

CONSOLIDATED FINANCIAL STATEMENTS

Baystate Health, Inc. and Subsidiaries  
Years Ended September 30, 2008 and 2007  
With Report of Independent Auditors

Baystate Health, Inc. and Subsidiaries

Consolidated Financial Statements

Years Ended September 30, 2008 and 2007

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## Report of Independent Auditors

The Board of Trustees  
Baystate Health, Inc.

We have audited the accompanying consolidated statements of financial position of Baystate Health, Inc. and Subsidiaries (Baystate Health) as of September 30, 2008 and 2007, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of Baystate Health's management. 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. We were not engaged to perform an audit of Baystate Health's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Baystate 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, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Baystate Health, Inc. and Subsidiaries at September 30, 2008 and 2007, and the consolidated results of their operations and changes in net assets and cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.

*Ernst & Young LLP*

December 12, 2008

Baystate Health, Inc. and Subsidiaries

Consolidated Statements of Financial Position  
(In Thousands)

	<b>September 30</b>			<b>September 30</b>	
	<b>2008</b>	<b>2007</b>		<b>2008</b>	<b>2007</b>
<b>Assets</b>			<b>Liabilities and net assets</b>		
Current assets:			Current liabilities:		
Cash and cash equivalents	\$ 58,731	\$ 61,344	Accounts payable	\$ 76,005	\$ 69,372
Investments	213,653	224,695	Medical claims payable	23,955	24,393
Accounts receivable, patients, less allowance for uncollectible accounts of \$31,886 (2007 – \$34,215)	109,781	97,662	Accrued salaries and wages	60,227	59,220
Accounts receivable, other	15,108	14,440	Accrued interest on bonds payable	1,575	1,634
Estimated final settlements receivable	14,260	12,064	Estimated final settlements payable	31,268	42,243
Inventories	15,831	14,546	Refundable advances	3,200	2,995
Prepaid expenses and other current assets	14,604	12,519	Short-term obligations	9,445	9,765
Total current assets	<u>441,968</u>	<u>437,270</u>	Deferred revenue	11,895	3,504
			Current portion of long-term debt	12,077	11,704
Long-term investments:			Total current liabilities	<u>229,647</u>	<u>224,830</u>
Investments	54,580	66,001			
Equity investment in unconsolidated affiliates	1,340	2,196	Long-term debt	195,897	209,004
Goodwill	1,764	2,045	Pension liability	–	38,192
Pension asset	4,000		Insurance liability loss reserves	79,813	73,657
Deferred expense	6,238	3,944	Other liabilities	9,250	2,687
Land, buildings, and equipment, net	<u>335,582</u>	<u>308,659</u>	Total liabilities	<u>514,607</u>	<u>548,370</u>
	<u>403,504</u>	<u>382,845</u>			
Assets whose use is limited:			Net assets:		
Board-designated funds:			Unrestricted:		
Cash and investments	200,170	244,802	Operating	611,983	622,452
Investments of captive insurance company	77,019	71,145	Pension adjustment	(63,130)	(105,559)
Investments held by trustee under bond indenture agreements	6,142	6,339	Total Unrestricted	<u>548,853</u>	<u>516,893</u>
Beneficial interest in perpetual trusts	31,645	39,149	Temporarily restricted	49,950	62,083
	<u>314,976</u>	<u>361,435</u>	Permanently restricted	47,038	54,204
Total assets	<u><u>\$1,160,448</u></u>	<u><u>\$1,181,550</u></u>	Total net assets	<u>645,841</u>	<u>633,180</u>
			Total liabilities and net assets	<u><u>\$1,160,448</u></u>	<u><u>\$1,181,550</u></u>

See accompanying notes.

Baystate Health, Inc. and Subsidiaries

Consolidated Statements of Operations

(In Thousands)

	<b>Year Ended September 30</b>	
	<b>2008</b>	<b>2007</b>
Operating revenues:		
Net patient service revenue (exclusive of standard charges for charity care of \$31,795 in 2008 and \$40,328 in 2007)	<b>\$1,004,202</b>	\$ 947,848
Premiums	<b>272,163</b>	255,698
Other revenue	<b>66,000</b>	80,202
Net assets released from restrictions used for operations	<b>2,693</b>	2,550
Total operating revenues	<b>1,345,058</b>	1,286,298
Operating expenses:		
Salaries and wages	<b>557,707</b>	520,516
Supplies and expense	<b>458,497</b>	438,992
Medical claims and capitation	<b>202,446</b>	183,888
Depreciation and amortization	<b>49,467</b>	47,342
Bad debts	<b>21,631</b>	25,465
Interest expense	<b>9,857</b>	10,992
Total operating expenses	<b>1,299,605</b>	1,227,195
Income from operations	<b>45,453</b>	59,103
Non-operating income (expense):		
Investment income	<b>5,536</b>	5,175
Net realized gain on investments	<b>381</b>	15,715
Equity gain in unconsolidated affiliates	<b>1,140</b>	1,633
Net interest savings on swap agreements	<b>829</b>	1,180
Change in fair value of swap agreements	<b>(3,130)</b>	(500)
Income taxes and other	<b>(3,913)</b>	(5,030)
Total non-operating income	<b>843</b>	18,173
Excess of revenues over expenses	<b>46,296</b>	77,276
Other changes in net assets:		
Net assets released from restrictions for capital	<b>2,550</b>	3,076
Transfers to restricted net assets	<b>(247)</b>	(110)
Net unrealized (loss) gain on investments	<b>(60,371)</b>	12,135
Pension adjustment	<b>42,429</b>	20,571
Other	<b>1,303</b>	1,518
Increase in unrestricted net assets	<b>\$ 31,960</b>	\$ 114,466

See accompanying notes.

Baystate Health, Inc. and Subsidiaries

Consolidated Statements of Changes in Net Assets  
(In Thousands)

	<b>Year Ended September 30</b>	
	<b>2008</b>	<b>2007</b>
Unrestricted net assets:		
Excess of revenues over expenses	\$ 46,296	\$ 77,276
Net assets released from restrictions for capital	2,550	3,076
Transfers to restricted net assets	(247)	(110)
Net unrealized (loss) gain on investments	(60,371)	12,135
Pension adjustment	42,429	20,571
Other	1,303	1,518
Increase in unrestricted net assets	31,960	114,466
Temporarily restricted net assets:		
Restricted investment income	327	327
Net realized and unrealized (loss) gain on investments	(10,276)	8,568
Contributions	3,823	5,760
Grants	252	270
Transfers from unrestricted net assets	247	110
Net assets released from restrictions:		
For operations	(2,693)	(2,550)
For capital	(2,550)	(3,076)
Other	(1,263)	(2,547)
(Decrease) increase in temporarily restricted net assets	(12,133)	6,862
Permanently restricted net assets:		
Contributions	338	365
Change in value of perpetual trusts	(7,504)	3,341
(Decrease) increase in permanently restricted net assets	(7,166)	3,706
Increase in net assets	12,661	125,034
Net assets at beginning of year	633,180	508,146
Net assets at end of year	\$645,841	\$633,180

*See accompanying notes.*

Baystate Health, Inc. and Subsidiaries

Consolidated Statements of Cash Flows  
(In Thousands)

	<b>Year Ended September 30</b>	
	<b>2008</b>	<b>2007</b>
<b>Operating activities</b>		
Change in net assets	<b>\$ 12,661</b>	\$ 125,034
Adjustments to reconcile change in net assets to cash provided by operating activities:		
Depreciation and amortization	<b>49,467</b>	47,342
Pension adjustment	<b>(42,429)</b>	(20,571)
Net realized and unrealized loss (gain) on investments	<b>72,422</b>	(53,142)
Provision for bad debts	<b>21,631</b>	25,465
Change in beneficial interest of perpetual trusts	<b>7,504</b>	(3,341)
Restricted contributions	<b>(4,161)</b>	(6,125)
Changes in equity investment of affiliate	<b>(1,140)</b>	(1,633)
Increase in accounts receivable, patients	<b>(33,750)</b>	(30,206)
Net change in estimated final settlements	<b>(13,171)</b>	(846)
Change in accounts payable and accrued expenses	<b>7,581</b>	16,390
Change in accrued pension liability, net	<b>237</b>	(949)
(Decrease) increase in medical claims payable	<b>(438)</b>	1,637
Increase in insurance liability loss reserves	<b>6,156</b>	4,767
Other	<b>11,389</b>	(7,420)
Net cash provided by operating activities	<b>93,959</b>	96,402
<b>Investing activities</b>		
Proceeds from sale and maturities of investments	<b>576,173</b>	564,911
Purchase of investments	<b>(587,177)</b>	(599,075)
Purchase of land, buildings, and equipment, net	<b>(76,209)</b>	(55,645)
Net cash used in investing activities	<b>(87,213)</b>	(89,809)
<b>Financing activities</b>		
Proceeds from restricted contributions	<b>4,161</b>	6,125
Proceeds from bond issuance	<b>10,158</b>	10,000
Net repayments of short-term obligations	<b>(320)</b>	(3,280)
Repayment of long-term debt	<b>(23,358)</b>	(12,157)
Net cash (used in) provided by financing activities	<b>(9,359)</b>	688
Net (decrease) increase in cash and cash equivalents	<b>(2,613)</b>	7,281
Cash and cash equivalents at beginning of year	<b>61,344</b>	54,063
Cash and cash equivalents at end of year	<b>\$ 58,731</b>	\$ 61,344

See accompanying notes.

# Baystate Health, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

September 30, 2008

### 1. Organization

Baystate Health, Inc. (Baystate Health or BH) based in Springfield, Massachusetts, is the parent corporation of an integrated health care delivery system with the mission “to improve the health of the people in our community every day, with quality and compassion.”

Baystate Health currently includes the following:

- Baystate Medical Center (BMC) located in Springfield, Massachusetts, is the largest of the three hospitals in the Baystate Health system. BMC, the leading health facility in western Massachusetts is the only tertiary care referral medical center and Level I trauma center in the region. It is also home to western New England’s only neonatal and pediatric intensive care units. BMC is a 653-bed, tax exempt, not-for-profit, academic teaching hospital that serves as the western campus of Tufts University School of Medicine.
- Baystate Franklin Medical Center (BFMC) located in Greenfield, Massachusetts, is a 90-bed, tax exempt, not-for-profit, acute care community hospital. BFMC serves the northern tier of northwestern Massachusetts and southern Vermont.
- Baystate Mary Lane Hospital Corporation (BMLH) located in Ware, Massachusetts, is a 31-bed, tax exempt, not-for-profit, acute care community hospital. BMLH provides services to more than sixteen central Massachusetts communities.
- Baystate Medical Education and Research Foundation, Inc. (BMERF) is a multi-specialty academic group practice established as a tax exempt, not-for-profit foundation to support the educational and research programs of Baystate Health, as well as numerous community primary care and outreach services.
- Baystate Affiliated Practice Organization, Inc. (BAPO) is a tax-exempt, not-for-profit organization, and consists of community based primary care (internists and pediatricians), medical and surgical specialty practices, obstetrical and gynecological, and hospitalist physicians dedicated to the care and management of patients hospitalized at BH affiliated hospitals.
- Baystate Vascular Services, Inc. (BVS) is a tax-exempt, not-for-profit organization that provides preventative, diagnostic and therapeutic health services. BVS enhances the cardiovascular clinical, educational, community, and research activities for Baystate Health and its service area.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 1. Organization (continued)

- Baystate Visiting Nurse Association & Hospice (BVNAH) is a tax-exempt, not-for-profit organization that provides comprehensive home health care committed to providing the highest quality care to patients and families, primarily in the home setting. BVNAH meets individual needs by bringing experienced nurses, rehabilitation therapists, social workers, and home care aides to patients' homes.
- Health New England, Inc. (HNE) is a for-profit, taxable health maintenance organization located in Springfield, Massachusetts, approximately 97% of which is owned by BH and the remaining 3% is owned by BH affiliated physicians. HNE's service area in Massachusetts includes Franklin, Berkshire, Hampden, and Hampshire counties, and part of Worcester county. HNE also serves Hartford, Litchfield, and Tolland counties in Connecticut.
- Ingraham Corporation (IC) is a for-profit, taxable corporation that currently serves as a holding company for Baystate Health Ambulance, Inc.
- Baystate Health Ambulance, Inc. (BHA) is a for-profit, taxable corporation that delivers the latest in mobile critical care providing 24-hour service throughout western New England.
- Baystate Administrative Services, Inc. (BAS) is a tax-exempt, not-for-profit corporation that provides management support for the BH subsidiaries, including human resources, marketing, strategic planning, information services, and financial services.
- Baystate Health Foundation, Inc. (BHF) is a tax-exempt, charitable organization established for the purpose of fund-raising for healthcare related activities, in support, and for the benefit, of BH and those subsidiaries of BH that are tax-exempt, not-for-profit corporations, and to hold endowment, charitable donations, and other funds for their benefit.
- Baystate Health Insurance Company, Ltd. (BHIC) is a captive insurance company organized and licensed in the Cayman Islands, British West Indies. BHIC provides professional liability and other insurance coverage to the corporate members of BH and their employees. In 2004, BHIC began offering malpractice insurance to members of BH's medical staff who meet criteria for participation.

# Baystate Health, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements (continued)

### 2. Significant Accounting Policies

#### Principles of Consolidation

The accompanying consolidated financial statements include the accounts of BH and its subsidiaries. All significant intercompany and subsidiary accounts and transactions have been eliminated.

#### Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates are made in the areas of the allowance for uncollectible patient accounts receivable, reserve for contractual allowances, investment valuation, accruals for settlements with third-party payors, medical claims payable, accrued insurance liability loss reserves, pension costs, and accrued compensation and benefits.

#### Net Assets

Baystate Health and its subsidiaries report net assets and revenues, expenses, gains, and losses based upon the existence or absence of donor-imposed restrictions. In the accompanying consolidated financial statements, net assets that have similar characteristics have been combined into the following categories:

Unrestricted	Net assets that are not subject to donor-imposed stipulations. Net assets may be designated for specific purposes by action of the Board of Trustees or may otherwise be limited by contractual agreements with outside parties.
Temporarily restricted	Net assets whose use by Baystate Health and its subsidiaries are subject to donor-imposed stipulations that can be fulfilled by actions of Baystate Health and its subsidiaries or that expire by the passage of time. At September 30, 2008 and 2007, temporarily restricted net assets consist of amounts restricted as to spending for various purposes, such as education, research, clinical, and healthcare programs, as well as cumulative net appreciation of permanent endowment funds.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 2. Significant Accounting Policies (continued)

Permanently restricted Net assets subject to donor-imposed stipulations that they be maintained permanently by Baystate Health and its subsidiaries. At September 30, 2008 and 2007, permanently restricted net assets consist of the original cost of permanent endowment gifts and beneficial interests in perpetual trusts.

Revenues from sources other than donor-restricted contributions are reported as increases in unrestricted net assets. Expenses are reported as decreases in unrestricted net assets. Gains and losses on investments are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulations or by law. Expirations of temporary restrictions recognized on net assets (i.e., the donor-stipulated purpose has been fulfilled and/or the stipulated time period has elapsed) are reported as reclassifications from temporarily restricted net assets to unrestricted net assets. Temporary restrictions on gifts to acquire long-lived assets are considered met in the period in which the assets are acquired or placed in service.

Contributions, including unconditional promises to give and grant awards, are recognized as revenues in the period received. Contributions received with donor-imposed restrictions are reported as permanently or temporarily restricted revenues depending upon the specific restriction. Conditional promises to give are not recognized until the conditions on which they depend are substantially met. Contributions of assets other than cash are recorded at their estimated fair values at the date of the gift. Contributions to be received after one year are discounted at a risk-free rate commensurate with the expected payment term. Amortization of the discount is recorded as contribution revenue in the appropriate net asset category. Allowance is made for uncollectible contributions based upon management's judgment and analysis of the creditworthiness of the donors, past collection experience, and other relevant information.

#### Cash and Cash Equivalents

Cash and cash equivalents include all highly liquid investments with a maturity of three months or less when purchased.

#### Investments

Investments, including funds held by trustees under bond indenture agreements, are recorded at fair value in the consolidated statements of financial position. The fair value of investments is estimated using quoted market values. Realized gains and losses, interest, and dividends on investments are included in other revenue or non-operating income in the statements of operations unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are included in the change in unrestricted or temporarily restricted net assets, as applicable. Investments include limited partnership interests in hedge funds and shares of

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **2. Significant Accounting Policies (continued)**

common collective trust funds. Baystate Health's policy is to record its ownership interest in these investments of less than 3% at cost. For those funds where the ownership interest is more than 3%, the ownership interests are reported using the equity method of accounting. Under the equity method, Baystate Health recognizes its share of the increase or the decrease of the investment's fair value in non-operating income. Certain of the partnerships may hold some securities without readily determinable fair values and consequently, the general partner may estimate fair value for such securities. These estimates may differ significantly from the values that would have been used had a ready market existed and may also differ significantly from the values at which such investments may be sold and the differences could be material.

Management reviews investments where the market value is substantially below cost, and in cases where the decline is considered to be other than temporary, an adjustment is recorded as a realized loss.

Certain pooled endowment funds are administered under a total return policy. Under this policy, any shortfall between investment income utilized under the total return spending policy and the actual income earned is met by reclassifying realized and unrealized gains of temporarily restricted net assets to unrestricted for operations.

Investments are included in pooled investment funds. Current market value is used to determine the percent of each fund in the pool. Income from investments of a pool, including gains or losses, is allocated to participating funds based on the respective fund's percentage of the pool.

#### **Fair Value of Financial Instruments**

Fair value approximates carrying value for cash and investments, accounts receivable, contributions receivable (included with other current assets on the consolidated statements of financial position), estimated final settlements receivable and payable with third-party payors, accounts payable, and medical claims payable.

The fair value of bonds payable is estimated using discounted cash flow analyses based on current estimated borrowing rates for similar types of borrowing arrangements or debt.

#### **Inventories**

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

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **2. Significant Accounting Policies (continued)**

##### **Deferred Expense**

Deferred expense includes unamortized bond issuance expenses, which are amortized over the weighted-average terms of the bonds, and deferred tax assets of HNE.

Goodwill is amortized on a straight-line basis over the expected life of the benefit.

##### **Assets Whose Use is Limited**

Assets whose use is limited include assets held by trustee under indenture agreements and designated assets set aside by the Board of Trustees for future capital improvements and other strategic initiatives which are in furtherance of Baystate Health and its subsidiaries' exempt and charitable purposes. Also included are investments of the captive insurance company and beneficial interests in perpetual trusts.

##### **Land, Buildings, and Equipment**

Land, buildings, and equipment are stated at cost, less depreciation and amortization determined on the straight-line basis.

Maintenance and repairs are charged to expense as incurred. Betterments and major renewals are capitalized. Cost of assets sold or retired and the related amounts of accumulated depreciation are eliminated from the accounts in the year of disposal, and the resulting gain or loss is included in other revenue. Buildings and equipment under capital lease obligations are amortized on the straight-line method over the shorter period of the lease term or the estimated useful life. Such amortization is included in depreciation and amortization in the consolidated financial statements. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

##### **Statements of Operations**

All activities of Baystate Health deemed by management to be ongoing and central to the provision of healthcare services are reported as operating revenues and expenses. Other activities are considered non-operating and include, board-designated investment income and realized gains and losses, equity gains in unconsolidated affiliates, loss on extinguishment of debt, interest savings on swap agreements, change in fair value of swap agreements, and income taxes.

The statements of operations include excess of revenues over expenses as the performance indicator. Changes in unrestricted net assets which are excluded from excess of revenues over expenses include net assets released from restrictions for capital, transfers to restricted net assets, unrealized gains and losses on investments, and the pension adjustment.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **2. Significant Accounting Policies (continued)**

##### **Net Patient Service Revenue**

Net patient service revenue is reported at estimated net realizable amounts 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. Contracts, laws, and regulations governing Medicare, Medicaid, Blue Cross, and the uncompensated care pool programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

Blue Cross and other managed care plans have negotiated with Baystate Health and its subsidiaries various forms of contractual payment rates. The most common payment rates include discounted charges, per case, per diems, and fee schedules.

Medicaid payment rates are negotiated between the Division of Medical Assistance and individual hospitals. Medicare Prospective Payment System (PPS) regulations determine payment due acute care hospitals for inpatient services provided to Medicare beneficiaries. Medicare payments for outpatient services are a blend of PPS and fee schedules.

During 2008 and 2007, Baystate Health recorded adjustments to amounts accrued for settlements related to prior fiscal years. The net effect of such adjustments was to increase net patient service revenue by approximately \$17,400,000 and \$6,537,000 in 2008 and 2007, respectively.

##### **Premium Revenue**

Premium revenue represents insurance membership contract revenue at HNE. The contracts generally cover a 12-month period, and are subject to cancellation by the employer group or HNE upon 30 days written notice. Premiums are due monthly and are recognized as revenue during the period in which HNE is obligated to provide services to members.

##### **Uncompensated Care Pool**

The Commonwealth of Massachusetts (the Commonwealth) operates an "Uncompensated Care Pool" which is partially funded by acute care hospitals through an assessment on gross charges billed to non-governmental payors. Hospitals within the Commonwealth are reimbursed for their uncompensated care at a predetermined amount based in part on free care provided in a prior year. The assessment and reimbursement are reported within net patient service revenue.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **2. Significant Accounting Policies (continued)**

In April 2006, the Commonwealth passed Chapter 58 of the Acts of 2006, An Act Providing Access to Affordable, Quality, Accountable Health Care, the goal of which is to provide near-universal health insurance coverage to Massachusetts residents through a combination of Medicaid expansions, subsidized private insurance programs, insurance market reforms, and the Health Safety Net.

Beginning in October 2007, the Health Safety Net replaced the Uncompensated Care Pool. The Health Safety Net reimburses hospitals for uncompensated care based on actual services provided at rates approximating the Medicare Prospective Payment System, subject to available funds. Like its predecessor, the Health Safety Net is partially funded by acute hospitals through an assessment on gross charges billed to non-governmental payors.

#### **Charity Care and Community Support**

It is the policy of Baystate Health to provide care to any patient in need of medical care, regardless of the patient's ability to pay for such care. Based upon the patient's financial capability to pay, such care is provided free of charge or at amounts below normal charges. Because amounts determined to qualify as charity care are not pursued, they are not reported as revenue. The amounts of such care at standard charges were approximately \$31,795,000 and \$40,328,000 for the years ended September 30, 2008 and 2007, respectively.

In addition to the charity care provided to patients, Baystate Health and its subsidiaries have ongoing community outreach initiatives in the areas of health services access, education, safety, and community reinvestment. The initiatives include free-standing health centers, improving school based health services, implementing an immunization tracking system to link preschool aged children to primary care providers, youth development programs, increasing minority employment, improving the community's health status, wellness, health and safety programs for senior citizens, and health screenings and forums.

#### **Income Taxes**

All of Baystate Health's consolidated entities qualify as tax-exempt, not-for-profit organizations under Section 501(c)(3) of the Internal Revenue Code, except for BHIC, IC and its subsidiary, and HNE and its subsidiaries.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 2. Significant Accounting Policies (continued)

##### New Accounting Pronouncements

On October 1, 2007, Baystate Health adopted the Financial Accounting Standards Board (FASB) Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken, or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, and disclosure requirement for uncertain tax positions. The adoption of FIN 48 did not have a material impact on Baystate Health's consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States, and expands disclosure about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. Baystate Health has not yet determined the effect that the adoption of SFAS No. 157 will have on its financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 permits companies to choose to measure certain financial instruments and other items at fair value that are not currently required to be measured at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Baystate Health has not yet determined the effect that the adoption of SFAS No. 159 will have on its consolidated financial statements.

##### Reclassifications

Certain 2007 amounts have been reclassified to conform to the current year's presentation.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 3. Cash and Investments

The composition of cash and investments at September 30, 2008 and 2007 are as follows (in thousands):

	<b>2008</b>	<b>2007</b>
Cash and cash equivalents	<b>\$ 88,829</b>	\$ 76,054
Common and preferred stock	<b>178,248</b>	238,927
U.S. government and domestic fixed income securities	<b>274,312</b>	279,923
Real estate	<b>27,062</b>	43,819
Commodities and other investments	<b>41,844</b>	35,603
	<b>\$610,295</b>	\$674,326

Cash and investments at September 30, 2008 and 2007 are included in the consolidated statements of financial position as follows (in thousands):

	<b>2008</b>	<b>2007</b>
Cash and cash equivalents	<b>\$ 58,731</b>	\$ 61,344
Investments	<b>213,653</b>	224,695
Long-term investments	<b>54,580</b>	66,001
Board-designated cash and investments	<b>200,170</b>	244,802
Investments of captive insurance company	<b>77,019</b>	71,145
Investments held by trustee	<b>6,142</b>	6,339
	<b>\$610,295</b>	\$674,326

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 3. Cash and Investments (continued)

Investment income, gains, and losses on unrestricted funds at September 30, 2008 and 2007 are as follows (in thousands):

	<b>2008</b>	<b>2007</b>
Investment income included in other revenue:		
Interest income	\$ 15,511	\$14,692
Net realized gain	974	17,224
Total included in other revenue	<b>\$ 16,485</b>	<b>\$31,916</b>
Investment income included in non-operating income:		
Interest income	\$ 5,536	\$ 5,175
Net realized gain	381	15,715
Net interest savings on swap agreements	829	1,180
Change in fair value of swap agreements	(3,130)	(500)
Total included in non-operating income	<b>\$ 3,616</b>	<b>\$21,570</b>
Other changes in unrestricted net assets:		
Net unrealized (loss) gain on investments	<b>\$(60,371)</b>	<b>\$12,135</b>

Management continually reviews its investment portfolio and evaluates whether declines in the fair value of securities should be considered other-than-temporary. Factored into this evaluation are the general market conditions, the issuer's financial condition and near-term prospects, conditions in the issuer's industry, the recommendation of advisors, the length of time and extent to which the market value has been less than cost, and Baystate Health's ability to hold the investment to maturity or market recovery.

At September 30, 2008, Baystate Health recognized an other-than-temporary loss of approximately \$4,700,000. At September 30, 2007, Baystate Health recognized an other-than-temporary loss of \$2,237,000.

Aggregate unrealized losses as of September 30, 2008 were \$22,756,000 on investments with a fair value of \$257,361,000. Of these losses, \$1,679,000 was on securities in a loss position for more than 12 consecutive months with a market value of \$18,885,000. At September 30, 2008, the investments that had a cost greater than fair value consisted of investments in equities, mutual funds, and fixed income securities. Management considers these investments core holdings and believes that, given the modest percentage declines below cost, market conditions, and management's intent and ability to hold the securities, these investments are likely to recover the existing unrealized losses prior to sale.

Consistent with recent declines in the broad equity investments markets, the fair value of Baystate Health's investments had declined 6% as of October 31, 2008.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 4. Land, Buildings, and Equipment

Details of land, buildings, and equipment at September 30, 2008 and 2007 are as follows (in thousands):

	<u>2008</u>	<u>2007</u>
Land, land improvements, and leasehold improvements	<b>\$ 30,126</b>	\$ 21,778
Buildings	<b>355,952</b>	339,489
Fixed equipment	<b>94,118</b>	93,917
Moveable equipment	<b>352,130</b>	315,822
Assets under capital leases	<b>15,108</b>	15,108
Construction in progress	<b>34,071</b>	20,446
	<b>881,505</b>	806,560
Less accumulated depreciation and amortization	<b>(545,923)</b>	(497,901)
Total land, buildings, and equipment, net	<b><u>\$ 335,582</u></b>	<b><u>\$ 308,659</u></b>

#### 5. Short-Term Obligations

Baystate Health's commercial paper borrowings at September 30, 2008, were \$9,445,000 (\$9,765,000 at September 30, 2007) at an average interest rate of 4.14%. The carrying value of these short-term obligations approximates fair value. The bank letter of credit committed to support commercial paper borrowings of Baystate Health amounted to \$10,000,000 and \$20,000,000 at September 30, 2008 and 2007.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 6. Leases

Baystate Health and its subsidiaries lease certain real property and equipment under non-cancelable leases expiring at various dates through 2016 with varying renewal options. Rentals generally include insurance and maintenance costs.

Future minimum lease payments at September 30, 2008 are as follows (in thousands):

Year Ending September 30	<b>Capital Leases</b>	<b>Operating Leases</b>
2009	\$ 1,387	\$ 9,916
2010	1,085	8,423
2011	550	7,065
2012	550	4,748
2013	550	2,951
Thereafter	3,062	3,541
Total minimum lease payments	7,184	\$36,644
Less amount representing interest	(2,347)	
Present value of net minimum lease payments	4,837	
Less current portion	(660)	
Long-term portion	\$ 4,177	

Rental expense of operating leases amounted to approximately \$11,826,000 and \$9,812,000 for the years ended September 30, 2008 and 2007, respectively.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 7. Long-Term Debt

BMC, BFMC, and BMLH have loan agreements with the Massachusetts Health and Educational Facilities Authority (MHEFA) for construction projects and equipment.

Long-term obligations issued consist of the following:

	<b>Amount Outstanding</b>	
	<b>September 30</b>	
	<b>2008</b>	<b>2007</b>
MHEFA issues:		
BMC Series M-2	<b>\$ 10,158</b>	\$ –
BMC Series H	<b>8,890</b>	9,556
BFMC Series M-4A	<b>8,152</b>	8,452
BMC Series G	<b>64,405</b>	67,075
BMC Series F	<b>43,975</b>	44,785
BMC Series J-2		11,412
BMC Series D	<b>67,205</b>	72,640
BMLH Series G-1	<b>291</b>	604
	<b>203,076</b>	214,524
Plus original issue premium	<b>61</b>	59
Capital leases ( <i>Note 6</i> )	<b>4,837</b>	6,125
Total long-term debt	<b>207,974</b>	220,708
Less current portion	<b>(12,077)</b>	(11,704)
Long-term debt excluding current portion	<b>\$195,897</b>	\$209,004

Summary information for each issue follows:

#### **Series M-2**

On June 30, 2008, BMC entered into a loan commitment under a Capital Asset Program financed by MHEFA through the issuance of variable rate demand Revenue Bonds, Series M-2. Proceeds of \$10,158,000 were used to refund the outstanding Revenue Bonds, BMC Issue, Series J-2. The Series J-2 bonds were issued to reimburse and fund certain capital renovation and equipment expenditures and fund the purchase of an office building. Interest on the bonds is variable, and resets weekly to reflect current market rates, and was 9.0% at September 30, 2008. Final maturity of the bonds is June 15, 2023.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### **7. Long-Term Debt (continued)**

##### **Series H Bonds**

On January 18, 2007, BMC issued Series H MHEFA Revenue Bonds in the aggregate principal amount of \$10,000,000. Proceeds from the bonds were used to reimburse and fund certain capital additions and fund the construction of a new parking garage. Interest on the bonds is variable based on monthly resets and was 2.75% at September 30, 2008. Final maturity of the bonds is January 1, 2022.

##### **Series M-4A Bonds**

On February 1, 2005, BFMC entered into a loan commitment under a Capital Asset Program financed by MHEFA through the issuance of variable rate demand Revenue Bonds, Series M-4A. Proceeds of \$9,100,000 were used to fund certain capital additions, renovations, and equipment expenditures related to the emergency department, radiology department, and in-patient facilities. Interest on the bonds is variable, and resets weekly to reflect current market rates, and was 9.0% at September 30, 2008. Final maturity of the bonds is June 15, 2024.

##### **Series G Bonds**

On October 27, 2005, BMC issued Series G MHEFA Revenue Bonds in the aggregate principal amount of \$71,740,000. Proceeds from the bonds were used to advance refund a portion of the outstanding Revenue Bonds, BMC Issue, Series E. The Series E bonds were issued to finance or refinance the following: (a) construction of a new 104,500 gross square foot Ambulatory Care Center; (b) construction of a new 100,000 gross square foot building to house the Ambulatory Surgery Center, Medical Library and education space; (c) renovation of various existing spaces within BMC; and (d) acquisition of equipment for the new facilities. Bond proceeds were also used to finance routine capital construction, renovations, and equipping of various facilities of BMC. Interest on the bonds is variable and resets every 35 days and was 7.9% at September 30, 2008. Final maturity of the bonds is July 1, 2026.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 7. Long-Term Debt (continued)

##### Series F Bonds

On June 1, 2002, BMC issued Series F MHEFA Revenue Bonds in the aggregate principal amount of \$47,640,000. Proceeds from the bonds were used to reimburse and fund certain capital renovation and equipment expenditures and fund the construction of a new interdisciplinary cancer center known as the D'Amour Center for Cancer Care. Interest on the bonds ranges between 5.0% and 5.75%. Final maturity of the bonds is July 1, 2033.

##### Series J-2 Bonds

On June 8, 1995, BMC entered into a loan commitment under a Capital Asset Program financed by MHEFA through the issuance of variable rate demand Revenue Bonds, Capital Asset Program Issue, Series J-2 in the aggregate principal amount of \$14,000,000. Proceeds from the bonds were used to reimburse and fund certain capital renovation and equipment expenditures, and fund the purchase of an office building.

On June 30, 2008, the Series J-2 Bonds were refunded with the proceeds from the demand Revenue Bonds, BMC Issue, Series M-2.

##### Series D Bonds

On August 15, 1993, BMC issued Series D MHEFA Revenue Bonds in the aggregate principal amount of \$122,925,000. Proceeds from the bonds were used to reimburse and fund certain capital additions related to the Daly Building construction, renovations, and equipment expenditures, and to refinance the Series C Revenue Bonds. Interest on the bonds ranges between 5.0% and 6.0%. Final maturity of the bonds is July 1, 2020.

##### Series G-1 Bonds

On October 8, 1992, BMLH entered into a loan commitment under a Capital Asset Program financed by MHEFA through the issuance of variable rate demand Revenue Bonds, Capital Asset Program Issue, Series G-1. Proceeds of \$3,900,000 were used to reimburse and fund certain capital additions, renovations, equipment, and the construction of an ambulatory care building.

On July 20, 2008, BMLH prepaid the outstanding Series G-1 bonds and interest accrued through the final redemption date of December 3, 2008.

Prepaid interest on the bonds was calculated using a maximum rate of 23%. Interest on the bonds is variable, and resets every 35 days, and was 9.75% at September 30, 2008.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 7. Long-Term Debt (continued)

##### Significant Debt Covenants

These agreements include various financial covenants, the most restrictive of which are a pledge of revenues and the maintenance of a ratio of Net Revenue Available to Meet Debt Service to Total Principal and Interest Requirements of at least 1.1 (as defined by the agreement). Baystate Health was in compliance with these covenants during the fiscal years ended September 30, 2008 and 2007.

Certain buildings and equipment have been pledged as collateral for these borrowings.

The following funds and their balances at September 30, 2008 and 2007 have been established in accordance with these agreements (in thousands):

	<u>2008</u>	<u>2007</u>
Debt service fund	<b>\$6,090</b>	\$6,308
Construction fund	<b>52</b>	31
	<u><b>\$6,142</b></u>	<u>\$6,339</u>

The combined aggregate future principal payments of all long-term borrowings are as follows (in thousands):

2009	\$ 12,077
2010	11,861
2011	11,936
2012	12,457
2013	13,014
Thereafter	<u>146,568</u>
	<u><u>\$207,913</u></u>

BMC has entered into guaranty agreements on behalf of BFMC and BMLH in connection with outstanding MHEFA bonds.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 7. Long-Term Debt (continued)

The fair value of the bonds payable at September 30, 2008 approximates \$200,913,000.

Interest paid was \$10,616,000 and \$11,865,000 for 2008 and 2007, respectively.

#### Interest Rate Swap Agreements

BMC periodically enters into interest rate swap agreements to moderate its exposure to interest rate changes and to lower the overall cost of borrowings. Gains and losses realized on termination of contracts are deferred and amortized over the remaining life of the associated contract.

In July 2003, BMC executed a total return swap agreement with a financial institution in the amount of \$87,420,000. The total return swap agreement provides for the financial institution to pay fixed payments to BMC equal to the debt service on the Series D Bonds and for BMC to pay the financial institution variable rate payments based upon the BMA Municipal Swap Index plus 40 basis points. The BMA Municipal Swap Index rate was 7.96% and 3.84% at September 30, 2008 and 2007, respectively. The agreement, in effect, converted \$87,420,000 of fixed rate debt to a variable rate of interest. There are termination provisions to this contract for each party.

In connection with the total return swap agreement, BMC entered into an interest rate swap agreement with the financial institution with a notional amount of \$67,470,000. Under the terms of the agreement, BMC pays a fixed rate of 3.26% and receives variable payments based upon the BMA Municipal Swap Index from the financial institution. The agreement, in effect, converted \$67,470,000 of variable rate debt to fixed rate debt.

In September 2005, BMC, in anticipation of the issuance of the Series G bonds, entered into an interest rate swap agreement with a financial institution with a notional amount of \$71,740,000. The agreement provides for the financial institution to pay variable rate payments to BMC equal to 56.9% of LIBOR plus 0.31% and for BMC to pay the financial institution a fixed rate of 3.02%. The LIBOR rate was 5.12% and 5.12% at September 30, 2008 and 2007, respectively. The agreement, in effect, converts \$71,740,000 of variable rate debt to a fixed rate of interest. There are termination provisions to this contract for each party.

The fair value of these agreements of approximately \$(510,000) and \$2,620,000 at September 30, 2008 and 2007, respectively, is included in investments in the consolidated statements of financial position.

The net interest savings and the change in the fair value of the associated interest rate swaps are included in non-operating income on the consolidated statements of operations.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 7. Long-Term Debt (continued)

##### Subsequent Event

In October 2008, a financial institution terminated its total return interest rate swap with BMC. As a result, BMC purchased \$67,205,000 of the Series D Fixed Rate Bonds underlying the swap. BMC financed the purchase of these bonds using a line of credit with another financial institution. The line of credit expires on October 16, 2009.

#### 8. Interest Expense

Baystate Health and its subsidiaries capitalize interest cost as part of the historical cost of acquiring certain significant qualifying assets. During the years ended September 30, 2008 and 2007, interest cost was as follows (in thousands):

	2008	2007
Total interest cost	\$10,558	\$11,793
Less interest earned on the temporary investment of proceeds from restricted tax exempt borrowings	(32)	(10)
Less amortized gain on terminated interest rate swaps	(49)	(69)
Net interest cost	10,477	11,714
Net interest cost capitalized	(620)	(722)
Net interest cost expensed	\$ 9,857	\$10,992

#### 9. Insurance Liability Loss Reserves

BHIC, wholly owned by Baystate Health, insures the professional and general liability of substantially all of Baystate Health's subsidiaries, with the exception of HNE, on an indemnity basis. Baystate Health and certain of its subsidiaries have also purchased excess professional and general coverage from other insurers. In addition, BHIC insures the workers' compensation, employer's liability, excess workers' compensation, and long-term disability of certain of Baystate Health's subsidiaries.

Reserves have been provided with the assistance of a consulting actuary for asserted claims and for unasserted claims probable of assertion arising from both reported and unreported incidents which are based on historical experience and existing reported incidents.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 10. Medical Claims and Capitation Expense

Medical claims and capitation expense include the following components for the years ended September 30, 2008 and 2007 (in thousands):

	<b>2008</b>	<b>2007</b>
Physician and other outpatient specialty services	<b>\$116,582</b>	\$104,072
Inpatient care and same day surgery	<b>36,219</b>	28,844
Pharmacy	<b>43,398</b>	41,428
Primary care capitation	<b>1,722</b>	1,806
Other medical services	<b>6,459</b>	5,417
Coordination of benefits	<b>(702)</b>	(679)
Net reinsurance recoveries	<b>(63)</b>	768
	<b>203,615</b>	181,656
Provider risk sharing, net	<b>(1,169)</b>	2,232
Total medical claims and capitation expense	<b>\$202,446</b>	\$183,888

#### 11. Income Taxes

Income tax expense for the year ended September 30, 2008, for HNE and its subsidiaries, was approximately \$2,753,000. Net federal and state deferred tax assets totaled approximately \$5,439,000 and \$2,423,000 as of September 30, 2008 and 2007, respectively.

Income tax expense for the year ended September 30, 2008, for IC and its subsidiary, was approximately \$3,000. As of September 30, 2008, operating loss carry-forwards for income tax purposes totaled approximately \$2,991,000, which expire in various years ranging from 2010 to 2027. This results in a deferred tax asset; however, because utilization of these net operating losses is not assured, IC has recorded a full valuation allowance offsetting this deferred tax asset.

#### 12. Funds Held in Trust by Others

Baystate Health and its subsidiaries are beneficiaries of certain perpetual trusts (the Trusts), from which they receive unrestricted income. Appreciation or depreciation in the value of the Trusts is recorded as an increase or decrease to permanently restricted net assets. During fiscal years 2008 and 2007, Trust distributions of approximately \$1,226,000 and \$1,192,000, respectively, are included in non-operating income.

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 13. Pension Plan

Baystate Health and certain of its consolidated subsidiaries and other ownership interest participate in a non-contributory, defined-benefit cash balance retirement plan (the plan) covering substantially all of their eligible employees.

Baystate Health's policy is to fund amounts as are necessary on an actuarial basis to provide for benefits in accordance with the Employee Retirement Income Security Act of 1974 (ERISA) using the accrued benefit (net credit) actuarial cost method.

SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)*. SFAS 158 requires plan sponsors of defined benefit pension and other postretirement benefit plans (collectively, postretirement benefit plans) to recognize the funded status of their postretirement benefit plans in the statement of financial position, measure the fair value of the assets and benefit obligations as of the date of the fiscal year-end statement of financial position, and provide additional disclosures.

On September 30, 2006, Baystate Health early adopted the recognition and disclosure provisions of SFAS 158. The provisions of SFAS 158 regarding the measurement date of the postretirement benefits are applicable for the year ending September 30, 2009. SFAS 158 required Baystate Health to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligation) of its pension plan in the statement of financial position, with a corresponding adjustment to unrestricted net assets. The adjustment to unrestricted net assets represents the net unrecognized actuarial losses and the unrecognized prior service costs remaining from the initial adoption of SFAS 87, all of which were previously netted against the plan's funded status in Baystate Health's statement of financial position pursuant to the provisions of SFAS 87. These amounts will be subsequently recognized as net periodic pension cost pursuant to Baystate Health's historical accounting policy for amortizing such amounts. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic pension cost in the same periods will be recognized as an adjustment to unrestricted net assets. Those amounts will be subsequently recognized as a component of net periodic pension cost on the same basis as the amounts recognized in unrestricted net assets at adoption of SFAS 158.

Baystate Health, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

**13. Pension Plan (continued)**

The following table presents a reconciliation of the beginning and ending balances of the plan-projected benefit obligation, change in plan assets and funded status of the plan as of September 30 (in thousands):

	2008	2007
<b>Change in pension obligation</b>		
Pension obligation at beginning of year	\$531,454	\$487,408
Service cost	28,545	27,640
Interest cost	35,057	32,737
Actuarial (gain) loss	(57,994)	11,549
Benefits paid	(21,835)	(27,880)
Plan amendments	388	
Pension obligation at end of year	515,615	531,454
<b>Change in plan assets</b>		
Fair value of plan assets at beginning of year	484,770	416,893
Actual return on plan assets	16,623	58,589
Employer contributions	32,000	37,168
Benefits paid	(21,835)	(27,880)
Fair value of plan assets at end of year	511,558	484,770
<b>Funded status</b>		
Funded status of the plan	(4,057)	(46,684)
Employer contributions made between measurement date and year end	7,935	8,195
Pension asset (liability)	\$ 3,878	\$ (38,489)
<b>Amounts recognized in unrestricted net assets consist of</b>		
Net actuarial loss	\$ 56,644	\$ 97,816
Prior service cost	6,773	8,208
Pension adjustment	\$ 63,417	\$106,024

The net overfunded status of the plan at September 30, 2008 of \$3,878,000 and the change in the pension adjustment of \$42,607,000 and the total pension adjustment of \$63,417,000 are reported net of the unconsolidated ownership interest in the accompanying consolidated financial statements.

The net actuarial loss and prior service cost expected to be recognized in benefit cost in 2009 is approximately \$115,000 and \$1,862,000, respectively.

Baystate Health, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

**13. Pension Plan (continued)**

The assumptions used to develop the projected benefit obligation as of September 30:

	<b>2008</b>	<b>2007</b>
Measurement date	<b>June 30, 2008</b>	June 30, 2007
Discount rate	<b>6.85%</b>	6.40%
Rate of compensation increase	<b>4.25%</b>	4.25%

The accumulated benefit obligation was approximately \$436,473,000 and \$471,327,000 at September 30, 2008 and 2007, respectively.

**Net Periodic Pension Cost**

Net pension cost for the defined-benefit plan for the years ended September 30, 2008 and 2007 includes the following components (in thousands):

	<b>2008</b>	<b>2007</b>
Service cost	<b>\$28,545</b>	\$ 27,640
Interest cost	<b>35,057</b>	32,737
Expected return on plan assets	<b>(40,385)</b>	(36,100)
Amortization of prior service cost	<b>1,823</b>	1,823
Recognized net actuarial loss	<b>6,940</b>	7,892
Net pension cost	<b>\$31,980</b>	\$ 33,992

The assumptions used to determine net pension cost for the years ended September 30, 2008 and 2007:

	<b>2008</b>	<b>2007</b>
Discount rate	<b>6.40%</b>	6.50%
Expected return on plan assets	<b>8.75</b>	8.75
Rate of compensation increase	<b>4.25</b>	4.25

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 13. Pension Plan (continued)

##### Plan Assets

The plan's investment objectives are to achieve long-term growth in excess of inflation and to provide a rate of return that meets or exceeds the actuarial expected long-term rate of return on plan assets. In order to minimize risk, the plan attempts to minimize the variability in yearly returns. The plan diversifies its holdings among sectors, industries, and companies. The target allocations of assets at September 30, 2008, were equities 40%, fixed income 25%, and other 35%.

To develop the expected long-term rate of return on plan assets assumption, Baystate Health considered the historical return and the future expectations for returns for each asset class, as well as the target asset allocation of the pension investment portfolio.

Baystate Health's pension plan asset allocation by asset category, as of September 30, is as follows:

	<u>2008</u>	<u>2007</u>
Common and preferred stock	37%	48%
U.S. government and domestic fixed income securities	37	35
Other investments	26	17
	<u>100%</u>	<u>100%</u>

##### Contributions

Baystate Health expects to contribute approximately \$19,100,000 to its pension plan in 2009.

##### Estimated Future Benefit Payments

The following approximate benefit payments, which reflect expected future service, as appropriate, are expected to be paid over the next ten calendar years (in thousands):

<u>Calendar Year</u>	<u>Pension Benefits</u>
2009	\$ 25,600
2010	21,800
2011	25,200
2012	29,100
2013	33,300
Years 2014 – 2018	231,500

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 13. Pension Plan (continued)

##### Defined-Contribution Plans

Baystate Health and certain of its consolidated subsidiaries and other ownership interest participate in a defined contribution retirement plan which covers all employees hired after December 31, 2004. Under this plan, Baystate Health contributes up to 7.5% of the employee's compensation based on age and years of service. Total expense under this plan was approximately \$4,510,000 in 2008 and \$2,507,000 in 2007.

HNE provides a 401(k) Retirement Plan (the Plan). Each year, employees may contribute up to 20% of pretax annual compensation, as defined in the Plan document. HNE matches 100% of the first 3% and 50% of the next 2% of employee contributions to the Plan. An additional contribution may be made by HNE at its discretion. Contributions and compensation levels are subject to certain limitations under the Internal Revenue Code. The Plan expense amounted to approximately \$1,177,000 and \$876,000 in 2008 and 2007, respectively.

#### 14. Concentrations of Credit Risk

Baystate Health and its subsidiaries grant credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at September 30, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
Medicare	17%	17%
Medicaid	14	14
Blue Cross	3	3
Health maintenance organizations	37	34
Commercial	15	14
Self-pay patients	14	18
	<u>100%</u>	<u>100%</u>

## Baystate Health, Inc. and Subsidiaries

### Notes to Consolidated Financial Statements (continued)

#### 15. Functional Expenses

Baystate Health and its subsidiaries provide general healthcare services to residents within its geographic location. Expenses related to providing these services for the years ended September 30, 2008 and 2007 are as follows (in thousands):

	<u>2008</u>	<u>2007</u>
Healthcare services	\$1,203,796	\$1,132,266
General and administrative	95,809	94,929
	<u>\$1,299,605</u>	<u>\$1,227,195</u>

#### 16. State Surplus Revenue Retention (Unaudited)

Through September 30, 2008, both BMC and BFMC had no surplus in excess of the Commonwealth of Massachusetts regulations governing the excess of state revenues over expenses for not-for-profit organizations. The total deficit attributable to state contracting for BMC and BFMC was approximately \$665,000 (2007 – \$596,000) and \$301,000 (2007 – \$364,000), respectively. As of September 30, 2008, the cumulative deficit attributable to state contracting of approximately \$4,925,000 and \$2,112,000 is included in the unrestricted net assets of BMC and BFMC, respectively.