

CONSOLIDATED FINANCIAL STATEMENTS AND
SUPPLEMENTARY INFORMATION

The William W. Backus Hospital
Year Ended September 30, 2014
Period from August 1, 2013 to September 30, 2013, and
Period from October 1, 2012 to July 31, 2013
With Report of Independent Auditors

Ernst & Young LLP



Building a better
working world

The William W. Backus Hospital

Consolidated Financial Statements and Supplementary Information

Year Ended September 30, 2014, Period from August 1, 2013 to September 30, 2013, and Period
from October 1, 2012 to July 31, 2013

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Ernst & Young LLP
20 Church Street
Hartford, CT 06103

Tel: +1 860 247 3100
Fax: +1 860 725 6040
ey.com

Report of Independent Auditors

The Board of Directors
Hartford Healthcare Corporation and Subsidiaries

We have audited the accompanying consolidated financial statements of The William W. Backus Hospital, which comprise the consolidated balance sheets as of September 30, 2014 and 2013, and the related consolidated statements of operations, changes in net assets and cash flows for the year ended September 30, 2014, the period from August 1, 2013 to September 30, 2013 and the period from October 1, 2012 to July 31, 2013, and the related notes to the 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 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 The William W. Backus Hospital at September 30, 2014 and 2013, and the results of its operations, its changes in net assets and its cash flows for the year ended September 30, 2014, the period from August 1, 2013 to September 30, 2013 and the period from October 1, 2012 to July 31, 2013, in conformity with U.S. generally accepted accounting principles.

Supplementary Information

Our audits were performed for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying consolidating balance sheet and consolidating statement of operations are presented for the purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the 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

January 28, 2015

The William W. Backus Hospital

Consolidated Balance Sheets

	September 30	
	2014	2013
Assets		
Current assets:		
Cash and cash equivalents	\$ 187,018,905	\$ 132,347,698
Accounts receivable, less allowances for doubtful accounts of approximately \$6,299,279 in 2014 and \$5,739,072 in 2013	36,980,052	31,013,657
Other receivables	1,320,143	2,286,728
Due from affiliates	2,052,950	184,696
Inventories of supplies	3,771,462	3,715,171
Prepaid expenses and other assets	1,643,561	752,260
Current portion of assets whose use is limited	3,285,815	6,509,778
Total current assets	236,072,888	176,809,988
Assets whose use is limited:		
Investments and other assets	57,081,792	112,198,811
Interest in investments held by Endowment LLC	47,662,263	-
Donor-restricted interest in investments held by Endowment LLC	8,311,558	-
Investments held in trust	26,640,012	25,594,126
Investments for donor-restricted purposes	-	7,935,735
Funds designated for debt service	-	3,737,303
	139,695,625	149,465,975
Funds held in trust by others	2,633,503	2,515,481
Other assets	7,214,261	9,206,465
Property, plant, and equipment, net	127,834,702	138,743,906
Total assets	\$ 513,450,979	\$ 476,741,815

Continued on next page.

The William W. Backus Hospital

Consolidated Balance Sheets (continued)

	September 30	
	2014	2013
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 8,403,969	\$ 8,031,635
Salaries, wages, payroll taxes, and amounts withheld from employees	7,611,745	6,965,186
Due to affiliates	2,841,766	–
Accrued expenses	6,965,890	6,319,677
Estimated third-party payor settlements postretirement liabilities	8,036,715	17,467,823
Current portion of long-term debt	399,818	2,443,472
Current portion of accrued pension and other postretirement liability	4,195,223	3,553,200
Current portion of other liabilities	653,974	–
Total current liabilities	<u>39,109,100</u>	44,780,993
Long-term debt	68,199,710	67,193,532
Accrued pension and other postretirement liabilities	38,600,633	18,267,625
Self-insured professional liability	8,527,863	14,348,700
Other liabilities	4,532,110	6,659,958
Total liabilities	<u>158,969,416</u>	151,250,808
Net assets:		
Unrestricted	342,594,117	314,117,949
Temporarily restricted	3,534,497	3,305,592
Permanently restricted	8,352,949	8,067,466
Total net assets	<u>354,481,563</u>	325,491,007
Total liabilities and net assets	<u>\$ 513,450,979</u>	<u>\$ 476,741,815</u>

See accompanying notes.

The William W. Backus Hospital
Consolidated Statements of Operations

	Year Ended September 30, 2014	Period From August 1, 2013 to September 30, 2013	<u>Predecessor Company</u> Period From October 1, 2012 to July 31, 2013
Unrestricted revenues, gains and other support:			
Net patient service revenue	\$ 301,653,222	\$ 46,288,627	\$ 230,444,135
Provision for bad debts	8,035,283	1,489,352	7,234,583
Net patient service revenue less provision for bad debts	293,617,939	44,799,275	223,209,552
Other operating revenue	7,226,224	710,072	6,815,117
Net assets released from restriction for operations	287,246	28,253	217,331
	301,131,409	45,537,600	230,242,000
Operating expenses:			
Salaries and wages	110,166,889	19,188,089	98,064,757
Employee benefits	21,447,489	3,125,646	23,754,968
Supplies and other	47,207,926	8,606,513	38,839,806
Purchased services	54,305,989	7,633,095	32,300,609
Depreciation and amortization	15,651,354	2,684,973	12,838,658
Interest	2,992,001	557,418	2,817,755
	251,771,648	41,795,734	208,616,553
Operating income before bond refinancing costs	49,359,761	3,741,866	21,625,447
Loss on bond refinancing	(722,310)	-	-
Operating income	48,637,451	3,741,866	21,625,447
Nonoperating income:			
Income from investments, gifts and bequests, net	9,253,115	1,299,791	9,005,044
Other	(186,851)	1,600	(140,249)
Excess of revenues over expenses	\$ 57,703,715	\$ 5,043,257	\$ 30,490,242

See accompanying notes.

The William W. Backus Hospital

Consolidated Statements of Changes in Net Assets

	Year Ended September 30, 2014	Period From August 1, 2013 to September 30, 2013	<u>Predecessor Company</u> Period From October 1, 2012 to July 31, 2013
Beginning balance of unrestricted net assets	\$ 314,117,949	\$ 308,205,973	\$ 187,215,454
Excess of revenues over expenses	57,703,715	5,043,257	30,490,242
Change in pension and post-retirement funding obligation	(26,854,297)	1,580,966	40,304,322
Transfer to affiliates	(2,553,495)	(712,247)	(2,082,312)
Net assets released from restrictions used for the purchase of equipment	180,245	—	495,151
Ending balance of unrestricted net assets	<u>342,594,117</u>	314,117,949	256,422,857
Beginning balance of temporarily restricted net assets	3,305,592	3,099,995	2,890,743
Restricted contributions	333,892	92,032	436,408
Restricted investment income	112,215	141,818	485,326
Return on investments held by Endowment LLC	250,289	—	—
Net assets released from restrictions for operations	(287,246)	(28,253)	(217,331)
Net assets released from restrictions for the purchase of equipment	(180,245)	—	(495,151)
Ending balance of temporarily restricted net assets	<u>3,534,497</u>	3,305,592	3,099,995
Beginning balance of permanently restricted net assets	8,067,466	8,024,584	7,755,916
Restricted investment income	167,461	—	155,116
Change in unrealized gains and losses on funds held in trust by others	118,022	42,882	113,552
Ending balance of permanently restricted net assets	<u>8,352,949</u>	8,067,466	8,024,584
Net assets at end of period	<u>\$ 354,481,563</u>	<u>\$ 325,491,007</u>	<u>\$ 267,547,436</u>

See accompanying notes.

The William W. Backus Hospital

Consolidated Statements of Cash Flows

	Year Ended September 30, 2014	Period From August 1, 2013 to September 30, 2013	Predecessor Company Period From October 1, 2012 to July 31, 2013
Cash flows from operating activities			
Increase in net assets	\$ 28,990,556	\$ 6,160,455	\$ 69,685,323
Adjustments to reconcile increase in net assets to net cash provided by operating activities:			
Non-cash items:			
Depreciation and amortization	15,651,354	2,684,973	12,838,658
Amortization of bond premium	(19,380)	-	-
Change in investments held by Endowment LLC	(1,635,146)	-	-
Change in unrealized gains and losses on funds held in trust by others	(118,022)	(42,882)	(113,551)
Provision for bad debts	8,035,283	1,489,352	7,234,583
Change in pension and post-retirement funding obligation	26,854,297	(1,580,966)	(40,304,322)
Transfer to affiliates	2,553,495	712,247	2,082,312
Loss on bond restructuring	722,310	-	-
Other changes in net assets:			
Restricted contributions and investment income	(613,568)	(233,850)	(1,076,850)
Changes in assets and liabilities (Note 13)	(30,694,693)	2,574,739	(16,644,276)
Net cash provided by operating activities	49,726,486	11,764,068	33,701,877
Cash flows from investing activities			
Purchases of property, plant, and equipment, net	(3,690,201)	(465,375)	(4,292,383)
Decrease (increase) in assets whose use is limited, net	14,629,459	(2,719,701)	(8,571,270)
(Increase) decrease in other assets	(112,133)	(648,658)	18,250
Net cash provided by (used) in investing activities	10,827,125	(3,833,734)	(12,845,403)
Cash flows from financing activities			
Principal payments on long-term debt	(359,582)	(50,249)	(2,295,959)
Payoff of long-term debt	(62,931,764)	-	-
Proceeds from long-term debt	60,307,211	-	-
Change in deferred financing costs	(958,342)	-	(37,408)
Restricted contributions and investment income	613,568	233,850	1,076,850
Transfer to affiliates	(2,553,495)	(712,247)	(2,082,312)
Net cash used in financing activities	(5,882,404)	(528,646)	(3,338,829)
Net increase in cash and cash equivalents	54,671,207	7,401,688	17,517,645
Cash and cash equivalents at beginning of year	132,347,698	124,946,010	107,428,365
Cash and cash equivalents at end of year	\$ 187,018,905	\$ 132,347,698	\$ 124,946,010

See accompanying notes.

The William W. Backus Hospital

Notes to Consolidated Financial Statements

September 30, 2014

1. Significant Accounting Policies

The accounting policies that affect significant elements of The William W. Backus Hospital's (the Hospital) consolidated financial statements are summarized below and in Note 2.

Organization

The Hospital, a voluntary association incorporated under the General Statutes of the State of Connecticut, is a wholly owned subsidiary of Backus Corporation (the sole member). Hartford Healthcare Corporation (HHC) elects a Board of Directors that has control of the operations of the Hospital.

The financial statements include the operations of Backus Medical Center Condominium Association, Inc. (the Association). All intercompany transactions have been eliminated in consolidation.

On August 1, 2013 (the Acquisition Date), HHC became the sole corporate member of Backus Corporation and a full corporate affiliation was completed. As a result, all of the Hospital's assets and liabilities were revalued to fair value as of August 1, 2013. The Hospital is consolidated in HHC's financials for all periods from August 1, 2013.

In connection with the acquisition, the Hospital's assets and liabilities were marked to fair value at the Acquisition Date. The increase in the Hospital's net assets at the Acquisition Date was \$51,783,116 when reported at fair value, as compared to the historical value of net assets as reported by the predecessor company. The \$51,783,116 increase in the Hospital's net assets was comprised of the following:

	Increase (Decrease)
Property, plant, and equipment	\$ 58,082,038
Long-term debt	(5,247,289)
Premium on bonds	629,869
Unamortized bond issue costs	(1,681,502)
	<u>\$ 51,783,116</u>

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

1. Significant Accounting Policies (continued)

The accompanying consolidated financial statements present the financial position and results of operations for the period prior to the Acquisition Date, which are reported as the predecessor company at historical value, and subsequent to acquisition, which are reported using fair value as the cost basis established on the Acquisition Date.

The accompanying consolidated statements of operations, changes in net assets and cash flows disclose activity related to the year ended September 30, 2014, and for the periods from August 1, 2013 to September 30, 2013 and October 1, 2012 to July 31, 2013, and are hereafter referred to collectively as the “Periods under Audit.”

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles (GAAP) 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 consolidated financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. There is at least a reasonable possibility that certain estimates will change by material amounts in the near term. Actual results could differ from those estimates.

Regulatory Matters

The Hospital is required to file annual operating information with the State of Connecticut Office of Health Care Access (OHCA).

Fair Value of Financial Instruments

The carrying value of financial instruments classified as current assets and current liabilities approximate fair value. The fair values of the Hospital’s financial instruments are disclosed in Note 5.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

1. Significant Accounting Policies (continued)

Cash and Cash Equivalents

The Hospital considers all highly liquid time deposits, commercial paper, and money market mutual funds purchased with a maturity at date of acquisition of three months or less to be cash equivalents. Cash and cash equivalents are maintained with domestic financial institutions with deposits that at times, exceed federally insured limits. It is the Hospital's policy to monitor the financial strength of those institutions.

Patient Accounts Receivable

Patient accounts receivable result from the health care services provided by the Hospital. Additions to the allowance for doubtful accounts result from the provision for bad debts. Accounts written off as uncollectible are deducted from the allowance for doubtful accounts.

The amount of the allowance for doubtful accounts is based upon management's assessment of historical and expected net collections, business and economic conditions, trends in Medicare and Medicaid health care coverage, and other collection indicators. See Note 2 for additional information relative to third-party payor programs.

The Hospital's primary concentration of credit risk is patient accounts receivables that consist of amounts owed by various governmental agencies, insurance companies, and private patients. The Hospital manages the receivables by regularly reviewing its patient accounts and contracts and by providing appropriate allowances for uncollectible accounts. The Hospital grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. Significant concentrations of patient accounts receivable include 36% and 8%, and 37% and 6% for Medicare and Medicaid, respectively, for the fiscal years ended September 30, 2014 and 2013, respectively.

Interest in Investments Held by Hartford Healthcare Endowment LLC

Effective August 29, 2011, Hartford HealthCare Endowment LLC (Endowment LLC) was created to maintain and manage, on a pooled basis, the endowment funds of the Hospital; Hartford Hospital; Windham Community Memorial Hospital, Inc.; MidState Medical Center; The Hospital of Central Connecticut at New Britain General and Bradley Memorial; and Hartford HealthCare at Home, Inc. Endowment LLC, a wholly owned subsidiary of HHC, acts as a manager and is named fiduciary for HHC within established investment guidelines. As of

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

1. Significant Accounting Policies (continued)

January 1, 2014, \$53,112,368 of the Hospital's investments were liquidated and transferred to Endowment LLC, at which time all previously unrealized gains and losses were realized. As of September 30, 2014, the Hospital has an interest in investments held by Endowment LLC, which is reflected in the accompanying consolidated balance sheets and represents the Hospital's pro rata share of Endowment LLC.

The Hospital reports its share of the increase or decrease in Endowment LLC as income or loss from investments in the excess of revenue and expenses, unless the income or loss is restricted by donor or law. Investments held by Endowment LLC in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value using quoted market prices or model-driven valuations at the consolidated balance sheet date. Alternative investments (nontraditional, not-readily-marketable assets), some of which are structured such that Endowment LLC holds limited partnership interests, are reported based upon net asset value (NAV) and derived from the application of the equity method of accounting. Individual investment holdings within the alternative investments may, in turn, include investments in both nonmarketable and market-traded securities. Valuations of these investments and, therefore, Endowment LLC's holdings may be determined by the investment manager or general partner and for "fund of funds" investments are primarily based on financial data supplied by the underlying investee funds. Values may be based on historical cost, appraisals, or other estimates that require varying degrees of judgment. Endowment LLC accounts for these investments using the equity method of accounting and reports its share of the increase or decrease in the funds' value as investment gain or loss. The financial statements of the investees are audited annually by independent auditors, although the timing for reporting the results of such audits does not coincide with Endowment LLC's annual consolidated financial statement reporting.

Investments

The Hospital's investment portfolio is classified as trading, with unrealized gains and losses included in the excess of revenues over expenses.

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value using quoted market prices or model-driven valuations at the consolidated balance sheet date. Assets temporarily and permanently restricted (by donor) are recorded at fair value at the date of donation, which is then considered cost. Investment income

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

1. Significant Accounting Policies (continued)

(including realized gains and losses on investments, interest and dividends, and the change in unrealized gains and losses) is included in nonoperating income unless the income or loss is restricted by the donor or law.

Inventories of Supplies

Inventories are stated at the lower of cost or market. The Hospital values its inventories using the first-in, first-out method.

Property, Plant, and Equipment

Property, plant, and equipment are stated on the basis of cost. The Hospital provides for depreciation using the straight-line method in amounts sufficient to depreciate the cost of its assets over their estimated useful lives, which range from 3 to 40 years. Amortization of assets recorded under capital leases is included in depreciation expense.

Assets Whose Use is Limited

Assets whose use is limited includes assets that are set aside internally by management or by the Board of Directors for future capital improvements, research, donor-restriction, education, escrow funds, and debt service funds for existing obligations on outstanding long-term debt. Amounts that are restricted by the Board of Directors are not available for use without the approval of the Board of Directors. Restricted investment income has also been set aside as long-term investments. Investments for restricted purposes represents assets reserved based on various agreements.

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those assets whose use by the Hospital has been limited by donors to a specific time frame or purpose. Permanently restricted net assets have been restricted by donors and are maintained by the Hospital in perpetuity. The Hospital is a partial beneficiary to various perpetual trust agreements. Assets recorded under these agreements are recognized at fair value. The investment income generated from these funds is expendable to support healthcare services, and the assets are classified as permanently restricted.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

1. Significant Accounting Policies (continued)

Contributions, including unconditional promises to give, are recognized as revenue in the period received. Conditional promises to give are not recognized until the conditions on which they depend are substantially met. Unrestricted contributions are recorded, net of expenses, within operating revenue.

Donor-Restricted Gifts

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the accompanying consolidated statements of operations and changes in net assets as net assets released from restrictions, which is included in operating revenues. Donor-restricted contributions whose restrictions are met within the same year as received are classified as unrestricted contributions in the accompanying financial statements.

Bond Issuance Costs

Bond issuance costs associated with long-term debt for capital projects are amortized over the term of the debt using a method that approximates the effective interest method. Bond issuance costs of \$946,144 and \$0 are recorded in other assets in the consolidated balance sheets as of September 30, 2014 and 2013, respectively. During 2014, the Hospital paid \$958,342 in additional bond issuance costs.

Other Operating Income

Other operating revenue includes services to other subsidiaries of HHC and other institutions, electronic health record incentive program revenue, rental income, grant income, cafeteria income, and unrestricted contributions. See Note 11.

Nonoperating Income

Activities other than those in connection with providing health care services are considered to be non-operating. Nonoperating income includes income on investments, return on interest in investments held by Endowment LLC, realized and unrealized gains and losses on trading investments, gifts, and bequests.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

1. Significant Accounting Policies (continued)

Excess of Revenues Over Expenses

The accompanying consolidated statements of operations and changes in net assets include the excess of revenues over expenses as the performance indicator. Changes in unrestricted net assets, which are excluded from the performance indicator, include transfers of assets to/from affiliates, the change in pension and postretirement funding obligations, fair value adjustments, and net assets released from restriction used for the purchase of property and equipment.

Professional Liability and Workers' Compensation Insurance

Coverage for medical malpractice insurance is provided on a claims-made basis. As of October 1, 2013, the primary coverage is with Hartford HealthCare Indemnity Services, Limited (HHCISL), a captive insurance company that is a wholly owned subsidiary of HHC.

Effective October 1, 2013, the policy limits for the primary coverage were \$7,500,000 per claim and \$39,000,000 in the aggregate. The primary layer of excess coverage of \$20,000,000 is shared with two insurance carriers. The secondary layer is \$20,000,000 with a single insurance carrier. The third and fourth layers are \$10,000,000 each with two other insurance carriers. The top layer is \$20,000,000 for a total excess coverage of \$80,000,000.

Malpractice claims are discounted at 1.72% for the incurred-but-not-reported liability which was approximately \$1,551,000 at September 30, 2014. In addition, medical malpractice insurance recoveries and the related claim liabilities of approximately \$3,187,000 and \$0 as of September 30, 2014 and 2013, respectively, are included in other current assets and other current liabilities, and medical malpractice insurance recoveries and the related claim liabilities of approximately \$6,847,000 and \$251,000 as of September 30, 2014 and 2013, respectively, are included in other long-term assets and other long-term current liabilities.

Prior to October 1, 2013, The Hospital had adopted the policy of self-insuring the deductible portion of its general and professional liability insurance coverage. The deductible limits were \$1,000,000 per claim and \$5,000,000 annually for 2013. Management accrued its best estimate of ultimate losses for both reported claims and claims incurred but not reported. The Hospital maintains a revocable trust for purposes of funding malpractice or comprehensive general liability losses.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

1. Significant Accounting Policies (continued)

The Hospital carries a worker's compensation policy with a \$250,000 per occurrence deductible. The reserves for losses within the deductible are funded by monthly payments based on reported claims.

Income Taxes

The Hospital is a not-for-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code (the Code), and is exempt from federal income taxes on related income pursuant to Section 501(a) of the Code. The Association is a taxable entity; however, any taxes are immaterial to the consolidated financial statements of the Hospital taken as a whole.

Electronic Health Record (EHR) Program

The Centers for Medicare & Medicaid Services (CMS) have implemented provisions of the American Recovery and Reinvestment Act of 2009 that provide incentive payments for the meaningful use of certified electronic health record (EHR) technology. CMS has defined meaningful use as meeting certain objectives and clinical quality measures based on current and updated technology capabilities over predetermined reporting periods as established by CMS. The Medicare EHR incentive program provides annual incentive payments to eligible professionals, hospitals, and critical access hospitals, as defined, that are meaningful users of certified EHR technology. The Medicaid EHR incentive program provides annual incentive payments to eligible professionals and hospitals for efforts to adopt, implement, and meaningfully use certified EHR technology. The Hospital uses a grant accounting model to recognize EHR incentive revenues. EHR incentive revenues are recognized ratably over the relevant cost report period to determine the amount of reimbursement. During the Periods under Audit, the Hospital has included \$1,058,108, \$96,957, and \$2,514,768, respectively, in other operating revenue related to the program, including \$294,850, \$0, and \$442,296 received from Medicaid. The estimate for the Medicare program is based on cost report data that is subject to audit, and the amounts recognized are subject to change. The Hospital's attestation of compliance with the meaningful use criteria is subject to audit by the federal or state government or its designee.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

1. Significant Accounting Policies (continued)

New Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The adoption of ASU 2014-09 is required on October 1, 2017, and management is currently evaluating the effect of this guidance on its consolidated financial statements.

Reclassifications

Certain reclassifications have been made to the year ended September 30, 2013, balances previously reported in the accompanying consolidated balance sheets, statements of operations and changes in net assets in order to conform with the year ended September 30, 2014, presentation.

2. Net Patient Service Revenue and Charity Care

Revenues from the Medicare and Medicaid programs accounted for approximately 31.7% and 12.1%, respectively, of the Hospital's net patient service revenue for the year ended September 30, 2014; 32.3% and 11.5%, respectively, for the period ended September 30, 2013, and 31.3% and 11.6%, respectively, for the period ended July 31, 2013. Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by material amounts in the near term.

The Hospital believes that it is in compliance with all applicable laws and regulations. While no regulatory inquiries are outstanding, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action, including fines, penalties, and exclusion from the Medicare and Medicaid programs. Changes in the Medicare and Medicaid programs and the reduction of funding levels could have an adverse impact on the Hospital.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

2. Net Patient Service Revenue and Charity Care (continued)

The following table summarizes net revenues from services to patients:

	Year Ended September 30, 2014	Period From August 1, 2013 to September 30, 2013	Period From October 1, 2012 to July 31, 2013
Gross patient service revenue:			
Inpatients	\$ 247,780,251	\$ 41,186,580	\$ 202,390,827
Outpatients	453,925,211	69,010,049	337,839,884
	701,705,462	110,196,629	540,230,711
Deductions:			
Allowances and discounts	394,788,265	62,906,364	304,997,146
Charity care	5,263,975	1,001,638	4,789,430
Net patient service revenue	301,653,222	46,288,627	230,444,135
Provision for bad debts	8,035,283	1,489,352	7,234,583
Net patient service revenue less provision for bad debts	\$ 293,617,939	\$ 44,799,275	\$ 223,209,552

The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. The difference is accounted for as allowances. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, fee-for-service, discounted charges, and per diem payments. Net patient service revenue is affected by the State of Connecticut Disproportionate Share program and is reported at the estimated net realizable amounts due from patients, third-party payors, and others for services rendered and includes estimated retroactive revenue adjustments due to future audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, and investigations. During the Periods under Audit, the Hospital recorded approximately \$13,674,000, \$0 and 494,000, respectively, of previously recognized estimated third-party payor settlements resulting in an increase in net patient service revenue.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

2. Net Patient Service Revenue and Charity Care (continued)

The Hospital has established estimates based on information presently available of amounts due to or from Medicare, Medicaid, and third-party payors for adjustments to current and prior year payment rates, based on industry-wide and Hospital-specific data. Such amounts are included in the accompanying consolidated balance sheets. Additionally, certain payors' payment rates for various years have been appealed by the Hospital. If the appeals are successful, additional income applicable to those years might be realized.

The Hospital accepts all patients regardless of their ability to pay. A patient is classified as a charity patient by reference to the established policies of the Hospital. Essentially, these policies define charity services as those services for which no payment is anticipated. In assessing a patient's inability to pay, the Hospital utilizes the generally recognized poverty income levels for the State of Connecticut but also includes certain cases where incurred charges are significant when compared to incomes.

The Hospital's policy is to reserve a portion of all self-pay receivables, including amounts due from the uninsured and amounts related to co-payments and deductibles, as these charges are recorded. The Hospital's allowance for doubtful accounts for self-pay patients increased to 66% of self-pay accounts receivable at September 30, 2014 from 63% of self-pay accounts receivable at September 30, 2013. On a monthly basis, the Hospital reviews its accounts receivable balances, the effectiveness of the Hospital's reserve policies, and various analytics to support the basis for its estimates. These efforts primarily consist of reviewing the following:

- Revenue and volume trends by payor, particularly the self-pay components.
- Changes in the aging and payor mix of accounts receivable, including focus on accounts due from the uninsured and accounts that represent co-payments and deductibles due from patients.
- Various allowance coverage statistics.

The Hospital regularly performs hindsight procedures to evaluate historical write-off and collection experience throughout the year to help determine the reasonableness of its process for estimating the allowance for doubtful accounts.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

2. Net Patient Service Revenue and Charity Care (continued)

The Hospital provides services without charge or at amounts less than its established rates to patients who meet the criteria of its charity care policy. Because the Hospital does not pursue collection of amounts determined to qualify as charity care, such services are not reported as revenue. For patients who were determined by the Hospital to have the ability to pay but did not, the uncollected amounts are recorded as part of the provision for bad debts. In distinguishing charity care from the provision for bad debts, a number of factors are considered, certain of which require a high degree of judgment.

Patient service revenue, net of contractual allowances and discounts and before the provision for bad debts, recognized in the period from major payor sources for the Periods under Audit is as follows:

	Year Ended September 30, 2014	Period From August 1, 2013 to September 30, 2013	Period From October 1, 2012 to July 31, 2013
Medicare	31.7%	32.3%	31.3%
Medicaid	12.1	11.5	11.6
Self-pay	2.9	4.7	3.2
All other	53.3	51.5	53.9
	100%	100%	100%

The estimated cost of charity care provided was \$2,000,311, \$420,688 and \$2,011,561 for the Periods under Audit. The estimated cost of charity care is based on the ratio of cost to charges, as determined by Hospital-specific data.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

3. Net Assets

Temporarily restricted net assets at September 30 are available for the following purposes:

	2014	2013
General use	\$ 1,841,192	\$ 1,621,905
Health care services	909,559	889,639
Free beds	237,755	180,939
Preventative care	190,994	214,764
Extraordinary nursing care	164,863	150,759
Laboratory	113,840	119,204
Nursing education	76,294	128,382
	\$ 3,534,497	\$ 3,305,592

Permanently restricted net assets at September 30 are restricted for:

	2014	2013
Investments to be held in perpetuity, the income from which is expendable to support health care service	\$ 5,719,446	\$ 5,551,985
Restricted funds held in trust by others, the income from which is expendable to support health care services	2,633,503	2,515,481
	\$ 8,352,949	\$ 8,067,466

The Hospital's endowment consists of individual funds established for a variety of purposes. Net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

The Board of Directors of the Hospital has interpreted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, the Hospital classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

3. Net Assets (continued)

instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the organization in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with UPMIFA, the Hospital considers the following factors in making a determination to appropriate or accumulate donor-restricted funds:

- 1) The duration and preservation of the fund
- 2) The purposes of the Hospital and the donor-restricted endowment fund
- 3) General economic conditions
- 4) The possible effect of inflation and deflation
- 5) The expected total return from income and the appreciation of investments
- 6) Other resources of the Hospital
- 7) The investment policies of the Hospital

The primary objective of the endowment fund is to provide long-term support for the Hospital's capital and operating programs. The Hospital's investment goals are to maximize total return (capital appreciation, dividends, and interest) while also protecting the Hospital's inflation-adjusted value over time. The Hospital's assets are diversified across multiple asset classes (e.g., common stocks, bonds, and cash) to achieve an optimal balance between risk and return and between current income and capital appreciation. The investment program is structured to offer reasonably high probability of generating a real return of 4% per year over a period of five to ten years to protect the real inflation-adjusted value of assets and to meet the spending requirements. The Investment Committee reviews investment policies annually to determine if changes need to be made due to changing market conditions or other factors.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

3. Net Assets (continued)

Changes in endowment funds for the fiscal year ended September 30, 2014, consisted of the following:

	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets at beginning of year	\$ 1,548,813	\$ 5,551,985	\$ 7,100,798
Investment return:			
Investment income	–	181,223	181,223
Net appreciation (realized and unrealized)	–	276,043	276,043
Earnings reclassified	289,805	(289,805)	–
Total investment return	<u>289,805</u>	<u>167,461</u>	<u>457,266</u>
Endowment net assets at end of year	<u>\$ 1,838,618</u>	<u>\$ 5,719,446</u>	<u>\$ 7,558,064</u>

Changes in endowment funds for the fiscal year ended September 30, 2013, consisted of the following:

	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets at beginning of year	\$ 1,116,993	\$ 5,396,869	\$ 6,513,862
Investment return:			
Investment income	–	263,499	263,499
Net appreciation (realized and unrealized)	–	323,437	323,437
Earnings reclassified	431,820	(431,820)	–
Total investment return	<u>431,820</u>	<u>155,116</u>	<u>586,936</u>
Endowment net assets at end of year	<u>\$ 1,548,813</u>	<u>\$ 5,551,985</u>	<u>\$ 7,100,798</u>

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor, as stipulated by UPMIFA, requires the Hospital to retain as a fund of perpetual duration. These deficiencies periodically result from unfavorable market fluctuations that occurred shortly after the investment of new permanently restricted contributions, in which case the Board of Directors may deem imprudent the continuation of appropriation for a limited period. There were no material deficiencies of this nature which are reported in unrestricted net assets as of September 30, 2014 or 2013.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

4. Assets Whose Use is Limited

The market value of assets whose use is limited at September 30 is set forth in the following table:

	2014	2013
Cash and cash equivalents	\$ 2,470,964	\$ 1,745,332
Interest in investments held by Endowment LLC	55,973,821	–
Certificates of deposit	4,958,058	24,945,386
Money market funds	12,870,647	18,694,650
Equity securities:		
U.S.	26,943,229	26,508,212
International	1,076,907	427,435
Fixed income bonds		
U.S.	25,059,695	20,832,689
International	2,257,725	603,377
Mutual funds		
U.S.	8,689,955	46,826,584
International	2,680,439	12,064,138
Alternative investments and other	–	3,327,950
	\$ 142,981,440	\$ 155,975,753

During 2014, a significant portion of the Hospital's assets whose use is limited was transferred to Endowment LLC, as discussed in Note 1.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

4. Assets Whose Use is Limited (continued)

The composition and presentation of income from investments, gifts, and bequests, net, which are included in nonoperating income in the consolidated statements of operations, are as follows:

	Year Ended September 30, 2014	Period From August 1, 2013 to September 30, 2013	Period From October 1, 2012 to July 31, 2013
Realized gains on investments, net	\$ 5,538,720	\$ 487,622	\$ 2,011,638
Unrealized gains on investments	604,064	352,480	4,760,681
Return on interest in investments held by Endowment LLC	1,384,857	–	–
Contributions	222,728	12,759	33,446
Interest and dividend income and other	1,502,746	446,930	2,199,279
	\$ 9,253,115	\$ 1,299,791	\$ 9,005,044

5. Fair Values of Financial Instruments

As defined in ASC 820, *Fair Value Measurement*, fair value is based on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In order to increase consistency and comparability in fair value measurements, ASC 820 establishes a fair value hierarchy that prioritizes observable and unobservable inputs used to measure fair value into three broad levels, which are described below:

Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for identical assets or liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.

Level 2: Observable inputs are based on inputs not quoted in active markets, but corroborated by market data.

Level 3: Unobservable inputs are used when little or no market data is available. The fair value hierarchy gives the lowest priority to Level 3 inputs.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

5. Fair Values of Financial Instruments (continued)

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. In determining fair value, the Hospital uses valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible and considers nonperformance risk in its assessment of fair value.

Financial assets and liabilities carried at fair value in the accompanying consolidated balance sheets, excluding assets invested in the Hospital's defined benefit pension plan and Endowment LLC, are classified in the following tables below in one of the three categories described above:

	September 30, 2014			
	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents	\$ 187,018,905	\$ —	\$ —	\$ 187,018,905
Assets whose use is limited:				
Cash and cash equivalents	2,470,964	—	—	2,470,964
Certificates of deposit	—	4,958,058	—	4,958,058
Money market funds	12,870,647	—	—	12,870,647
Equity securities:				
U.S.	26,943,229	—	—	26,943,229
International	1,076,907	—	—	1,076,907
Fixed income bonds:				
U.S.	—	25,059,695	—	25,059,695
International	—	2,257,725	—	2,257,725
Mutual funds:				
U.S.	1,407,128	7,282,827	—	8,689,955
International	2,202,834	477,605	—	2,680,439
Funds held in trust by others	—	2,633,503	—	2,633,503
Total	\$ 233,990,614	\$ 42,669,413	\$ —	\$ 276,660,027

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

5. Fair Values of Financial Instruments (continued)

The Hospital has \$55,973,821 of financial assets as of September 30, 2014, that are held by Endowment LLC (Note 1). Financial assets classified within the trust are 54.3% Level 1, 20.9% Level 2, and 24.8% in alternative investments accounted for under the equity method.

	September 30, 2013			
	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents	\$ 132,347,698	\$ —	\$ —	\$ 132,347,698
Assets whose use is limited:				
Cash and cash equivalents	1,745,332	—	—	1,745,332
Certificates of deposit	—	24,945,386	—	24,945,386
Money market funds	18,694,650	—	—	18,694,650
Equity securities:				
U.S.	26,508,212	—	—	26,508,212
International	427,435	—	—	427,435
Fixed income bonds:				
U.S.	—	20,832,689	—	20,832,689
International	—	603,377	—	603,377
Mutual funds:				
U.S.	12,988,025	33,838,559	—	46,826,584
International	11,569,985	494,153	—	12,064,138
Alternative investments and other	—	3,327,950	—	3,327,950
Funds held in trust by others	—	2,515,481	—	2,515,481
Total	\$ 204,281,337	\$ 86,557,595	\$ —	\$ 290,838,932

Effective January 1, 2014, the assets of the Hospital's pension plan were liquidated and \$163,446,172 of cash was transferred into the Hartford HealthCare Defined Master Trust. The Hospital owns participant units in the trust. Financial assets classified within the trust are 52.3% Level 1, 37.1% Level 2 and 10.6% Level 3 as of September 30, 2014.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

5. Fair Values of Financial Instruments (continued)

The following table presents the Hospital's fair value hierarchy for defined benefit plan assets as of September 30, 2013.

	Level 1	Level 2	Level 3	Total
Assets				
Money market funds	\$ 2,758,810	\$ –	\$ –	\$ 2,758,810
Fixed income bonds:				
U.S.	–	27,205,353	–	27,205,353
International	–	3,586,219	–	3,586,219
Mutual funds:				
U.S.	30,752,217	70,077,144	–	100,829,361
International	23,296,667	–	–	23,296,667
Total	\$ 56,807,694	\$ 100,868,716	\$ –	\$ 157,676,410

The following table presents changes in the fair value of all Level 3 assets for the year ended September 30, 2013.

	Mortgage-Backed Obligations
Beginning balance	\$ 188,330
Unrealized gains	5,270
Sales	(193,600)
Total	\$ –

Fair value for Level 1 assets is based upon quoted market prices. Fair value for Level 2 assets is based upon 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. Inputs are obtained from various sources, including market participants, dealers, and brokers.

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

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

6. Property, Plant, and Equipment

Property, plant, and equipment consist of the following at September 30:

	2014	2013
Land and land improvements	\$ 8,427,224	\$ 8,395,039
Buildings and leasehold improvements	184,043,214	183,404,866
Equipment	110,441,761	107,805,047
	302,912,199	299,604,952
Less accumulated depreciation	(175,263,190)	(160,938,198)
	127,649,009	138,666,754
Construction-in-process (2014 estimated cost to complete \$1,073,000)	185,693	77,152
	\$ 127,834,702	\$ 138,743,906

The Hospital wrote off approximately \$1,114,000 and \$2,848,000 of fully depreciated assets in 2014 and 2013, respectively.

7. Pensions and Other Postretirement Benefits

Effective January 1, 2010, the Hospital amended its defined benefit pension plan to close the plan to new participants and to freeze accruals for the existing participants in favor of a defined contribution plan.

The defined contribution plan covers substantially all of the employees of the Hospital. Under the provisions of the plan, the Hospital will make non-elective contributions to the plan on behalf of each eligible employee in the amount of 3% of the employee's eligible earnings. The Hospital will also make a non-elective transition contribution equal to 3% of employee's eligible earnings for all employees who meet the transition participant criteria. The Hospital may also, at the discretion of the Board of Trustees, make an elective matching contribution at the end of the plan year based on the Hospital's financial performance. The cost recorded for the Periods under Audit are \$5,327,091, \$611,400, and \$4,361,092 respectively.

The Hospital also provides non-contributory postretirement health care benefits to eligible retirees and to eligible spouses of retirees who retired prior to January 1, 1994. Subsequent to 1993, covered retirees contribute a percentage of the cost based on years of service. In addition,

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

7. Pensions and Other Postretirement Benefits (continued)

the Hospital sponsors a nonqualified pension benefit program. Included in other long-term liabilities at September 30, 2014 and 2013, are approximately \$949,000 and \$1,204,000, respectively, related to the future obligation for the nonqualified benefits.

Included in unrestricted net assets at September 30 are the following amounts that have not yet been recognized in net periodic benefit cost:

	Pension Benefits			Other Postretirement Benefits		
	September 30, 2014	September 30, 2013	July 31, 2013	September 30 , 2014	September 30, 2013	July 31, 2013
	<i>(In Thousands)</i>					
Unrecognized actuarial loss (gain)	\$ 24,982	\$ (1,582)	\$ -	\$ 291	\$ 1	\$ -

The actuarial loss in 2014 primarily relates to changes in the discount rate and mortality table used to measure the benefit obligation, and the actuarial gain in 2013 primarily relates to changes in the discount rate used to measure the benefit obligation.

The actuarial loss included in unrestricted net assets that is expected to be recognized in net periodic benefit cost during 2015 is \$152,998.

At September 30, 2014, the unfunded status of the pension plan is included in long-term liabilities in the amount of \$34,587,100. The unfunded status of the postretirement benefits is \$3,431,004, with \$366,823 included in current liabilities, and the remainder of \$3,064,181 included in long-term liabilities. At September 30, 2013, the unfunded status of the pension plan is included in long-term liabilities in the amount of \$14,032,589. The unfunded status of the postretirement benefits \$3,408,366, with \$377,682 included in current liabilities, and the remainder of \$3,030,684 included in long-term liabilities.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

7. Pensions and Other Postretirement Benefits (continued)

The following tables set forth the funded status of the plans as of September 30:

	Pension Benefits		Other Postretirement Benefits	
	2014	2013	2014	2013
	<i>(In Thousands)</i>			
Change in projected benefit obligation				
Benefit obligation at beginning of year	\$ (171,709)	\$ (201,178)	\$ (3,408)	\$ (3,882)
Interest cost	(8,421)	(7,681)	(130)	(139)
Change in assumptions	–	31,468	–	54
Actuarial (loss) gain	(26,428)	161	(291)	178
Benefits paid	6,032	5,521	398	381
Benefit obligation at end of year	<u>\$ (200,526)</u>	<u>\$ (171,709)</u>	<u>\$ (3,431)</u>	<u>\$ (3,408)</u>
Change in plan assets				
Fair value of plan assets at beginning of year	\$ 157,676	\$ 139,692	\$ –	\$ –
Actual return on plan assets	11,445	15,405	–	–
Contributions	2,850	8,100	398	381
Benefits paid	(6,032)	(5,521)	(398)	(381)
Fair value of plan assets at end of year	<u>\$ 165,939</u>	<u>\$ 157,676</u>	<u>\$ –</u>	<u>\$ –</u>
Underfunded status				
Accrued benefit liability recognized in the balance sheets	<u>\$ (34,587)</u>	<u>\$ (14,033)</u>	<u>\$ (3,431)</u>	<u>\$ (3,408)</u>

	Pension Benefits			Other Postretirement Benefits		
	Year Ended September 30, 2014	Period From August 1, 2013 to September 30, 2013	Period From October 1, 2012 to July 31, 2013	Year Ended September 30, 2014	Period From August 1, 2013 to September 30, 2013	Period From October 1, 2012 to July 31, 2013
	<i>(In Thousands)</i>					
Components of net periodic benefit cost						
Interest cost	\$ 8,421	\$ 1,398	\$ 6,283	\$ 130	\$ 22	\$ 117
Expected return on plan assets	(11,581)	(2,178)	(13,228)	–	–	–
Net amortization and deferral	–	421	9,477	–	–	127
Net periodic benefit cost	<u>\$ (3,160)</u>	<u>\$ (359)</u>	<u>\$ 2,532</u>	<u>\$ 130</u>	<u>\$ 22</u>	<u>\$ 244</u>

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

7. Pensions and Other Postretirement Benefits (continued)

The expected rate of return on assets was determined by the expected return on each asset class based on a model that considers historical and expected future performance.

	Pension Benefits		Other Postretirement Benefits	
	2014	2013	2014	2013
Assumptions:				
Weighted-average assumptions used to determine benefit obligations:				
Discount rate	4.40%	5.00%	3.80%	4.05%
Weighted-average assumptions used to determine net periodic benefit cost:				
Discount rate	5.00%	4.95%	4.05%	4.05%
Expected long-term rate of return on plan assets	7.50%	6.75%	–	–

The accumulated benefit obligation at September 30, 2014 and 2013, was \$200,526,842 and \$171,708,999, respectively.

Plan Assets

The Hospital's retirement plan weighted-average asset allocations at September 30, by asset category, are as follows:

Asset Category	Target	2014	2013
Equity securities	57%	59%	59%
Fixed income/debt securities	25	22	41
Commodities/inflation/real assets	8	6	–
Other	10	13	–
Total	100%	100%	100%

The Hospital Plan's asset portfolio has target allocations similar to the allocations noted in the table above. The goals of the plans are to provide a secure retirement benefit for plan participants and to manage plan assets for the exclusive benefit of the participants. The Investment Committee of the Board of Directors is responsible for developing, reviewing, and monitoring the investment policy. The plans' assets are invested in accordance with the policy.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

7. Pensions and Other Postretirement Benefits (continued)

Contributions

The Hospital expects to make contributions of approximately \$0 and \$366,823 in fiscal year 2015 related to its defined benefit pension plan and its other postretirement benefit plan, respectively.

Estimated Future Benefits Payments

Future benefit payments are expected to be paid as follows:

Fiscal Year	Pension Benefits	Postretirement Benefits
2015	\$ 6,961,836	\$ 366,823
2016	7,522,340	350,562
2017	8,079,212	331,873
2018	8,766,148	313,422
2019	9,442,226	295,235
2020-2024	55,490,755	1,217,264

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

8. Long-Term Debt

Details of long-term debt at September 30 are as follows:

	2014	2013
Intercompany debt with HHC:		
Series E , tax-exempt with interest rates ranging from 4.00% to 5.00%	\$ 58,784,343	\$ —
Tax-exempt Hospital Revenue Bonds:		
Series E, term maturities (\$6,920,000) from 2017 to 2022 at an interest rate of 5.00%	—	7,647,301
Series F, serial maturities (\$4,350,000) from 2014 to 2018, with interest rates of 4.00% to 4.25%, term maturities (\$22,125,000) from 2023 to 2035 with interest rates of 5.00%	—	28,945,938
Series G, serial maturities (\$16,405,000) from 2014 to 2026, with interest rates of 3.60% to 5.00%, term maturities (\$7,420,000) in 2035 at an interest rate of 5%	—	25,412,237
Other long-term debt:		
Mortgage, maturing May 1, 2025, with a fixed interest rate of 6.125%	1,463,627	1,527,930
Obligations under capital leases	6,848,070	6,103,598
Premium on bonds	1,503,488	—
	68,599,528	69,637,004
Less current portion	(399,818)	(2,443,472)
Long-term debt	\$ 68,199,710	\$ 67,193,532

Effective January 1, 2014, the Board of Directors of the Hospital resolved to become a part of the HHC Obligated Group, which is comprised of HHC, Hartford Hospital, The Hospital of Central Connecticut at New Britain General and Bradley Memorial, Windham Community Memorial Hospital, and MidState Medical Center. On January 27, 2014, the HHC Obligated Group entered into a bridge loan in the amount of \$80,902,000, part of which was used to defease the Hospital's outstanding obligations of the Series E, Series F, and Series G bonds. The Hospital placed \$57,511,994 in an escrow refunding trust relating to Series F and Series G bonds which will be redeemed as of July 1, 2018 and July 1, 2015, respectively. The Hospital recorded a loss on the early extinguishment of the bonds of \$722,310.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

8. Long-Term Debt (continued)

On March 26, 2014, HHC issued approximately \$163,180,000 of Taxable Bonds Series D (the HHC Series D Bonds) and approximately \$83,790,000 of CHEFA Revenue Bonds Series E (the HHC 2014 Series E Bonds) concurrently (collectively referred to as the HHC 2014 Bonds). Obligated Group members are jointly and severally liable under a Master Trust Indenture (MTI) to make all payments required with respect to obligations under the MTI. HHC does have the right to name designated affiliates outside of the Obligated Group, although presently none exist.

The HHC 2014 Bonds were issued to refund portions of existing debt under HHC and to obtain funds for future capital needs. As such, the HHC 2014 Bonds are reflected as intercompany debt in the preceding schedule. The Hospital is party only to the HHC Series E Bonds. The HHC Series E Bonds consist of term bonds that mature from July 1, 2025 through July 1, 2042.

The MTI and Supplemental MTI provide for the potential establishment and maintenance of a debt service reserve fund, a pledge of gross receipts, as defined, and parity with the HHC Series E Bonds that remain outstanding. The MTI and loan agreements establish certain restrictive covenants, including a debt service coverage ratio and days cash on hand requirement. No violations of covenants existed as of or for the fiscal year ended September 30, 2014.

The fair value of the HHC 2014 Bonds was approximately \$283,862,000 at September 30, 2014. The carrying value of the HHC 2014 Bonds was \$246,970,000 at September 30, 2014. The fair value of the HHC 2014 Bonds was determined by the HHC's investment advisor using a market approach that uses prices and other relevant information generated by market transactions involving identical or comparable liabilities and categorized as Level 2 in the fair value hierarchy described in Note 5. The fair value of the Hospital's other long-term debt is approximately \$1,100,000 and \$1,528,000 at September 30, 2014 and 2013, respectively.

Prior to January 27, 2014 the Master Indenture, as amended and supplemented by Supplemental Master Indenture No. 4 (Prior MTI), provided for, among other things, a pledge of the gross receipts, as defined, of the Hospital, restriction on the incurrence of certain indebtedness of the Hospital, and covenants regarding the Hospital's debt service coverage ratios, sale and lease of assets, and other covenants similar in financings of this type. The bonds were secured by the real property of the Hospital, including all buildings and equipment. Pursuant to the loan agreements, the Hospital was obligated to provide amounts that would be sufficient to enable the Authority to pay the principal and interest on the Series E, Series F, and Series G bonds.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

8. Long-Term Debt (continued)

Principal payments due on long-term debt are as follows:

	Long-Term Debt
Fiscal year ending September 30:	
2015	\$ 399,818
2016	356,337
2017	387,433
2018	422,028
2019	461,027
Thereafter	<u>65,069,397</u>
	<u>\$ 67,096,040</u>

Interest paid for the Periods under Audit was \$3,499,676, \$95,899, and \$3,339,278, respectively.

In 2010, the Hospital entered into a fixed rate commercial mortgage of \$1,250,000 for a period of 15 years at a rate of 6.125%. The note is secured by real property located at 11 Stott Avenue, Norwich, CT.

In 2014, the Hospital entered into a 10-year capital lease of \$1,039,751 with an interest rate of 3.9% for a building located at 42 Town Street, Norwich, CT, to be used for patient services. The outstanding balance on this capital lease at September 30, 2014 was \$1,003,642.

In 2012, the Hospital entered into a 20-year capital lease of \$5,108,015 with an interest rate of 6.06% for a building located at 582 Norwich Road, Plainfield, CT, to be used for emergency, radiology, and lab services. Under the terms of the lease, the Hospital has the option for two additional five-year terms, as well as an option to purchase the property. The outstanding balance on this capital lease at September 30, 2014 and 2013 was \$4,772,491 and \$4,919,654, respectively.

In 2010, the Hospital entered into a five-year capital lease of \$458,781 with an interest rate of 5.9% for a building located at 80 Route 32, Montville, CT, to be used for patient services. The outstanding balance on this capital lease at September 30, 2014 and 2013 was \$71,206 and \$161,377, respectively.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

8. Long-Term Debt (continued)

In 2004, the Hospital entered into a 20-year capital lease of \$1,094,640 with an interest rate of 4.875% for a building located at 151-163 Broadway, Colchester, CT, to be used for patient services. The outstanding balance on this capital lease at September 30, 2014 and 2013 was \$1,000,731 and \$1,022,567, respectively.

9. Commitments and Contingencies

Various lawsuits and claims arising in the normal course of operations are pending or are in progress against the Hospital. Such lawsuits and claims are either specifically covered by insurance as explained in Note 1 or are deemed to be immaterial. While the outcomes of the lawsuits cannot be determined at this time, management believes that any loss that may arise from these actions will not have a material adverse effect on the financial position or changes in net assets of the Hospital.

Hospital employees covered by collective bargaining agreements represent approximately 23% of total employees as of September 30 2014, and 2013. The SPFPA (Security, Police, and Fire Professionals of America) contract expired in August of 2014 and represents approximately 2% of the total employees. The contract is currently under negotiation as there is a signed extension. The AFT Connecticut Backus Federation of Nurses contract is due to expire May 2015 and represents approximately 21% of total employees.

The Hospital leases space to be used for patient service. The original term of the lease expired September 30, 2014, and the Hospital opted to exercise the first of the two five-year options. Rent expense for the Periods under Audit was \$875,048, \$96,856, and \$706,707 respectively.

The Hospital has several operating lease agreements for various types of equipment with annual payments ranging from \$2,100 to \$30,000. Expenses as a result of these leases were approximately \$169,000, \$37,000, and \$129,000 for the Periods under Audit, respectively.

The future minimum lease payments are as follows:

2015	\$ 1,397,137
2016	1,254,878
2017	1,225,572
2018	1,232,838
2019	419,923
	<u>\$ 5,530,348</u>

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

10. Related-Party Transactions

The Hospital processes payroll, disbursements and provides services for several of its affiliated entities for which it is reimbursed. The Hospital also leases space to its affiliated entities. Rental income from the affiliates was \$790,154, \$81,597, and \$410,331, for the Periods under Audit, respectively.

The Hospital also obtains services from various HHC affiliates that are recorded at cost that represent an allocation of shared expense. Services provided by affiliates for the year ended September 30, 2014 and for the period from August 1, 2013 through September 30, 2013 was \$11,604,091 and \$46,347, respectively.

Amounts due from affiliates related to these services as of September 30 are as follows:

	2014	2013
Due from ConnCare, Inc.	\$ 788,821	\$ 41,562
Due from WWB Inc.	612,417	117,079
Due from HHC	513,782	–
Due from Integrated Care Partners	69,683	–
Due from Hartford Healthcare Medical Group	23,213	–
Due from Clinical Laboratory Partners	20,190	–
Due from Backus Health Care Inc.	18,695	17,073
Due from Windham Community Memorial Hospital	4,862	–
Due from Natchaug	1,287	–
Due from Backus Corporation	–	8,982
	\$ 2,052,950	\$ 184,696

Amounts due to affiliates related to these services as of September 30 are as follows:

	2014	2013
Due to HHC	\$ (2,237,710)	\$ –
Due to Hartford Hospital	(596,172)	–
Due to Hartford Healthcare Rehabilitation Network	(7,868)	–
Due to Backus Corporation	(16)	–
	\$ (2,841,766)	\$ –

During 2014, the Hospital transferred \$2,553,495 of unrestricted net assets primarily to provide additional funding to various affiliated organizations.

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

11. Other Operating Revenues

Other operating revenues consist of the following:

	Year Ended September 30, 2014	Period From August 1, 2013 to September 30, 2013	Period From October 1, 2012 to July 31, 2013
Unrestricted contributions	\$ 1,284,416	\$ —	\$ 91,435
Cafeteria sales	1,250,359	201,149	1,024,093
Rental income	1,177,783	162,794	716,306
EHR revenue	1,058,108	96,957	2,514,768
Miscellaneous	976,115	112,857	1,106,799
Grants	556,154	15,000	571,588
Condominium income	465,797	81,379	395,657
Fee income	457,492	39,936	394,471
	<u>\$ 7,226,224</u>	<u>\$ 710,072</u>	<u>\$ 6,815,117</u>

12. Functional Expenses

The Hospital provides inpatient medical and surgical, outpatient, psychiatric, and emergency care services to residents of eastern Connecticut. Expenses related to providing these services are as follows:

	Year Ended September 30, 2014	Period From August 1, 2013 to September 30, 2013	Period From October 1, 2012 to July 31, 2013
Health care services	\$ 195,903,362	\$ 32,266,325	\$ 162,235,409
Support Services	55,868,286	9,529,409	46,381,144
	<u>\$ 251,771,648</u>	<u>\$ 41,795,734</u>	<u>\$ 208,616,553</u>

The William W. Backus Hospital

Notes to Consolidated Financial Statements (continued)

13. Supplemental Cash Flow Information

Changes in operating assets and liabilities at September 30 include the following:

	Year Ended September 30, 2014	Period From August 1, 2013 to September 30, 2013	Period From October 1, 2012 to July 31, 2013
Increase in accounts receivable	\$ (14,001,678)	\$ (758,134)	\$ (6,964,118)
Decrease in other receivables	966,585	1,895	412
(Increase) decrease in due from affiliates	(1,868,254)	(26,158)	403,503
(Increase) decrease in inventories of supplies, prepaid expenses and other assets	(947,592)	705,973	(551,553)
Increase (decrease) in accounts payable	372,334	749,962	(1,894,671)
Increase (decrease) in salaries, wages, payroll taxes and amounts withheld from employees	646,559	(373,268)	536,303
Increase in due to affiliates	2,841,766	—	—
Increase (decrease) in accrued expenses	2,697,445	916,324	(2,201,822)
Decrease in accrued pension and other postretirement liabilities	(5,879,266)	(1,297,510)	(5,241,494)
(Decrease) increase in self-insured professional liability	(3,963,636)	624,737	1,428,572
(Decrease) increase in estimated third party payor settlements	(9,431,108)	2,143,707	(2,869,304)
(Decrease) increase in other liabilities	(2,127,848)	(112,789)	709,896
	<u>\$ (30,694,693)</u>	<u>\$ 2,574,739</u>	<u>\$ (16,644,276)</u>

14. Subsequent Events

The Hospital evaluated subsequent events through January 28, 2015, which is the date the consolidated financial statements were issued, for potential recognition in the consolidated financial statements as of balance sheet date for the fiscal year ended September 30, 2014.

No events occurred that require disclosure or adjustment to the combined financial statements.

Supplementary Information

The William W. Backus Hospital

Consolidating Balance Sheet

September 30, 2014

	The William W. Backus Hospital	Backus Medical Center Condominium Association, Inc.	Eliminations	Consolidated
Assets				
Current assets:				
Cash and cash equivalents	\$ 187,018,905	\$ —	\$ —	\$ 187,018,905
Accounts receivable, less allowances for doubtful accounts	36,980,052	—	—	36,980,052
Other receivables	1,317,632	2,511	—	1,320,143
Due from affiliates	2,037,361	15,589	—	2,052,950
Inventories of supplies	3,771,462	—	—	3,771,462
Prepaid expenses and other assets	1,643,561	—	—	1,643,561
Current portion of assets whose use is limited	3,285,815	—	—	3,285,815
Total current assets	236,054,788	18,100	—	236,072,888
Assets whose use is limited:				
Investments and other assets	57,081,792	—	—	57,081,792
Interest in investments held by Endowment LLC	47,662,263	—	—	47,662,263
Donor-restricted interest in investments held by Endowment LLC	8,311,558	—	—	8,311,558
Investments for restricted purposes	26,640,012	—	—	26,640,012
	139,695,625	—	—	139,695,625
Funds held in trust by others	2,633,503	—	—	2,633,503
Other assets	7,214,261	—	—	7,214,261
Property, plant, and equipment, net	127,834,702	—	—	127,834,702
Total assets	\$ 513,432,879	\$ 18,100	\$ —	\$ 513,450,979

Continued on next page.

The William W. Backus Hospital

Consolidating Balance Sheet (continued)

September 30, 2014

	The William W. Backus Hospital	Backus Medical Center Condominium Association, Inc.	Eliminations	Consolidated
Liabilities and net assets				
Current liabilities:				
Accounts payable	\$ 8,403,938	\$ 31	\$ –	\$ 8,403,969
Salaries, wages, payroll taxes, and amounts withheld from employees	7,611,745	–	–	7,611,745
Due to affiliates	2,841,766	–	–	2,841,766
Accrued expenses	6,965,890	–	–	6,965,890
Estimated third-party payor settlements	8,036,715	–	–	8,036,715
Current portion of long-term debt	399,818	–	–	399,818
Current portion of accrued pension and other postretirement liability	4,195,223	–	–	4,195,223
Current portion of other liabilities	653,974	–	–	653,974
Total current liabilities	39,109,069	31	–	39,109,100
Long-term debt	68,199,710	–	–	68,199,710
Accrued pension and other postretirement liabilities	38,600,633	–	–	38,600,633
Self-insured professional liability	8,527,863	–	–	8,527,863
Other liabilities	4,532,110	–	–	4,532,110
Total liabilities	158,969,385	31	–	158,969,416
Net assets:				
Unrestricted	342,576,048	18,069	–	342,594,117
Temporarily restricted	3,534,497	–	–	3,534,497
Permanently restricted	8,352,949	–	–	8,352,949
Total net assets	354,463,494	18,069	–	354,481,563
Total liabilities and net assets	\$ 513,432,879	\$ 18,100	\$ –	\$ 513,450,979

The William W. Backus Hospital
Consolidating Statement of Operations

Year Ended September 30, 2014

	The William W. Backus Hospital	Backus Medical Center Condominium Association, Inc.	Eliminations	Consolidated
Unrestricted revenues, gains and other support:				
Net patient service revenue	\$ 301,653,222	\$ —	\$ —	\$ 301,653,222
Provision for bad debts	8,035,283	—	—	8,035,283
Net patient service revenue less provision for bad debts	293,617,939	—	—	293,617,939
Other operating revenue	6,760,427	489,409	(23,612)	7,226,224
Net assets released from restriction for operations	287,246	—	—	287,246
	<u>300,665,612</u>	<u>489,409</u>	<u>(23,612)</u>	<u>301,131,409</u>
Operating expenses:				
Salaries and wages	110,166,889	—	—	110,166,889
Employee benefits	21,447,489	—	—	21,447,489
Supplies and other	47,207,926	—	—	47,207,926
Purchased services	53,840,192	489,409	(23,612)	54,305,989
Depreciation and amortization	15,651,354	—	—	15,651,354
Interest	2,992,001	—	—	2,992,001
	<u>251,305,851</u>	<u>489,409</u>	<u>(23,612)</u>	<u>251,771,648</u>
Operating income before bond refinancing costs	49,359,761	—	—	49,359,761
Loss on bond refinancing	(722,310)	—	—	(722,310)
Operating income	<u>48,637,451</u>			<u>48,637,451</u>
Nonoperating income:				
Income from investments, gifts and bequests, net	9,253,115	—	—	9,253,115
Other	(186,851)	—	—	(186,851)
Excess of revenues over expenses	<u>\$ 57,703,715</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 57,703,715</u>

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