



## ENTERPRISE MANAGEMENT CORPORATION

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April 23, 2012

Ms. Melinda Thomas  
Senior Policy Advisor  
Health Systems Planning  
Rhode Island Department of Health  
Three Capitol Hill  
Providence, RI 02908

Dear Ms. Thomas:

In accordance with our discussion, I have prepared this list of noteworthy observations regarding the Consolidated Financial Statements of Steward Health Care System LLC (Steward) for the year ended September 30, 2011. As you know, these statements were audited by the public accounting firm of Ernst & Young LLP, which issued an unqualified audit opinion regarding the information contained therein.

As we discussed, the statements contain a number of "red flags" that raise questions regarding the financial health of Steward. Because we have not been granted access to the financial business plans of the organization, we cannot assess whether (and, if so, how) Steward is prepared to address these questions.

The purpose of this letter is to list the "red flags" and describe why they raise questions regarding Steward's financial health. I have also attached the extracted source material from the financial statements to this correspondence.

1. According to the Consolidated Balance Sheet, as of September 30, 2011, total current liabilities equaled \$286.0 million and total current assets equaled \$242.4 million. Thus, the organization's working capital shortfall was \$43.6 million. In other words, the total amount of liabilities that Steward expected to pay during the twelve month period following September 30, 2011 exceeded (by \$43.6 million) the total amount of assets that Steward owned as of that date and could expect to utilize or liquidate to facilitate the payment of those liabilities.

2. According to the Consolidated Balance Sheet, although the total equity value of the organization was positive \$123.9 million as of September 30, 2011, that amount consisted of a pair of offsetting amounts: positive \$251.5 million in contributed capital and negative \$127.6 million in deficits. In other words, the \$251.5 million in capital that was contributed by Steward's owners had already been offset by \$127.6 million in deficits by September 30, 2011.

3. According to the Consolidated Balance Sheet, \$35.2 million of Steward's assets as of September 30, 2011 was categorized as the intangible asset of Goodwill, reflecting payments made by Steward for previous acquisitions that exceeded the value of the net assets that were acquired by the organization. If not for this intangible asset, the negative \$127.6 million of deficits of the organization would have been worse (i.e. more negative) by \$35.2 million, and the overall positive \$123.9 million equity value of the organization would have been worse (i.e. less positive) by \$35.2 million.

4. According to the Consolidated Balance Sheet, Steward owed \$96.3 million on its revolving credit facility as of September 30, 2011. Although revolving credit facilities are generally designed to cover temporary shortfalls in working capital, Steward actually incurred a working capital shortfall of \$43.6 million (see item 1, above) while this \$96.3 million liability was outstanding.

5. According to the Consolidated Balance Sheet, Steward's pension plan was underfunded by \$263.9 million as of September 30, 2011. According to the 11th Note to the Consolidated Financial Statements, its benefit obligation as of September 30, 2011 was \$598.1 million but the fair value of the plan assets was only \$334.2 million. In other words, its pension obligation was less than 56% funded.

6. According to the Consolidated Statement of Operations, Steward incurred a Net Loss of \$56.9 million during fiscal 2011. Furthermore, according to the Consolidated Statement of Cash Flows, Steward incurred a deficit of Net Cash Used in Operating Activities of negative \$32.9 million in fiscal 2011.

7. According to the 13th Note to the Consolidated Financial Statements, Steward has been working to resolve potential Stark Law violations that occurred during the period 2008 - 2010. Although management at Steward has estimated the exposure at the low and high ends of the potential range of liability to be \$1 million and \$35 million, respectively, only \$1 million of loss contingency has been recorded in the financial statements.

Based on this information, I recommend that the Department of Health request answers to the following questions:

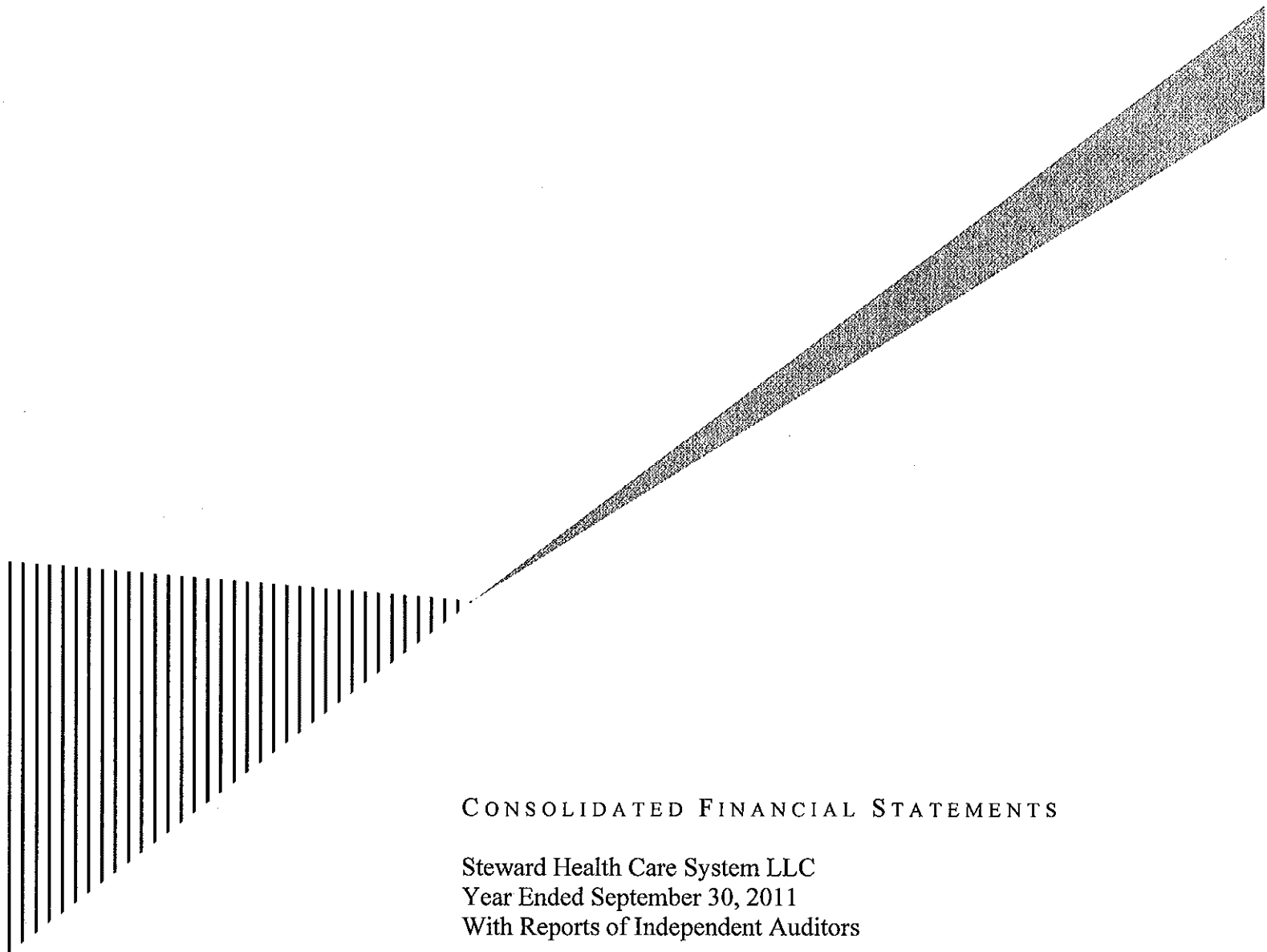
1. Is Steward implementing plans to eliminate its working capital shortfall of \$43.6 million?
2. Is Steward implementing plans to eliminate its deficits of \$127.6 million?
3. Once the deficits are eliminated, does Steward intend to establish a surplus that exceeds the \$35.2 million value of its Goodwill?
4. Is Steward implementing plans to pay down its revolving credit facility of \$96.3 million?
5. Is Steward implementing plans to pay down its pension plan liability of \$263.9 million?
6. Is Steward implementing plans to eliminate its net loss of \$56.9 million and its operating cash flow deficit of \$32.9 million?
7. Can Steward absorb a Stark Law violation liability that falls closer to \$35 million than \$1 million?

I recommend that the Health Systems Planning function of the Department of Health obtain detailed information regarding these plans, and then assess the viability of these plans, before concluding its review of the proposed transaction involving Landmark Medical Center and Affiliates. These seven questions directly address the financial health of Steward Health Care System LLC.

Sincerely,



Michael Kraten, PhD, CPA  
President



CONSOLIDATED FINANCIAL STATEMENTS

Steward Health Care System LLC  
Year Ended September 30, 2011  
With Reports of Independent Auditors

Ernst & Young LLP



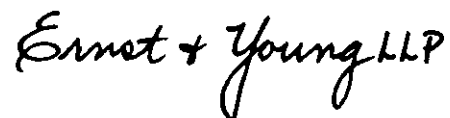
## Report of Independent Auditors

Board of Directors and Member  
Steward Health Care System LLC

We have audited the accompanying consolidated balance sheet of Steward Health Care System LLC (Steward or the System) and subsidiaries as of September 30, 2011, and the related consolidated statements of operations, changes in member's equity, and cash flows for the year then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Steward Health Care System LLC and subsidiaries as of September 30, 2011, and the results of their consolidated operations, changes in member's equity, and cash flows for the year then ended, in conformity with U.S. generally accepted accounting principles.



January 30, 2012

# Steward Health Care System LLC

## Consolidated Balance Sheet

September 30, 2011

*(Amounts in thousands, except for membership interests)*

### Assets

Cash and cash equivalents	\$ 35,137
Patient accounts receivable, less allowance for uncollectible accounts of \$48,444	138,933
Other accounts receivable	29,300
Deferred tax assets	6,007
Other current assets	33,075
Total current assets	<u>242,452</u>
Investments of insurance subsidiary	54,432
Property and equipment — net	470,532
Other assets	55,633
Goodwill	35,213
Total assets	<u>\$ 858,262</u>

### Liabilities and member's equity

#### Current liabilities:

Current portion of long-term debt and capital lease obligations	\$ 1,456
Accounts payable and accrued expenses	193,646
Accrued compensation and benefits	75,448
Estimated settlements with third-party payors	8,579
Other current liabilities	6,885
Total current liabilities	<u>286,014</u>
Long-term debt and capital lease obligations — net of current portion	2,004
Revolving credit facility	96,331
Estimated settlements with third-party payors — net of current portion	9,051
Professional liability costs	47,873
Deferred taxes	19,725
Pension liabilities	263,992
Other liabilities	9,418
Total liabilities	<u>734,408</u>

#### Member's equity:

Common membership interests; 100 interests authorized, issued and outstanding	—
Contributed capital	251,516
Accumulated deficit	(70,487)
Accumulated other comprehensive deficit	(57,175)
Total member's equity	<u>123,854</u>
Total liabilities and member's equity	<u>\$ 858,262</u>

*See accompanying notes.*

# Steward Health Care System LLC

## Consolidated Statement of Operations

Year Ended September 30, 2011

*(Amounts in thousands)*

Patient service revenues	\$ 1,194,177
Less: provision for bad debts	<u>(52,052)</u>
Patient service revenues, net	1,142,125
Premium revenue	134,545
Research	7,299
Other	<u>43,691</u>
Total revenues	1,327,660
Expenses:	
Salaries, wages, and fringe benefits	807,655
Supplies and other expenses	407,438
Purchased provider services and other expenses related to premium revenue	61,479
Depreciation and amortization	64,708
Interest	1,034
Reorganization expenses	14,316
Acquisition-related expenses	<u>25,236</u>
Total expenses	<u>1,381,866</u>
Loss before income taxes	(54,206)
Income tax expense	<u>2,706</u>
Net loss	<u>\$ (56,912)</u>

*See accompanying notes.*

## Steward Health Care System LLC

### Consolidated Statement of Changes in Member's Equity

*(Amounts in thousands)*

	Contributed Capital	Accumulated Deficit	Accumulated Other Comprehensive Deficit	Total Member's Equity
Balances, September 30, 2010	\$ —	\$ (13,575)	\$ —	\$ (13,575)
Contribution by financial sponsor	245,931	—	—	245,931
Acquired not-for-profit interests	4,604	—	—	4,604
Net loss	—	(56,912)	—	(56,912)
Pension liability adjustment, net of tax of \$0	—	—	(57,175)	(57,175)
Total comprehensive loss				(114,087)
Equity-based compensation expense	1,200	—	—	1,200
Change in not-for-profit interests	(219)	—	—	(219)
Balances, September 30, 2011	<u>\$ 251,516</u>	<u>\$ (70,487)</u>	<u>\$ (57,175)</u>	<u>\$ 123,854</u>

*See accompanying notes.*

# Steward Health Care System LLC

## Consolidated Statement of Cash Flows

Year Ended September 30, 2011

*(Amounts in thousands)*

### Operating activities

Net loss	\$ (56,912)
Adjustments to reconcile net loss to net cash used in operating activities:	
Depreciation and amortization	64,708
Provision for bad debts	52,052
Equity-based compensation expense	1,200
Other	(219)
(Decrease) increase in cash resulting from a change in:	
Patient accounts receivable	(81,147)
Other current assets	(24,354)
Investments of insurance subsidiary	(5,371)
Accounts payable, accrued expenses and other liabilities	13,488
Estimated settlements with third-party payors	(935)
Professional liability costs	11,079
Deferred taxes	194
Pension liability	(6,728)
Net cash used in operating activities	<u>(32,945)</u>

### Investing activities

Purchase of property and equipment	(141,740)
Cash paid for acquisitions, net of cash acquired	(88,723)
Increase in non-current assets	<u>(42,853)</u>
Net cash used in investing activities	<u>(273,046)</u>

### Financing activities

Contribution by financial sponsor	245,931
Net borrowings under revolving credit facility	96,331
Repayments of debt and capital lease obligations	<u>(1,134)</u>
Net cash provided by financing activities	<u>341,128</u>
Net increase in cash and cash equivalents	35,137
Cash and cash equivalents at beginning of year	—
Cash and cash equivalents at end of year	<u>\$ 35,137</u>



Steward Health Care System LLC

Consolidated Statement of Cash Flows (continued)

Year Ended September 30, 2011  
*(Amounts in thousands)*

**Supplemental disclosure of cash flow information**

Net cash paid for interest	<u>\$ 373</u>
Net cash paid for income taxes	<u>\$ —</u>

**Supplemental schedule of non-cash investing and financing activity**

Purchase of property and equipment financed by capital leases	<u>\$ 764</u>
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*See accompanying notes.*

## Steward Health Care System LLC

### Notes to Consolidated Financial Statements (continued)

#### 11. Employees' Retirement Plans (continued)

established by the trustees solely to hold the segregated assets. During the transition period, the System is at-risk for any decrease in value of the segregated assets. Also during the transition period, Steward is required to make quarterly payments of \$1,625,000 to the RCAB, with the first payment due in April 2011. Upon receipt of the payments, the RCAB is required to deposit the full amount of the payment into the separate trust holding the segregated assets. During the transition period, all benefit payments made to or in respect of participants in the Caritas Plan will be made pursuant to the Plan and paid from the separate trust holding the segregated assets.

Steward has sole discretion to determine the transfer date, provided that the transfer date will be no later than November 6, 2013. As of the transfer date, the segregated assets will be transferred to a trust established by Steward for the benefit of the Steward Pension Plan (yet to be formed) and the Steward Pension Plan will formally assume the Caritas pension obligation.

Steward's obligation to assume the obligations pursuant to the Caritas Plan is unconditional and therefore the System has accounted for this obligation pursuant to the provisions of ASC 715, *Compensation – Retirement Benefits*.

The following table provides a reconciliation of the aggregate benefit obligations, plan assets, and funded status of the Norwood and SGSMC defined benefit plans and the Caritas Plan (collectively, the Plan), and the related amounts that are recognized in the accompanying consolidated balance sheet at September 30, 2011 (in thousands of dollars):

Change in benefit obligation:	
Benefit obligation at acquisition date	\$ (560,821)
Interest cost	(24,804)
Actuarial loss	(30,318)
Benefits paid	17,794
Benefit obligation at September 30, 2011	(598,149)
Change in plan assets:	
Fair value of Plan assets at acquisition date	347,276
Actual return on Plan assets	(3,906)
Employer contributions	8,581
Benefits paid from Plan assets	(17,794)
Fair value of Plan assets at September 30, 2011	334,157
Funded status of the Plan	\$ (263,992)

## Steward Health Care System LLC

### Notes to Consolidated Financial Statements (continued)

#### **13. Contingencies (continued)**

##### **Workers' Compensation**

Steward is licensed by the Commonwealth of Massachusetts to provide workers' compensation coverage on a self-insured basis. Steward has obtained surety bonds to support its potential obligations for coverage, has purchased excess insurance coverage to limit its exposure in the event of adverse claims experience, and has provided letters of credit in a total amount of \$3.1 million to obtain the surety bonds.

##### **Loss Contingency**

Subsequent to the Caritas acquisition, Steward self-reported certain technical violations of federal law relating to arrangements with certain physicians during the period 2008 – 2010. Steward has been working with the Centers for Medicare and Medicaid Services to resolve these potential Stark Law violations, which may result in a payment to the federal government.

At this time, management cannot predict the amount of its payment obligation, or other terms of a negotiated resolution. The accompanying financial statements at September 30, 2011, include a provision of \$1,000,000 related to this matter, representing management's estimate of the low end of the range of the potential settlement amount. Management has estimated the exposure at the high end of the range to be \$35,000,000. However, it is not possible at this time to reasonably predict the ultimate amount that may be payable within this range. As of January 30, 2012, no demand for payment has been made by the federal government.

##### **Asset Retirement Obligation**

Steward maintains a liability primarily related to estimated costs to remove asbestos that is contained within Steward's hospital facilities. The liability, reported in other non-current liabilities in the accompanying consolidated balance sheet, was \$8.6 million as of September 30, 2011. Accretion expense was \$0.4 million for the year ended September 30, 2011.