)	79,298
Prepaid expenses and other receivables	1,374,760	(95,784)
Assets limited as to use, net	(27,468)	(74,740)
Investments, net	(8,528,812)	(4,236,950)
Accounts payable and accrued expenses	(934,526)	622,186
Accrued compensation	(53,085)	166,370
Estimated third-party payor settlements	1,525,544	(850,277)
Net cash provided by operating activities	5,232,137	10,319,379
Investing activities		
Purchases of property and equipment, net	(4,695,431)	(7,509,828)
Proceeds from sales of property and equipment	541,583	29,400
Decrease in interests in affiliates	52,702	101,753
Net cash used in investing activities	(4,101,146)	(7,378,675)
Financing activities		
Payments on long-term debt	(1,388,748)	(1,283,300)
Decrease in other financing activities	(571,349)	(231,162)
(Decrease) increase in other liabilities	(156,276)	1,643,724
Net cash (used in) provided by financing activities	(2,116,373)	129,262
Net (decrease) increase in cash	(985,382)	3,069,966
Cash and cash equivalents, beginning of year	13,025,498	9,955,532
Cash and cash equivalents, end of year	\$ 12,040,116	\$ 13,025,498
Supplemental disclosures of cash flow information		
Cash paid for interest	\$ 1,755,443	\$ 1,835,742

See accompanying notes.

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements

June 30, 2011

1. Organization

Sierra Vista Regional Health Center, Inc. (the Hospital) is an Arizona not-for-profit corporation exempt from income taxes. The Hospital is an 81-bed acute care hospital that provides a full range of inpatient and outpatient services in Sierra Vista, Arizona, and Cochise County. Services range from the inpatient units of medical/surgical, intensive care, progressive care, telemetry, obstetrics, and neonatal intensive care to an emergency room that serves as a base station for many emergency medical service providers. Other outpatient services include diagnostic, rehabilitation, surgical, hospice, infusion, imaging center, outpatient surgery center, and clinics. The existence of the full continuum of services allows the Hospital to function seamlessly and without interruption to patient care.

Combination

The Hospital's affiliates include the Sierra Vista Community Hospital Foundation (the Foundation), the Sierra Vista Community Hospital Auxiliary (the Auxiliary), and Arizona Family Care Associates, Inc. (AFCA). The accounts and transactions of the Foundation are combined with that of the Hospital. The Auxiliary and AFCA are accounted for under the equity method of accounting.

The accompanying combined financial statements include the accounts of the Hospital and all affiliates after elimination of intercompany accounts and transactions.

2. Summary of Significant Accounting Policies

Use of Estimates

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

Cash and Cash Equivalents

Cash and cash equivalents includes certificates of deposit with original maturities of three months or less when acquired.

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Patient Accounts Receivable

The Hospital grants credit without collateral to its patients, most of whom are local residents who are insured under third-party payor agreements. The following table summarizes the percentage of gross accounts receivable from all payors as of June 30:

	<u>2011</u>	<u>2010</u>
Medicare	27%	28%
AHCCCS	24	23
Other commercial third party	42	42
Self-pay and other	7	7
	<u>100%</u>	<u>100%</u>

Inventories

Inventories, consisting of drugs, medical devices, and medical supplies, are stated at the lower of cost (first-in, first-out method) or market.

Investments

Investments with original maturities greater than three months but less than one year are classified as short-term investments. Investments with maturities greater than one year are classified as long-term investments.

Investments are carried at fair value based on quoted market values. Investment income or loss (including realized or unrealized gains and losses on investments, interest, and dividends) is included in the excess of revenues over expenses unless the income or loss is restricted by donor or law.

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is computed using the straight-line method, and is provided over the following estimated useful lives for each class of depreciable asset:

	<u>Years</u>
Buildings and improvements	15-30
Land improvements	15-25
Equipment	3-10

Deferred Financing Costs

Certain costs incurred in connection with the issuance of long-term debt have been deferred and are being amortized over the life of the related debt using the straight-line method, which approximates the effective-interest method.

Restricted Net Assets

The Hospital reports contributions of cash and other assets as temporarily or permanently restricted revenue if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, restricted net assets are reclassified to unrestricted net assets and reported in the combined statements of operations and changes in net assets as released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reflected as unrestricted contributions. Donor restrictions have been imposed restricting usage of assets primarily for property and equipment and other purposes.

Net Patient Service Revenue

The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

Other Operating Revenue

Other operating revenue consists primarily of cafeteria sales, donations, equity changes in affiliates, and radiology professional fees.

Excess of Revenues Over Expenses

The combined statements of operations include a measurement for excess of revenues over expenses. Changes in unrestricted net assets which are excluded from excess of revenues over expenses, consistent with industry practice, include contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purpose of acquiring such assets).

Physician Income Guarantees

The Hospital enters into agreements with nonemployed physicians that include minimum net collection guarantees. These guarantees arise out of a community need to recruit physicians in certain specialties to the areas surrounding the Hospital and provide a guaranteed level of income to the physicians for the first year of practice. The guarantee provides a buffer between the physicians' actual collections on patient billings in this initial period and an agreed-upon income level based on the specialty. The physicians are expected to practice in the area for a total period of three to four years. Over the period subsequent to the guarantee period, amounts paid to the physicians during the guarantee period are ratably forgiven, resulting in income to the physicians in the years of forgiveness. The estimated amount of the liability for the Hospital's obligation under these guarantees is approximately \$856,000 and \$863,000 at June 30, 2011 and 2010, respectively.

Recent Accounting Pronouncements

In August 2010, a new accounting standard was issued relating to the accounting by an insured entity for claims incurred under claims-made insurance and retroactive insurance contracts. Under this accounting standard, unless conditions that allow for the right of offset exist,

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

offsetting prepaid insurance and receivables for expected recoveries from insurers against a recognized incurred but not reported liability, or the liability incurred as a result of a past insurable event, is no longer appropriate. The application of this guidance will result in claims liabilities and related insurance recoveries being recorded on a gross basis. This accounting guidance will be applied as of the beginning of the period of adoption, with a cumulative effect adjustment recorded in net assets as of the beginning of the period. The new accounting standard is effective for fiscal years beginning July 1, 2011. The Hospital does not believe that the adoption of this standard will have a material impact on its combined financial statements.

In August 2010, an accounting standard was released that will require the measurement of the amount of charity care provided to be based on the direct and indirect costs of providing that care. This standard will be effective for the Hospital beginning July 1, 2011, with retrospective application to all periods presented. The Hospital is currently evaluating the impact that the adoption of this accounting standard will have on its combined financial statements and disclosures.

In July 2011, an accounting standard was released relating to the presentation and disclosure of patient service revenue, provision for doubtful accounts and the allowance for doubtful accounts for certain health care entities. The accounting standard will require health care providers to report the provision for doubtful accounts as a reduction of net patient service revenue in the statement of operations. In addition, the notes to the financial statements will include additional disclosures relating to the methods used to recognize net patient service revenue, amount of net patient service revenue recognized by major payor source, methods used to analyze the allowance for doubtful accounts by major payor source, and any significant changes to the allowance for doubtful accounts. The accounting standard is effective for the Hospital's fiscal year beginning July 1, 2011. Management is currently evaluating the effect of adopting this accounting standard in the combined financial statements.

Subsequent Events

The Hospital considers the accounting and disclosure of events or transactions that occur after the balance sheet date, but before the financial statements are issued. There are two types of subsequent events: recognized subsequent events, which provide additional evidence about conditions that existed at the balance sheet date, and nonrecognized subsequent events, which provide evidence about conditions that did not exist at the balance sheet date, but arose before the financial statements were issued. Recognized subsequent events are required to be

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

recognized in the financial statements, and nonrecognized subsequent events are required to be disclosed. In the preparation of the accompanying combined financial statements, the Hospital has evaluated subsequent events through the date of issuance, August 24, 2011.

Reclassifications

Certain reclassifications were made to the 2010 combined financial statements to conform to the classifications used in 2011. The reclassifications had no effect on the change in net assets or on net assets as previously reported.

3. Net Patient Service Revenue

Net patient service revenue is reported at estimated net realizable amounts from patients and third-party payors for services rendered. The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

Medicare

Inpatient acute care services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. Outpatient services rendered are paid at prospectively determined rates using a set fee schedule. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. As of June 30, 2011, the Hospital's Medicare cost reports have been audited by the Medicare fiscal intermediary through June 30, 2007.

Arizona Health Care Cost Containment System (AHCCCS)

AHCCCS is Arizona's alternative to the Medicaid program and is designed to meet indigent health care needs. The Hospital receives both a percentage of charges adjusted each year for any rate increase and per diem rates depending on the AHCCCS plan payor and the nature of the services provided.

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

3. Net Patient Service Revenue (continued)

Other Third-Party Payors

The Hospital has also entered into payment arrangements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment to the Hospital under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

4. Community Benefit and Charity Care

Traditional Charity Care

In support of its mission and philosophy, the Hospital provides care to all patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. The Hospital does not pursue collection of amounts determined to qualify as charity care. The costs of these services were approximately \$1,248,000 in fiscal 2011 and \$1,166,000 in fiscal 2010.

Care for Undocumented Patients

The Hospital provides care to patients who have entered the community illegally. The charges for these patients are partially reimbursed under Section 1011 of the Medicare Prescription Drug, Improvement and Modernization Act of 2003. The unreimbursed costs for serving these patients were approximately \$12,000 in fiscal 2011 and \$49,000 in fiscal 2010.

Unpaid Costs of Public Programs

Public programs such as AHCCCS provide for the poor and indigent. Public programs such as Medicare provide for the elderly. Public programs do not always cover the costs of providing these services. The unreimbursed costs of the AHCCCS program were approximately \$1,831,000 in fiscal 2011 and \$0 in fiscal 2010. The unreimbursed costs of the Medicare program were approximately \$8,186,000 in fiscal 2011 and \$10,789,000 in fiscal 2010.

Other Community Benefit Programs

Community benefit includes the cost of providing services to other populations who may not qualify as poor; but may need special services and support. This type of community benefit

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

4. Community Benefit and Charity Care (continued)

includes the cost of programs for senior citizens such as health promotion and education, health clinics, and screenings. It also includes costs incurred by the Hospital for training health professionals such as medical residents, nursing students, and students in allied health professionals.

The Hospital also commits significant time and resources to endeavors and critical services which meet otherwise unfilled community needs. Many of these activities are sponsored with the knowledge that they will not be financially viable. The development of these programs is based on a community health care assessment performed by an independent company. The current community outreach programs are:

- | | |
|-----------------------------|-----------------------------------|
| Better Breathers Club | Bike Safety |
| Blood Pressure Checks | Cardiac Rehabilitation |
| Diabetes Support Group | Diabetes Education |
| Food Drives | Health Fairs |
| Hospice Bereavement Group | Mall Walkers Program |
| Parish Nurse Program | Perinatal Grief Support |
| Poison Safety Classes | Postpartum Depression Information |
| Power of Pink Breast Cancer | Prenatal Classes |
| Pulmonary Rehabilitation | Speakers Bureau |
| Smart Teen Eating Program | Smoke Support Group |
| Telecare Home Bound | Virtual Tour Kits for all Schools |
| Weight Management Program | Wellness Depot |
| Cholesterol Testing | Old Medication Disposal |
| VICAP space and supplies | H1N1 Awareness |
| Arthritis Programs | Chair Yoga |
| Water Safety | MRSA Awareness |
| Flu Precaution Programs | Kids Sports Teams First Aid Kits |
| Music Therapy | Sun Safety |
| Advanced Directives | Living Wills |
| Immunization Information | Bone Marrow Collection |
| Pulse Oxygen Tests | Body Mass Index |
| Southwest Snake Safety | Southwest Insect Safety |
| Arrhythmic Death Syndrome | Heart Safety |

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

4. Community Benefit and Charity Care (continued)

The Hospital also sponsors events in the community through other health and welfare organizations which promote healthy life styles and/or disease prevention/information; these include:

American Cancer Society	Forgach House (Battered Women/Children)
Little League	Good Neighbor Alliance (Men's Shelter)
United Way (numerous programs)	March of Dimes
Just Kids (clothing program)	Running Club
Youth Soccer Club	Senior Olympics
High School Scholarships	College Scholarships
State of Arizona Kids Care	American Heart Association
American Red Cross Blood Drives	VICAP
Project Graduation (drug/alcohol free evening for graduating seniors)	

5. Investments and Assets Whose Use Is Limited

A summary of investments (carried at fair value based upon quoted market prices) at June 30 follows:

	<u>2011</u>	<u>2010</u>
Certificates of deposit	\$ 20,804,869	\$ 16,569,013
U.S. government agency and treasury securities	4,365,606	3,613,416
Municipal bonds	1,485,039	30,767
Corporate bonds	8,314,968	7,200,759
Common stocks	10,497,596	8,252,147
Mutual funds	2,667,961	2,201,557
Closed-end funds	183,280	197,200
Mortgage-backed securities	1,111,537	457,910
	<u>49,430,856</u>	<u>38,522,769</u>
Less short-term investments	4,536,652	3,912,883
	<u>\$ 44,894,204</u>	<u>\$ 34,609,886</u>

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

5. Investments and Assets Whose Use Is Limited (continued)

Assets whose use is limited represents assets held by a trustee under indenture agreements. Assets whose use is limited are carried at fair value, based upon quoted market prices. The debt reserve fund consists of U.S. government agency and treasury securities. The other funds consist of money market funds. The composition at June 30 follows:

	2011	2010
Assets held by trustee under bond indenture:		
Bond reserve fund	\$ 3,184,383	\$ 3,183,414
Bond principal fund	586,382	554,413
Bond interest fund	142,122	147,592
	3,912,887	3,885,419
Less current portion	728,504	702,005
	<u>\$ 3,184,383</u>	<u>\$ 3,183,414</u>

In 1998, the Hospital entered into agreements with a broker whereby the Hospital sold the future income stream pertaining to the Series 1997 bond reserve fund and the Series 1997, 1996A, 1996B, and 1996C principal and interest funds of the respective bonds in exchange for fees totaling \$750,000. The terms of the agreements include provisions for termination penalties in certain events. The Hospital recorded the proceeds received as an other long-term liability which is being amortized over the terms of the agreements under the interest method. The unamortized balance was approximately \$239,000 and \$275,000 at June 30, 2011 and 2010, respectively.

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

6. Fair Value Measurements

The Hospital utilizes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

- *Level 1* – Pricing is based on observable inputs such as quoted prices in active markets. Financial assets and liabilities in Level 1 generally include U.S. government agency and treasury securities and listed equities.
- *Level 2* – Pricing inputs are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Financial assets in this category generally include certificates of deposit, corporate bonds and loans, municipal bonds, mutual funds, closed-end funds, and mortgage-backed securities.
- *Level 3* – Pricing inputs are generally unobservable and include situations where there is little, if any, market activity for the investment. The inputs into the determination of fair value require management's judgment or estimation of assumptions that market participants would use in pricing the assets or liabilities. The fair values are therefore determined using factors that involve considerable judgment and interpretations, including but not limited to private and public comparables, third-party appraisals, discounted cash flow models, and fund manager estimates.

Assets measured at fair value are based on one or more of three valuation techniques. The three valuation techniques are identified in the tables below. Where more than one technique is noted, individual assets were valued using one or more of the noted techniques. The valuation techniques are as follows:

- (a) *Market approach* – Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.
- (b) *Cost approach* – Amount that would be required to replace the service capacity of an asset (replacement cost).

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

6. Fair Value Measurements (continued)

(c) *Income approach* – Techniques to convert future amounts to a single present amount based on market expectations (including present value techniques, option-pricing, and excess earnings models).

	Balance at June 30 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique (a,b,c)
Cash and cash equivalents	\$ 12,040,116	\$ 12,040,116	\$ –	\$ –	(a)
Short-term investments:					
Certificates of deposit	\$ 2,836,801	\$ –	\$ 2,836,801	\$ –	(a)
Government securities	588,573	588,573	–	–	(a)
Municipal bonds	30,249	–	30,249	–	(a)
Corporate bonds	1,081,029	–	1,081,029	–	(a)
Total short-term investments	\$ 4,536,652	\$ 588,573	\$ 3,948,079	\$ –	
Assets limited as to use:					
Cash and cash equivalents	\$ 1,949,061	\$ 1,949,061	\$ –	\$ –	(a)
Government securities	1,963,826	1,963,826	–	–	(a)
Total assets limited as to use	\$ 3,912,887	\$ 3,912,887	\$ –	\$ –	
Long-term investments:					
Certificates of deposit	\$ 17,968,068	\$ –	\$ 17,968,068	\$ –	(a)
Government securities	3,777,034	3,777,034	–	–	(a)
SVRHC municipal bonds	1,454,790	–	1,454,790	–	(a)
Corporate bonds	7,233,939	–	7,233,939	–	(a)
Common stocks	10,497,596	10,497,596	–	–	(a)
Mutual funds – bonds	2,667,960	2,667,960	–	–	(a)
Closed-end funds	183,280	–	183,280	–	(a)
Mortgage-backed securities	1,111,537	–	1,111,537	–	(c)
Total long-term investments	\$ 44,894,204	\$ 16,942,590	\$ 27,951,614	\$ –	

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

6. Fair Value Measurements (continued)

	Balance at June 30 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique (a,b,c)
Cash and cash equivalents	\$ 13,025,498	\$ 13,025,498	\$ -	\$ -	(a)
Short-term investments:					(a)
Certificates of deposit	\$ 2,677,775	\$ -	\$ 2,677,775	\$ -	(a)
Government securities	224,080	224,080	-	-	(a)
Corporate bonds	1,011,028	-	1,011,028	-	(a)
Total short-term investments	<u>\$ 3,912,883</u>	<u>\$ 224,080</u>	<u>\$ 3,688,803</u>	<u>\$ -</u>	
Assets limited as to use:					
Cash and cash equivalents	\$ 2,344,479	\$ 2,344,479	\$ -	\$ -	(a)
Government securities	1,540,940	1,540,940	-	-	(a)
Total assets limited as to use	<u>\$ 3,885,419</u>	<u>\$ 3,885,419</u>	<u>\$ -</u>	<u>\$ -</u>	
Long-term investments					
Certificates of deposit	\$ 13,891,238	\$ -	\$ 13,891,238	\$ -	(a)
Government securities	3,389,336	3,389,336	-	-	(a)
Municipal bonds	30,767	-	30,767	-	(a)
Corporate bonds	6,189,731	-	6,189,731	-	(a)
Common stocks	8,252,147	8,252,147	-	-	(a)
Mutual funds – bonds	2,201,557	2,201,557	-	-	(a)
Closed-end funds	197,200	-	197,200	-	(a)
Mortgage-backed securities	457,910	-	457,910	-	(c)
Total long-term investments	<u>\$ 34,609,886</u>	<u>\$ 13,483,040</u>	<u>\$ 20,766,846</u>	<u>\$ -</u>	

The Hospital purchased a portion of their 2003 revenue bonds in December 2010. The purchase price was \$1,463,250.

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

7. Property and Equipment

A summary of property and equipment at June 30 follows:

	2011	2010
Land and land improvements	\$ 2,832,263	\$ 2,832,263
Buildings, building improvements, and fixed equipment	37,379,904	37,094,087
Major and minor equipment	44,959,626	42,200,470
	85,171,793	82,126,820
Less accumulated depreciation	52,308,606	46,863,678
	32,863,187	35,263,142
Construction in progress	1,939,557	1,610,559
	\$ 34,802,744	\$ 36,873,701

The Hospital had no capitalized interest costs for fiscal 2011 or fiscal 2010.

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

8. Long-Term Debt

A summary of long-term debt as of June 30 follows:

	<u>2011</u>	<u>2010</u>
Industrial Development Authority Hospital Refunding Bonds, Series 2003, term bonds in the original amount of \$2,670,000 at 6.00% fixed interest rate, maturing in December 2021, secured by the Hospital's land, buildings, and equipment	\$ 2,670,000	\$ 2,670,000
Industrial Development Authority Hospital Revenue Bonds, Series 2001, term bonds in the original amount of \$6,625,000 at 7.75% fixed interest rate, maturing in December 2030, secured by the Hospital's land, buildings, and equipment	5,421,631	5,566,524
Industrial Development Authority Hospital Revenue Refunding Bonds, Series 1999A, term bonds in the original amount of \$8,320,000 at 6.2% fixed interest rate, maturing in December 2021, secured by the Hospital's land	6,973,448	7,216,374
Industrial Development Authority Hospital Revenue Bonds, Series 1997, term bonds in the original amount of \$6,500,000 at 6.45% fixed interest rate, maturing in December 2017, secured by the Hospital's land, buildings, and equipment	2,925,000	3,250,000
Industrial Development Authority Hospital Revenue Refunding Bonds, Series 1996A, term bonds in the original amount of \$9,010,100 at 6.75% fixed interest rate, maturing in December 2026, secured by the Hospital's land, buildings, and equipment	7,325,000	7,550,000
Capital lease for equipment, monthly payments of principal and interest through July 2014, interest fixed at notes ranging from 3.9% to 5.5%	262,575	701,323
	<u>25,577,654</u>	26,954,221
Less current portion	1,147,979	1,389,805
	<u>\$ 24,429,675</u>	<u>\$ 25,564,416</u>

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

8. Long-Term Debt (continued)

Future aggregate principal payments on long-term debt as of June 30, 2011, follow:

2012	\$ 1,147,979
2013	1,176,451
2014	1,158,145
2015	1,220,000
2016	1,380,000
Thereafter	<u>19,630,000</u>
	25,712,575
Less unamortized discount	<u>134,921</u>
	<u>\$ 25,577,654</u>

Pursuant to the terms of the bond indentures, the Hospital is required to maintain amounts on deposit with a trustee which may only be used to satisfy obligations as permitted by the trust agreements. Such deposits are included in assets whose use is limited in the accompanying combined balance sheets.

The Hospital is subject to certain financial covenants which have been complied with for the year ended June 30, 2011. In addition, the indenture places certain restrictions on the incurrence of additional indebtedness and the sale or acquisition of property.

9. Lease Commitments

As of June 30, 2011, future minimum lease payments due under existing, noncancelable operating leases for buildings, equipment, and medical devices are as follows:

2012	\$ 1,184,016
2013	1,130,729
2014	504,215
2015	278,004
2016	<u>246,973</u>
	<u>\$ 3,343,937</u>

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

10. Professional and General Liability Coverage

The Hospital is insured for professional liabilities under a claims-made policy with no deductible per claim. An unlimited tail is in place for all claims prior to July 2006. The limit of liability is \$11,000,000 per claim with a \$20,000,000 aggregate limit. In addition, the Hospital has general and umbrella liability coverage on a claims-made basis with a \$5,000,000 aggregate limit.

11. Employee Benefit Plan

The Hospital has a 403(b) employee benefit plan (the Plan). Under the terms of the Plan, the Hospital matches eligible participant contributions from 2.5% to 4.5% of gross pay based upon years of service as defined in the Plan agreement. Eligible participants must contribute at least 2.5% to receive the employer match. Participants are 100% vested in the value of their account attributable to their contributions and vest in the value of the account attributable to the employer's contributions over a five-year period. The Hospital's contributions to the Plan were approximately \$619,000 and \$589,000 for the years ended June 30, 2011 and 2010, respectively.

12. Commitment and Contingencies

Commitment

The Hospital has an unrecorded liability to the City of Sierra Vista to extend the road at Colonia de Salud. The City is not requiring the Hospital to complete the road at this time, but will require it at some future date based upon traffic flow. The Hospital will be responsible for one half of the cost to construct the road. Since this will occur at some future unknown date, it is not possible to estimate an actual liability at this time.

Health Care Regulatory Environment

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements, and reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Recently, government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by health care providers. Violations of these laws and regulations could result in expulsion from government health care programs together with the imposition of significant fines and penalties, as well as significant

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

12. Commitment and Contingencies (continued)

repayments for patient services previously billed. Management believes that the Hospital is in compliance with fraud and abuse as well as other applicable government laws and regulations. Compliance with such laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time.

Litigation

The Hospital is party to pending or threatened lawsuits arising out of, or incident to, its ordinary course of business for which it carries professional liability and other insurance coverages. In management's opinion, upon consultation with legal counsel, these matters will not have a material adverse effect on the Hospital's financial position.

13. Functional Expenses

The Hospital provides general health care services to residents within its geographic location. Expenses related to providing these services for the years ended June 30 were as follows:

	<u>2011</u>	<u>2010</u>
Health care services	\$ 65,940,522	\$ 66,410,317
General and administrative	26,367,920	26,555,779
	<u>\$ 92,308,442</u>	<u>\$ 92,966,096</u>

14. Agreement With Carondelet Health Network

During fiscal 2010, the Company entered into a two-year Integrative Network Agreement with the Carondelet Health Network (CHN), who is a member of Ascension Health, the nation's largest nonprofit health care system. The purpose of this agreement was to focus on improving clinical and quality outcomes as well as driving operational efficiencies.

CHN and SVRHC mutually agreed to sever the formal Integrative Network Agreement on April 7, 2011. Both organizations continue to collaborate on improving clinical and quality outcomes. There was no significant impact to the Hospital from the termination of this arrangement.

Sierra Vista Regional Health Center, Inc. and Affiliates

Notes to Combined Financial Statements (continued)

15. Subsequent Events

The Hospital entered into a Management Services and Support Agreement with Community Healthcare of Douglas, Inc. dba Southeast Arizona Medical Center (SAMC) as of July 14, 2011. The five-year agreement provides that SAMC delegates the power and authority to manage the day-to-day operations and administration of Southeast Arizona Medical Center to the Hospital. SAMC will pay the Hospital an annual fee, reimburse the Hospital direct costs for services, plus a contingent annual fee based on profitability. Under the terms of the agreement, the Hospital agrees to provide general administrative oversight, assist with human resource services, billing and financial management, marketing, purchasing, quality control, and other patient care related services. The Hospital has the right to terminate the agreement with 90 day notice.

The Hospital and SAMC executed a contract on July 7, 2011, for the Hospital to extend a \$1,000,000 line of credit to SAMC. The line of credit is secured by a security interest in substantially all of SAMC's assets and bears interest at the prime interest rate plus 225 basis points, but in no case less than 5.5%. The loan matures in June 2016. No interest payments are due until January 2012, after which time monthly payments of interest are required. Subsequent to June 30, 2011, there was a \$680,000 draw on the line of credit.

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