



Report of Independent Auditors
and Consolidated Financial Statements for

**Prime Healthcare Services, Inc.
and Subsidiaries**

December 31, 2013 and 2012

MOSS ADAMS LLP

Certified Public Accountants | Business Consultants

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REPORT OF INDEPENDENT AUDITORS

The Board of Directors
Prime Healthcare Services, Inc. and Subsidiaries

Report on Financial Statements

We have audited the accompanying consolidated financial statements of Prime Healthcare Services, Inc. and Subsidiaries (the "Company"), which comprise the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of income, stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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 audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Prime Healthcare Services, Inc. and Subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Moss Adams LLP

Irvine, California
May 19, 2014

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS**

ASSETS	DECEMBER 31,	
	2013	2012
CURRENT ASSETS		
Cash and cash equivalents*	\$ 30,873,477	\$ 33,064,792
Patient accounts receivable, net of allowance for doubtful accounts of \$166,771,221 in 2013 and \$157,997,904 in 2012*	382,749,240	299,647,741
Related party receivables*	5,758,448	359,811
Estimated third-party payor settlements	25,524,685	4,797,746
Supplies inventory*	18,587,715	16,906,642
Prepaid expenses and other current assets*	129,273,732	129,802,383
Total current assets	592,767,297	484,579,115
RESTRICTED CASH	209,013,585	-
PROPERTY AND EQUIPMENT , net of accumulated depreciation and amortization*	692,287,134	581,848,148
INSURANCE CLAIMS AND RESERVES RECOVERABLE*	95,205,333	76,524,889
GOODWILL	38,881,903	39,944,429
OTHER ASSETS*	20,182,850	7,422,835
	\$ 1,648,338,102	\$ 1,190,319,416

**Account balances contain assets of the consolidated variable interest entities that can only be used to settle obligations of the variable interest entities (see Note 2) as of December 31, 2013 and 2012, respectively: Cash and cash equivalents \$2,285,078 and \$4,861,228; Patient accounts receivable, net of allowance for doubtful accounts \$4,052,415 and \$3,855,329; Related party receivables of \$145,157,659 and \$109,380,200; Supplies inventory \$46,632 and \$48,454; Prepaid expenses and other current assets \$12,148,754 and \$9,877,228; Property and Equipment \$34,755,462 and \$36,189,243; and Insurance claims and reserves recoverable \$6,596,542 and \$5,568,711.*

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS (CONTINUED)**

LIABILITIES AND STOCKHOLDERS' EQUITY

	DECEMBER 31,	
	2013	2012
CURRENT LIABILITIES		
Accounts payable*	\$ 107,842,610	\$ 89,990,383
Accrued expenses*	92,426,358	91,355,748
Medical claims payable*	2,597,122	2,298,774
Line of credit	110,049,171	45,392,743
Current portion of capital leases	6,737,672	7,322,536
Current portion of long-term debt*	3,143,266	2,510,891
	<u>322,796,199</u>	<u>238,871,075</u>
LONG-TERM LIABILITIES		
Sale lease-back liability	348,000,000	248,000,000
Insurance claims liabilities and reserves*	95,205,333	76,524,889
Capital leases, net of current portion	24,414,104	23,700,499
Long-term debt, net of current portion*	509,984,840	302,838,507
Other long-term liabilities	15,650,234	11,131,540
	<u>993,254,511</u>	<u>662,195,435</u>
STOCKHOLDERS' EQUITY		
Common stock, \$0.01 par value, 3,000 shares authorized, 30 shares issued and outstanding	1	1
Additional paid in capital	2,999	2,999
Retained earnings	160,785,283	147,369,884
Non-controlling interest	171,499,109	141,880,022
	<u>332,287,392</u>	<u>289,252,906</u>
	<u>\$ 1,648,338,102</u>	<u>\$ 1,190,319,416</u>

* Account balances contain liabilities of consolidated variable interest entities for which creditors do not have recourse to the general credit of the Company (see Note 2) as of December 31, 2013 and 2012, respectively: Accounts payable \$3,276,468 and \$2,685,442; Accrued expenses \$3,759,183 and \$3,715,476; Medical claims payable \$395,599 and \$216,239; Insurance claim liabilities and reserves \$6,596,542 and \$5,568,711; Current portion of long-term debt \$716,721 and \$669,943, and long-term debt \$37,825,788 and \$39,679,455.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME**

	YEARS ENDED DECEMBER 31,	
	2013	2012
REVENUE		
Net patient service revenue (net of contractual allowances and discounts)	\$ 2,349,313,582	\$ 1,758,717,715
Provision for doubtful accounts	442,128,590	308,313,901
Net patient service revenue less provision for doubtful accounts	1,907,184,992	1,450,403,814
Premium revenue	20,228,163	26,123,115
Other revenue	94,201,532	72,868,064
	<u>2,021,614,687</u>	<u>1,549,394,993</u>
OPERATING EXPENSES		
Compensation and employee benefits	888,929,951	693,747,333
General and administrative	309,328,048	216,417,189
Supplies	273,756,371	197,291,883
Professional services	225,142,173	155,382,760
Depreciation and amortization	64,304,844	46,512,490
Rent and lease	37,174,627	40,238,854
Medical claims	4,130,952	8,016,787
	<u>1,802,766,966</u>	<u>1,357,607,296</u>
INCOME FROM OPERATIONS	218,847,721	191,787,697
GAIN FROM ACQUISITIONS	-	1,542,181
INTEREST EXPENSE, net	<u>(76,622,613)</u>	<u>(63,061,275)</u>
INCOME BEFORE PROVISION FOR INCOME TAXES	142,225,108	130,268,603
INCOME TAX PROVISION	<u>2,136,758</u>	<u>2,963,430</u>
INCOME BEFORE ALLOCATION TO NON-CONTROLLING INTEREST	140,088,350	127,305,173
ALLOCATION OF INCOME TO NON-CONTROLLING INTEREST	<u>(98,377,200)</u>	<u>(75,661,111)</u>
CONTROLLING INTEREST IN NET INCOME	<u>\$ 41,711,150</u>	<u>\$ 51,644,062</u>

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

	Shares	Common Stock	Additional Paid in Capital	Retained Earnings	Non-controlling Interest	Total
BALANCE, December 31, 2011	30	\$ 1	\$ 2,999	\$ 135,209,780	\$ 102,691,039	\$ 237,903,819
Distribution of Huntington Beach Hospital (see Note 4)	-	-	-	(39,483,958)	-	(39,483,958)
Cash distributions	-	-	-	-	(36,472,128)	(36,472,128)
Controlling interest in net income	-	-	-	51,644,062	-	51,644,062
Non-controlling interest in net income	-	-	-	-	75,661,111	75,661,111
BALANCE, December 31, 2012	30	1	2,999	147,369,884	141,880,022	289,252,906
Distribution of Pampa Regional Medical Center and Pampa Regional Medical Group (see Note 4)	-	-	-	(28,295,751)	-	(28,295,751)
Cash distributions	-	-	-	-	(68,758,113)	(68,758,113)
Controlling interest in net income	-	-	-	41,711,150	-	41,711,150
Non-controlling interest in net income	-	-	-	-	98,377,200	98,377,200
BALANCE, December 31, 2013	<u>30</u>	<u>\$ 1</u>	<u>\$ 2,999</u>	<u>\$ 160,785,283</u>	<u>\$ 171,499,109</u>	<u>\$ 332,287,392</u>

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS**

	YEARS ENDED DECEMBER 31,	
	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Income before allocation to non-controlling interest	\$ 140,088,350	\$ 127,305,173
Adjustments to reconcile controlling interest in net income to net cash provided by operating activities:		
Depreciation and amortization	64,304,844	46,512,490
Loss (gain) on sale of assets	1,694	(302,580)
Provision for doubtful accounts	442,128,590	308,313,901
Gain on acquisition	-	(1,542,181)
Change in interest rate swap	-	593,988
Write-off of deferred loan issuance costs	-	4,939,000
Changes in assets and liabilities net of acquisitions/dispositions:		
Patient accounts receivable	(531,755,683)	(403,840,447)
Supplies inventory	(926,234)	1,111,475
Prepaid expenses and other current assets	1,264,417	(53,707,792)
Other assets	(1,115,864)	4,805,355
Related party receivables/payables	(5,398,637)	(1,322,900)
Accounts payable	12,857,576	29,104,326
Accrued expenses and other long-term liabilities	8,307,016	5,176,645
Medical claims payable	298,348	187,261
Estimated third-party payor settlements	(21,316,444)	45,537,361
Net cash provided by operating activities	<u>108,737,973</u>	<u>112,871,075</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(100,517,996)	(66,748,542)
Proceeds from sale of property and equipment	-	363,256
Cash paid for acquisitions, net of cash acquired	(55,874,033)	(81,591,288)
Purchase of related party note receivable	-	(11,072,500)
Repayments on notes receivable	-	9,099,880
Net cash used in investing activities	<u>(156,392,029)</u>	<u>(149,949,194)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments of loan issuance costs	(8,987,236)	(3,642,855)
Proceeds from borrowings on sale lease-back	75,000,000	110,000,000
Borrowings on line of credit	1,460,102,810	638,155,181
Repayments on line of credit	(1,395,446,382)	(592,762,438)
Payments on long-term debt	(1,221,292)	(197,113,081)
Payments on capital lease obligations	(8,061,989)	(10,648,223)
Payment for settlement of interest rate swap	-	(4,385,000)
Proceeds from long-term debt borrowing	-	100,000,000
Lease buyout of Huntington Beach Hospital facility	-	(12,199,324)
Lines of credit, net	-	(14,180,737)
Proceeds from sale of mortgage note	-	36,531,007
Cash distributions	(68,758,113)	(36,472,128)
Cash distributed with Pampa Regional Medical Center	(7,165,057)	-
Cash distributed with Huntington Beach Hospital	-	(437,749)
Net cash provided by financing activities	<u>45,462,741</u>	<u>12,844,653</u>
NET DECREASE IN CASH AND CASH EQUIVALENTS	(2,191,315)	(24,233,466)
CASH AND CASH EQUIVALENTS, beginning of year	<u>33,064,792</u>	<u>57,298,258</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 30,873,477</u>	<u>\$ 33,064,792</u>

See accompanying notes.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)**

SUPPLEMENTAL CASH FLOW INFORMATION

	<u>YEARS ENDED DECEMBER 31,</u>	
	<u>2013</u>	<u>2012</u>
Cash paid during the year for:		
Interest	\$ 70,152,803	\$ 69,194,944
Income taxes	\$ 2,136,758	\$ 2,963,430

SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES

Capital lease obligations incurred for the acquisition of property and equipment	\$ 8,190,730	\$ 940,089
Non-cash distribution of Pampa Regional Medical Center assets (see Note 4)	\$ 21,130,694	\$ -
Non-cash distribution of Huntington Beach Hospital assets (see Note 4)	\$ -	\$ 39,046,209
Sale lease-back of Dallas Medical Center facility (see Note 8)	\$ 25,000,000	\$ -
Proceeds of restricted cash from issuance of long-term debt	\$ 209,000,000	\$ -

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES**
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Nature of Business

Prime Healthcare Services, Inc. and Subsidiaries (the "Company" or "PHSI") is a Delaware corporation that incorporated on March 27, 2000.

During the year ended December 31, 2013, the Company operated 18 acute care hospitals with 3,667 licensed beds located in various communities throughout California, Nevada, Texas, Kansas and Pennsylvania. The Company's operations also include five medical groups and other operations related to its hospital business. The Company operates the following acute care hospitals:

<u>Hospital</u>	<u>Licensed Beds</u>	<u>Location</u>
Desert Valley Hospital	148	Victorville, CA
Chino Valley Medical Center	126	Chino, CA
La Palma Intercommunity Hospital	141	La Palma, CA
West Anaheim Medical Center	219	Anaheim, CA
Paradise Valley Hospital	301	National City, CA
Centinela Hospital Medical Center	370	Inglewood, CA
Garden Grove Hospital Medical Center	167	Garden Grove, CA
San Dimas Community Hospital	101	San Dimas, CA
Shasta Regional Medical Center	246	Redding, CA
Alvarado Hospital	306	San Diego, CA
Harlingen Medical Center	112	Harlingen, TX
Roxborough Memorial Hospital	140	Philadelphia, PA
Pampa Regional Medical Center*	115	Pampa, TX
Saint Mary's Regional Medical Center	380	Reno, NV
Dallas Medical Center	155	Dallas, TX
Lower Bucks Hospital	160	Bristol, PA
Providence Medical Center	400	Kansas City, KS
Saint John Hospital	80	Leavenworth, KS
Total	<u>3,667</u>	

* Effective December 31, 2013, the Company's equity interest in Pampa Regional Medical Center was distributed by the Company to its controlling stockholder, who contributed Pampa Regional Medical Center to Prime Healthcare Services Foundation, Inc. (see Note 4).

The Company has a 67.9% equity interest in Harlingen Medical Center. All other acute care hospitals are wholly owned subsidiaries.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 2 - Organization and Summary of Significant Accounting Policies

Basis of consolidation - The consolidated financial statements include the accounts of the Company, the hospital subsidiaries as described in Note 1 and the following other wholly owned subsidiaries:

Prime Healthcare Services Alvarado Hospital, LLC
Bio-Med Services, Inc.
Prime Healthcare Services Los Angeles, LLC
PHS Dallas II, LLC
BMC Primary Care Physicians, LLC
BMC Specialty Physicians, LLC
Prime Healthcare Services Roxborough Providers, LLC
Pampa Regional Medical Group, Inc.*
Providence Physician Group
Providence Place, Inc.
Physicians Resources, Inc.
Saint John Physician Group
Saint Mary's Regional Medical Group
Dallas Medical Group

- * The Company's results of operations include Pampa Regional Medical Group, Inc. through the date of disposition. Effective December 31, 2013, the Company's equity interest was distributed to its controlling stockholder, who contributed Pampa Regional Medical Group to Prime Healthcare Services Foundation, Inc. (see Note 4)

The Company has a variable interest in the following entities as defined by Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 810, for which PHSI is the primary beneficiary of these variable interest entities:

Medical groups:

Desert Valley Medical Group, Inc.
Sherman Oaks Medical Group Management, Inc.
Paradise Valley Medical Group, Inc.
Shasta Regional Medical Group, Inc.

Other entities:

Prime Healthcare Management, Inc.
Hospital Business Service, Inc.
Prime Healthcare Air Transport LLC
International Aircraft Investments LLC
HMC Realty, LLC

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 2 - Organization and Summary of Significant Accounting Policies (continued)

The Company has determined that the medical groups are variable interest entities due to the equity interest holder's lack of ability to exercise control. The Company has determined that the other entities are variable interest entities due to a lack of sufficient equity at risk. The Company has also determined it is the primary beneficiary of the medical groups and other entities because the Company has the power to direct activities that most significantly impact the economic performance of these entities. Accordingly, the Company has consolidated these entities into PHSI.

The equity of the variable interest entities have been reflected as a non-controlling interest as of December 31, 2013 and 2012. The consolidation of these entities does not change any legal ownership, and does not change the assets or the liabilities and equity of PHSI as a stand-alone entity. Total assets of these variable interest entities were approximately \$205,043,000 and \$165,605,000 as of December 31, 2013 and 2012, respectively. Total liabilities of these variable interest entities were approximately \$52,570,000 and \$48,360,000 as of December 31, 2013 and 2012, respectively. With the exception of HMC Realty, LLC, these entities provide management services for the Company, as well as providing health care services through the medical groups for which total revenues were approximately \$183,953,000 and \$142,372,000 for the years ended December 31, 2013 and 2012, respectively. HMC Realty, LLC is a real estate partnership which owns the land and hospital building leased to and operated by Harlingen Medical Center. The Company owns a 36.06 percent interest in HMC Realty, LLC. All intercompany accounts and transactions have been eliminated upon consolidation.

Net patient service revenue - Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. In some cases, reimbursement is based on formulas which cannot be determined until cost reports are filed and audited or otherwise settled by the various programs.

Premium revenue and medical claims expense - The Company has agreements with various Health Maintenance Organizations ("HMO") to provide medical services to enrollees. Under these agreements, the Company receives monthly capitation revenue based on the number of each HMO's enrollees, regardless of services actually performed by the Company. Premium revenue under HMO contracts is recognized during the period in which the Company is obligated to provide services. Certain HMO contracts also contain shared-risk provisions whereby the Company can earn additional incentive revenue or incur penalties based upon the utilization of inpatient hospital services by assigned HMO enrollees. The Company records shared-risk revenue and expenses based upon inpatient utilization on an estimated basis. Differences between estimated shared-risk revenue or expenses and actual amounts are recorded upon final settlement with each HMO. Amounts due to unaffiliated health care providers for out of network claims are recognized as incurred. The amounts recorded are based upon projections of historical developments. Such projections are adjusted and estimates changed when developments of claims information are warranted. There was no significant impact to the 2013 and 2012 operating results due to changes in this estimate.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 2 - Organization and Summary of Significant Accounting Policies (continued)

Supplies inventory - Supplies inventory is stated at cost, determined by the average cost method, which is not in excess of market.

Property and equipment - Property and equipment is stated at cost, net of depreciation and amortization. Depreciation and amortization is computed using the straight-line method over the estimated useful lives of the assets, which range from three to forty years. Amortization of leasehold improvements is computed over the lesser of the lease term and the estimated useful lives of the assets and is included in depreciation and amortization expense.

Asset retirement obligations - The Company recognizes the fair value of a liability for legal obligations associated with asset retirements in the period in which it is incurred if a reasonable estimate of the fair value of the obligation can be made. When the liability is initially recorded, the Company capitalizes the cost of the asset retirement obligation by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost associated with the retirement obligation is depreciated over the useful life of the related asset. Upon settlement of the obligation, any difference between the cost to settle the asset retirement obligation and the liability recorded is recognized as a gain or loss in the consolidated statements of income.

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 and 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. Actual results could differ from those estimates.

Income taxes - The Company has elected to be taxed under the provisions of subchapter S of the Internal Revenue Code. Under these provisions, the Company does not pay federal corporate income taxes on its taxable income. However, the Company is subject to a 1.5% California franchise tax along with applicable income taxes in states where the Company has operations. The stockholders of PHSI will be taxed on their proportionate share of their respective taxable income as defined by the Internal Revenue Code. The Company disburses funds necessary to satisfy the stockholders' tax liability. The stock basis (accumulated previously taxed income) is available to the S Corporation stockholders in subsequent periods as tax free distributions. As of December 31, 2013 and 2012, the accumulated previously taxed income available to the stockholders is approximately \$172,487,000 and \$123,117,000, respectively.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 2 - Organization and Summary of Significant Accounting Policies (continued)

The Company accounts for uncertain tax positions in accordance with the provisions of ASC 740-10. ASC 740-10 prescribes a recognition threshold and measurement process for accounting for uncertain tax positions and also provides guidance on various related matters such as derecognition, interest, penalties and disclosures required. The Company does not have any entity level uncertain tax positions. The Company files income tax returns in the U.S. federal jurisdiction and various state jurisdictions. Generally, the Company is subject to examination by U.S. federal (or state and local) income tax authorities for three years from the filing of a tax return.

Cash and cash equivalents - The Company considers all highly liquid investments with an original maturity of three months or less when purchased to be cash equivalents.

Restricted cash - Restricted cash of \$209,000,000 consists of proceeds from the amended and restated revolving and term loan and security agreement (see Note 8). The proceeds of the term loan are classified as restricted cash, and the Company must meet certain term loan draw conditions before funds can be disbursed including permitted target acquisitions, certain acquisition-related capital expenditures, or permitted acquisition-related working capital fundings, as defined in the amended and restated revolving and term loan and security agreement.

Goodwill - Management evaluates goodwill, on an annual basis and whenever events and changes in circumstances suggest that the carrying amount may not be recoverable. Impairment of goodwill is tested at the reporting unit level by comparing the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit. The fair value of the reporting units are estimated using a combination of the income or discounted cash flow approach and market approach, which uses comparable data. If the carrying amount of the reporting unit exceeds fair value, goodwill is considered impaired and a second step is performed to measure the amount of impairment loss, if any.

For the years ended December 31, 2013 and 2012, the management of the Company determined that an impairment did not exist. However, if estimates or the related assumptions change in the future, the Company may be required to record impairment charges to reduce the carrying amount of this asset.

Fair value of financial instruments - The Company's consolidated balance sheets include the following financial instruments: cash and cash equivalents, patient accounts receivable, notes receivable, accounts payable and accrued liabilities, and long-term debt. The Company considers the carrying amounts of current assets and liabilities in the consolidated balance sheets to approximate the fair value of these financial instruments and their expected realization. The carrying amount of notes receivable and long-term debt approximated their fair value, based on current market rates of instruments of the same risks and maturities.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 2 - Organization and Summary of Significant Accounting Policies (continued)

Deferred loan issuance costs - Deferred loan issuance costs are amortized over the term of the loan (see Note 7).

Charity care - The Company provides care to patients who lack financial resources and are deemed to be medically indigent based on criteria established under the Company's charity care policy. This care is provided without charge or at amounts less than the Company's established rates. Because the Company does not pursue collection of amounts determined to qualify as charity care, such amounts are not reported as revenue. The Company maintains records to identify and monitor the level of charity care provided. These records include the amount of direct and indirect costs for services and supplies furnished under its charity care policy. The direct and indirect costs related to this care totaled approximately \$26,309,000 and \$23,953,000 for the years ended December 31, 2013 and 2012, respectively. Direct and indirect costs for providing charity care are estimated by calculating a ratio of cost to gross charges and then multiplying that ratio by the gross uncompensated charges associated with providing care to charity patients. In addition, the Company provides services to other medically indigent patients under various state Medicaid programs. Such programs pay amounts that are less than the cost of the services provided to the recipients.

Allowance for contractual adjustments and doubtful accounts - The Company's patient accounts receivable are reduced by allowances for contractual adjustments and doubtful accounts. In evaluating the collectibility of patient accounts receivable, the Company analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowances for both contractual adjustments and doubtful accounts and provision for bad debts. Management regularly reviews data about these major payor sources of revenue in evaluating the sufficiency of these allowances. For receivables associated with services provided to patients who have third-party coverage, the Company analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts, if necessary (for example, for expected uncollectible deductibles and copayments on accounts for which the third-party payor has not yet paid, or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely). For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the Company records a provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the expected rates (or the discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

The Company's allowance for doubtful accounts decreased from 9.3 percent of gross patient accounts receivable at December 31, 2012 to 9.0 percent of gross patient accounts receivable at December 31, 2013. In addition, the Company's write-offs were approximately \$429,806,000 and \$286,523,000 for the years ended December 31, 2013 and 2012, respectively. The Company has not changed its charity care or uninsured discount policies during 2013 or 2012.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 2 - Organization and Summary of Significant Accounting Policies (continued)

Reclassification - Certain prior year amounts were reclassified to conform to the current year presentation. There was no change in reported net income or stockholders' equity related to these reclassifications.

Subsequent events - Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are available to be issued. The Company recognizes in the consolidated financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing the consolidated financial statements. The Company's consolidated financial statements do not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date and before consolidated financial statements are available to be issued. The Company has evaluated subsequent events through May 19, 2014, which is the date the consolidated financial statements were available to be issued.

Note 3 - Net Patient Service Revenue

The Company has arrangements with third-party payors that provide for payments to the Company at amounts different from its established rates. A summary of the payment arrangements with major third-party payors are as follows:

Medicare - Inpatient acute-care services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Medicare reimburses the Company for covered outpatient services rendered to Medicare beneficiaries by way of an outpatient prospective payment system based on ambulatory payment classifications. The Company's classification of patients under the Medicare program and the appropriateness of their admissions are subject to an independent review.

Inpatient non-acute services, certain outpatient services, medical education costs, and defined capital costs related to Medicare beneficiaries are paid based, in part, on a cost reimbursement methodology. The Company is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports and audits thereof by the Medicare fiscal intermediary. The estimated amounts due to or from the program are reviewed and adjusted annually based on the status of such audits and any subsequent appeals. Differences between final settlements and amounts accrued in previous years are reported as adjustments to net patient service revenue in the year that examination is substantially completed. These differences increased net patient service revenue by approximately \$5,621,000 for the year ended December 31, 2013 and decreased net patient service revenue by approximately \$4,661,000 for the year ended December 31, 2012. The Company does not believe that there are significant credit risks associated with this government agency.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 3 - Net Patient Service Revenue (continued)

Medicaid - Inpatient services rendered to Medicaid program beneficiaries in California, Texas, Pennsylvania, Nevada and Kansas are reimbursed under a prospective payment system. Outpatient services are reimbursed based on a mixture of fee schedules and a cost reimbursement methodology. The Company is reimbursed for cost reimbursable services at tentative rates with final settlement determined after submission of annual cost reports and audits thereof by the Medicaid fiscal intermediaries. The Company also participates in Medicaid managed care arrangements. Payments for services of Medicaid beneficiaries that participate in those programs include prospectively determined rates and fee schedule payments. The estimated amounts due to or from the Medicaid fiscal intermediaries are reviewed and adjusted annually based on the status of such audits and any subsequent appeals. Differences between final settlements and amounts accrued in previous years are reported as adjustments to net patient service revenue in the year examination is substantially complete. These differences decreased net patient service revenue by approximately \$6,163,000 and \$5,901,000 for the years ended December 31, 2013 and 2012, respectively. The Company does not believe that there are significant credit risks associated with these government agencies.

Commercial insurance, health maintenance organizations, and preferred provider organizations

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

Other - The Company also provides its services to patients enrolled in programs of commercial insurance carriers, health maintenance organizations and preferred provider organizations under which the Company does not have agreements. The Company recognizes revenue for these patients based on its usual customary rates for these services adjusted for historical trends in the Company's reimbursement for similar services.

Laws and regulations governing the third party payor arrangements are extremely 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. Normal estimation differences between subsequent cash collections on patient accounts receivable and net patient accounts receivable estimated in the prior year are reported as adjustments to net patient service revenue in the current period. These differences decreased net patient service revenue by approximately \$10,102,000 and \$12,388,000 for the years ended December 31, 2013 and 2012, respectively.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 4 - Acquisitions and Dispositions

During 2013 and 2012, the Company entered into the following acquisitions and dispositions. All acquisitions have been accounted for using the acquisition method of accounting. Operating results for each of the acquisitions have been included in the accompanying consolidated financial statements from the date of acquisition. Operating results for the dispositions have been included in the accompanying consolidated financial statements through the date of disposition.

Effective December 31, 2013, the Company distributed the ownership interest of Pampa Regional Medical Center and subsidiary to Prime Healthcare Services Foundation, Inc. on behalf of its controlling stockholder. The following table summarizes the components of assets distributed:

Cash and cash equivalents	\$	7,165,057
Patient accounts receivable, net of allowance		7,696,128
Supplies inventory		745,594
Prepaid expenses and other current assets		538,818
Estimated third-party payor settlements		589,505
Property and equipment		11,012,564
Other assets		548,085
		<u>548,085</u>
	\$	<u>28,295,751</u>

All liabilities of Pampa Regional Medical Center and subsidiary were assumed by PHSI in conjunction with the distribution.

Effective December 31, 2012, the Company distributed the ownership interest of Huntington Beach Hospital to Prime Healthcare Services Foundation, Inc. on behalf of its controlling stockholder. The following table summarizes the components of assets distributed:

Cash and cash equivalents	\$	437,749
Patient accounts receivable, net of allowance		8,434,031
Supplies inventory		237,493
Related party receivable		3,318,307
Prepaid expenses and other current assets		6,775,754
Property and equipment		17,111,608
Goodwill		1,461,947
Estimated third-party payor settlements		1,707,069
		<u>1,707,069</u>
	\$	<u>39,483,958</u>

All liabilities of Huntington Beach Hospital were assumed by PHSI in conjunction with the distribution.

**PRIME HEALTHCARE SERVICES, INC.
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Note 4 - Acquisitions and Dispositions (continued)

During 2013, the Company acquired two general acute care hospitals and a medical group.

On January 18, 2013, the Company entered into an asset purchase agreement with Sisters of Charity of Leavenworth Health System, Inc. Pursuant to the agreement, the Company acquired certain assets and liabilities of Providence Medical Center and Saint John Hospital.

	Providence Medical Center	Saint John Hospital	Providence Place, Inc. and Physician Resources, Inc.	Total
Cash	\$ -	\$ -	\$ 1,210,164	\$ 1,210,164
Patient accounts receivable	-	-	1,184,119	1,184,119
Inventory	1,019,421	372,773	108,239	1,500,433
Prepaid expenses	752,364	70,628	451,592	1,274,584
Property and equipment	41,828,000	8,945,000	1,276,362	52,049,362
Intangible assets	2,600,000	440,000	165,000	3,205,000
Goodwill	1,655,186	-	-	1,655,186
Liabilities	<u>(2,803,060)</u>	<u>(555,059)</u>	<u>(1,636,532)</u>	<u>(4,994,651)</u>
Net cash consideration	<u>\$ 45,051,911</u>	<u>\$ 9,273,342</u>	<u>\$ 2,758,944</u>	<u>\$ 57,084,197</u>

During 2012, the Company acquired five general acute care service providers, consistent with the Company's strategic growth plan.

On February 22, 2012 the Company entered into an asset purchase agreement with Solis Healthcare, LP. Pursuant to the agreements, the Company acquired certain assets and liabilities of Roxborough Memorial Hospital.

On April 25, 2012 the Company entered into an asset purchase agreement with Signature Pampa Hospital, LP to acquire certain assets and liabilities of Pampa Regional Medical Center. The transaction closed on May 31, 2012.

On July 2, 2012 the Company entered into an asset purchase agreement with Dignity Health and Saint Mary's Multi-Specialty Clinic, Inc. Pursuant to the agreements, the Company acquired certain assets and liabilities of St. Mary's Regional Medical Center.

On October 3, 2012, the Company entered into an asset purchase agreement with Lower Bucks Hospital, Lower Bucks Health Enterprises, Inc., Advanced Primary Care Physicians, and Advanced Specialty Physicians Group. Pursuant to the agreements, the Company acquired certain assets and liabilities of Lower Bucks Hospital.

On October 24, 2012, the Company acquired 100% of the membership interests in Dallas Medical Center from Dallas SV Health Care, LLC, PSG-Dallas, LLC and local physician investors.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 4 - Acquisitions and Dispositions (continued)

The following table presents the allocation of the aggregate purchase price for each of the five hospitals purchased in 2012:

	Roxborough Memorial Hospital	Pampa Regional Medical Center	Saint Mary's Regional Medical Center	Dallas Medical Center	Lower Bucks Hospital	Total
Cash	\$ -	\$ 1,320	\$ 10,122	\$ 3,247,971	\$ 1,784,288	\$ 5,043,701
Patient accounts receivable	-	3,984,706	-	5,418,409	8,942,182	18,345,297
Inventory	1,358,885	776,612	6,434,784	1,026,205	627,257	10,223,743
Prepaid expenses	429,781	298,894	201,442	71,896	612,073	1,614,086
Property and equipment	25,229,856	4,886,895	58,453,806	2,117,968	9,412,645	100,101,170
Other assets	-	-	1,362,692	-	-	1,362,692
Goodwill	-	-	1,500,000	20,489,302	1,849,307	23,838,609
Liabilities	(2,223,513)	(1,622,033)	(24,523,445)	(30,709,342)	(13,273,795)	(72,352,128)
Gain on acquisition	(1,542,181)	-	-	-	-	(1,542,181)
Net cash consideration	<u>\$ 23,252,828</u>	<u>\$ 8,326,394</u>	<u>\$ 43,439,401</u>	<u>\$ 1,662,409</u>	<u>\$ 9,953,957</u>	<u>\$ 86,634,989</u>

Note 5 - Concentration of Credit Risk

Financial instruments which potentially subject the Company to significant concentrations of credit risk consist primarily of cash. The Company maintains cash in bank deposit accounts at high credit quality financial institutions. The balances, at times, may exceed federally insured limits. Management monitors the financial condition of these institutions on an ongoing basis and does not believe any significant credit risk exists as of December 31, 2013.

At December 31, 2013 and 2012, patient accounts receivable were comprised of the following: government programs, primarily Medicare 34% and 37%, respectively; Medicaid and Medi-Cal 22% and 22%, respectively; healthcare maintenance and preferred provider organizations (managed care programs) 12% and 9%, respectively; and private pay and commercial insurance patients 32% and 32%, respectively. Management believes there are no credit risks associated with receivables from government programs. Receivables from managed care programs and others are from various payors who are subject to differing economic conditions and do not represent concentrated risks to the Company. Management continually monitors and adjusts the reserves associated with receivables.

**PRIME HEALTHCARE SERVICES, INC.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 6 - Property and Equipment

Property and equipment consist of the following at December 31:

	<u>2013</u>	<u>2012</u>
Land	\$ 82,487,307	\$ 66,264,728
Buildings	401,051,659	363,552,124
Building improvements	40,686,408	18,635,116
Equipment	351,026,385	266,373,723
Construction in progress (estimated cost to complete is approximately \$72,164,000 and \$74,057,000 at December 31, 2013 and 2012, respectively)	<u>51,547,665</u>	<u>30,349,177</u>
	926,799,424	745,174,868
Less: Accumulated depreciation and amortization	<u>(234,512,290)</u>	<u>(163,326,720)</u>
	<u>\$ 692,287,134</u>	<u>\$ 581,848,148</u>

Gross property and equipment includes approximately \$63,082,000 and \$54,639,000 of equipment under capital lease arrangements as of December 31, 2013 and 2012, respectively. Related accumulated amortization totaled approximately \$37,138,000 and \$26,465,000 as of December 31, 2013 and 2012, respectively.

Note 7 - Line of Credit

As of December 19, 2013, the Company entered into an amended and restated revolving and term loan and security agreement with HFG. This agreement increased the available line of credit amounts from \$175,000,000 to \$225,000,000. The line of credit accrues interest at LIBOR (with a LIBOR floor of 1.00%) plus 3.25%. At December 31, 2013, the interest rate was 4.25% and balances outstanding as of December 31, 2013 and 2012 were \$110,049,171 and \$45,392,743, respectively. The line of credit matures on December 18, 2018. See Note 8 for discussion of the term loan.

**PRIME HEALTHCARE SERVICES, INC.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 8 - Long-Term Debt

During 2010, the Company entered into a credit agreement including Term Loan A and Term Loan B with Royal Bank of Canada ("RBC"). A portion of the total proceeds of \$232,000,000 from Term Loan A and Term Loan B was used to pay off existing bank debt for various amounts totaling \$130,400,000. Approximately \$9,500,000 of deferred loan issuance costs were incurred relating to this credit agreement and were being amortized over the term of the loans. The Company refinanced its debt on July 3, 2012 and paid off Term Loan A and Term Loan B. Non-amortized deferred loan issuance costs of approximately \$4,939,000 were expensed as interest expense as a result of this refinancing during the year ended December 31, 2012.

On July 3, 2012, the Company entered into a revolving loan and security agreement with Healthcare Finance Group, LLC ("HFG") with a total available amount of \$175,000,000. The line of credit matures on July 15, 2016. The interest rate is LIBOR (with a LIBOR floor of 1.25%) plus 3.5%. At December 31, 2012, the interest rate was 4.75%. The following hospitals previously had lines of credit with HFG which were terminated on July 3, 2012: Chino Valley Medical Center, Huntington Beach Hospital, La Palma Intercommunity Hospital, West Anaheim Medical Center, Chino Valley Medical Center and Paradise Valley Hospital.

In conjunction with the Company's refinancing of its revolving loan and security agreement on July 3, 2012, the Company also restructured its obligations with MPT. The Company entered into (a) an agreement with MPT of Inglewood, L.P. for \$100,000,000, (b) a cross-collateralization and cross-guarantee agreement with the Company's other obligations due to MPT, and (c) included properties owned by Prime A ("the Prime A properties") for which the Company is also obligated to repay in the collateralization and guarantee agreements.

As of December 19, 2013, the Company entered into an amended and restated revolving and term loan and security agreement with HFG. This agreement increased the available line of credit (see Note 7) and included a term loan for \$209,000,000. The term loan accrues interest at LIBOR (with a LIBOR floor of 1.25%) plus 4.50%. At December 31, 2013, the interest rate was 5.75%. The term loan matures on December 18, 2018.

The Company's revolving loan and security agreement with HFG is subject to certain financial covenants, including 1) minimum liquidity of \$40,000,000; 2) fixed charge coverage ratio not to be less than 1.25 to 1.00; and 3) accounts receivable days outstanding not to be greater than 85 days.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 8 - Long-Term Debt (continued)

Long-term debt consists of the following as of December 31:

	<u>2013</u>	<u>2012</u>
Loan with MPT secured by Desert Valley Hospital and Chino Valley Medical Center facilities, monthly payments of interest only, interest accrues at a variable rate (10.66% at December 31, 2013), maturing in February 2022.	\$ 140,000,000	\$ 140,000,000
Loan with MPT, secured by real property of Centinela Hospital Medical Center monthly payments of interest only, interest accrues at a variable rate (10.54% at December 31, 2013), maturing in June 30, 2022.	100,000,000	100,000,000
Term loans with BBVA Compass, secured by certain real property, principal and interest of \$153,000 payable monthly at an annual rate of 7.45%, maturing in July 2022.	35,586,120	36,723,066
Term loan with Siemens Financial Services, secured by certain equipment of Prime Healthcare Air Transport LLC, payable in monthly installments of approximately \$75,000 including interest at a fixed rate of 6.77% per annum, maturing in 2017.	2,956,389	3,626,332
Note payable with MPT secured by certain property and equipment and lease deposits of Paradise Valley Hospital, bearing interest at a variable rate (10.54% at December 31, 2013). Interest only payments due monthly, principal balance due at maturity in May 2022.	25,000,000	25,000,000
Term loan with HFG, secured by the assets of the Company, interest payable monthly at an annual rate of Libor + 4.5% (5.75% at December 31, 2013), maturing in December 2018. The Company is required to maintain certain financial and non-financial covenants at year end.	\$ 209,000,000	\$ -

**PRIME HEALTHCARE SERVICES, INC.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 8 - Long-Term Debt (continued)

Long-term debt consists of the following as of December 31 (continued):

	2013	2012
Other	585,597	-
	513,128,106	305,349,398
Less: Current portion	(3,143,266)	(2,510,891)
	\$ 509,984,840	\$ 302,838,507

Aggregate annual principal maturities of long-term debt for the five years subsequent to December 31, 2013 and thereafter, are as follows:

Years ending December 31,	
2014	\$ 3,143,266
2015	2,607,713
2016	2,661,252
2017	2,493,547
2018	1,840,948
Thereafter	500,381,380
	\$ 513,128,106

Note 9 - Interest Rate Swap

In conjunction with the RBC Term B Loan, the Company entered into an interest rate swap and floor agreement with a commercial bank. The swap agreement served to convert the underlying variable interest rates of the Term Loans. The swap was not designated as a cash flow hedge for accounting purposes, therefore changes in the fair value of the swap were recorded as interest expense. The Company paid approximately \$4,385,000 to terminate the interest swap agreement in conjunction with the July 3, 2012 refinancing.

The net change in value of the swap of approximately \$340,000 was included within interest expense for the year ended December 31, 2012 (prior to termination).

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 10 - Leases

In May 2007, in connection with the acquisition of certain assets, Paradise Valley Hospital sold the real estate and related hospital building acquired to a health care real estate investment trust ("the REIT"). As part of the sale, Paradise Valley Hospital leased back the real estate and hospital building ("leased property") in a lease agreement which expires in May 2022. Paradise Valley Hospital has an option to extend the term of the lease for three additional five year periods. After ten years, or at the end of the lease term, Paradise Valley Hospital has the option to purchase the leased property for \$23,000,000. If at the end of the lease term, including renewal terms, Paradise Valley Hospital does not exercise its option to purchase the leased property; Paradise Valley Hospital must pay the lessor a lease make up payment equal to the difference between the then fair market value of the leased property and \$23,000,000. Due to the guarantee and option to purchase included in the lease, this transaction was recognized as a finance obligation. The proceeds of \$23,000,000 were recorded as a sales lease-back liability on the consolidated balance sheets.

In November 2008, in connection with the acquisition of certain assets, San Dimas Community Hospital sold the real estate and related hospital and medical office buildings acquired to the REIT. As part of the sale, San Dimas Community Hospital leased back the hospital and related land as well as the medical office buildings and the related land ("leased property") which lease expires in November 2018. San Dimas Community Hospital has options to extend the terms of the leases for three additional five year periods. After ten years, or at the end of the lease term, San Dimas Community Hospital has the option to purchase the leased property for \$13,000,000 for the hospital and related land and \$7,000,000 for the medical office buildings and related land. If at the end of the lease term, including renewal terms, San Dimas Community Hospital does not exercise its option to purchase the leased property, San Dimas Community Hospital must pay to the lessor a lease make up payment equal to the difference between the then fair market value of the leased property and \$13,000,000 and \$7,000,000, for the hospital and medical office buildings, respectively. Due to the guarantee and option to purchase included in the lease, this transaction was recognized as a finance obligation. The proceeds of \$13,000,000 and \$7,000,000 were recorded as sale lease-back liabilities on the consolidated balance sheets.

In November 2008, in connection with the acquisition of certain assets, Garden Grove Hospital Medical Center sold the real estate and related hospital and medical office buildings acquired from Tenet to the REIT. As part of the sale, Garden Grove Hospital Medical Center leased back the hospital and related land as well as the medical office building and the related land ("leased property") in a lease agreement which expires in November 2018. Garden Grove Hospital Medical Center has options to extend the terms of the leases for three additional five year periods. After ten years, or at the end of the lease term, Garden Grove Hospital Medical Center has the option to purchase the leased property for \$16,250,000 for the hospital and related land and \$8,750,000 for the medical office buildings and related land. If at the end of the lease term, including renewal terms, Garden Grove Hospital Medical Center does not exercise its option to purchase the leased property, Garden Grove Hospital Medical Center must pay to the lessor a lease make up payment equal to the difference between the then fair market value of the leased property and \$16,250,000 and \$8,750,000, respectively. Due to the guarantee included in the lease, this transaction was recognized as a finance obligation. The proceeds of \$16,250,000 and \$8,750,000 were recorded as sale lease-back liabilities on the consolidated balance sheets.

**PRIME HEALTHCARE SERVICES, INC.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 10 - Leases (continued)

In February 2011, the Company agreed to sell the land and buildings acquired in the November 2010 Alvarado Hospital acquisition to the REIT. As part of the sale, Alvarado Hospital leased back the hospital and related land in a lease agreement which expires in February 2021. Alvarado Hospital has options to extend the terms of the lease for three additional five year periods. After ten years, or at the end of the lease term, Alvarado Hospital has the option to purchase the leased property for \$70,000,000 for the hospital and related land. If at the end of the lease term, including renewal terms, Alvarado Hospital does not exercise its option to purchase the leased property, Alvarado Hospital must pay to the lessor a lease make up payment equal to the difference between the then fair market value of the leased property and \$70,000,000. Due to the guarantee and option to purchase included in the lease, this transaction was recognized as a finance obligation. The proceeds of \$70,000,000 were recorded as a sale lease-back liability on the consolidated balance sheets.

The Company entered into a master lease agreement (the “master lease”) on July 3, 2012 which replaced the existing leases to lease the hospital properties and related other medical office buildings for San Dimas Community Hospital, Garden Grove Hospital Medical Center, Paradise Valley Hospital and Alvarado Hospital from the REIT.

On September 10, 2012, the Company entered into an agreement with the REIT to sell the land and buildings acquired in February 2012 acquisition for Roxborough Memorial Hospital and in the July 2012 acquisition for St. Mary’s Regional Medical Center to the REIT. Concurrent with this agreement, the Company entered into an amendment to the master lease agreement whereby the hospital properties and related other medical office buildings of St. Mary’s Regional Medical Center and Roxborough Memorial Hospital were added to the master lease.

On June 11, 2013, the Company entered into an agreement with the REIT to sell the land and buildings acquired in the April 2013 acquisition of Providence Medical Center and Saint John’s Hospital and concurrently entered into an amendment to the master lease agreement whereby the hospital properties and related other medical office buildings of Providence Medical Center and Saint John’s Hospital were added to the master lease.

On December 12, 2013, the Company entered into an agreement with the REIT to sell the land and buildings acquired in the October 2012 acquisition of the land and buildings of Dallas Medical Center and concurrently entered into an amendment to the master lease agreement whereby the hospital properties and related other medical office buildings of Dallas Medical Center were added to the master lease.

**PRIME HEALTHCARE SERVICES, INC.
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Note 10 - Leases (continued)

The master lease agreement has a 10-year term with options to extend the term by two 60 month periods. Monthly rent is defined as 10.54% of the lease base, subject to annual escalation of the greater of 2% or the consumer price index. If at the end of the lease term, including renewal terms, the Company does not exercise its option to purchase the leased property, the Company must pay to the REIT a lease make up payment equal to the difference between the then fair market value of the leased property and the option price. Due to the guarantee and option to purchase included in the lease, this transaction was recognized as a finance obligation. The significant terms of the lease are as follows:

The Paradise Valley Hospital facility includes monthly rent payments of approximately \$202,000 per month at inception based on the \$23,000,000 lease base.

The Alvarado Hospital facility includes monthly rent payments of approximately \$615,000 per month at inception based on the \$70,000,000 lease base.

The San Dimas Community Hospital facility includes monthly rent payments of approximately \$176,000 per month at inception. The lease base and purchase option for the leased property is \$13,000,000 for the hospital and related land and \$7,000,000 for the medical office buildings and related land.

The Garden Grove Hospital Medical Center facility includes monthly rent payments of approximately \$220,000 per month at inception based on the combined \$25,000,000 lease base.

The Roxborough Memorial Hospital facility includes monthly rent payments of approximately \$263,000 per month at inception based on the \$30,000,000 lease base.

The St. Mary's Regional Medical Center facility includes monthly rent payments of approximately \$702,000 per month at inception based on the \$80,000,000 lease base.

The Dallas Medical Center facility includes monthly rent payments of approximately \$146,000 per month at inception based on the \$25,000,000 lease base.

The Providence Medical Center facility includes monthly rent payments of approximately \$527,000 per month at inception based on the \$60,000,000 lease base.

The Saint John's Hospital facility includes monthly rent payments of approximately \$132,000 per month at inception based on the \$15,000,000 lease base.

**PRIME HEALTHCARE SERVICES, INC.
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Note 10 - Leases (continued)

The Company's sales lease back liabilities consist of the following:

Hospital	December 31,	
	2013	2012
Paradise Valley Hospital	\$ 23,000,000	\$ 23,000,000
Alvarado Hospital	70,000,000	70,000,000
San Dimas Community Hospital	13,000,000	13,000,000
San Dimas Medical Office Building	7,000,000	7,000,000
Garden Grove Hospital Medical Center	16,250,000	16,250,000
Garden Grove Medical Office Building	8,750,000	8,750,000
Roxborough Memorial Hospital	30,000,000	30,000,000
Saint Mary's Regional Medical Center	80,000,000	80,000,000
Dallas Medical Center	25,000,000	-
Providence Medical Center	60,000,000	-
Saint John Hospital	15,000,000	-
	\$ 348,000,000	\$ 248,000,000

In addition to the hospital facilities operated through the sale leaseback transactions and the related party agreements for Desert Valley Hospital and Chino Valley Medical Center's hospital buildings, the Company entered into a master lease agreement on July 3, 2012 to lease the hospital properties and related other medical office buildings for La Palma Intercommunity Hospital, West Anaheim Medical Center, and Shasta Regional Medical Center from the REIT. All leases under this master lease agreement have a 10-year term with options to extend the term by two 60 month periods. Monthly rent is defined as 10.33% of the lease base, subject to annual escalation of the greater of 2% or the consumer price index.

The significant terms of the lease are as follows:

The La Palma Intercommunity Hospital facility includes monthly rent payments of approximately \$110,000 at inception based on the \$12,500,000 lease base.

The West Anaheim Medical Center facility includes monthly rent payments of approximately \$220,000 at inception based on the \$25,000,000 lease base.

The Shasta Regional Medical Center facility includes monthly rent payments of approximately \$553,000 based on the \$63,000,000 lease base.

Lease expense, consisting primarily of building rent and equipment leases, amounted to approximately \$37,175,000 and \$40,239,000 for the years ended December 31, 2013 and 2012, respectively.

**PRIME HEALTHCARE SERVICES, INC.
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Note 10 - Leases (continued)

As of December 31, 2013, future minimum lease payments under non-cancelable operating leases (with initial or remaining lease terms in excess of one year) and future minimum capital lease payments are:

Years ending December 31,	Capital Leases	Operating Lease Commitments	Sale Leaseback Commitments
2014	\$ 8,566,973	\$ 27,714,939	\$ 26,518,670
2015	8,145,789	27,562,379	27,049,044
2016	4,979,563	22,980,247	27,590,025
2017	4,689,297	22,992,236	28,141,825
2018	4,067,578	22,175,913	28,447,468
Thereafter	11,291,834	56,600,546	466,445,404
Total minimum payments	41,741,034	\$ 180,026,260	604,192,436
Less: Amounts representing interest	(10,589,258)		(256,190,815)
	31,151,776		348,001,621
Less: Current portion	(6,737,672)		-
	\$ 24,414,104		\$ 348,001,621

Note 11 - Professional Liability, Workers' Compensation, Healthcare and Earthquake Insurance

Desert Valley Insurance, LTD. ("DVIL") provides workers' compensation, professional liability, medical insurance, and earthquake insurance coverage to the Company. DVIL is affiliated with the Company through common ownership.

Workers' compensation insurance - Under the terms of the agreement DVIL is obligated to insure each workers' compensation claim up to a maximum of \$1,000,000 per claim. Losses in excess of \$1,000,000 per claim are insured by the Hartford Insurance Company.

**PRIME HEALTHCARE SERVICES, INC.
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**Note 11 - Professional Liability, Workers' Compensation, Healthcare and Earthquake Insurance
(continued)**

Professional liability insurance - DVIL provides professional liability insurance on a claims-made basis. Under this policy, insurance premiums cover only those claims actually reported during the policy term. Should the claims made policy not be renewed or replaced with equivalent insurance, claims related to occurrences during the policy term but reported subsequent to the policy's termination may be uninsured. Under the current policy, the medical groups of PHSI are covered up to a \$1,000,000 per claim and \$3,000,000 general aggregate limit with no amount deductible. The hospitals of PHSI are covered up to a \$3,000,000 per claim and \$21,000,000 general aggregate limit with no amount deductible. Excess losses up to an additional \$7,000,000 per incident and \$14,000,000 general aggregate will be insured by CNA Insurance Company. The Company renewed its claims made policy with DVIL for the next policy year ending December 31, 2014, under the same terms.

Accounting principles generally accepted in the United States of America require that a health care facility recognize the estimated costs of malpractice claims in the period of the incident of malpractice, if it is reasonably possible that liabilities may be incurred and losses can be reasonably estimated. The Company recognized an estimated liability based upon its claims experience to cover the Company's potential exposure to incurred but unreported claims. The claim reserve is based on the best data available to the Company; however, the estimate is subject to a significant degree of inherent variability.

The estimate is continually monitored and reviewed, and as the reserve is adjusted, the difference is reflected in current operations. While the ultimate amount of professional liability is dependent on future developments, management is of the opinion that the associated liabilities recognized in the accompanying consolidated financial statements is adequate to cover such claims. Management is aware of no potential professional liability claims whose settlement, if any, would have a material adverse effect on the Company's consolidated financial position.

Earthquake and flood insurance - Under the DVIL policy, insurance premiums cover only those claims which occurred during the policy term. Should the claims made policy not be renewed, or replaced with equivalent insurance, claims related to occurrences during the policy term but reported subsequent to the policy's termination may be uninsured under the current policy. The Company is covered up to \$30,000,000 per occurrence and in the aggregate subject to a five percent deductible. The Company renewed its policy through June 2014.

Medical insurance - The Company began a medical insurance program with DVIL for healthcare coverage for employees effective January 1, 2010. The Company has renewed this policy through December 31, 2014. Under the terms of the agreement, DVIL is obligated to insure each employee medical claim subject to a deductible of \$500 per claim. Claims are adjudicated by an independent third party administrator.

**PRIME HEALTHCARE SERVICES, INC.
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**Note 11 - Professional Liability, Workers' Compensation, Healthcare and Earthquake Insurance
(continued)**

The Company has evaluated whether they are required to consolidate DVIL in accordance with ASC 810 as of December 31, 2013, and has determined that DVIL is not a variable interest entity. The Company is not exposed to the risk that it may be required to subsidize the losses, if any of DVIL. DVIL provides workers compensation, hospital and medical professional, general liability, healthcare and earthquake insurance. DVIL had total assets of approximately \$257,000,000 and \$218,000,000 as of December 31, 2013 and 2012, respectively. DVIL had total admitted assets of approximately \$250,000,000 and \$209,000,000 and total equity of approximately \$65,000,000 and \$51,000,000 as of December 31, 2013 and 2012, respectively.

Note 12 - Related Party Transactions

Amounts due (to)/from related parties as of December 31 are as follows:

	<u>2013</u>	<u>2012</u>
Payable to Prime Healthcare Services Foundation and subsidiaries	\$ (1,442,226)	\$ (5,998,272)
Receivable from DVIL, related to expenses incurred in excess of deductibles and over-payment of health insurance premiums	6,374,231	6,424,289
Other	<u>826,443</u>	<u>(66,206)</u>
	<u>\$ 5,758,448</u>	<u>\$ 359,811</u>

The Company entered into agreements with DVIL to provide workers' compensation, earthquake insurance coverage, commercial malpractice liability insurance and healthcare insurance for employees on a claims-made basis (see Note 11), and healthcare insurance for employees. Insurance premiums paid to DVIL totaled \$79,011,000 and \$70,401,000 for the years ended December 31, 2013 and 2012, respectively. The Company receives reimbursement from DVIL for workers' compensation insurance deductibles paid on behalf of DVIL. As of December 31, 2013 and 2012, the Company has recorded a prepaid insurance expense of approximately \$56,476,000 and \$56,544,000, respectively, related to coverage being provided by DVIL in future years.

The Company leases certain office buildings and parking facilities from Prime A. The leases are for five year terms. Rent expense incurred under these leases was approximately \$8,038,000 and \$1,543,000 for the years ended December 31, 2013 and 2012, respectively.

**PRIME HEALTHCARE SERVICES, INC.
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Note 13 - Retirement Savings Plan

The Company has a defined contribution pension plan covering substantially all of its employees. The Company's contribution to the plan is at the Company's discretion but limited to the maximum amount deductible for federal income tax purposes under the applicable Internal Revenue Code. During the years ended December 31, 2013 and 2012, the Company made contributions of approximately \$8,173,000 and \$4,840,000, respectively, to the plan.

Note 14 - Contingencies

The Company is aware of certain asserted and unasserted legal claims arising in the normal course of business. While the outcomes cannot be determined at this time, it is management's opinion that the liability, if any, from these actions will not have a material adverse effect on the Company's consolidated financial position.

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. 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. These laws and regulations include, but are not limited to, accreditation, licensure, and government health care program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Recently, government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by health care providers. Violations of these laws and regulations could result in exclusion from government health care program participation, together with the imposition of significant fines and penalties, as well as significant repayment for past reimbursement for received patient services. While the Company is subject to similar regulatory review, management believes that the outcome of any potential regulatory review will not have a material adverse effect on the Company's consolidated financial position.

On June 15, 2012, the Company received a document subpoena from the United States Department of Justice in connection with an investigation of alleged coding deficiencies. Certain of these allegations have already been reviewed by the Joint Commission, Healthcare Facilities Accreditation Program, Palmetto GBA, Recovery Audit Contractors, Health Services Advisory Group (a Medicare quality improvement organization) and the California Department of Public Health without identification of the alleged coding deficiencies. The Company is cooperating fully with the government in its investigations.

Management believes that the Company is in compliance with government laws and regulations related to fraud and abuse and other applicable areas. Compliance with such laws and regulations can be subject to future governmental review and interpretation, as well as regulatory actions unknown or unasserted at this time.

**PRIME HEALTHCARE SERVICES, INC.
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Note 15 - Revenue from Governmental Programs

Hospital fee program - The California Hospital Fee Program (the "Program") is comprised of three laws enacted by the state of California. The three laws cover the periods from April 1, 2009, through December 31, 2010 (the "Twenty Month Program"); January 1, 2011, through June 30, 2011 (the "Six Month Program"); and July 1, 2011, through December 31, 2013 (the "Thirty Month Program"). The Program requires a Quality Assurance Fee ("QA Fee") to be paid by certain hospitals to a State fund established to accumulate the assessed QA Fees and receive matching federal funds. QA Fees and corresponding matching federal funds are then paid to participating hospitals in two supplemental payment methodologies: a fee-for service methodology and a managed care plan methodology.

CMS approved California's State Plan Amendment and Waivers as of October 8, 2010, May 18, 2011, and June 22, 2012, allowing the State to implement the QA Fee and the fee-for-service Supplement Payment methodology of the legislation for the Twenty Month, Six Month and Thirty Month programs. CMS approved the managed care plan methodology on January 18, 2011, and December 29, 2011, for the Twenty Month and Six Month Programs. The managed care plan methodology for the Thirty Month Program was approved by CMS through June 30, 2013.

Based on formulas contained in the legislation as well as modeling done by the California Hospital Association, the Company recognized net patient service revenue for payments received and quality assurance fee expense included within general and administrative expenses in the accompanying consolidated statements of income. The net gain recognized from the program was approximately \$45,868,000 and \$29,524,000 for the years ended December 31, 2013 and 2012, respectively. At December 31, 2012, QA Fees related to the managed care portion of the program of approximately \$31,711,000 were included in prepaid and other current assets in the accompanying consolidated balance sheet. The Company has also recorded a receivable of approximately \$9,366,000 and a liability of approximately \$9,769,000 within estimated third-party payor settlements in the accompanying consolidated balance sheets at December 31, 2013 and 2012, respectively.

"Meaningful Use" incentives - The American Recovery and Reinvestment Act of 2009 ("ARRA") established incentive payments under the Medicare and Medicaid programs for certain professionals and hospitals that meaningfully use certified electronic health record ("EHR") technology. The Medicare incentive payments will be paid out to qualifying hospitals over four consecutive years on a transitional schedule. To qualify for Medicare incentives, hospitals and physicians must meet EHR meaningful use criteria that become more stringent over three stages designated by the Centers for Medicare and Medicaid ("CMS").

Medicaid programs and payment schedules vary from state to state. The Medi-Cal programs requires hospitals to register for the program prior to 2016, to engage in efforts to adopt, implement or upgrade certified EHR technology in order to qualify for the initial year of participation, and to demonstrate meaningful use of certified EHR technology in order to qualify for payment for up to three additional years.

**PRIME HEALTHCARE SERVICES, INC.
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Note 15 - Revenue from Governmental Programs (continued)

For the year ended December 31, 2013, the Company recorded revenue of approximately \$15,738,000 related to the Medicare program and approximately \$4,316,000 related to the Medicaid program. For the year ended December 31, 2012, the Company recorded revenue of \$19,238,000 related to the Medicare program and \$8,394,000 related to the Medicaid program. Meaningful use incentives are included in other revenue in the consolidated statements of income. These incentives have been recognized following the grant accounting model, recognizing income ratably over the applicable reporting period as management becomes reasonably assured of meeting the required criteria. Subsequent changes to these estimates will be recognized in the consolidated statement of income in the period in which additional information is available. Such estimates are subject to audit by the federal government or its designee.

Note 16 - Labor Relations

Centinela Hospital Medical Center - SEIU-UHW represents approximately 800 employees at Centinela Hospital Medical Center and the California Nurses Association ("CNA") represents approximately 400 registered nurses at Centinela Hospital Medical Center. The collective bargaining agreement with SEIU-UHW terminated on December 31, 2009 and efforts to negotiate the terms of a new collective bargaining agreement have been unsuccessful to date. Subject to certain exceptions, the terms and conditions of employment as of the date on which the collective bargaining agreement terminated remain in place until such time that a new agreement is reached. Centinela negotiated a new collective bargaining agreement with CNA, which expires in 2015.

Garden Grove Hospital Medical Center - SEIU-UHW represents approximately 400 employees and the United Nurses Association of California ("UNAC") represents approximately 250 registered nurses at Garden Grove Hospital Medical Center. The collective bargaining agreement with SEIU-UHW terminated on March 31, 2011. Subject to certain exceptions, the terms and conditions of employment as of the date on which the collective bargaining agreement with SEIU terminated remain in place until such time that a new agreement is reached. A new collective bargaining agreement with UNAC was negotiated in 2013, which expires until mid- 2016

Alvarado Hospital - CNA represents approximately 200 registered nurses at Alvarado Hospital. In March 2012, a new four-year agreement was signed with CNA.

Note 17 - Subsequent Events

On January 2, 2014, PHSI acquired substantially all of the assets of Landmark Medical Center in North Smithfield, Rhode Island. The acquisition was funded primarily through a drawdown of the term loan for a purchase price of approximately \$43,250,000. Landmark Medical Center is a 214 licensed bed acute care hospital. The acquisition is consistent with the Company's strategic growth plans.