ST. CHARLES HEALTH SYSTEM, INC.

Consolidated Financial Statements
and Supplementary Schedules

December 31, 2011 and 2010

(With Independent Auditors' Report Thereon)

ST. CHARLES HEALTH SYSTEM, INC.

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KPMG LLP
Suite 3800
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Independent Auditors' Report

The Board of Directors
St. Charles Health System, Inc.:

We have audited the accompanying consolidated balance sheets of St. Charles Health System, Inc. (SCHS) as of December 31, 2011 and 2010, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of SCHS' management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of SCHS' internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of St. Charles Health System, Inc. as of December 31, 2011 and 2010, and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The supplementary information included in schedules I through III is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic consolidated financial statements taken as a whole.

KPMG LLP

March 28, 2012

ST. CHARLES HEALTH SYSTEM, INC.

Consolidated Balance Sheets

December 31, 2011 and 2010

Assets		2011	2010
Current assets:			
Cash and cash equivalents	$	18,477,000	22,302,000
Assets limited as to use, current portion		8,033,000	8,011,000
Patient accounts receivable, net of reserves for uncollectible accounts of $13,785,000 and $11,183,000 at December 31, 2011 and 2010, respectively		76,772,000	70,275,000
Other receivables, net		6,922,000	3,093,000
Supplies inventory		9,365,000	5,107,000
Prepaid expenses and other current assets		6,564,000	4,882,000
Total current assets		126,133,000	113,670,000
Assets limited as to use, net of current portion		203,501,000	192,306,000
Property and equipment, net		223,057,000	238,475,000
Other assets, net		11,138,000	12,427,000
Total assets	$	563,829,000	556,878,000
Liabilities and Net Assets			
Current liabilities:			
Accounts payable	$	21,730,000	18,478,000
Accrued liabilities		31,798,000	32,189,000
Estimated third-party payor settlements payable, net		3,549,000	1,297,000
Deferred revenue		1,068,000	1,132,000
Current portion of long-term obligations		9,298,000	9,415,000
Total current liabilities		67,443,000	62,511,000
Long-term obligations, net of current portion		165,340,000	173,936,000
Other liabilities		4,699,000	2,926,000
Total liabilities		237,482,000	239,373,000
Net assets:			
Unrestricted, SCHS		318,617,000	309,951,000
Unrestricted, noncontrolling interests		2,693,000	2,550,000
Temporarily restricted		3,662,000	3,590,000
Permanently restricted		1,375,000	1,414,000
Total net assets		326,347,000	317,505,000
Total liabilities and net assets	$	563,829,000	556,878,000

See accompanying notes to consolidated financial statements.

ST. CHARLES HEALTH SYSTEM, INC.

Consolidated Statements of Operations

Years ended December 31, 2011 and 2010

	2011	2010
Operating revenue:		
Net patient service revenue prior to bad debt adjustments	$ 483,411,000	460,117,000
Bad debt adjustments	26,522,000	18,660,000
Net patient service revenue	456,889,000	441,457,000
Other revenue	18,957,000	18,750,000
Total operating revenue	475,846,000	460,207,000
Expenses:		
Salaries and wages	188,081,000	172,202,000
Employee benefits	60,242,000	62,119,000
Professional fees	39,733,000	38,518,000
Depreciation	31,497,000	29,784,000
Interest	13,216,000	13,759,000
Medical supplies, drugs, and other	134,221,000	129,491,000
Total expenses	466,990,000	445,873,000
Operating income	8,856,000	14,334,000
Other income (losses):		
Investment income, net	2,042,000	18,920,000
Other, net	(200,000)	319,000
Total other income, net	1,842,000	19,239,000
Excess of revenue over expenses	10,698,000	33,573,000
Net assets released from restriction	183,000	278,000
Other transfers	(34,000)	(580,000)
Distributions	(2,038,000)	(2,520,000)
Purchase of noncontrolling interest in net assets	—	(287,000)
Increase in unrestricted net assets	$ 8,809,000	30,464,000

See accompanying notes to consolidated financial statements.

ST. CHARLES HEALTH SYSTEM, INC.

Consolidated Statements of Changes in Net Assets

Years ended December 31, 2011 and 2010

	Unrestricted – SCHS	Unrestricted noncontrolling interests	Temporarily restricted	Permanently restricted	Total
Net assets at December 31, 2009	$ 278,795,000	3,242,000	2,529,000	1,277,000	285,843,000
Excess of revenue over expenses	31,458,000	2,115,000	—	—	33,573,000
Restricted contributions	—	—	1,241,000	92,000	1,333,000
Net assets released from restriction	278,000	—	(969,000)	—	(691,000)
Other transfers	(580,000)	—	580,000	—	—
Distributions	—	(2,520,000)	(46,000)	—	(2,566,000)
Purchase of noncontrolling interest in net assets	—	(287,000)	—	—	(287,000)
Other changes in net assets	—	—	255,000	45,000	300,000
Change in net assets	31,156,000	(692,000)	1,061,000	137,000	31,662,000
Net assets at December 31, 2010	309,951,000	2,550,000	3,590,000	1,414,000	317,505,000
Excess of revenue over expenses	8,517,000	2,181,000	—	—	10,698,000
Restricted contributions	—	—	1,176,000	—	1,176,000
Net assets released from restriction	183,000	—	(1,073,000)	—	(890,000)
Other transfers	(34,000)	—	30,000	4,000	—
Distributions	—	(2,038,000)	(42,000)	—	(2,080,000)
Other changes in net assets	—	—	(19,000)	(43,000)	(62,000)
Change in net assets	8,666,000	143,000	72,000	(39,000)	8,842,000
Net assets at December 31, 2011	$ 318,617,000	2,693,000	3,662,000	1,375,000	326,347,000

See accompanying notes to consolidated financial statements.

ST. CHARLES HEALTH SYSTEM, INC.

Consolidated Statements of Cash Flows

Years ended December 31, 2011 and 2010

	2011	2010
Cash flows from operating activities:		
Increase in net assets	$ 8,842,000	31,662,000
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation	31,497,000	29,784,000
Net unrealized loss (gain) on investments	9,391,000	(10,696,000)
Loss (gain) on sale of property and equipment	(26,000)	1,049,000
Accretion of debt obligation	323,000	148,000
Restricted contributions	(1,176,000)	(1,333,000)
Distributions to noncontrolling owners	2,038,000	2,520,000
Changes in certain operating assets and liabilities:		
Patient accounts receivable	(6,497,000)	3,984,000
Other receivables, net	(3,829,000)	594,000
Supplies inventory	(4,258,000)	(660,000)
Other assets	(2,529,000)	(64,000)
Accounts payable	1,236,000	(10,467,000)
Accrued liabilities	(391,000)	3,187,000
Estimated third-party payor settlements payable, net	2,252,000	(407,000)
Deferred revenue	(64,000)	114,000
Other liabilities	1,773,000	5,000
Net cash provided by operating activities	38,582,000	49,420,000
Cash flows from investing activities:		
Purchases of investments	(46,020,000)	(44,379,000)
Proceeds from sale of investments	25,412,000	18,519,000
Distributions from joint ventures	2,136,000	8,985,000
Proceeds from sale of property and equipment	134,000	192,000
Purchases of property and equipment	(13,242,000)	(14,009,000)
Net cash used in investing activities	(31,580,000)	(30,692,000)
Cash flows from financing activities:		
Payments on long-term obligations	(9,965,000)	(9,967,000)
Proceeds from restricted contributions	1,176,000	1,333,000
Purchase of noncontrolling interest	—	(1,804,000)
Distributions to noncontrolling owners	(2,038,000)	(2,520,000)
Net cash used in financing activities	(10,827,000)	(12,958,000)
Net increase (decrease) in cash and cash equivalents	(3,825,000)	5,770,000
Cash and cash equivalents at beginning of year	22,302,000	16,532,000
Cash and cash equivalents at end of year	$ 18,477,000	22,302,000
Supplemental disclosures:		
Cash paid for interest	$ 12,915,000	13,605,000
Change in property and equipment in accounts payable	2,016,000	4,045,000

See accompanying notes to consolidated financial statements.

(1) Business, Organization, and Summary of Significant Accounting Policies

(a) Business and Organization

St. Charles Health System, Inc. (SCHS or the Corporation) is an Oregon nonprofit corporation that operates a healthcare delivery system, which includes three hospitals in central Oregon: St. Charles Medical Center Bend (SCMC – Bend), St. Charles Medical Center Redmond (SCMC – Redmond), and Pioneer Memorial Hospital in Prineville (PMH), as well as several other lines of healthcare-related businesses. SCHS also manages one other hospital located within its primary service area in Madras. These management services include strategic support, management personnel, and information technology support. SCHS provides healthcare and healthcare-related services primarily to residents in Central, Southeastern, and Eastern Oregon. In addition, SCHS is the sole member of Cascadia Insurance Company, Inc. (CICI), a captive insurance company domiciled in Hawaii, established for the purpose of providing malpractice insurance coverage for SCHS. SCHS is also the sole member of St. Charles Management Services Organization LLC (formerly known as Cascade Medical Group, LLC) (SCMSO), a limited liability company established originally to employ or contract with physicians, provide billing services to physicians and medical clinics, and sell certain durable medical equipment. Effective January 1, 2011, all employees of SCMSO were transferred to SCHS. These healthcare businesses and subsidiaries, along with the Corporation's home office, form the obligated group. The assets of any one are available for the satisfaction of debts of the others within the obligated group (subject to certain contractual limitations).

The St. Charles Foundation, Inc. (SCF), an Oregon nonprofit corporation, was established to engage in and conduct charitable, educational, and scientific activities and to raise funds in support of SCHS. The Corporation is the sole member of SCF, and SCF is included in the consolidated statements of SCHS but is not a member of the obligated group.

SCHS also has a controlling interest in Cascade Medical Imaging, LLC (CMI). CMI is a limited liability corporation whose two members are SCHS (70% ownership interest) and Central Oregon Radiology Associates, P.C. (CORA) (30% ownership interest). CMI provides positron emission tomography (PET) scanning, computer-assisted tomography (CT) scanning, nuclear medicine, and picture archiving and communications system (PACS) services in Central, Southeastern, and Eastern Oregon. CMI has been consolidated into the financial statements of SCHS but is not part of the obligated group.

In April 2010, the Corporation legally changed its name from Cascade Healthcare Community, Inc. to St. Charles Health System, Inc.

(b) Principles of Consolidation

The accompanying consolidated financial statements include the accounts and transactions of SCHS, CICI, SCMSO, SCF, and CMI. All material intercompany accounts and transactions have been eliminated in consolidation.

(c) 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 the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue, income, gains, expenses, and losses during the reporting period. Actual results could differ from those estimates. The significant estimates in the Corporation's consolidated financial statements include accounts receivable allowances, third-party payor settlement liabilities, valuation of investments, and liabilities related to self-insurance programs.

(d) Cash and Cash Equivalents

Cash and cash equivalents consist of petty cash and cash in demand bank accounts. Amounts held in demand bank accounts are often in excess of FDIC coverage levels.

(e) Assets Limited as to Use

Assets limited as to use primarily consist of assets internally designated for future capital acquisitions and operating purposes (over which SCHS retains control and may, at its discretion, subsequently use for other purposes), assets held by a trustee under bond indenture agreements and temporarily and permanently restricted funds held by SCF. Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value based on quoted market prices in the accompanying consolidated financial statements. The investment in the Oregon Community Foundation (OCF) represents a beneficial interest in a recipient organization. SCHS established an interest in OCF by contributing funds to their investment portfolio. The value of this interest is then adjusted at a rate proportional to the investment returns obtained by OCF on their investment portfolio. SCHS recognizes their interest in the net assets of OCF and adjusts that interest for its share of the change in the value of the investment portfolio using a method that is similar to the equity method of accounting for investments in common stock. The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values of this investment. Furthermore, while SCHS believes that its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

Investment income or loss (including interest, dividends, realized gains and losses, and unrealized gains and losses) is included in the excess of revenue over expenses unless the income or loss is restricted by donor or law.

Trading securities are debt and equity securities that are bought and held principally for the purpose of selling them in the near term. The Corporation classifies all of it investments in internally designated assets as trading securities, based on the nature of trading activity in its portfolio by the Corporation's investment manager.

As of December 31, 2011 and 2010, the Corporation had investments in equity and fixed-income mutual funds, corporate obligations, U.S. government agency and treasury securities, commercial paper, and an interest in the Oregon Community Foundation. Management believes that the Corporation's credit risk with respect to these investments is minimal due to the diversity of the individual investments and the financial strength of the entities, which have issued the securities or instruments. However, due to changes in economic conditions, interest rates, and common stock prices, the fair value of the Corporation's investments can be volatile. Consequently, the fair value of the Corporation's investments can significantly change in the near term as a result of such volatility.

(f) Patient Accounts Receivable, Allowance for Doubtful Accounts, and Other Receivables

The collection of receivables from third-party payors and patients is SCHS' primary source of cash and is critical to its operating performance. When SCHS provides care to patients, it does not require collateral; however, it maintains an estimated allowance for doubtful accounts. Additionally, SCHS adjusts accounts receivable balances to estimated collectible balances based on the terms of contracts in place with third-party payors. The primary collection risks relate to uninsured patient accounts and patient accounts for which the primary insurance payor has paid, but patient responsibility amounts (generally deductibles and copayments) remain outstanding. The allowance for doubtful accounts is estimated based primarily upon SCHS' historical collection experience, the age of the patient's account, management's estimate of the patient's economic ability to pay, and the effectiveness of collection efforts. Patient accounts receivable balances are routinely reviewed in conjunction with historical collection rates and other economic conditions that might ultimately affect the collectibility of patient accounts when considering the adequacy of the amounts recorded in the allowance for doubtful accounts. Actual write-offs have historically been within management's expectations. Significant changes in payor mix, business office operations, economic conditions, or trends in federal and state governmental healthcare coverage could affect SCHS' collection of patient accounts receivable, cash flows, and results of operations.

SCHS' patient responsibility write-offs increased to $23,451,000 in fiscal 2011 from $19,523,000 in fiscal 2010. As a result of the increase in write-offs and estimated uncollectible amounts, total bad debt expense, which is a reduction in deriving net patient service revenue, for the years ended December 31, 2011 and 2010 was $26,522,000 and $18,660,000, respectively. The Company also maintains an allowance for doubtful accounts for third-party payors, which has been determined based on historical bad debt expense on those account types.

Significant concentrations of patient accounts receivable as of December 31, 2011 and 2010 were approximately as follows:

	2011	2010
Medicare and Medicare managed care contracts	28%	26%
Medicaid and Oregon Health Plan (OHP)	14	14
Commercial and managed care insurance	33	36
Self-pay	25	24
	100%	100%

(g) Supplies Inventory

Supplies inventory is recorded at the lower of cost (first-in, first-out method) or market.

The consolidated financial statements for the year ended December 31, 2011 include a correction in SCHS' accounting for certain components of their inventory. Previously, certain supplies were expensed when purchased. Management has determined that these supplies should be reflected more appropriately as an asset prior to their consumption in the provision of healthcare services. To adjust for the change at December 31, 2011, supplies inventory was increased by $3,429,000, resulting in a reduction to the related medical supplies expense balance in the consolidated statement of operations for the year ended December 31, 2011 in the same amount.

(h) Property and Equipment

Property and equipment acquisitions are recorded at cost. Donated property and equipment items are recorded on the basis of estimated fair value at the date of donation. Improvements and replacements of property and equipment are capitalized. Maintenance and repairs are charged to expense as incurred.

Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Assets under capital lease obligations are amortized using the straight-line method over the shorter period of the lease term or the estimated useful life of the asset. Such amortization is included in depreciation expense in the accompanying consolidated financial statements. Net interest costs incurred on borrowed funds during the period of construction of capital assets are capitalized as a component of the cost of acquiring those assets. Estimated useful lives are as follows:

Land improvements	5 – 25 years
Buildings and fixed equipment	5 – 40 years
Furniture and moveable equipment	3 – 20 years

Management reviews property and equipment for possible impairment whenever events or circumstances indicate the carrying amount of such assets may not be recoverable. If there is an indication of impairment, management would prepare an estimate of future cash flows (undiscounted and without interest charges) expected to result from the use of the asset and its eventual disposition. If these cash flows were less than the carrying amount of the asset, an impairment loss would be recognized to write down the asset to its estimated fair value.

Contributions of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, the Corporation reports expirations of donor restrictions as support when the donated or acquired long-lived assets are placed in service.

(i) Contributions and Grants

Unrestricted donations and grants are recorded as other operating revenue. Donor-restricted contributions and grants are recorded as additions to the appropriate class of net assets. When capital expenditures are made consistent with the purpose intended by the donor, a transfer is made from temporarily restricted net assets to unrestricted net assets. If restricted amounts are expended for

(Continued)

operations, the amounts are recorded as other revenues in the accompanying consolidated statements of operations.

(j) Other Assets

Other assets include SCHS' investments in various related entities, which are not consolidated. SCHS consolidates such investees if it owns a majority of the investee's stock, is the sole member of the investee, or controls a majority voting interest in the investee's Board of Directors and has an economic interest in such investee. If SCHS owns 50% or less of the voting stock of an investee and can exercise significant influence over the investee's operating and financial policies (generally presumed to be when SCHS owns more than 20% of the voting stock of the investee), SCHS accounts for such investments under the equity method of accounting, whereby SCHS records its proportionate share of the investee's income or loss in the consolidated statements of operations and records distributions received from the investee as a reduction in the related investment balance. If SCHS cannot exercise significant influence over the investee's operating and financial policies (generally presumed to be when SCHS owns less than 20% of the voting stock of the investee), SCHS accounts for such investments at cost and records dividends or distributions from the investee as other income when received.

SCF's assets, liabilities, and results are consolidated with SCHS. The net assets of SCF are reported as unrestricted, temporarily restricted or permanently restricted, according to donor or legal restrictions, in the accompanying consolidated financial statements.

(k) Unamortized Bond Discount

Unamortized bond discount, a component of long-term obligations, is amortized over the term of the related bonds using the effective-interest method.

(l) Net Patient Service Revenue

SCHS has agreements with third-party payors that provide for payments at amounts different from established rates. Payment arrangements include prospectively determined rates per discharge, outpatient case rates, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts due and determined to be collectible from patients, third-party payors, and others for services rendered and includes estimates for potential retroactive revenue adjustments under reimbursement agreements with third-party payors. Such estimates are adjusted in future periods as final settlements are determined.

Effective January 1, 2011 SCHS adopted Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-07, *Health Care Entities* (Topic 954): *Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*. The adoption of this ASU resulted in a reclassification of bad debt expense from an operating expense to be a reduction in deriving net patient service revenue. The basis SCHS uses to assess and evaluate the collectibility of patient accounts is described in note 1(f). Bad debt expense, a reduction of net patient service revenue, for the years ended December 31, 2011 and 2010 was $26,522,000 and $18,660,000, respectively.

(Continued)

A significant portion of SCHS' services are provided to Medicare, Medicaid, and Oregon Health Plan (OHP) patients under contractual arrangements. Inpatient acute care services rendered by SCHS to Medicare, Medicaid, and OHP program beneficiaries are generally reimbursed at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors (i.e., Medicare severity-diagnosis related groups or MS-DRGs). Such payments include a capital cost component and may be greater or less than the actual charges for services. Most outpatient services related to Medicare beneficiaries are reimbursed prospectively under the ambulatory payment classifications methodology. Home health services related to Medicare beneficiaries are reimbursed under a prospective payment system methodology. OHP outpatient services are reimbursed based on a percentage of charges. SCHS is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after audits of SCHS' annual cost reports by the Medicare fiscal intermediary and Medicaid. SCMC – Bend's and SCMC – Redmond's cost reports have been audited and final settled by the Medicare fiscal intermediary and Medicaid through December 31, 2006 and December 31, 2008, respectively.

PMH is a "critical access hospital" (CAH) for Medicare and Medicaid program purposes. As a CAH, PMH cannot operate more than 25 beds, and PMH's average length of stay for acute care patients cannot exceed 96 hours. As a CAH, PMH is reimbursed for Medicare and Medicaid inpatient and outpatient services under a cost-reimbursement methodology. Since SCHS has only assumed the operations of PMH effective January 1, 2008, it is not responsible for amounts receivable or payable related to PMH's cost reports prior to 2008.

The laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that estimated third-party payor settlements payable, net, will change by a material amount in the near term. Net patient service revenue was increased by approximately $1,128,000 and $99,000 for the years ended December 31, 2011 and 2010, respectively, as a result of final settlements of prior years cost reports and revisions of estimates for prior years cost report settlements.

SCHS has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations to provide medical services to subscribing participants. The basis for payment to SCHS under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined fee schedules.

(m) Charity Care

SCHS provides services without charge, or at amounts less than its established rates, to patients who meet the criteria of its charity care policy. SCHS' criteria for the determination of charity care include the patient's – or other responsible party's – annual household income, assets, credit history, existing medical debt obligations, and other indicators of the patient's ability to pay. Generally, those individuals with an annual household income at or less than 200% of the Federal Poverty Guidelines (the Guidelines) qualify for charity care under SCHS' policy. In addition, SCHS provides discounts on a sliding scale to those individuals with an annual household income of between 200% and 400% of the Guidelines. Since SCHS does not pursue collection of amounts determined to qualify as charity care, those amounts are not reported as net patient service revenue. The cost of the services and supplies furnished under the charity care policy for the years ended December 31, 2011 and 2010 was approximately $11,236,000 and $13,837,000, respectively. The Company uses a ratio of cost to charges based on the direct and indirect costs and gross charges of SCHS to determine the cost of providing the services and supplies. The cost to charge ratio is developed by facility using SCHS' cost accounting system in conjunction with other analysis tools. The weighted average cost to charge ratio used in this determination was 39.7% and 35.0% for the years ended December 31, 2011 and 2010, respectively. The amount of subsidies received by SCHS for providing charity care for the years ended December 31, 2011 and 2010 was approximately $1,096,000 and $1,366,000, respectively.

(n) Consolidated Statements of Operations

For purposes of presentation, transactions deemed by management to be ongoing, major, or central to the provision of healthcare services are reported as operating revenue and expenses. SCHS' income from investments in healthcare-related joint ventures recorded on the equity method of accounting is reported as other operating revenue. Peripheral or incidental transactions are reported as other income (losses).

The performance indicator for the accompanying consolidated statements of operations is excess of revenue over expenses. Changes in unrestricted net assets, which are excluded from the excess of revenue over expenses, consistent with industry practice, include the change in net assets released from restrictions used for purchases of property and equipment, contributions for property and equipment, distributions to and purchases of noncontrolling interest, and net asset transfers.

(o) State of Oregon Provider Tax

Effective July 1, 2004, the State of Oregon instituted a provider tax on certain qualifying hospitals. SCHS recorded provider taxes of approximately $11,922,000 and $8,038,000 for the years ended December 31, 2011 and 2010, respectively, which are included in medical supplies, drugs, and other expense in the accompanying consolidated statements of operations. The increase in the 2011 tax is attributed primarily to a rate increase instituted by the State of Oregon. In addition, SCHS has entered into an agreement with the Oregon Association of Hospitals and Health Systems (OAHHS), which provides that all payments owed to SCHS related to beneficiaries of the Oregon Medical Assistance Program are to be remitted directly to OAHHS. OAHHS aggregates these payments, returning a portion to SCHS. The remaining funds are pooled by OAHHS with like amounts received on behalf of other hospitals subject to the provider tax, and OAHHS redistributes such funds to qualifying hospitals on a quarterly basis. SCHS estimates the amount of receipts via the quarterly redistribution process from OAHHS for the years ended December 31, 2011 and 2010 will match the annual amounts of taxes paid, which is reflected as a component of net patient service revenue in the accompanying consolidated statements of operations.

(p) Income Taxes

The Corporation has received a determination letter from the Internal Revenue Service stating that it is exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code except for tax on unrelated business income. It is management's belief that none of its activities have produced material unrelated business income, and that SCHS has operated in a manner that qualifies it for tax-exempt status.

Accounting principles generally accepted in the United States of America require SCHS' management to evaluate tax positions taken by the Corporation and recognize a tax liability (or asset) if the Corporation has taken an uncertain position that more likely than not would not be sustained upon examination by the IRS. Management has analyzed tax positions taken by the Corporation and has concluded that as of December 31, 2011, there are no uncertain positions taken or expected to be taken that would require recognition of a liability (or asset) or disclosure in the financial statements. The Corporation is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress. The Corporation's management believes it is no longer subject to income tax examinations for years prior to 2008.

(q) Recently Adopted Accounting Standards

SCHS adopted FASB issued ASU No. 2010-23, *Health Care Entities* (Topic 954): *Measuring Charity Care for Disclosure*, effective December 31, 2011. This ASU is intended to reduce the diversity in practice regarding the measurement basis used in the disclosure of charity care. This ASU requires that cost, including direct and indirect costs, be used as the measurement basis for charity care disclosure purposes and that the method used to identify or determine such costs be disclosed.

(r) Reclassifications

Certain reclassifications have been made to prior year amounts to conform to the current year presentation.

(2) Assets Limited as to Use

The composition of assets limited as to use as of December 31, 2011 and 2010 is set forth in the following table. Investments are carried at fair value.

	2011	2010
Internally designated for capital acquisitions:		
Cash and cash equivalents	$ 12,000	9,000
Equity mutual funds	116,663,000	112,091,000
Fixed-income mutual funds	65,918,000	58,841,000
International bonds	7,000	—
Corporate obligations	163,000	188,000
U.S. government agency and treasury securities	181,000	190,000
Accrued interest receivable	4,000	5,000
Total internally designated for capital acquisitions	182,948,000	171,324,000
Internally designated for operating purposes:		
Cash and cash equivalents	504,000	518,000
Equity mutual funds	426,000	410,000
Fixed-income mutual funds	434,000	425,000
Commercial paper	—	250,000
Corporate obligations	267,000	200,000
U.S. government agency and treasury securities	3,840,000	4,056,000
Cash surrender value of life insurance	229,000	202,000
Total internally designated for operating purposes	5,700,000	6,061,000
Total internally designated	188,648,000	177,385,000
Held by trustee:		
Cash and cash equivalents	8,033,000	8,011,000
Corporate obligations	10,329,000	10,170,000
Total held by trustee	18,362,000	18,181,000

		2011	2010
Board designated endowment:			
Investment in Oregon Community Foundation	$	1,377,000	1,403,000
Donor restricted – temporarily:			
Investment in Oregon Community Foundation		—	127,000
Cash and cash equivalents		698,000	723,000
Equity mutual funds		1,053,000	1,055,000
Fixed-income mutual funds		20,000	29,000
Donor restricted – permanently:			
Investment in Oregon Community Foundation		683,000	700,000
Cash and cash equivalents		11,000	14,000
Equity mutual funds		341,000	363,000
Fixed-income mutual funds		341,000	337,000
Total assets limited as to use		211,534,000	200,317,000
Less portion reported as current		(8,033,000)	(8,011,000)
Total assets limited as to use, net of current portion	$	203,501,000	192,306,000

Investment income, net, consisted of the following for the years ended December 31, 2011 and 2010:

		2011	2010
Interest and dividend income	$	5,278,000	4,175,000
Realized gains on sales of securities, net		6,155,000	4,049,000
Unrealized gains (losses) on trading securities, net		(9,391,000)	10,696,000
Investment income, net	$	2,042,000	18,920,000

SCHS maintains investments with The Oregon Community Foundation (OCF). The investments are used solely to support the endowments of SCHS, and are recorded as a beneficial interest by SCHS, in accordance with the provisions of FASB ASC 958¬20, regarding financially interrelated not-for-profit entities. The investments, which represent an endowment fund that is legally owned by the Oregon Community Foundation, primarily include equity securities and fixed income investments. SCHS' investment in the Oregon Community Foundation is recorded based on their initial contribution to the Oregon Community Foundation, adjusted for subsequent changes. All earnings of the investments held by the Oregon Community Foundation, less investment management fees charged by the Oregon Community Foundation, are allocated by OCF, and are recorded by SCHS as investment earnings in the consolidated statements of operations, within the appropriate category of net assets based on related donor restrictions. Earnings consist of interest, dividends, realized gains and losses, and changes in unrealized gains and losses. Funds held by OCF may be distributed once per quarter, subject to approval by the OCF board of directors.

(3) Property and Equipment

Property and equipment consisted of the following at December 31, 2011 and 2010:

	2011	2010
Land and improvements	$ 15,902,000	15,617,000
Buildings and fixed equipment	240,163,000	237,746,000
Furniture and movable equipment	197,292,000	185,108,000
	453,357,000	438,471,000
Less accumulated depreciation	(235,960,000)	(209,087,000)
	217,397,000	229,384,000
Construction in progress	5,660,000	9,091,000
Property and equipment, net	$ 223,057,000	238,475,000

Construction in progress includes costs incurred in connection with various construction projects and costs incurred related to the acquisition and implementation of various software applications. As of December 31, 2011, management estimates that the remaining cost to complete the construction projects is approximately $3,264,000, and the remaining cost to complete the software acquisitions and implementations is approximately $4,090,000.

(4) Restricted Net Assets

Restricted net assets are held by SCF and are those whose use has been limited by donor-imposed restrictions to a specific time period and/or purpose. SCF also holds funds that are not donor restricted for a specific purpose and are distributed to SCHS in amounts and in periods determined by SCF’s Board of Directors. SCF’s temporarily restricted net assets are distributed to SCHS or other recipients for the purposes specified by the donors. SCF’s permanently restricted net assets consist of the principal amount of contributions accepted by SCF with the stipulation from donors that the principal be maintained in perpetuity and only the income from investments thereof be expended to support SCF’s general activities or restricted purposes, as stipulated by the respective donors.

During 2011 and 2010, net assets were released from donor restrictions by SCHS incurring operating expenses satisfying the restricted purpose of approximately $890,000 and $691,000, respectively, and are included in other revenues. Further, approximately $183,000 and $278,000 were released from restriction to SCHS for capital expenditures made during 2011 and 2010, respectively.

(Continued)

Temporarily and permanently restricted net assets are available for the following purposes at December 31, 2011 and 2010:

		2011	2010
Temporarily restricted:			
Education and research	$	1,081,000	1,135,000
Indigent care		79,000	230,000
Patient care operating activities		1,804,000	1,502,000
Purchase of property and equipment		698,000	723,000
Net assets, temporarily restricted	$	3,662,000	3,590,000
Permanently restricted:			
Education and research	$	438,000	446,000
Indigent care		937,000	968,000
Net assets, permanently restricted	$	1,375,000	1,414,000

SCF follows the guidance in the Uniform Prudent Management of Institutional Funds Act (UPMIFA) in determining the net asset classification of all donor-restricted endowment funds. In accordance with board policy, assets classified as permanent endowments in accordance with donor intent are only utilized for current period expenditures to the extent that earnings on the endowment exceed the original fair value of the donation. To the extent earnings on endowment funds exceed identified expenditures on which to apply those earnings, the earnings are classified as temporarily restricted net assets. As of December 31, 2011 and 2010, unspent earnings on endowment funds totaling $123,000 and $317,000, respectively, were included in temporarily restricted net assets.

SCF has adopted investment and spending policies for endowment assets to provide a predictable stream of funding to programs supported by its endowment and to maintain the value of the endowment assets. Asset allocation is reviewed quarterly with respect to: i) SCF's tolerance for risk based on its financial condition and need for cash from investments to support operations; ii) expected asset class return, risk, and correlation characteristics; and iii) changes in accounting guidance, tax law, or other restrictions.

SCF's spending practices are intended to comply with donor's wishes and meet all applicable laws and regulations. Spending must be for a purpose that is consistent with the documented intent of the donor, and may not exceed the amounts annually determined by the SCF's Board of Directors. Factors that are considered in addressing the annual spending allocation are: i) market value of the fund relative to the principal of the gift and ii) the level of spending in prior years.

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or UPMIFA requires SCF to retain as a fund of perpetual duration. Deficiencies of this nature are reported as a reduction to unrestricted net assets and are excluded from the performance indicator.

(5) Debt Agreements

Long-term obligations consisted of the following at December 31, 2011 and 2010:

	2011	2010
Hospital Facility Authority of Deschutes County Oregon (the Authority) Hospital Revenue Refunding Bonds Series 2008 (the 2008 Bonds)	$ 103,460,000	103,460,000
The Authority Hospital Revenue Bonds Series 2005B (the 2005B Bonds)	47,525,000	48,450,000
The Authority Hospital Revenue Bonds Series 2002 (the 2002 Bonds)	1,720,000	3,360,000
GE Healthcare Finance Notes Payable	1,010,000	1,961,000
Wells Fargo Bank and Wells Equipment Finance Notes Payable	1,116,000	1,339,000
GE Healthcare Financial Notes Payable	1,051,000	2,452,000
U.S. Bancorp Technology Leasing Master Lease	7,660,000	10,278,000
Bend Ortho Building Associates Lease	8,567,000	8,346,000
Banc of America Leasing Healthcare Finance	3,450,000	4,929,000
Other	733,000	532,000
Less unamortized discount on bonds, net	(1,654,000)	(1,756,000)
Total long-term obligations	174,638,000	183,351,000
Less current portion	(9,298,000)	(9,415,000)
Long-term obligations, net of current portion	$ 165,340,000	173,936,000

In December 2008, the Authority issued the 2008 Bonds in the amount of $103,460,000. The proceeds of the 2008 Bonds were primarily used to advance refund the 2005A Bonds, make the termination payment related to a swap agreement, and establish a debt service reserve fund. The 2008 Bonds bear interest at rates ranging from 5.500% to 8.250% payable semiannually each January 1 and July 1 and require annual principal payments each January 1 (including mandatory redemptions) ranging from $1,420,000 in 2013 to $12,000,000 in 2038. The 2008 Bonds maturing on and after January 1, 2020 are subject to optional redemption prior to maturity, at the option of the Authority (such option shall be exercised at the request of the Corporation), at par, plus accrued interest.

In December 2005, SCHS entered into agreements with the Authority, whereby the Authority issued the 2005B Bonds in the amount of $51,800,000 (the 2005 Bonds). The proceeds from the 2005B Bonds were primarily used to finance certain capital additions and improvements at SCMC – Bend and SCMC – Redmond. The 2005B Bonds bear interest at rates ranging from 4.000% to 5.375% payable semiannually each January 1 and July 1 and require annual principal payments each January 1 (including mandatory redemptions) ranging from $925,000 in 2012 to $7,150,000 in 2035.

In April 2002, SCHS entered into an agreement with the Authority, whereby the Authority issued the 2002 Bonds in the amount of $75,000,000. The proceeds from the 2002 Bonds were primarily used to finance certain capital additions and improvements at SCMC – Bend and SCMC – Redmond. The 2002 Bonds bear interest at rates ranging from 4.70% to 5.00% payable semiannually each January 1 and July 1 with the final annual principal payment of $1,720,000 due January 1, 2012.

Under the terms of the agreements (the Agreements) between SCHS and the Authority related to the 2005B Bonds and the 2002 Bonds (collectively, the 2005B and 2002 Bonds), SCHS has (1) collateralized the 2005B and 2002 Bonds with SCHS' gross receivables (as defined in the Agreements) and (2) obtained bond insurance which unconditionally guarantees payment of principal and interest on the 2005B and 2002 Bonds. Under the terms of the agreement (the 2008 Agreement) between SCHS and the Authority related to the 2008 Bonds, SCHS has (1) collateralized the 2008 Bonds with SCHS' gross receivables (as defined in the 2008 Agreement) and (2) agreed to grant a leasehold deed of trust on the SCMC – Bend main hospital building and related improvements to the trustee for the 2008 Bonds (the Trustee), as well as entered into a 50-year ground lease related to the underlying land for this property with the Trustee. Additionally, SCHS has agreed to not create or allow any other mortgage, pledge, or security in SCHS' facilities, except as permitted in the Agreements; maintain certain reserve funds with a trustee; and meet certain financial ratios on an annual basis.

The note payable to GE Healthcare Finance (the note Payable), which was used to finance the purchase of a new helicopter and the remodel of a hangar, bears interest at a fixed rate of 5.97% and is collateralized by a security interest in the helicopter. The note Payable requires monthly payments of principal and interest of approximately $87,000 through December 2012.

In July 2007, SCHS entered into a lease agreement with U.S. Bancorp Technology Leasing (the U.S. Bancorp Master Lease Agreement) to partially finance the acquisition and implementation of a new information system. As of December 31, 2011, $7,660,000 was outstanding related to eight leases under the U.S. Bancorp Master Lease Agreement. As of December 31, 2011, monthly lease payments for these leases totaling $272,000 (including interest at 4.80% to 7.70%) are required through October 2012; total monthly payments decline thereafter as individual leases mature through December 2015.

The Bend Ortho Building Associates lease represents a lease of an approximately 30,000-square-foot building that expires on December 31, 2014, with two 5-year renewal options. Under this agreement, SCHS has the option to purchase the building on December 31, 2014 – or at the end of either of the subsequent renewal periods – at a price determined based on a formula that includes the net operating income of the building and a capitalization rate, all as defined in this agreement. In addition, the lessor has the right at any time during the lease term (including renewals) to require SCHS to purchase the building at a price using this same formula. Under the terms of the lease, SCHS is required to make monthly payments of approximately $65,000. Additionally, SCHS incurs annual interest expense, representing the accretion of the obligation, in order to have the purchase obligation under the lease properly recorded.

In September 2003, SCHS entered into a sublease agreement with the Authority, whereby the Authority financed the construction of a central utility plant and related energy management systems (the Plant) for SCMC – Bend with a lease agreement with Banc of America Healthcare Finance (B of A) (collectively, the B of A Master Lease and Sublease Agreement). Under the terms of the B of A Master Lease and Sublease Agreement, SCHS is required to make monthly payments of $140,000 through March 2014, including interest at 4.65%. Upon receipt of the final scheduled lease payment, B of A shall terminate and release its security interest in the Plant to SCHS. SCHS has the option to purchase the Plant at any time during the term of the B of A Master Lease and Sublease Agreement by paying the remaining lease payments, plus a 1.00% prepayment penalty multiplied by the number of years remaining in the term of the lease.

Notes payable to Wells Fargo Bank, Wells Equipment Finance, and GE Healthcare Financial represent various equipment financing arrangements at CMI. The notes bear interest ranging from 4.02% to 6.82%, mature at various times from 2012 to 2016, and are secured by equipment.

Scheduled principal repayments on long-term debt and payments on capital lease obligations are as follows:

	Long-term debt	Capital lease obligations
2012	$ 4,959,000	5,672,000
2013	2,859,000	5,347,000
2014	2,760,000	3,475,000
2015	2,810,000	9,579,000
2016	2,850,000	43,000
Thereafter	140,072,000	—
	$ 156,310,000	24,116,000
Less amount representing interest under capital lease obligations		(4,134,000)
		$ 19,982,000

The above described debt instruments carry various financial covenants that the Corporation is required to measure on an annual basis.

As of December 31, 2011, SCHS had a $3,000,000 unsecured line-of-credit agreement with US Bank. There were no amounts outstanding under this line-of-credit agreement at December 31, 2011 or 2010. Borrowings outstanding under this line-of-credit agreement bear interest at the greater of the US Bank's prime rate plus 0.50% or 3.75%. The line of credit expires November 30, 2012.

Interest cost incurred during the years ended December 31, 2011 and 2010 was $13,216,000 and $13,759,000, respectively. No interest expense or interest income was capitalized during the years ended December 31, 2011 and 2010.

(6) Commitments and Contingencies

(a) Operating Leases

SCHS leases office space and equipment under operating lease agreements, which expire at various dates through 2026. Certain of these lease agreements contain renewal options. A portion of the leased office space has been subleased to unrelated third parties. In addition, effective January 1, 2008, SCHS leased the land, buildings, and equipment of PMH (the PMH Lease) and the lessor is Pioneer Memorial Hospital. As of December 31, 2011, future minimum rental commitments for the five years subsequent to and thereafter, under noncancelable operating lease agreements, that have initial or remaining lease terms in excess of a year were as follows:

2012	$	7,294,000
2013		6,898,000
2014		4,322,000
2015		3,482,000
2016		2,073,000
Thereafter		7,341,000
Total minimum lease payments		31,410,000
Less total minimum sublease rentals		(651,000)
	$	30,759,000

Included in the commitments above are lease payments required under the PMH Lease. Such payments vary by year based on PMH's future required debt and lease payments that were in effect as of January 1, 2008. Such future minimum lease payments total approximately $10,660,000 and decrease from approximately $852,000 in 2012 to approximately $202,000 in 2026 (at which time, all currently outstanding PMH debt and lease payments will have been paid). In addition, the PMH Lease requires SCHS to annually invest a minimum of $200,000 toward capital purchases and renovations at PMH through the term of the lease (2031), plus certain additional amounts based on PMH's operating results.

Certain of the leases above are with related entities. As of December 31, 2011, the total future minimum rental commitments expected to be paid on these related entity leases aggregate approximately $5,300,000.

Rent expense totaled $8,767,000 and $8,648,000 for the years ended December 31, 2011 and 2010, respectively, and is included in medical supplies, drugs, and other in the accompanying consolidated statements of operations.

(b) Medical Malpractice Insurance

SCHS is self-insured for malpractice and other general liability coverage through Cascadia Insurance Company, Inc. (CICI), a captive insurance company wholly owned by SCHS. CICI provides coverage of SCHS' claims up to a $500,000 per occurrence limit and a $3,000,000 annual aggregate limit, and SCHS purchases excess insurance for claims exceeding such limits. CICI's coverage for SCHS is retroactive to occurrences since July 1, 2004 reported after July 1, 2005. Under SCHS' policy with CICI, medical malpractice claims reported by SCHS to CICI during the policy period are covered; however, any medical malpractice claim that has been incurred but not reported (IBNR) to CICI during the policy period is not covered.

Based on an actuarial valuation, the Corporation, including CICI, has recorded estimated liabilities for IBNR medical malpractice claims, which, along with deductibles on reported claims, aggregated $4,342,000 and $2,847,000 as of December 31, 2011 and 2010, respectively, and are included in other noncurrent liabilities in the accompanying consolidated balance sheets. Management believes that these estimated liabilities are adequate; however, the establishment of estimates for IBNR medical malpractice claims is an inherently uncertain process, and there can be no assurance that currently established liabilities will prove adequate to cover actual ultimate expenses. Subsequent actual experience could result in liabilities being too high or too low, which could positively or negatively impact the Corporation’s reported consolidated operations in future periods.

SCHS adopted FASB issued ASU No. 2010-24, *Health Care Entities* (Topic 954): *Presentation of Insurance Claims and Related Insurance Recoveries*. ASU No. 2010-24 requires claim liabilities to be reported without consideration of insurance recoveries and receivables for insurance recoveries to be reported separately subject to a valuation allowance as appropriate. As a result of the adoption of ASU No. 2010-24, SCHS recorded an asset for insurance recoveries receivable and the estimated liabilities are not net of any estimated recoveries. Although ASU No. 2010-24 is required to be adopted retrospectively, there was no cumulative effect of adoption of this ASU on SCHS net assets as of January 1, 2010.

(c) Self-Insurance

SCHS is self-insured for medical, dental, and vision benefits provided to its employees for claims up to $300,000 per employee. SCHS is also self-insured for state unemployment claims. SCHS recognizes self-insurance costs based on claims filed with its third-party administrators and estimates for IBNR claims. Management believes that adequate amounts have been accrued in the accompanying consolidated financial statements to cover any related potential losses.

(d) Risk Management

In the ordinary course of business, the Corporation is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; and natural disasters. However, management believes that adequate commercial insurance coverage has been purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage for the years ended December 31, 2011 and 2010.

(e) Guaranties

As of December 31, 2011, SCHS is a guarantor of the following loans of certain related entities:

Entity		Loan balances outstanding at December 31, 2011 (unaudited)	SCHS’ guaranties	Loan expiration dates
Cascade Medical Buildings, LLC	$	22,991,000	11,496,000	April 2021
Heart Center of the Cascades, LLC		9,322,000	4,661,000	December 2015

In the opinion of management, the likelihood that SCHS will be required to make any payments under the guaranties is remote, and the estimated fair value of such guaranties is not significant to the accompanying consolidated financial statements; accordingly, no liability related to these guaranties has been recorded in the accompanying consolidated balance sheets.

(f) Regulations and Litigation

The healthcare industry is subject to various laws and regulations from federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Government activity has remained high with respect to investigations and allegations concerning possible violations by healthcare providers of regulations, which could result in the expulsion from government healthcare programs, together with the imposition of significant fines and penalties, as well as significant repayments of patient services previously billed and collected. Management believes that the Corporation is in compliance with the fraud and abuse regulations, as well as other applicable government laws and regulations; however, 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.

In addition, the Corporation becomes involved in litigation and other regulatory investigations arising in the ordinary course of business. After consultation with legal counsel, management believes that these matters will be resolved without causing a material adverse effect on the Corporation's future consolidated financial position or results of operations.

(g) Collective Bargaining Agreements

Approximately 23% of SCHS employees, including nurses and certain professional employees, were covered under collective bargaining agreements at December 31, 2011 that expire in 2012. An additional 6% are covered under contracts expiring beyond 2012.

In February 2011, selected SCHS employees voted in favor to become part of a new collective bargaining unit covering service workers representing approximately 19% of SCHS employees. A collective bargaining agreement has not yet been reached with this new unit.

(h) Healthcare Reform

As a result of enacted and pending federal healthcare reform legislation, substantial changes are anticipated in the U.S. healthcare system. Such legislation includes numerous provisions affecting the delivery of healthcare services, the financing of healthcare costs, reimbursement of healthcare providers, and the legal obligations of health insurers, providers, and employers. These provisions are currently slated to take effect at specified times over approximately the next decade. This federal healthcare reform legislation does not affect the 2010 or 2011 consolidated financial statements.

(7) Retirement Plan

Substantially all employees of SCHS are eligible to participate in SCHS' defined contribution retirement plan (the Plan). Under the Plan, SCHS matches each participant's contributions up to 6% of his or her salary. Employees are eligible to receive SCHS' matching contributions once they achieve at least 21 years of age, work 1,000 hours or more during the year, and have been continuously employed by SCHS for one year or more. SCHS' expense relating to the Plan during the years ended December 31, 2011 and 2010 was $7,028,000 and $6,621,000, respectively, and is included in employee benefits in the accompanying consolidated statements of operations.

(8) Other Related-Party Transactions

The following is a summary of SCHS' primary unconsolidated related-party investments at December 31, 2011 and 2010:

Entity	Basis of accounting	Ownership as of December 31, 2011	Investment balance included in the accompanying consolidated balance sheets December 31 2011	Investment balance December 31 2010	SCHS' share of income (loss) included in the accompanying consolidated statements of operations 2011	SCHS' share of income (loss) 2010
CMB	Equity method	50%	$ 762,000	724,000	175,000	155,000
CPH	Equity method	50	249,000	334,000	(85,000)	(92,000)
HCC	Equity method	50	(1,412,000)	(1,032,000)	(370,000)	(502,000)
CS	Equity method	50	473,000	324,000	854,000	703,000
COMRI	Equity method	33	501,000	398,000	1,384,000	904,000
SOLS	Equity method	28	540,000	530,000	13,000	59,000
CONet	Fair value investment	N/A	—	—	—	424,000
IOC	Cost method	50	20,000	20,000	—	—
HF	Cost method	14	54,000	54,000	—	—

In addition to CICI, SCMSO, and CMI, SCHS has investments in the following related entities:

(a) Cascade Medical Buildings, LLC (CMB)

CMB is a limited liability company whose two members are SCHS (50% ownership interest) and Deschutes Medical Buildings, LLC (50% ownership interest). CMB was formed to build, own, and manage a medical office building on land leased from SCHS. SCHS rents approximately 7,900 square feet in this building. During the years ended December 31, 2011 and 2010, SCHS received member distributions of $137,000 and $129,000, respectively, from CMB. During each of the years ended December 31, 2011 and 2010, SCHS earned rental income from CMB of approximately $155,000 under the land lease. During the years ended December 31, 2011 and 2010, SCHS incurred rent expense for facilities owned by CMB of $216,000 and $236,000, respectively.

(b) Cascade Property Holdings, LLC (CPH)

CPH is a limited liability company, formed in January 2007, whose two members are SCHS (50% ownership interest) and Deschutes Property Holdings, LLC (50% ownership interest). CPH owns bare land held for investment purposes in Bend, Oregon.

(c) Heart Center of the Cascades, LLC (HCC)

HCC is a limited liability company whose two members are SCHS (50% ownership interest) and CCC Real Properties, LLC (50% ownership interest). HCC was formed to build, own, and manage a medical building on land leased from SCHS. During the years ended December 31, 2011 and 2010, SCHS received member distributions of $10,000 and $10,000 from HCC. During the years ended December 31, 2011 and 2010, SCHS earned income from HCC of $306,000 and $306,000, respectively, under the land lease and from the provision of certain facility services. During the years ended December 31, 2011 and 2010, SCHS incurred rent expense related to a lease with HCC of $791,000 and $781,000, respectively.

HCC entered into an interest rate swap agreement in 2007 with KeyBank; the swap agreement was transferred to US Bank in November 2010. The swap agreement is considered a cash flow hedge and has been deemed ineffective by management. As a result, the changes in fair value in the interest rate swap are included in excess of revenues over expenses. As of December 31, 2011 and 2010, HCC had a liability of $1,911,000 and $1,579,000, respectively, related to this swap agreement. SCHS recorded its share of the changes in the fair value of the swap agreement as a component of other, net in the accompanying consolidated statements of operations.

(d) Cascade Surgicenter, LLC (CS)

CS is a limited liability company whose two members are SCHS (50% ownership interest) and Deschutes Surgicenter, LLC (50% ownership interest). CS was formed to own, operate, and manage an outpatient surgery center located in facilities owned by CMB. SCHS received member distributions of $705,000 and $650,000, respectively, from CS during the years ended December 31, 2011 and 2010. During the years ended December 31, 2011 and 2010, CS incurred rent expense for facilities owned by CMB of $776,000 and $761,000, respectively.

(e) Central Oregon Magnetic Resonance Imaging, LLC (COMRI)

COMRI is a limited liability company, which includes SCHS, CORA, and certain physicians. SCHS owns a one-third interest in COMRI. COMRI owns and operates three magnetic resonance imaging machines located in Bend and Redmond, Oregon. During the years ended December 31, 2011 and 2010, SCHS received member distributions of $1,281,000 and $825,000, respectively, from COMRI. During the years ended December 31, 2011 and 2010, SCHS charged COMRI $535,000 and $482,000, respectively, for certain staffing services, rent, and supplies. In addition, during the years ended December 31, 2011 and 2010, SCHS incurred professional fees expense of $2,442,000 and $1,703,000, respectively, for services rendered by COMRI. Included in accounts payable in the accompanying consolidated balance sheets are amounts due to COMRI for these services of $209,000 and $134,000, as of December 31, 2011 and 2010, respectively.

(f) Southern Oregon Linen Service (SOLS)

SOLS is an Oregon cooperative corporation that provides laundry, linen, and uniform services to members of the cooperative. SCHS owns 28% of the outstanding common stock of SOLS, and both SCMC – Bend and SCMC – Redmond utilize the laundry and linen services provided by this cooperative. SCHS received member distributions of $3,000 and $12,000, respectively, from SOLS during the years ended December 31, 2011 and 2010. SCHS incurred laundry and linen expense with SOLS of $1,225,000 and $1,064,000, for the years ended December 31, 2011 and 2010, respectively.

(Continued)

(g) CONet Inc. (CONet)

CONet is an Oregon public benefit nonprofit corporation established to facilitate the provision of certain healthcare services to Central and Eastern Oregon residents by combining the resources of certain hospitals in the Central and Eastern Oregon area. SCHS works cooperatively with hospitals in other communities through CONet to provide a smooth continuation of healthcare services. CONet also negotiates managed care contracts on behalf of its member hospitals and provides joint purchasing services. CONet's Board of Directors consists of the Chief Executive Officer of SCMC – Bend and the Chief Executive Officer of each of the five other hospitals in the central and eastern Oregon area. CONet owned certain common stock of Clear One Health Plans, Inc. (COHP) that was attributed to each participating hospital, 76% of which was attributed to SCHS. COHP was a corporation, which administered the OHP, Clear Choice Health Plans (a Medicare risk plan), and other commercial health insurance and third-party administrator programs in Central and Eastern Oregon. In May 2010, Pacific Source Health Plans completed its acquisition of COHP for $26.00 per share at which time the Corporation received $7,358,000 in cash proceeds. SCHS considered CONet to be a financially interrelated organization under the provisions of ASC 958 and, therefore, recorded their investment at fair value similar to accounting for an investment under the equity method. During the years ended December 31, 2011 and 2010, SCHS recognized other income from CONet of approximately $0 and $424,000, respectively.

(h) Institute of the Cascades (IOC)

IOC is a limited liability company whose two members are SCHS (50% ownership interest) and The Neuromusculoskeletal Center of the Cascades PC (NCC) (50% ownership interest). IOC provides administration and marketing to promote CMB, CSC, NCC, and SCHS.

(i) Health Futures (HF)

Health Futures LLC (HF) is a limited liability company whose members participate in centralized administrative services in Oregon. SCHS owns approximately 14% of HF. Primarily SCHS benefits from group purchasing agreements. SCHS receives distributions from time to time that are treated as a reduction to purchases and not a return of capital as they are the result of group purchasing agreements.

(9) Functional Classification of Expenses

Expenses on a functional basis for the years ended December 31, 2011 and 2010 were as follows:

		2011	2010
Healthcare services	$	379,190,000	365,628,000
General and administrative		87,800,000	80,245,000
	$	466,990,000	445,873,000

(10) Fair Value Measurements

The Corporation applies to provisions of FASB ASC 820 for fair value measurements of financial assets and financial liabilities and for fair value measurements of nonfinancial items that are recognized or disclosed at fair value in the financial statements on a recurring basis. ASC 820 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The levels of the fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Corporation has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are unobservable inputs for the asset or liability.

The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

The following table presents assets and liabilities that are measured at fair value on a recurring basis at December 31, 2011:

		Fair value measurements at reporting date using		
	December 31, 2011	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Assets limited as to use:				
Cash and cash equivalents	$ 9,257,000	9,257,000	—	—
Equity mutual funds:				
Medium cap blend	5,584,000	5,584,000	—	—
Small cap blend	5,526,000	5,526,000	—	—
Small cap value	35,000	35,000	—	—
Large cap growth	12,524,000	12,524,000	—	—
Large cap balanced	36,612,000	36,612,000	—	—
Large cap value	13,151,000	13,151,000	—	—
International growth	6,310,000	6,310,000	—	—
International value	6,203,000	6,203,000	—	—
International large cap	40,000	40,000	—	—
International balance	12,415,000	12,415,000	—	—
REIT sector	18,683,000	18,683,000	—	—
Money market	1,393,000	1,393,000	—	—
Fixed-income mutual funds:				
Treasury intermediate	19,668,000	19,668,000	—	—
Inv grade corp interm	9,621,000	9,621,000	—	—
Inv grade corp short	37,090,000	37,090,000	—	—
High-yield bond	54,000	54,000	—	—
Intermediate bond	287,000	287,000	—	—
Corporate obligations	10,767,000	—	10,767,000	—
U.S. government agencies	2,229,000	—	2,229,000	—
U.S. government treasuries	1,792,000	1,792,000	—	—
Cash surrender value of life insurance	229,000	—	229,000	—
Accrued interest receivable	4,000	—	4,000	—
	$ 209,474,000	196,245,000	13,229,000	—

The following table presents assets and liabilities that are measured at fair value on a recurring basis at December 31, 2010:

		Fair value measurements at reporting date using		
	December 31, 2010	**Quoted prices in active markets for identical assets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant unobservable inputs (Level 3)**
Assets:				
Assets limited as to use:				
Cash and cash equivalents	$ 9,525,000	9,525,000	—	—
Equity mutual funds:				
Medium cap blend	5,322,000	5,322,000	—	—
Small cap blend	5,397,000	5,397,000	—	—
Small cap value	38,000	38,000	—	—
Large cap growth	12,315,000	12,315,000	—	—
Large cap balanced	35,133,000	35,133,000	—	—
Large cap value	12,437,000	12,437,000	—	—
International growth	6,587,000	6,587,000	—	—
International value	6,334,000	6,334,000	—	—
International large cap	49,000	49,000	—	—
International balance	12,724,000	12,724,000	—	—
REIT sector	16,206,000	16,206,000	—	—
Money market	1,377,000	1,377,000	—	—
Fixed-income mutual funds:				
Treasury intermediate	16,509,000	16,509,000	—	—
Inv grade corp interm	8,204,000	8,204,000	—	—
Inv grade corp short	34,582,000	34,582,000	—	—
High-yield bond	56,000	56,000	—	—
Intermediate bond	281,000	281,000	—	—
Corporate obligations	10,558,000	—	10,558,000	—
U.S. government agencies	2,068,000	—	2,068,000	—
U.S. government treasuries	2,178,000	2,178,000	—	—
Cash surrender value of life insurance	202,000	—	202,000	—
Accrued interest receivable	5,000	—	5,000	—
	$ 198,087,000	185,254,000	12,833,000	—

(Continued)

The fair value of long-term obligations is estimated using current market activity and discounted cash flow analysis. The fair value and carrying amount of long-term obligations at December 31, 2011 and 2010 were as follows:

	2011		2010	
	Carrying amount	**Fair value**	**Carrying amount**	**Fair value**
Long-term obligations	$ 174,638,000	199,406,000	183,351,000	199,991,000

(11) Subsequent Events

The Corporation has performed an evaluation of subsequent events through March 28, 2012, which is the date these consolidated financial statements were issued.

SUPPLEMENTARY SCHEDULES

Schedule I

ST. CHARLES HEALTH SYSTEM, INC.

Supplementary Schedule – Balance Sheet Information

December 31, 2011 and 2010

Assets	**Obligated group**	**Nonobligated group excluding St. Charles Foundation**	**St. Charles Foundation**	**Eliminating and reclassifying entries**	**2011**	**2010**
Current assets:						
Cash and cash equivalents	$ 15,334,000	541,000	2,602,000	—	18,477,000	22,302,000
Assets limited as to use, current portion	8,033,000	—	—	—	8,033,000	8,011,000
Patient accounts receivable, net of allowance	75,118,000	1,654,000	—	—	76,772,000	70,275,000
Other receivables, net	7,123,000	220,000	282,000	(703,000)	6,922,000	3,093,000
Supplies inventory	9,365,000	—	—	—	9,365,000	5,107,000
Prepaid expenses and other current assets	6,395,000	164,000	5,000	—	6,564,000	4,882,000
Total current assets	121,368,000	2,579,000	2,889,000	(703,000)	126,133,000	113,670,000
Assets limited as to use, net of current portion	197,385,000	504,000	5,612,000	—	203,501,000	192,306,000
Property and equipment, net	218,046,000	5,011,000	—	—	223,057,000	238,475,000
Other assets, net	18,321,000	6,842,000	—	(14,025,000)	11,138,000	12,427,000
Total assets	$ 555,120,000	14,936,000	8,501,000	(14,728,000)	563,829,000	556,878,000
Liabilities and Net Assets						
Current liabilities:						
Accounts payable	$ 21,038,000	648,000	169,000	(125,000)	21,730,000	18,478,000
Accrued liabilities	31,783,000	593,000	—	(578,000)	31,798,000	32,189,000
Estimated third-party payor settlements, net	3,549,000	—	—	—	3,549,000	1,297,000
Deferred revenue	1,068,000	—	—	—	1,068,000	1,132,000
Current portion of long-term obligations	7,997,000	1,301,000	—	—	9,298,000	9,415,000
Total current liabilities	65,435,000	2,542,000	169,000	(703,000)	67,443,000	62,511,000
Long-term obligations, net of current portion	164,168,000	1,172,000	—	—	165,340,000	173,936,000
Other liabilities	4,621,000	—	78,000	—	4,699,000	2,926,000
Total liabilities	234,224,000	3,714,000	247,000	(703,000)	237,482,000	239,373,000
Net assets:						
Unrestricted, SCHS	315,859,000	11,222,000	1,458,000	(9,922,000)	318,617,000	309,951,000
Unrestricted, noncontrolling interests	—	—	—	2,693,000	2,693,000	2,550,000
Temporarily restricted	3,662,000	—	4,044,000	(4,044,000)	3,662,000	3,590,000
Permanently restricted	1,375,000	—	2,752,000	(2,752,000)	1,375,000	1,414,000
Total net assets	320,896,000	11,222,000	8,254,000	(14,025,000)	326,347,000	317,505,000
Total liabilities and net assets	$ 555,120,000	14,936,000	8,501,000	(14,728,000)	563,829,000	556,878,000

See accompanying independent auditors' report.

Schedule II

ST. CHARLES HEALTH SYSTEM, INC.

Supplementary Schedule – Statement of Operations Information

Years ended December 31, 2011 and 2010

(Dollars in thousands)

	Obligated group	Nonobligated group excluding St. Charles Foundation	St. Charles Foundation	Eliminating and reclassifying entries	2011	2010
Operating revenue:						
Net patient service revenue prior to bad debt adjustments	$ 474,482,000	20,704,000	—	(11,775,000)	483,411,000	460,117,000
Bad debt adjustments	26,522,000	—	—	—	26,522,000	18,660,000
Net patient service revenue	447,960,000	20,704,000	—	(11,775,000)	456,889,000	441,457,000
Other revenue	20,463,000	—	1,012,000	(2,518,000)	18,957,000	18,750,000
Total operating revenue	468,423,000	20,704,000	1,012,000	(14,293,000)	475,846,000	460,207,000
Expenses:						
Salaries and wages	182,885,000	5,196,000	312,000	(312,000)	188,081,000	172,202,000
Employee benefits	60,242,000	—	107,000	(107,000)	60,242,000	62,119,000
Professional fees	51,496,000	—	12,000	(11,775,000)	39,733,000	38,518,000
Depreciation	29,928,000	1,569,000	—	—	31,497,000	29,784,000
Interest	13,033,000	183,000	—	—	13,216,000	13,759,000
Medical supplies, drugs, and other	129,322,000	6,483,000	391,000	(1,975,000)	134,221,000	129,491,000
Total expenses	466,906,000	13,431,000	822,000	(14,169,000)	466,990,000	445,873,000
Operating income	1,517,000	7,273,000	190,000	(124,000)	8,856,000	14,334,000
Other income (losses):						
Investment income, net	2,047,000	—	39,000	(44,000)	2,042,000	18,920,000
Other, net	(200,000)	—	—	—	(200,000)	319,000
Total other income, net	1,847,000	—	39,000	(44,000)	1,842,000	19,239,000
Excess of revenue over expenses	3,364,000	7,273,000	229,000	(168,000)	10,698,000	33,573,000
Increase (decrease) in interest in net assets of St. Charles Foundation	(23,000)	—	—	23,000	—	—
Net assets released from restriction for use	183,000	—	—	—	183,000	278,000
Transfers (to) from affiliated organizations	—	—	(192,000)	158,000	(34,000)	(580,000)
Noncontrolling interests net assets	—	—	—	(2,181,000)	(2,181,000)	(2,115,000)
Distributions	4,757,000	(6,795,000)	—	2,038,000	—	—
Change in unrestricted net assets	$ 8,281,000	478,000	37,000	(130,000)	8,666,000	31,156,000

See accompanying independent auditors' report.

Schedule III

ST. CHARLES HEALTH SYSTEM, INC.

Supplementary Schedule – Changes in Net Assets Information

Years ended December 31, 2011 and 2010

(Dollars in thousands)

	Obligated group	Nonobligated group excluding St. Charles Foundation	St. Charles Foundation	Eliminating and reclassifying entries	2011	2010
Unrestricted net assets, SCHS:						
Excess of revenues over expenses	$ 3,364,000	7,273,000	229,000	(168,000)	10,698,000	33,573,000
Increase (decrease) in interest in net assets of St. Charles Foundation	26,000	—	—	(26,000)	—	—
Net assets released from restriction for use	183,000	—	—	—	183,000	278,000
Transfers (to) from affiliated organizations	—	—	(192,000)	158,000	(34,000)	(580,000)
Noncontrolling interests in net assets	—	—	—	(2,181,000)	(2,181,000)	(2,115,000)
Distributions	4,757,000	(6,795,000)	—	2,038,000	—	—
Change in unrestricted net assets	8,330,000	478,000	37,000	(179,000)	8,666,000	31,156,000
Unrestricted, noncontrolling interests:						
Noncontrolling interests net assets	—	—	—	—	—	(287,000)
Excess of revenues over expenses	—	—	—	2,181,000	2,181,000	2,115,000
Distributions	—	—	—	(2,038,000)	(2,038,000)	(2,520,000)
Change in noncontrolling interests	—	—	—	143,000	143,000	(692,000)
Temporarily restricted net assets:						
Contributions	—	—	1,176,000	—	1,176,000	1,241,000
Transfers from (to) affiliated organizations	—	—	170,000	(140,000)	30,000	580,000
Increase (decrease) in interest in net assets of St. Charles Foundation	72,000	—	—	(72,000)	—	—
Net assets released from restrictions for use	—	—	(1,198,000)	125,000	(1,073,000)	(969,000)
Distributions	—	—	(42,000)	—	(42,000)	(46,000)
Other changes in net assets	—	—	(19,000)	—	(19,000)	255,000
Change in temporarily restricted net assets	72,000	—	87,000	(87,000)	72,000	1,061,000
Permanently restricted net assets:						
Contributions	—	—	—	—	—	92,000
Transfers from (to) affiliated organizations	—	—	22,000	(18,000)	4,000	—
Increase (decrease) in interest in net assets of St. Charles Foundation	(39,000)	—	—	39,000	—	—
Other changes in net assets	—	—	(87,000)	44,000	(43,000)	45,000
Change in permanently restricted net assets	(39,000)	—	(65,000)	65,000	(39,000)	137,000
Change in net assets	8,363,000	478,000	59,000	(58,000)	8,842,000	31,662,000
Net assets, beginning of year	312,533,000	10,744,000	8,195,000	(13,967,000)	317,505,000	285,843,000
Net assets, end of year	$ 320,896,000	11,222,000	8,254,000	(14,025,000)	326,347,000	317,505,000

See accompanying independent auditors’ report.