McLeod Health

Consolidated Financial Statements as of and for the Years Ended September 30, 2012 and 2011, Supplemental Consolidating Information as of and for the Year Ended September 30, 2012, and Independent Auditors' Report

MCLEOD HEALTH

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INDEPENDENT AUDITORS' REPORT

To the Board of Trustees of McLeod Health
Florence, South Carolina

We have audited the accompanying consolidated balance sheets of McLeod Health and subsidiaries ("McLeod Health") as of September 30, 2012 and 2011, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of McLeod Health's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 McLeod Health'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 financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the consolidated financial position of McLeod Health as of September 30, 2012 and 2011, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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

Deloitte & Touche LLP

December 17, 2012

MCLEOD HEALTH

CONSOLIDATED BALANCE SHEETS
AS OF SEPTEMBER 30, 2012 AND 2011

	2012	2011
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 62,631,211	$ 21,057,239
Investments	3,639,453	1,847,399
Receivables:		
Patient — net of allowances for doubtful accounts of $79,932,000 and $57,301,000 in 2012 and 2011, respectively	84,434,932	69,652,166
Other	3,965,282	1,865,976
Inventories	7,299,854	3,505,261
Prepaid expenses	9,213,359	7,519,236
Total current assets	171,184,091	105,447,277
ASSETS LIMITED AS TO USE	584,657,306	532,471,216
PROPERTY AND EQUIPMENT — Net	496,700,953	373,423,136
OTHER ASSETS:		
Bond issue costs — net	5,730,355	5,984,186
Goodwill	3,261,544	3,261,544
Other assets	9,458,439	8,499,115
Total other assets	18,450,338	17,744,845
TOTAL	$1,270,992,688	$1,029,086,474
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES:		
Current portion of long-term debt	$ 10,116,759	$ 5,247,427
Accounts payable	25,917,251	22,426,141
Accrued expenses and other liabilities	42,367,472	32,394,029
Estimated third-party settlements	40,171,947	36,858,605
Total current liabilities	118,573,429	96,926,202
LONG-TERM DEBT — Net of current portion	349,110,967	283,544,537
Total liabilities	467,684,396	380,470,739
COMMITMENTS AND CONTINGENCIES (Note 11)		
NET ASSETS:		
Unrestricted:		
McLeod Health	796,074,979	640,786,395
Noncontrolling interest in MMP	1,551,083	1,838,339
Total unrestricted	797,626,062	642,624,734
Temporarily restricted	4,940,257	5,274,028
Permanently restricted	741,973	716,973
Total net assets	803,308,292	648,615,735
TOTAL	$1,270,992,688	$1,029,086,474

See notes to consolidated financial statements.

MCLEOD HEALTH

CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED SEPTEMBER 30, 2012 AND 2011

	2012	2011
UNRESTRICTED REVENUES, GAINS, AND OTHER SUPPORT:		
Net patient service revenues	$830,582,390	$710,092,620
Other operating revenues	25,386,171	17,055,801
Net assets released from restrictions	896,857	837,068
Total unrestricted revenues, gains, and other support	856,865,418	727,985,489
EXPENSES:		
Personnel	371,583,797	311,829,650
Professional fees	21,986,980	16,790,772
Supplies	128,701,139	122,667,471
Purchased services	38,138,322	30,482,204
Facility-related costs	16,300,763	13,290,955
Insurance	5,687,642	3,498,627
Other	24,070,220	21,309,231
Interest	14,620,021	11,485,951
Depreciation and amortization	40,766,770	33,075,925
Loss on disposal of property	520,977	549,791
Provision for uncollectible accounts — net	149,140,717	117,292,509
Total expenses	811,517,348	682,273,086
INCOME FROM OPERATIONS	45,348,070	45,712,403
OTHER REVENUES (EXPENSES)	75,068,093	(20,860,100)
EXCESS OF REVENUES OVER EXPENSES FROM CONSOLIDATED OPERATIONS	120,416,163	24,852,303
INHERENT CONTRIBUTION FROM THE ACQUISITION OF LHS	32,249,059	
LESS INCOME ATTRIBUTABLE TO NONCONTROLLING INTEREST	(74,733)	(440,635)
EXCESS OF REVENUES OVER EXPENSES ATTRIBUTABLE TO MCLEOD HEALTH	152,590,489	24,411,668
NET ASSETS RELEASED FROM RESTRICTIONS FOR PURCHASES OF PROPERTY AND EQUIPMENT	2,698,095	746,948
INCREASE IN UNRESTRICTED NET ASSETS ATTRIBUTABLE TO MCLEOD HEALTH	$155,288,584	$ 25,158,616

See notes to consolidated financial statements.

MCLEOD HEALTH

CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS
FOR THE YEARS ENDED SEPTEMBER 30, 2012 AND 2011

	Unrestricted					
	McLeod Health	Noncontrolling Interest	Total	Temporarily Restricted	Permanently Restricted	Total
NET ASSETS — September 30, 2010	$615,627,779	$1,674,543	$617,302,322	$ 2,953,480	$716,973	$620,972,775
Excess of revenues over expenses	24,411,668	440,635	24,852,303	(837,068)		24,015,235
Restricted donations and investment income			-	3,904,564		3,904,564
Distributions to noncontrolling interest		(276,839)	(276,839)			(276,839)
Net assets released from restrictions for property and equipment	746,948		746,948	(746,948)		-
Change in net assets	25,158,616	163,796	25,322,412	2,320,548	-	27,642,960
NET ASSETS — September 30, 2011	640,786,395	1,838,339	642,624,734	5,274,028	716,973	648,615,735
Excess of revenues over expenses	120,341,430	74,733	120,416,163	(896,857)		119,519,306
Restricted donations and investment income			-	3,261,181	25,000	3,286,181
Distributions to noncontrolling interest		(361,989)	(361,989)			(361,989)
Inherent contribution of restricted net assets from the acquisition of LHS	32,249,059		32,249,059			32,249,059
Net assets released from restrictions for property and equipment	2,698,095		2,698,095	(2,698,095)		-
Change in net assets	155,288,584	(287,256)	155,001,328	(333,771)	25,000	154,692,557
NET ASSETS — September 30, 2012	$796,074,979	$1,551,083	$797,626,062	$ 4,940,257	$741,973	$803,308,292

See notes to consolidated financial statements.

MCLEOD HEALTH

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED SEPTEMBER 30, 2012 AND 2011

	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Change in net assets	$ 154,692,557	$ 27,642,960
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	40,766,770	33,075,925
Provision for uncollectible accounts — net	149,140,717	117,292,509
Change in fair market value of interest rate swap agreement	763,242	(329,824)
Loss on disposal of property	520,977	565,791
Proceeds from sales of trading securities	348,607,288	315,147,359
Purchases of trading securities	(388,956,824)	(379,081,124)
Unrealized (gains) losses on investments	(65,151,343)	42,973,497
Inherent contribution from the acquisition of LHS	(32,249,059)	
Noncontrolling interest distributions	361,989	276,839
Changes in operating assets and liabilities (excluding those acquired):		
Patient receivables	(151,557,495)	(107,257,875)
Other receivables	(2,099,306)	454,835
Inventories	(995,018)	(205,449)
Prepaid expenses	4,570,271	(431,312)
Other assets	1,770,763	(2,543,735)
Accounts payable	2,948,312	(6,464,496)
Estimated third-party settlements	(1,902,106)	1,072,686
Accrued expenses and other liabilities	1,617,151	3,080,361
Net cash provided by operating activities	62,848,886	45,268,947
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from sale of property and equipment	564,771	382,667
Purchase of property and equipment	(75,122,566)	(81,693,770)
Bond proceeds designated for capital purchases	53,292,778	43,117,528
Other investing activities	3,908,925	
Net cash used in investing activities	(17,356,092)	(38,193,575)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayments of long-term debt	(4,890,419)	(5,156,841)
Borrowings (repayments) of short-term debt	1,627,916	(59,156)
Repayments of capital lease obligations	(294,330)	(427,332)
Noncontrolling interest distributions	(361,989)	(276,839)
Net cash used in financing activities	(3,918,822)	(5,920,168)
NET INCREASE IN CASH AND CASH EQUIVALENTS	41,573,972	1,155,204
CASH AND CASH EQUIVALENTS — Beginning of year	21,057,239	19,902,035
CASH AND CASH EQUIVALENTS — End of year	$ 62,631,211	$ 21,057,239
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest	$ 14,687,712	$ 10,055,426
Liabilities accrued for the purchase of property and equipment — net	$ 5,881,845	$ 5,339,047
Equipment purchased through capital leases	$ 3,241,418	$ 1,153,262

See notes to consolidated financial statements.

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization — McLeod Health is a South Carolina nonprofit corporation and is also an organization as described under Sections 501(c)(3) and 509(a)(3) of the Internal Revenue Code (IRC). McLeod Health serves as the parent corporation and sole member of McLeod Regional Medical Center of the Pee Dee, Inc. ("McLeod Regional Medical Center" or MRMC), McLeod Medical Center — Dillon, McLeod Health Foundation (the "Foundation"), McLeod Physician Associates II, McLeod Loris Seacoast Hospital (MLSH), and Loris/Seacoast Healthcare Foundation (LSHF) and is the sole shareholder of McLeod Physician Associates, Inc. (MPA).

McLeod Health serves the health care needs of a 14-county region in eastern South Carolina and the extreme southeastern portion of North Carolina. The activities of the principal entities comprising McLeod Health are summarized as follows:

McLeod Regional Medical Center — MRMC is a 453-bed teaching hospital and tertiary care referral center located in Florence, South Carolina.

McLeod Medical Center — Dillon — McLeod Medical Center — Dillon is a 79-bed community hospital located in Dillon, South Carolina.

McLeod Medical Center — Darlington — McLeod Medical Center — Darlington is a division of MRMC and operates a 49-bed community hospital located in Darlington, South Carolina.

McLeod Behavioral Health — McLeod Behavioral Health is a division of MRMC and operates a 23-bed psychiatric facility located in Darlington, South Carolina.

McLeod Hospice House — McLeod Hospice House is a division of MRMC and operates a 24-bed inpatient hospice facility located in Florence, South Carolina.

McLeod Home Health — McLeod Home Health is a division of MRMC that provides home health care services.

Foundation — The Foundation is a not-for-profit foundation organized to solicit funds for facilities, research, and general support of McLeod Health.

McLeod Health and Fitness Center — McLeod Health and Fitness Center is a division of MRMC that operates a health and fitness center.

MPA — MPA is a for-profit corporation that was composed of approximately 30 medical practices located throughout the Pee Dee region prior to October 1, 2006. Effective October 1, 2006, substantially all assets and operations were transferred to McLeod Physician Associates II, which is a not-for-profit corporation (see discussion below).

McLeod Physician Associates II — McLeod Physician Associates II is a not-for-profit corporation that is composed of 52 medical practices located throughout the Pee Dee and Northern Horry county regions.

McLeod Ambulatory Surgery Center — McLeod Ambulatory Surgery Center is a division of MRMC that provides outpatient surgery services.

McLeod Medical Partners, LLC (MMP) — MMP is a for-profit corporation that owns and operates three medical office buildings adjacent to MRMC. MRMC owns approximately a 62% controlling share in the equity of MMP.

McLeod Loris (formerly Loris Community Hospital) — McLeod Loris is a division of MLSH and operates a 105-bed community hospital located in Loris, South Carolina (Note 2).

McLeod Seacoast (formerly Seacoast Medical Center) — McLeod Seacoast is a division of MLSH and operates a 50-bed community hospital located in Little River, South Carolina (Note 2).

Loris Extended Care Center — Loris Extended Care Center is a division of MLSH and operates a long-term care facility in Loris, South Carolina (Note 2).

LSHF — LSHF is a not-for-profit foundation organized to solicit funds for facilities, research, and general support of MLSH. Loris Foundation is a division of McLeod Health (Note 2).

Principles of Consolidation — The consolidated financial statements include the accounts of McLeod Health and all wholly owned or controlled subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. The Obligated Group consists of McLeod Health, MRMC, McLeod Medical Center — Dillon, and McLeod Physician Associates II. The Nonobligated Group consists of the Foundation, MPA, MMP, and MLSH.

Use of Estimates — The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates and assumptions are used for, but not limited to: net patient service revenue; valuation of accounts receivable, including contractual allowances and provisions for doubtful accounts; estimated third-party settlements; and accounting for business combinations. Future events and their effects cannot be predicted with certainty; accordingly, management's accounting estimates require the exercise of judgment. The accounting estimates used in the preparation of the accompanying consolidated financial statements will change as new events occur, as more experience is acquired, as additional information is obtained, and as the operating environment changes. Management regularly evaluates the accounting policies and estimates it uses. In general, management relies on historical experience and on other assumptions believed to be reasonable under the circumstances, and may employ outside experts to assist in the evaluation, as considered necessary. Although management believes all adjustments considered necessary for fair presentation have been included, actual results may vary from those estimates.

Cash and Cash Equivalents — Cash and cash equivalents include highly liquid investments with original maturities of three months or less at the time of purchase, which have not been designated as limited as to use.

Investments and Investment Income — Investments, including those recorded as assets limited as to use, are stated at fair value in the accompanying consolidated balance sheets. Investment income or loss, including realized and unrealized gains and losses, is included in excess of revenues over expenses, unless the income or loss is restricted by donor or law

Assets limited as to use include investments designated by the Board of Trustees of McLeod Health ("Board of Trustees") for future capital improvements (over which the Board of Trustees retains control and may at its discretion subsequently use for other purposes) and funds held by trustees under bond indenture agreements. Assets limited as to use that are required for settlement of current liabilities are reported within current assets in the accompanying consolidated balance sheets.

Inventories — Inventories are stated at the lower of cost (first-in, first-out method) or market.

Property and Equipment — Property and equipment are recorded at cost, except for donated assets, which are recorded at fair value at the date of receipt. Assets under capital lease obligations are stated at the lesser of fair value or the present value of the minimum lease payments at the inception of the lease. Depreciation is provided on a straight-line basis over the estimated useful lives of the assets, which range from three to 40 years. Equipment under capital lease obligations is amortized using the straight-line method over the shorter of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the accompanying consolidated financial statements.

Expenditures, which materially extend the useful lives of the related assets, are capitalized. Routine maintenance and repair costs are charged to expense.

Interest costs incurred during the construction period for significant construction projects are capitalized as part of the cost of the constructed asset and amortized over the applicable useful lives.

Bond Issue Costs — Bond issue costs are amortized over the term of the respective obligation utilizing the straight-line method, which approximates the effective interest method. Bond discounts and premiums are also amortized over the terms of the outstanding obligations using the straight-line method. Amortization, discounts, and premiums are included as components of depreciation and amortization in the accompanying consolidated financial statements.

Goodwill — Effective October 1, 2010, McLeod Health adopted the provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 958-805, *Business Combinations*, relating to goodwill. Prior to the adoption of ASC 958-805, goodwill of $8,272,000 associated with the purchase of McLeod Medical Center — Dillon was amortized over a 20-year period using a straight-line method. Beginning October 1, 2010, and upon adoption of ASC 958-805, the goodwill associated with the purchase of McLeod Medical Center — Dillon is no longer amortized. The remaining unamortized balance of goodwill of approximately $3,262,000 is now subject to at least an annual assessment for impairment or more frequently if events or circumstances indicate that assets might be impaired by applying a fair-value based test. There was no impairment of goodwill during the years ended September 30, 2012 and 2011.

Interest Rate Swap Agreement — In May 2005, MMP entered into a nine-year interest rate swap agreement related to its note payable. As part of the refinancing of the associated note payable, the interest rate swap agreement was amended and restated in February 2012. The agreement terminates in February 2022. The terms of the amended and restated agreement do not differ significantly from the terms of the original agreement. The notional amount of the agreement at September 30, 2012 and 2011, was $11,838,084 and $11,586,947, respectively. The agreement requires MMP to pay the counterparty a 4.66% fixed rate of interest on the notional amount. In return, the counterparty will pay MMP interest at a variable rate based on the published London InterBank Offered Rate (LIBOR) index in accordance with the swap agreement. MMP did not designate the derivative as a hedge instrument. The net settlement between the fixed and variable rates is included as a component of interest expense in the accompanying consolidated statements of operations. The fair value of this derivative, which was estimated using Level 2 observable inputs, of $(1,953,258) and $(1,190,016) as of September 30, 2012 and 2011, respectively, is reported in the accompanying consolidated balance sheets as a component of accrued expenses and other liabilities, and changes in the fair value are reflected in other revenues (expenses) in the accompanying consolidated statements of operations.

Noncontrolling Interest — Noncontrolling interest represents the minority stockholders' proportionate share of the net assets of MMP. Revenues in excess of expenses are allocated to the noncontrolling interest of MMP in proportion to their ownership percentage and are reflected as income attributable to noncontrolling interest on the consolidated statements of operations.

Temporarily and Permanently Restricted Net Assets — Temporarily restricted net assets are those assets whose use has been limited by a donor to a specific time period or purpose. Temporarily restricted net assets at September 30, 2012 and 2011, of $4,940,257 and $5,274,028, respectively, are available for scholarships, continuing education, and various other health-related programs. Temporarily restricted net assets are transferred to unrestricted net assets when the donor restrictions as to time or purpose have been met and are reflected as net assets released from restrictions in the accompanying consolidated financial statements. Net assets released from restrictions in fiscal years 2012 and 2011 of $3,594,952 and $1,584,016, respectively, included $2,698,095 and $746,948 for the purchase of property and equipment, respectively, and $896,857 and $837,068 for operating activities, respectively.

Permanently restricted net assets of $741,973 and $716,973 at September 30, 2012 and 2011, respectively, have been restricted by the donors to be maintained by McLeod Health in perpetuity. The income from permanently restricted net assets is recorded as temporarily restricted net assets, and is expendable for scholarships, continuing education, and various other health-related programs.

Net Patient Service Revenues — Net patient service revenues are reported at the estimated net realizable amounts received, or to be received, from patients, third-party payors, and others for the specific services and supplies rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered, and are adjusted in future periods as estimates change or final settlements are determined.

Charity Care — McLeod Health provides care without charge, or at amounts less than its established rates, to patients who meet certain criteria under its charity care policy. Because McLeod Health does not pursue collection of patient accounts determined to qualify as charity care, they are not reported as net patient service revenues. McLeod Health estimates the direct and indirect costs of providing charity care using a calculated ratio of costs to gross charges for each facility.

Contributions — Unconditional promises by donors to give cash or other assets are reported at fair value at the date the promises are received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gifts are received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor restrictions 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 consolidated financial statements as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year that they are received are reported as unrestricted contributions in the accompanying consolidated financial statements. Contributions of property and equipment are recorded as unrestricted support in the absence of donor stipulations regarding how long the assets are to be used.

Income Taxes — McLeod Health and its not-for-profit subsidiaries have been recognized by the Internal Revenue Service as tax exempt under IRC Section 501(c)(3). Accordingly, no provision for income taxes has been recorded in the accompanying consolidated financial statements.

Excess of Revenues over Expenses — The accompanying consolidated financial statements reflect an excess of revenues over expenses. Changes in unrestricted net assets resulting from permanent transfers of assets to and from affiliates for other than goods and services and contributions of long-lived assets (including assets acquired using contributions which, by donor restriction, were to be used for the purposes of acquiring such assets) are excluded from excess of revenues over expenses.

Subsequent Events — McLeod Health has evaluated events and transactions occurring after September 30, 2012, for potential recognition or disclosure in its consolidated financial statements through December 17, 2012, the date that the consolidated financial statements were issued.

Adopted Accounting Pronouncements — In August 2010, the FASB issued Accounting Standards Update (ASU) No. 2010-24, *Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries*. The objective of this ASU is to address the current diversity in practice related to the accounting by health care entities for medical malpractice claims and similar liabilities and their related anticipated insurance recoveries. The amendments of this ASU clarify that a health care entity should not net insurance recoveries against a related claim liability. The amendments in this ASU are effective for fiscal years beginning after December 15, 2010. The adoption of this standard did not have a material effect on the consolidated financial statements.

In August 2010, the FASB issued ASU No. 2010-23, *Health Care Entities (Topic 954): Measuring Charity Care for Disclosure*. This ASU provides amendments to require that cost be used as the measurement basis for charity care disclosure purposes and that cost be identified as the direct and indirect costs of providing charity care. This update also requires disclosure of the methodology used to determine such costs. This ASU is effective for fiscal years beginning after December 15, 2010. The adoption of this guidance was limited to the form and content of disclosures (see Note 3), and did not have a material effect on the consolidated financial statements.

New Accounting Pronouncements — In July 2011, the FASB issued ASU No. 2011-07, *Health Care Entities (Topic 954): Presentation and Disclosure of Patient Services Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*. ASU No. 2011-07 requires certain health care entities to change the presentation of their statements of operations by reclassifying the provision for bad debts associated with patient service revenue from an operating expense to a deduction from patient service revenue (net of contractual allowances and discounts). Additionally, those health care entities are required to provide enhanced disclosure about their policies for recognizing revenue and assessing bad debts. ASU No. 2011-07 also requires disclosures of patient service revenue (net of contractual allowances and discounts), as well as qualitative and quantitative information about changes in the allowance for doubtful accounts. ASU No. 2011-07 is effective for nonpublic entities for fiscal years ending after December 15, 2012, with early adoption permitted. McLeod Health is currently evaluating the provisions of this update and their impact on its consolidated financial statements.

2. BUSINESS COMBINATIONS

On November 9, 2011, McLeod Health entered into an affiliation agreement with the Loris Community Hospital District d/b/a Loris Healthcare System (LHS). LHS provides care for residents of northern Horry County in South Carolina and southern Brunswick and Columbus Counties in North Carolina. LHS operated Loris Community Hospital which has 105 licensed inpatient beds, Seacoast Medical Center which has 50 licensed inpatient beds, and a network of physician practices. The affiliation agreement was subject to approval by the U.S. Department of Housing and Urban Development (HUD). Effective January 9, 2012, HUD approved the affiliation agreement and LHS contributed all of the assets, properties, rights, obligations, and liabilities associated with the LHS business, including, but not limited to, the Loris/Seacoast Hospitals, to McLeod Loris Seacoast Hospital, a South Carolina nonprofit corporation, in which McLeod Health is the sole member. As of the effective date McLeod Health also became the sole member of the Loris Foundation. The fair value of unrestricted assets acquired exceeded liabilities assumed resulting in an inherent contribution of $32,249,059, which was recorded in the consolidated statements of operations and changes in net assets for the year ended September 30, 2012. Transaction costs incurred, primarily for legal and consulting services, are included in purchased services in the consolidated statements of operations and changes in net assets.

Summarized consolidated opening balance sheet information for the assets acquired and liabilities assumed from LHS as of January 9, 2012, is as follows:

Assets	
Cash and cash equivalents	$ 3,908,925
Patient accounts receivable	12,365,988
Other current assets	10,834,012
Property, plant, and equipment	85,908,637
Other assets	2,730,087
Total assets acquired at fair value	115,747,649
Liabilities	
Current portion of long-term debt	1,257,585
Other current liabilities	12,808,498
Long-term debt	69,432,507
Total liabilities assumed at fair value	83,498,590
Total unrestricted net assets acquired	$ 32,249,059

The operating results of the MLSH for the period January 9, 2012 through September 30, 2012, included total unrestricted revenue of $80.1 million and a deficit of revenues over expenses of $9.9 million.

The amount of McLeod Health’s revenue and changes in net assets had the acquisition of LHS occurred on October 1, 2010, are as follows:

	2012	2011
	(pro forma)	
Total operating revenue	$ 876,376,881	$ 796,056,371
Excess of revenue over expenses	109,909,303	12,494,275
Change in unrestricted net assets	144,813,979	13,169,498
Change in temporarily restricted net assets	(333,771)	2,320,548
Change in permanently restricted net assets	25,000	

3. NET PATIENT SERVICE REVENUES

McLeod Health has agreements with third-party payors that provide for payments to McLeod Health at amounts different from its established rates. A summary of the payment arrangements with certain third-party payors is as follows:

Medicare — Inpatient acute care services rendered to Medicare program beneficiaries are generally paid at prospectively determined rates per discharge, which vary according to a patient classification system based on clinical, diagnostic, and other factors. McLeod Health's classification of Medicare patients and the appropriateness of their admissions are subject to review by a Medicare contracted independent organization. Most outpatient services are also reimbursed at prospectively determined rates. However, final Medicare reimbursement is determined based upon the submission of annual cost reports by McLeod Health and audits thereof by the Medicare Audit Contractor (MAC).

McLeod Health's Medicare cost reports have been audited by Palmetto GBA, the MAC, through September 30, 2009. However, final settlements for all acute-care hospitals were delayed by the Centers for Medicare and Medicaid Services for fiscal years ending on or after September 30, 2007, due to issues related to the computation of the SSI fraction, a key component in the calculation of Medicare Disproportionate Share reimbursement. As of September 30, 2012, McLeod Health's Medicare cost reports have been settled through fiscal year ending September 30, 2007.

Since final determination of amounts due from or to the Medicare and Medicaid programs is subject to audit and subsequent re-openings, changes resulting from final determinations are reflected as changes in estimates, generally in the year of determination. In the opinion of management, adequate provision has been made for adjustments, if any, that may result from such reviews. Net patient service revenue decreased approximately $2.3 million for the year ended September 30, 2012, due to increases in estimated third-party settlement reserves for fiscal years ended September 30, 2005 through September 30, 2012. Net patient service revenue decreased approximately $1.8 million for the year ended September 30, 2011, due to increases in estimated third-party settlement reserves for fiscal years ended September 30, 2005 through September 30, 2011.

Medicaid — Inpatient and outpatient Medicaid services are reimbursed on a reasonable cost basis. Interim payments are made by the state based on each facility's historical costs trended forward. Tentative settlements are made based on actual costs reported on hospital cost reports, but these are subject to further adjustment based on subsequent audits. As of September 30, 2012, final settlements have been determined by the State of South Carolina for fiscal years 2004 and 2007. Management has established reserves for potential Medicaid cost settlements and settlement adjustments for fiscal years 2004–2012.

In the state of South Carolina, providers are assessed a quarterly tax and receive periodic Medicaid disproportionate share and upper payment limit funds from the State of South Carolina. The tax assessment was $14,136,520 and $12,745,473 for the years ended September 30, 2012 and 2011, respectively, and is recorded as an operating expense in the accompanying consolidated statements of operations. McLeod Health received approximately $24,449,749 and $23,799,251 of disproportionate share funds from the state for the years ended September 30, 2012 and 2011, respectively, and recorded the funds as net patient service revenue in the accompanying consolidated statements of operations. Effective January 1, 2003, funds received under the upper payment limit program may be subject to a retroactive settlement process. McLeod Health continues to evaluate the settlement process related to the upper payment limit payment program and believes that it has recorded adequate provisions as of September 30, 2012 and 2011, in estimated third-party settlements in the accompanying consolidated balance sheets. Funds received under these programs may be subject to a retroactive settlement process and future receipts of funds are not guaranteed. Beginning in fiscal year 2012, states are required to perform audits of hospital disproportionate share data and make adjustments to payments if over or underpayments have occurred based on the results of these audits.

Charity Care — In accordance with McLeod Health's mission to improve the health of its communities, McLeod Health facilities accept patients regardless of their ability to pay. McLeod Health offers financial assistance to patients who meet established financial assistance guidelines. Because McLeod Health does not pursue collection of patient accounts determined to qualify as charity care, they are not reported as net patient service revenues. McLeod Health estimates the direct and indirect costs of providing charity care using a calculated ratio of costs to gross charges for each facility. The estimated cost of charity care provided by McLeod Health under its charity care policy was $36,435,000 and $32,713,000 for the years ended September 30, 2012 and 2011, respectively.

4. INVESTMENTS

Investments as of September 30, 2012 and 2011, are composed of investments held by the Foundation and LSHF and are recorded as follows:

	2012	2011
Investments held by the Foundation	$ 4,445,017	$ 3,936,232
Investments held by LSHF	1,778,368	
Less amounts included in assets limited to use	(2,583,932)	(2,088,833)
Total investments held as certificates of deposit and money market funds	$ 3,639,453	$ 1,847,399

McLeod Health has segregated assets limited as to use maintained by the Foundation into the most appropriate level within the fair value hierarchy based on the inputs used to determine the fair value as of September 30, 2012 and 2011, as follows:

	Fair Value Measurement as of September 30, 2012			
	September 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Common stocks	$1,252,433	$1,252,433	$ -	$ -
Mutual funds	133,885	133,885		
Corporate bond funds	845,627	845,627		
Government bonds	311,925		311,925	
Other	40,062		40,062	
Total	$2,583,932	$2,231,945	$351,987	$ -

	Fair Value Measurement as of September 30, 2011			
	September 30, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Common stocks	$ 1,204,675	$ 1,204,675	$ -	$ -
Mutual funds	108,878	108,878		
Corporate bond funds	529,647	529,647		
Government bonds	217,400		217,400	
Other	28,233		28,233	
Total	$ 2,088,833	$ 1,843,200	$ 245,633	$ -

5. ASSETS LIMITED AS TO USE

McLeod Health combines its investments in a system-wide investment pool, which includes investments and assets whose use is limited. Assets whose use is limited primarily include assets held by trustees under a master trust indenture agreement and assets designated by the board of directors for future capital improvements, over which the board retains control and may, at its discretion, subsequently use for other purposes.

Assets limited as to use are stated at fair value as of September 30, 2012 and 2011, and have been designated as follows:

	2012	2011
By the Board of Trustees for future expansion, purchase of property and equipment, and repayment of debt	$ 572,338,453	$ 480,639,471
Held by trustee for construction and purchase of property and equipment	1,204,852	42,203,820
Held by trustee for debt service reserve	7,539,698	7,539,092
Held by the Foundation	2,583,932	2,088,833
MRF Trust Fund	990,371	
Total	$ 584,657,306	$ 532,471,216

McLeod Health has segregated its investments and assets limited as to use into the most appropriate level within the fair value hierarchy based on the inputs used to determine the fair value as of September 30, 2012 and 2011, as follows:

	Fair Value Measurement as of September 30, 2012			
	September 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash, cash equivalents, and money market funds	$ 15,911,158	$ 15,911,158	$ -	$ -
Mutual funds	100,133,148	100,133,148		
Domestic equities	75,772,075	75,772,075		
Fixed income:				
Government bonds and government-backed securities	54,405,744		54,405,744	
Corporate bonds	30,744,116		30,744,116	
Mortgage-backed securities	7,280,995		7,280,995	
Other	10,702,338		10,702,338	
Large-cap commingled funds:				
State Street Global Advisors S&P 500 Index Funds	43,737,255		43,737,255	
JPMorgan U.S. Large Cap 130/30 Fund LLC	48,345,210		48,345,210	
International Equity Commingled Funds:				
Blackrock Global Investors Fund	62,356,151		62,356,151	
Alliance Institutional International Equity Fund	29,456,038		29,456,038	
Bernstein International Value Fund	27,009,464		27,009,464	
Alternative investments:				
Blackstone Partners Offshore Fund Ltd.	50,536,536			50,536,536
Winton Futures Fund Ltd.	12,243,075			12,243,075
Global Ascent Ltd.	12,449,700			12,449,700
MRF Trust Fund (Note 8)	990,371	990,371		
Investments held by the Foundation (Note 4)	2,583,932	2,231,945	351,987	
Total	$584,657,306	$195,038,697	$314,389,298	$75,229,311

	Fair Value Measurement as of September 30, 2011			
	September 30, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash, cash equivalents, and money market funds	$ 59,479,162	$ 59,479,162	$ -	$ -
Mutual funds	76,217,959	76,217,959		
Domestic equities	57,440,591	57,440,591		
Fixed income:				
Government bonds and government-backed securities	57,814,686		57,814,686	
Corporate bonds	23,784,472		23,784,472	
Mortgage-backed securities	6,234,288		6,234,288	
Other	7,594,969		7,594,969	
Large-cap commingled funds:				
State Street Global Advisors S&P 500 Index Funds	42,418,639		42,418,639	
JPMorgan U.S. Large Cap 130/30 Fund LLC	45,795,791		45,795,791	
International Equity Commingled Funds:				
Blackrock Global Investors Fund	54,425,790		54,425,790	
Alliance Institutional International Equity Fund	23,475,119		23,475,119	
Bernstein International Value Fund	28,400,339		28,400,339	
Alternative investment — Blackstone Partners Offshore Fund Ltd.	47,300,578			47,300,578
Investments held by the Foundation (Note 4)	2,088,833	1,843,200	245,633	
Total	$532,471,216	$194,980,912	$290,189,726	$47,300,578

The fair value of fixed-income securities shown in Level 2 above are measured using inputs other than quoted prices that are observable for the assets, including the stated interest rate, maturity, and credit risk.

McLeod Health's commingled funds and alternative investments include the following funds that do not have readily determinable market values:

State Street Global Advisors S&P 500 Index Funds — privately held funds that invest primarily in equity securities that trade on national stock exchanges and seeks to gain exposure to large capitalization U.S. companies by replicating the returns and characteristics of the S&P 500 Index. There are no redemption restrictions on this fund.

JPMorgan U.S. Large Cap 130/30 Fund, LLC — a privately held fund that invests primarily in equity securities that trade on a national stock exchange and utilizes active stock selection with a systematic valuation process and seeks to invest in a diversified portfolio of U.S. large-cap equities with a target average exposure of 130% long and 30% short. There are no redemption restrictions on this fund.

Blackrock Global Investors Fund (formerly Barclay's) — a privately held fund that invests primarily in international equity securities that trade on global stock exchanges. There are no redemption restrictions on this fund.

Alliance Institutional International Equity Fund — a privately held fund that invests primarily in equity securities of non-U.S. companies actively traded on foreign exchanges. The portfolio generally will be broadly diversified at the country level, with no more than 5% of any class of securities of any single issuer. The notification periods required for redemption or other limits on redemption as of September 30, 2012, were four business days.

Bernstein International Value Fund — a privately held fund that invests primarily in equity securities of non-U.S. companies actively traded on foreign exchanges located in the countries comprising the Morgan Stanley Capital International All Country World Index. The notification periods required for redemption or other limits on redemption as of September 30, 2012, were four business days.

Blackstone Partners Offshore Fund Ltd. — a privately held fund that invests primarily in other funds that are not publicly traded and is a fund of funds constructed through a multimanager framework of strategies that collectively are not highly correlated to traditional asset classes. This fund provides for redemptions on a semiannual basis with 95 days' prior written notice.

Winton Futures Fund Ltd. — a privately held fund that seeks to achieve long-term capital appreciation of assets in a variety of changing market conditions using a diversified futures trading program focused on quantitative technical analysis. The fund trades a portfolio of more than 100 international futures, options and forward contracts. This fund provides for redemptions on any dealing day provided that written notice is received two days prior to the relevant dealing date (first business day of each month).

Global Ascent Ltd. — a privately held fund managed by Blackrock and domiciled in the Cayman Islands. The U.S. dollar exposure of the fund is hedged back into Australian dollars. The strategy focuses on three groups of investment insights — fundamental valuation, economic environment, and market sentiment. This fund provides for redemptions 10 business days prior to the dealing date (last day of the month).

The commingled funds and alternative investments may contain elements of both credit and market risk. Such risks could include, but are not limited to, limited liquidity, absence of oversight, dependence upon key individuals, emphasis on speculative investments (both derivatives and nonmarketable investments), and nondisclosure of portfolio composition. McLeod Health reviews and evaluates the values provided by the investment managers for commingled funds and alternative investments and agrees with the valuation methods and assumptions used in determining the fair value of commingled funds and alternative investments. Financial instruments, which involve varying degrees of off-balance-sheet risk for the various limited partnerships, limited liability corporations, and offshore investment funds included within alternative investments, may result in a loss due to changes in the market (market risk).

There were no significant reclassifications between Level 1, Level 2, or Level 3 during the years ended September 30, 2012 and 2011.

The estimated fair value of certain alternative investments is based on valuations performed prior to the balance sheet date by the external investment managers and adjusted for cash receipts, cash disbursements, and securities distributions through September 30, 2012. Because alternative investments are not readily marketable, their estimated value is subject to uncertainty and, therefore, may differ from the value that would have been used had a ready market for such investments existed. Such differences could be material.

A summary of the change in the fair value of McLeod Health's Level 3 alternative investments for the years ended September 30, 2012 and 2011, is as follows:

Balance — September 30, 2010	$36,456,276
Unrealized gains	844,302
Capital contribution	10,000,000
Balance — September 30, 2011	47,300,578
Unrealized gains	2,928,733
Capital contribution	25,000,000
Balance — September 30, 2012	$75,229,311

Other revenues (expenses) for the years ended September 30, 2012 and 2011, is as follows:

	2012	2011
Unrealized gains (losses) on investments	$65,151,343	$(42,973,497)
Realized gains on sales of investments	5,603,051	14,834,612
Dividends and interest — net of management fees	5,076,941	6,948,961
Change in fair market value of interest rate swap	(763,242)	329,824
Total	$75,068,093	$(20,860,100)

6. PROPERTY AND EQUIPMENT

Property and equipment as of September 30, 2012 and 2011, consist of the following:

	2012	2011
Land and land improvements	$ 76,132,992	$ 59,263,402
Buildings	542,026,206	452,073,020
Fixed and moveable equipment	307,929,411	233,657,313
Leasehold improvements	2,991,450	2,431,031
Construction in progress	90,892,862	48,889,940
	1,019,972,921	796,314,706
Less accumulated depreciation	(523,271,968)	(422,891,570)
Total	$ 496,700,953	$ 373,423,136

7. SHORT-TERM BORROWINGS

McLeod Health has a $20,000,000 unsecured line of credit with a local financial institution. The line of credit bears interest at LIBOR, plus 1.25% (LIBOR was 0.22% at September 30, 2012). Interest is assessed at a variable interest rate adjusted daily and is payable monthly. There were no outstanding borrowings at September 30, 2012 and 2011.

8. LONG-TERM DEBT

Long-term debt as of September 30, 2012 and 2011, consists of the following:

	2012	2011
1998 Series A Bonds, less unamortized bond discount, due in various installments of $2,585,000 to $3,415,000, beginning November 1, 2010. Interest is paid semiannually at rates ranging from 4.75% to 5.25%	$ 20,585,640	$ 20,565,901
2004 Series A Bonds, plus unamortized premium, due in various installments ranging from $805,000 to $26,275,000 through 2034. Interest is paid semiannually at rates ranging from 4.10% to 5.25%	76,110,423	76,166,968
2010 Series A Bonds, plus unamortized premium, due in various installments ranging from $2,420,000 to $15,215,000, beginning in 2011 and extending to 2037. Interest is paid semiannually at rates ranging from 1.50% to 5.00%	120,637,325	123,058,304
2010 Series B Bonds, plus unamortized premium, due in annual installments of $15,375,000 to $15,805,000, beginning in 2038 and extending to 2040. Interest is paid monthly based on a variable rate (0.20% at September 30, 2012)	46,770,000	46,770,000
Note payable, due in monthly principal installments of $159,236, with the outstanding balance to be paid in August 2016. Interest is paid monthly at LIBOR (0.22% at September 30, 2012) plus 0.75%. Collateralized by a portion of assets	7,802,512	9,713,343
Note payable, due in monthly installments of approximately $30,000 with the remaining outstanding balance of $7.8 million to be paid in February 2022. Interest is paid monthly according to a swap agreement described in Note 1. Collateralized by MMP's land and buildings	11,838,085	11,586,947
Mortgage payable, due in monthly installments of approximately $522,000 with the outstanding balance to be paid in November 2036. Interest is paid monthly based on a fixed interest rate of 7.25%.	71,238,828	
Other	4,244,913	930,501
	359,227,726	288,791,964
Less current portion of long-term debt	(10,116,759)	(5,247,427)
Total	$349,110,967	$283,544,537

McLeod Health's Series 2010A and 2010B, Series 2004A, and Series 1998A bonds were issued through the governmental municipality of Florence County, South Carolina. Each member of the Obligated Group is jointly and severally liable for the repayment of the principal and interest as they become due on the bonds under a master indenture agreement. All accounts receivable of McLeod Health, now owned or hereafter acquired, and all proceeds thereof are pledged as collateral for the bonds. Additionally, under the master indenture agreement, the bonds are secured by the mortgage, as described in Note 11, on McLeod Health's land and all personal property and fixtures located thereon. Upon payment or defeasance of the Series 2004A and Series 1998A bonds, the master trustee has agreed to cancel the mortgage, and upon such cancellation, the Series 2010A and 2010B bonds will no longer be secured by the mortgage. Also, under the master indenture agreement, McLeod Health is subject to various restrictions as a part of debt covenants for the bonds and other debt. At September 30, 2012, McLeod Health was in compliance with its restrictive debt covenants under the master indenture agreement.

The approximately $11,800,000 note payable was refinanced during February 2012. As part of the refinancing, $575,000 was added to the principal amount of the loan. The amended and restated loan agreement extended maturity date of the loan from February 2014 to February 2022. All other terms of the amended and restated agreement do not differ significantly from the terms of the original agreement.

As part of the acquisition of LHS, McLeod Health assumed a secured mortgage fully insured by the U.S. Department of Housing and Urban Development Federal Housing Administration (FHA) pursuant to Section 242 of the National Housing Act, as amended, related to construction projects, refunding of other long-term debt, and other projects and equipment purchases of LHS. At the date of acquisition, the outstanding principal balance of the mortgage of approximately $71,567,000 was assigned to the newly formed MLSH. The mortgage calls for monthly installments of approximately $522,000, which includes interest at 7.25% with the final payment expected in November 2036. The mortgage is secured by all current or future properties and revenues of MLSH.

As part of the agreement to the assigned mortgage (the “agreement”) MLSH was required to establish a mortgage reserve fund (MRF) with a trustee to provide reserve funds related to the mortgage. MLSH is required to make monthly payments to the MRF which, when coupled with an assumed investment rate of return of 4%, will equal approximately 12 months and 24 months of mortgage debt service at five and 10 years, respectively. Such deposits held by the trustee are included with assets limited to use in the consolidated financial statements. The agreement also places limits on the incurrence of additional borrowings and distribution of assets, including cash, and requires that certain financial performance measures be satisfied as long as the mortgage is outstanding. As of September 30, 2012, MLSH did not meet all of the financial performance measures but has complied with the remediation requirements outlined in the agreement when such measures have not been met.

Future aggregate annual principal payments applicable to long-term debt are as follows:

Years Ending September 30	
2013	$ 10,116,759
2014	6,886,695
2015	6,374,222
2016	6,492,841
2017	6,283,570
Thereafter	323,073,639
Total	$ 359,227,726

9. EMPLOYEE BENEFIT PLANS

McLeod Health maintains a defined contribution plan covering a limited number of employees who were hired prior to January 1, 2001. McLeod Health contributes 3% of each eligible participant’s compensation. Such contributions amounted to $2,619,841 and $1,979,240 in fiscal years 2012 and 2011, respectively.

McLeod Health sponsors a 401(k) plan covering substantially all employees of McLeod Health. Annual contributions are based upon a matching of the participant's elective deferrals and amounted to $4,778,341 and $4,436,172 in fiscal years 2012 and 2011, respectively.

10. CONCENTRATIONS OF CREDIT RISK

McLeod Health provides acute and nonacute health care services to residents of the Pee Dee region of South Carolina. While the majority of patient receivables are due from the Medicare and Medicaid programs and various insurance companies, the collectibility of receivable balances is affected by the economic stability of the area. Accordingly, receivables are reflected in the balance sheet net of valuation allowances based on the anticipated collectibility of the related gross receivables.

The mix of receivables from patients and third-party payors as of September 30, 2012 and 2011, is as follows:

	2012	2011
Medicare	36 %	34 %
Medicaid	13	12
Managed care and other commercial insurers	24	30
Self-pay patients	27	24
Total	100 %	100 %

11. COMMITMENTS AND CONTINGENCIES

McLeod Health has leased a portion of its land for its physical plant through 2076, at which time McLeod Health has the option to purchase the property for a nominal cost. McLeod Health is also contingently responsible for any debt service cost of the landlord, plus any expenses incurred by the landlord in connection with the ownership of the premises. For the years ended September 30, 2012 and 2011, the landlord had incurred no debt service costs or other expenses in connection with the land.

McLeod Health has a claims-made professional liability insurance policy to cover medical malpractice claims in accordance with state-mandated limits for both hospital operations and its physicians. The South Carolina Charitable Immunity Statute allows for recovery against a charitable organization only the actual damages sustained, in an amount not exceeding the limitations of liability imposed in the South Carolina Tort Claims Act (the "Tort Claims Act"). The Tort Claims Act provides that no person shall recover in any action or claim brought hereunder a sum exceeding $300,000 per person, per occurrence or a total of $600,000 per occurrence, except that both the per-person and per-occurrence amounts are raised to $1.2 million for the tort of a licensed physician or dentist employed by such facility. No award for damages under the Tort Claims Act shall include punitive or exemplary damages or interest prior to judgment. While any medical malpractice claims contain an element of uncertainty, management believes that the outcome of any pending lawsuit or claim is covered by insurance and the related claim liability and anticipated insurance recoveries are not material due to the limitations of liability imposed in the Tort Claims Act.

McLeod Health is self-insured with respect to employee health benefits and workers' compensation.

McLeod Health is involved in various litigation, regulatory matters, and administrative proceedings arising in the ordinary course of business, including personnel- and employment-related matters. While any litigation contains an element of uncertainty, management believes that the outcome of any pending lawsuit or claim is covered by insurance and/or has been adequately reflected as accrued expenses and other liabilities in the accompanying consolidated financial statements. McLeod Health believes that the ultimate resolution of these matters will not have a material adverse effect on future financial position, results from consolidated operations or its cash flows.

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, reimbursement for patient care services, and Medicare and Medicaid fraud and abuse. 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. 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 repayments for patient services previously billed.

The health care industry continues to attract much legislative interest and public attention. In March of 2010, the President signed into law H.R. 3590, *The Patient Protection and Affordable Care Act*, and companion bill H.R. 4872, *The Health Care and Education Affordability Reconciliation Act of 2010*. The reform will be effective over a 10-year period through 2020, and contains an individual insurance mandate, low-income subsidies, an expansion of Medicaid, insurance reforms, and the creation of state-based health insurance exchanges. It is unclear at this time what the net impact of this legislation will be on McLeod Health. Such effects may include material and adverse changes to the amounts of reimbursement received by McLeod Health's facilities.

McLeod Health has committed to contracts with outside parties for various construction projects and equipment purchases that still have approximately $51,100,000 due to be paid subsequent to September 30, 2012.

Investment securities, in general, are exposed to various risks, such as interest rate, credit, and overall market volatility. Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the consolidated financial statements.

12. RELATED-PARTY TRANSACTIONS

Total expenditures for related-party transactions during fiscal years 2012 and 2011 were approximately $2,374,000 and $2,101,000, respectively. Such transactions primarily consist of cardiac call pay to Pee Dee Cardiology, of which a member of the Foundation Board practices cardiology, payments to Pee Dee Pathology where a member of the Foundation Board practices, as well as medical director and chief of staff fees for several members of the Board of Trustees and community board. In addition, a Board of Trustees member and a community board member are key employees of an anesthesiology group that has an exclusive arrangement with McLeod Health for provision of anesthesiology services.

In fiscal years 2012 and 2011, McLeod Health purchased insurance coverage from third-party insurance companies involving premiums totaling approximately $2,790,000 and $2,230,000, respectively. This coverage was placed by an insurance broker who serves on the Board of Trustees of the Foundation.

13. OPERATING LEASES

McLeod Health leases office space to outside parties under lease agreements with varying expiration dates through fiscal year 2028. Portions of the buildings below are used by McLeod Health, and accordingly, no rental income is recognized for that space. The cost and carrying amounts of property covered by these leases as of September 30, 2012, are as follows:

Buildings	$ 36,873,052
Less accumulated depreciation	(15,327,778)
Total	$ 21,545,274

Aggregate annual rental payments during the remaining terms of these agreements as of September 30, 2012, is as follows:

Years Ending September 30	
2013	$ 2,557,827
2014	2,257,545
2015	1,079,886
2016	605,009
2017	339,698
Thereafter	3,532,419
Total	$ 10,372,384

Rental income for the years ended September 30, 2012 and 2011, totaled $2,966,225 and $2,979,410, respectively.

McLeod Health leases certain equipment and office space used in its operations. Generally, the leases provide for renewal for various periods at stipulated rates. Aggregate future minimum lease payments under noncancelable operating leases as of September 30, 2012, are as follows:

Years Ending September 30	
2013	$ 2,264,103
2014	1,642,574
2015	1,379,040
2016	609,104
2017	524,776
Thereafter	84,480
Total	$ 6,504,077

Rent expense related to office space for the years ended September 30, 2012 and 2011, was $1,685,132 and $527,000, respectively. Rent expense related to equipment for the years ended September 30, 2012 and 2011, was $4,348,899 and $3,741,000, respectively.

14. FUNCTIONAL EXPENSES

McLeod Health primarily provides various health care services to its patients. Expenses related to providing these services during fiscal years 2012 and 2011, are summarized as follows:

	2012	2011
Health care services	$748,757,032	$626,545,752
General and administrative	62,760,316	55,727,333
Total	$811,517,348	$682,273,085

15. FAIR VALUE MEASUREMENTS

The following methods and assumptions were used in estimating the fair value of financial instruments:

Cash and Cash Equivalents — The carrying amount reported in the accompanying consolidated balance sheets for cash and cash equivalents approximates its fair value.

Investments and Assets Limited as to Use — The carrying amounts reported in the accompanying consolidated balance sheets are based on quoted market prices, if available, or estimated using quoted market prices for similar securities (see Notes 4 and 5 for additional information).

Receivables — The carrying amounts reported in the accompanying consolidated balance sheets for receivables approximate their fair value.

Accounts Payable and Accrued Expenses and Other Liabilities — The carrying amounts reported in the accompanying consolidated balance sheets for accounts payable and accrued expenses and other liabilities approximate their fair value.

Estimated Third-Party Settlements — The carrying amount reported in the accompanying consolidated balance sheets for estimated third-party settlements approximates its fair value.

Long-Term Debt — The fair value of McLeod Health's long-term debt was approximately $374,648,000 and $297,684,000 at September 30, 2012 and 2011, respectively, and was determined based on quoted market prices for bonds and the carrying amounts of notes payable with variable interest rates.

16. ENDOWMENT FUNDS

McLeod Health's endowment funds consist of donor-restricted funds and internally designated funds established primarily for scholarship purposes.

Management has interpreted FASB Staff Position FAS 117-1, *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for All Endowment Funds* (ASC Topic 958) as requiring the preservation of the fair value of original gifts and subsequent contributions as of the gift date of donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result, the Foundation classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent contributions to the permanent endowment, and (c) other accumulations to the permanent endowment as required by donor gift instruments. The remaining portion of donor-restricted endowment funds that is not classified as permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the Foundation consistent with the donor's wishes. Losses on the investments of donor-restricted endowment funds are recorded as a reduction of temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before the loss occurs. Any remaining losses reduce unrestricted net assets. Investment gains (losses) on donor-restricted endowment funds totaling $43,506 and $(3,775) as of September 30, 2012 and 2011, respectively, have been recorded as changes in the temporarily restricted net assets of the endowment funds.

The Foundation has developed an investment policy for all its investable assets whose general purpose is to preserve the capital and purchasing power of the endowments and to produce sufficient investment earnings for current and future spending needs. The Foundation has adopted a spending policy that limits the amount of funds available for distribution each year to four percent (4%) of a 12-quarter trailing average market value of each portfolio computed as of the prior September 30 fiscal year end.

Depending on investment conditions, the Board may approve a spending policy of no less than 3.5% and no more than 5% of the 12-quarter trailing average market value of the fund. With this policy, the annual dollar amount available for spending will be known at the beginning of the year. If necessary, quarterly transfers of approximately 1% of the earnings of the endowment will be scheduled to be transferred to the main cash account from the endowment funds. In establishing this policy, the Foundation considered the long-term expected return on its investments and the objective to preserve purchasing power.

As of September 30, 2012 and 2011, McLeod Health's total endowment net assets were $910,146 and $840,010, respectively. Changes in endowment net assets for the years ended September 30, 2012 and 2011, consisted of the following:

	Unrestricted	**Temporarily Restricted**	**Permanently Restricted**	**Total**
Endowment net assets — beginning of year — October 1, 2010	$ -	$ 124,451	$ 716,973	$ 841,424
Investment loss		(3,775)		(3,775)
Additions		3,361		3,361
Expenses		(1,000)		(1,000)
Endowment net assets — end of year — September 30, 2011	-	123,037	716,973	840,010
Investment gain		43,506		43,506
Additions		3,636	25,000	28,636
Expenses		(2,006)		(2,006)
Endowment net assets — end of year — September 30, 2012	$ -	$ 168,173	$ 741,973	$ 910,146

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SUPPLEMENTAL CONSOLIDATING INFORMATION

MCLEOD HEALTH

SUPPLEMENTAL CONSOLIDATING BALANCE SHEET INFORMATION — OBLIGATED AND NONOBLIGATED GROUP AS OF SEPTEMBER 30, 2012

ASSETS	Obligated Group	Nonobligated Group	Eliminations	Total
CURRENT ASSETS:				
Cash and cash equivalents	$ 54,656,002	$ 7,975,209	$	$ 62,631,211
Investments	1,701,888	1,937,565		3,639,453
Net patient receivables	70,914,714	13,520,218		84,434,932
Other receivables	1,837,606	2,396,270	(268,594)	3,965,282
Inventories	4,933,585	2,366,269		7,299,854
Prepaid expenses	7,989,559	1,223,800		9,213,359
Total current assets	142,033,354	29,419,331	(268,594)	171,184,091
INVESTMENT IN SUBSIDIARIES	6,540,299		(6,540,299)	-
DUE FROM/(TO) AFFILIATED ENTITIES — Net	3,873,409	(3,873,409)		-
ASSETS LIMITED AS TO USE	581,083,003	3,574,303		584,657,306
PROPERTY AND EQUIPMENT — Net	407,178,026	89,522,927		496,700,953
BOND ISSUE COSTS — Net	5,730,355			5,730,355
GOODWILL	3,261,544			3,261,544
OTHER ASSETS	6,529,746	2,928,693		9,458,439
TOTAL	$ 1,156,229,736	$ 121,571,845	$ (6,808,893)	$ 1,270,992,688

LIABILITIES AND NET ASSETS	Obligated Group	Nonobligated Group	Eliminations	Total
CURRENT LIABILITIES:				
Current portion of long-term debt	$ 8,606,200	$ 1,510,559	$	$ 10,116,759
Accounts payable	23,691,758	2,494,087	(268,594)	25,917,251
Accrued expenses and other liabilities	36,494,814	5,872,658		42,367,472
Estimated third-party settlements	38,133,643	2,038,304		40,171,947
Total current liabilities	106,926,415	11,915,608	(268,594)	118,573,429
LONG-TERM DEBT — Net of current portion	267,338,510	81,772,457		349,110,967
Total liabilities	374,264,925	93,688,065	(268,594)	467,684,396
NET ASSETS:				
Noncontrolling interest		1,551,083		1,551,083
McLeod Health	781,964,811	26,332,697	(6,540,299)	801,757,209
TOTAL	$ 1,156,229,736	$ 121,571,845	$ (6,808,893)	$ 1,270,992,688

MCLEOD HEALTH

SUPPLEMENTAL CONSOLIDATING STATEMENT OF OPERATIONS INFORMATION — OBLIGATED AND NONOBLIGATED GROUP
FOR THE YEAR ENDED SEPTEMBER 30, 2012

	Obligated Group	Nonobligated Group	Eliminations	Total
REVENUES, GAINS, AND OTHER SUPPORT:				
Net patient service revenues	$751,640,072	$ 78,942,318	$ -	$ 830,582,390
Other operating revenues	21,595,657	10,009,278	(6,218,764)	25,386,171
Net assets released from restrictions	896,857			896,857
Total revenues, gains, and other support	774,132,586	88,951,596	(6,218,764)	856,865,418
EXPENSES:				
Personnel	339,928,909	31,654,888		371,583,797
Professional fees	10,086,290	11,900,690		21,986,980
Supplies	117,633,948	11,067,191		128,701,139
Purchased services	30,494,673	8,764,033	(1,120,384)	38,138,322
Facility-related costs	17,522,041	2,801,811	(4,023,089)	16,300,763
Insurance	4,997,847	689,795		5,687,642
Other	21,760,046	3,385,465	(1,075,291)	24,070,220
Interest	10,248,675	4,371,346		14,620,021
Depreciation and amortization	35,155,061	5,611,709		40,766,770
Loss on disposal of property	492,515	28,462		520,977
Provision for uncollectible accounts — net	131,092,460	18,048,257		149,140,717
Total expenses	719,412,465	98,323,647	(6,218,764)	811,517,348
INCOME (LOSS) FROM OPERATIONS	54,720,121	(9,372,051)	-	45,348,070
OTHER REVENUES (EXPENSES)	75,827,457	(759,364)		75,068,093
SUBSIDIARIES' (LOSS) INCOME — Net	(336,027)		336,027	-
EXCESS OF REVENUES OVER EXPENSES	130,211,551	(10,131,415)	336,027	120,416,163
INHERENT CONTRIBUTION FROM THE ACQUISITION OF LHS	5,081,012	27,168,047		32,249,059
LESS INCOME ATTRIBUTABLE TO NONCONTROLLING INTEREST		(74,733)		(74,733)
EXCESS OF REVENUES OVER EXPENSES ATTRIBUTABLE TO MCLEOD HEALTH	135,292,563	16,961,899	336,027	152,590,489
MMP DISTRIBUTIONS	458,854	(458,854)		-
NET ASSETS RELEASED FROM RESTRICTIONS FOR PURCHASES OF PROPERTY AND EQUIPMENT	2,698,095			2,698,095
CHANGE IN NET ASSETS ATTRIBUTABLE TO MCLEOD HEALTH:				
Unrestricted	138,449,512	16,503,045	336,027	155,288,584
Temporarily restricted		(333,771)		(333,771)
Permanently restricted		25,000		25,000
TOTAL CHANGE IN NET ASSETS ATTRIBUTABLE TO MCLEOD HEALTH	$138,449,512	$ 16,194,274	$ 336,027	$ 154,979,813