READING HEALTH SYSTEM AND SUBSIDARIES

Reports on Federal Awards in Accordance with OMB Circular A-133

June 30, 2014

Federal Entity Identification Number: 23-1352204

READING HEALTH SYSTEM AND SUBSIDIARIES

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PART I
FINANCIAL STATEMENTS

KPMG LLP
1601 Market Street
Philadelphia, PA 19103-2499

Independent Auditors' Report

The Board of Directors of
Reading Health System:

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Reading Health System and Subsidiaries, which comprise the consolidated statement balance sheet as of June 30, 2014, and the related consolidated statements of operations, changes in net assets, and cash flows for the year then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America 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 consolidated financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the 2014 consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Reading Health System and Subsidiaries as of June 30, 2014, and the results of their and their cash flows for the year then ended in accordance with U.S. generally accepted accounting principles.

Other Matter

As part of our audit of the 2014 consolidated financial statements, we also audited the adjustments described in Note 15 that were applied to restate net assets as of June 30, 2013. Reading Health System and Subsidiaries' previously issued consolidated financial statements were audited by other auditors. In our opinion, such adjustments are appropriate and have been properly applied.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated November 24, 2014 on our consideration of Reading Health System and Subsidiaries' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Reading Health System and Subsidiaries' internal control over financial reporting and compliance.

KPMG LLP

Philadelphia, Pennsylvania
November 24, 2014

READING HEALTH SYSTEM AND SUBSIDIARIES

Consolidated Balance Sheet

June 30, 2014

(Dollars in thousands)

Assets

Current:		
Cash and cash equivalents	$	9,033
Patient accounts receivable, less allowance for uncollectible accounts of $69,031		122,508
Other receivables		34,586
Receivable from affiliates		850
Inventories		14,501
Estimated third-party payor receivables		8,729
Prepaid expenses and other current assets		16,034
Assets whose use is limited – required for current liabilities:		
Self-insurance funding arrangements		10,722
Revenue bond indentures – debt service requirements		3,107
By board for capital improvements and under regulatory requirements		9,177
Total current assets		229,247
Assets whose use is limited:		
Self-insurance funding arrangements		18,167
Under regulatory requirements		3,071
By board for capital improvements		1,032,282
Total assets whose use is limited, net of current portion		1,053,520
Restricted investments		24,362
Temporarily restricted funds		667
Property, plant and equipment, net		698,291
Deferred financing costs, net		4,641
Deferred compensation fund		2,352
Other assets		13,644
Total assets	$	2,026,724

(Continued)

READING HEALTH SYSTEM AND SUBSIDIARIES

Consolidated Balance Sheet

June 30, 2014

(Dollars in thousands)

Liabilities and Net Assets

Current:		
Current installments of long-term debt	$	7,074
Accounts payable		36,855
Estimated third-party payor settlements		3,841
Current portion of estimated self-insurance costs		35,722
Accrued expenses		40,164
Accrued vacation		24,555
Advances from third-party payor		3,832
Other current liabilities		10,049
Total current liabilities		162,092
Long-term debt, net of current portion and unamortized discount/premium		589,739
Accrued pension liabilities		136,577
Deferred revenue		37,100
Deferred compensation		2,694
Gift annuities		488
Estimated self-insurance costs, net of current portion		39,759
Swap contracts		52,550
Total liabilities		1,020,999
Net assets:		
Unrestricted (note 15)		982,453
Temporarily restricted		667
Permanently restricted		22,605
Total net assets		1,005,725
Total liabilities and net assets	$	2,026,724

See accompanying notes to consolidated financial statements.

READING HEALTH SYSTEM AND SUBSIDIARIES

Consolidated Statement of Operations

Year Ended June 30, 2014

(Dollars in thousands)

Unrestricted revenues and other support:		
Net patient service revenue	$	879,264
Provision for uncollectible accounts		(30,334)
Net patient service revenue less provision for uncollectible accounts		848,930
Residential revenue		20,200
Other revenue		31,953
Total revenues and other support		901,083
Expenses:		
Salaries and benefits		499,572
Supplies		141,614
Utilities		15,939
Interest		14,644
Depreciation		90,704
Purchased services		79,494
Repairs and maintenance		33,989
Other		55,381
Total expenses		931,337
Loss from operations		(30,254)
Nonoperating gains (losses):		
Investment income		63,121
Change in fair value of swap contracts and net settlement payments		(4,250)
Other losses		(4,144)
Nonoperating gains (losses), net		54,727
Excess of revenues, gains and other support over expenses	$	24,473

See accompanying notes to consolidated financial statements.

READING HEALTH SYSTEM AND SUBSIDIARIES

Consolidated Statement of Changes in Net Assets

Year Ended June 30, 2014

(Dollars in thousands)

Unrestricted net assets:		
Excess of revenues, gains and other support over expenses	$	24,473
Change in unrealized gains on investments, net		61,546
Change in pension liability		(27,025)
Other		(28)
Increase in unrestricted net assets		58,966
Temporarily restricted net assets:		
Contributions		17
Change in unrealized gains on investments, net		1,942
Realized gains on investments		9
Net assets released from restrictions – for operations		(20)
Increase in temporarily restricted net assets		1,948
Permanently restricted net assets:		
Contributions		1,241
Change in beneficial interest in trusts		592
Increase in permanently restricted net assets		1,833
Change in net assets		62,747
Net assets:		
Beginning of year (note 15)		942,978
End of year	$	1,005,725

See accompanying notes to consolidated financial statements.

READING HEALTH SYSTEM AND SUBSIDIARIES

Consolidated Statement of Cash Flows

Year Ended June 30, 2014

(Dollars in thousands)

Cash flows from operating activities:		
Change in net assets	$	62,747
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Change in unrealized gains on investments		(64,080)
Change in fair value of swap contracts		4,250
Amortization of bond discount		78
Amortization of bond premium		(212)
Amortization of deferred financing costs		174
Change in pension liability, net		23,625
Depreciation		90,704
Amortization of entrance fees		(4,519)
Proceeds from entrance fees and deposits		6,228
Provision for uncollectible accounts		30,334
Realized gains on investments		(63,121)
Equity in earnings of affiliates		(5,500)
Restricted contributions		(1,258)
Change in cash due to changes in operating assets and liabilities:		
Receivable from patients and others		(50,594)
Receivable from affiliates		(172)
Inventories		321
Prepaid expenses and other assets		1,139
Accounts payable and other liabilities		(20,928)
Estimated self-insurance costs		20,908
Deferred compensation		12
Gift annuities		(91)
Deferred revenue		1,434
Third-party payor settlements		(1,244)
Net cash provided by operating activities		30,235
Cash flows from investing activities:		
Acquisition of property, plant and equipment		(92,300)
Distribution from equity investees		4,942
Investment in affiliate		(1,000)
Sales of investments and assets whose use is limited, net		282,170
Purchases of investments and assets whose use is limited, net		(261,169)
Net settlement payments on swap contracts		(11,559)
Net cash used in investing activities		(78,916)
Cash flows from financing activities:		
Restricted contributions and investment income received		1,258
Payments of long-term debt		(6,735)
Refunds of entrance fees and deposits		(1,003)
Net cash used in financing activities		(6,480)
Net decrease in cash and cash equivalents		(55,161)
Cash and cash equivalents:		
Beginning of year		64,194
End of year	$	9,033
Supplemental cash flow information:		
Cash paid during the year for interest, net of capitalized interest of $2,800	$	14,926
Fixed asset additions included in accounts payable and other liabilities		14,997

See accompanying notes to consolidated financial statements.

(1) Organizational Structure and Nature of Operations

Reading Health System (Parent) is a tax-exempt not-for-profit corporation under Section 501(c)(3) of the Internal Revenue Code. The Parent is located in West Reading, Pennsylvania, and provides inpatient, outpatient and emergency care for residents of the greater Berks County area. Admitting physicians are primarily practitioners in the local area.

(a) Subsidiaries of the Parent Include:

Reading Hospital (Hospital), a tax-exempt not-for-profit acute and post-acute care hospital.

Reading Professional Services (RPS), a tax-exempt entity established for charitable, educational, and scientific purposes. RPS recruits physicians and provides administrative services for the Hospital, including supervision and instruction for medical students completing their residency training.

MC Realty, Inc. (MC Realty), a wholly owned subsidiary, established to strategically acquire real estate in Berks County and the surrounding areas. MC Realty is consolidated into the Parent.

The Reading Hospital Medical Group (TRHMG), a not-for-profit entity to assure access to high quality primary care physicians and specialty physicians in sufficient numbers to meet the community need; and providing physician billing.

The Highlands at Wyomissing (Highlands), a not-for-profit corporation, is a fully controlled entity of The Reading Hospital. The purpose of the Highlands is to operate a continuing care retirement community including residential, recreational and health care facilities and services specially designed to meet the physical, social and psychological needs of elderly persons. The Highlands facility is located in Wyomissing, Pennsylvania, and its residents are principally from the Wyomissing and Reading, Pennsylvania, area. The facility contains 287 residential living units, an 80-bed skilled nursing unit, and 66 personal care units. Certain members of the Board of Directors from the Hospital are also members of the Board of Directors of the Highlands.

Reading Health Partners (RHP), a (Pennsylvania) limited liability company, established on December 12, 2012, was formed to develop a physician network working in conjunction with the Reading Health System to implement a clinical integration program. Clinical integration is the implementation of an active and ongoing program to evaluate and modify practice patterns by the network’s physician participants and create a high degree of interdependence and cooperation among the physicians to control costs and improve the quality and efficiency of health care in the community.

(b) Other Noncontrolled Related Entities Include:

Berkshire Health Partners (BHP) is licensed by the Commonwealth of Pennsylvania as a fully integrated, nonrisk bearing preferred provider organization. A not-for-profit corporation in Pennsylvania, BHP was established by hospitals and physicians and offers a provider network of physicians, hospitals and ancillary providers and services. Certain members of the Hospital’s Board of Directors are directors of BHP. In September 2011, BHP entered into a membership repurchase agreement giving the Parent full ownership of the hospital operations of BHP. The other 50% is owned by Reading Physicians Organization.

Medicus Resource Management (MRM), a wholly owned subsidiary of BHP, is a for-profit company for Pennsylvania tax purposes that coordinates the utilization management process and provides precertification, case management, concurrent reviews and short term disability reviews.

Reading Berks Physical Therapy LLC (RBPT), a limited liability corporation established to provide physical therapies at eight locations within the greater Berks County area. The Hospital maintains a 40% interest in RBPT under the equity method of accounting. This interest is included in other assets on the accompanying consolidated balance sheet.

The Reading Hospital Surgicenter at Springridge, LLC (Springridge LLC), a limited liability company, was established to provide ambulatory surgery services to the surrounding community. The Hospital maintains a 50% ownership under the equity method of accounting. In FY 2014, Reading Hospital received a distribution of $4,167. This interest is included in other assets on the accompanying consolidated balance sheet.

The Parent, along with several other acute care service hospitals throughout the central Pennsylvania area, contributed capital to form Central Pennsylvania Alliance Laboratories (CPAL), a joint venture to combine laboratory operations. The Parent maintains a 20% ownership interest in CPAL. This interest is recorded under the equity method of accounting and is included in other assets on the accompanying consolidated balance sheet.

The Parent’s ownership of Central Pennsylvania Homecare, Inc. (d.b.a. Affilia Home Health, AHH) is 44.1%. AHH provides visiting home nursing services to outpatients of the Hospital and other healthcare providers in the surrounding community. This investment is recorded under the equity method of accounting and is included in other assets on the accompanying consolidated balance sheet.

The Parent is a 20% owner of Quest Behavioral Health, Inc. (Quest). Quest is a not-for-profit corporation providing full service managed behavioral healthcare. This investment is recorded under the equity method of accounting and is included in other assets on the accompanying consolidated balance sheet.

Horizon is a for-profit limited liability partnership of which Reading Hospital is a 25% owner. Reading Hospital received a distribution of $775. The investment is recorded under the equity method of accounting and is included in other assets on the accompanying consolidated balance sheet.

AllSpire Health Partners, LLC is an alliance of seven systems in New Jersey and Pennsylvania for which the Parent is a 14% owner. The consortium will carry out joint activities in traditional areas of patient care services, research and education to enhance the value of health care that communities receive.

(Continued)

(2) Summary of Significant Accounting Policies

Basis of Accounting

These consolidated financial statements have been prepared on the accrual basis of accounting in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP). The significant accounting policies followed by Reading Health System and Subsidiaries (the System) are as follows:

(a) Principles of Consolidation

The consolidated financial statements of the System include the accounts of the Parent, the Hospital, RPS, TRHMG, Highlands, RHP and MC Realty. All significant intercompany balances and transactions have been eliminated.

(b) Use of Estimates

The preparation of the consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. These significant estimates include the accounts receivable allowance for uncollectible accounts, contractual allowances, estimated third-party payor settlements, investments, accrued pension liabilities, swap liabilities, accrued retirement costs and accrued insurance costs. Actual results could differ from those estimates.

(c) Cash and Cash Equivalents

Cash and cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less. At June 30, 2014, the System had cash balances in financial institutions that exceeded federal depository insurance limits. Management believes that the credit risk related to these deposits is minimal.

(d) Net Patient Service Revenue and Patient Accounts Receivable

The System has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges and per-diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered and include estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

The System recognizes patient service revenue associated with services provided to patients who have third-party payor coverage on the basis of contractual rates for the services rendered. For uninsured patients who do not qualify for charity care, the System recognizes revenue based on established rates, subject to certain discounts as determined by the Hospital. An estimated provision for uncollectible accounts is recorded that results in net patient service revenue being reported at the net amount expected to be received. The System has determined that patient service revenue primarily is recorded prior to assessing the patient's ability to pay, and, as such, the entire provision for uncollectible accounts related to patient revenue is recorded as a deduction from patient service revenue in the accompanying consolidated statement of operations and changes in net assets. Patient service revenue, net of contractual allowances and discounts (but before the provision for uncollectible accounts), for the year ended 2014 from its major payor sources are as follows:

	Third-party payors	Self-pay	Total
Patient service revenue (net of contractual allowances and discounts)	94%	6%	100%

Revenue from the Medicare and Medicaid programs accounted for approximately 32% and 9%, respectively, of the Hospital's net patient service revenue for the year ended June 30, 2014. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

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

(e) Residential Revenue and Deferred Revenue

Entrance fees paid by residents of the Highlands' independent living units are recorded as deferred revenue. Entrance fees are amortized to income using the straight-line method over the estimated remaining life expectancy of the resident. In addition, for all contracts entered into prior to January 1, 2005, a portion equal to 30% of the entrance fee, referred to as the health fund is reserved to be accounted for individually for each resident/couple and is refundable to the extent not amortized. Amortization of the health fund occurs when a resident utilizes health services (Nursing or Personal Care).

The Highlands' entrance fees are refundable for a period of time up to 50 months. During this time, for refund purposes only, a resident's entrance fee is amortized at the rate of 2% per month for 50 months beginning on the date of occupancy. The Highlands has deferred revenue pertaining to entrance fees of $34,010 at June 30, 2014. The amount of entrance fees, which is refundable to residents at June 30, 2014 under contractual refund provisions, was approximately $11,000.

(f) Other Revenue

Significant components of other revenue include rental income on leased properties, tuition revenue for The Reading Hospital School of Health Sciences, and cafeteria revenues.

(g) Donor Restricted Gifts

Unconditional promises to give cash and other assets to the Hospital are reported at estimated fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at estimated fair value at the date the gift is received.

Contributions are reported as either temporarily or permanently restricted if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statement of operations as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying consolidated statement of operations.

(h) Accrued Vacation

The System records a liability for amounts due to employees for future paid leave, which are attributable to services performed in the current and prior periods.

(i) Excess of Revenue, Gains and Other Support Over Expenses

The consolidated statement of operations include the excess of revenues, gains and other support over expenses. Changes in unrestricted net assets that are excluded from this performance indicator, consistent with industry practice, include changes in unrealized gains and losses on marketable securities classified as other than trading securities, adjustments for defined benefit and other postretirement benefits, and contributions of long-lived assets (including assets acquired using contributions, which by donor-restriction were to be used for the purposes of acquiring such assets).

(Dollars in thousands)

(j) Assets Whose Use is Limited

Assets whose use is limited includes designated assets set aside by the Board of Directors for future capital improvements, assets held by trustees under indenture agreements and self insurance trust arrangements. The Board of Directors retains control over Board-restricted assets and may at its discretion subsequently use these assets for other purposes.

Assets whose use is limited includes cash and cash equivalents, marketable securities (including U.S. government and government agencies, corporate, state and local government), marketable equity securities (including common, preferred, and foreign stock), exchange traded/listed mutual funds (including fixed income funds), hedge funds, private equity funds, and limited partnerships.

The Pennsylvania Continuing Care Provide Registration and Disclosure Act requires a statutory reserve equivalent to the greater of the total of debt service payments due during the next 12 months on account of any loan, or 10% of the projected annual operating expenses of the facilities exclusive of depreciation, computed only on the proportional share of financing or operating expenses that is applicable to residents under entrance agreement contracts. For the System, this statutory requirement applies only to The Highlands. This statutory reserve requirement is considered to be fulfilled from board-designated funds included within assets limited as to use under regulatory requirements.

The calculation of the 10% of the annual operating expenses for the fiscal year ended June 30, 2015 is as follows:

Budgeted operating expenses for fiscal year ended June 30, 2015	$	24,748
Less: Budgeted depreciation and amortization expense		(3,461)
Net budgeted operating expenses for fiscal year ended June 30, 2015		21,287
Required reserve as of July 1, 2014 (10%)	$	2,129

The principal and interest due in the next 12-month period for long-term financing of the Highlands is the greater of the two options and is calculated as follows:

Principal due	$	1,522
Interest due		1,303
Required reserve as of July 1, 2014	$	2,825

(k) Property, Plant and Equipment

Property, plant and equipment are carried at cost, less accumulated depreciation. Expenditures that substantially increase the useful lives of existing assets are capitalized. Routine maintenance and repairs are expensed as incurred. Depreciation is computed using the straight-line method over the estimated useful lives of each class of depreciable asset. Useful lives range as follows:

Land improvements	5–25 years
Buildings and building improvements	10–40 years
Fixed equipment	5–10 years
Movable equipment	3–7 years

Gains and losses resulting from the retirement or sale of property, plant and equipment are included in the consolidated statement of operations. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. Gifts of long-lived operating assets such as land, buildings or equipment are reported as unrestricted contributions and are excluded from the performance indicator unless explicit donor stipulations specify how the donated asset must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts 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, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

(l) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the System have been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the System in perpetuity.

(m) Inventories

Inventories are stated at lower of cost determined by the first-in, first-out method or market. Physical inventory counts are conducted semi-annually and adjustments recorded.

(n) Investments and Investment Income

Investment income earned on securities (interest and dividends) is reported in the nonoperating gains/(losses) section of the consolidated statement of operations within Investment income. Realized gains or losses related to the sale of investments, other than temporary impairments on other than trading investments, and unrealized gains or losses on alternative investments, are included in the nonoperating gains/(losses) section of the consolidated statement of operations in Investment income unless the income or loss is restricted by donor or law.

Investments in equity securities with readily determinable fair values and all investments in debt securities are recorded at fair value in the consolidated balance sheet. These securities have been classified as other than trading, and changes in unrealized gains on these instruments are included in the consolidated statement of changes in net assets. Unrealized losses are included in the consolidated statement of operations within nonoperating gains/(losses).

The fair value option for financial assets and liabilities permits the System to elect to measure eligible items at fair value on an instrument by instrument basis. If elected, this option requires the System to report the unrealized gains and losses on these instruments as part of the performance indicator. Once elected, the fair value option is irrevocable for that instrument. Alternative investments include investments in managed funds, which include hedge funds, private equities, limited partnerships and other investments that do not have readily determinable fair values and may be subject to withdrawal restrictions. Investments in hedge funds, private equities, limited partnerships, and other investments in managed funds (collectively alternative investments) are accounted for using the fair value option. The unrealized gains or losses from these alternative investments are included in the consolidated statement of operations as part of nonoperating gains/(losses) within Investment income.

(o) Fair Value Measurements

The System follows the provisions of Financial Accounting Standards Board (FASB) ASC 820, *Fair Value Measurement* (ASC 820), which defines fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date. ASC 820 also establishes a framework for measuring fair value using valuation techniques such as the market approach, cost approach and income approach and making disclosures about fair value measurements.

ASC 820 emphasizes that fair value is a market-based measurement, not an entity specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing an asset or liability. As a basis for considering market participant assumption in fair value measurements, ASC 820 defines a three-Level fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity and the reporting entity's own assumptions about market participants. The fair value hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

Level 1 – Inputs utilized quoted market prices in active markets for identical assets or liabilities that the System has the ability to access.

Level 2 – Inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the asset and liability (other than quoted prices) such as interest rates, foreign exchange rates and yield curves that are observable at commonly quoted intervals.

Level 3 – Inputs are unobservable inputs for the asset or liability, which is typically based on an entity's own assumptions, as there is little, if any, related market activity.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the Level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest Level input that is significant to the fair value measurement in its entirety. The System's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

Where quoted prices are available in an active market, investments are classified in Level 1 of the valuation hierarchy. Investments in Level 1 include cash, exchange-traded equity securities and mutual funds with a published daily net asset value or its equivalent (NAV). Investments in Level 2 include financial instruments valued based on quoted market prices for identical securities in markets that are not active, quoted prices for similar securities in markets that are active, broker or dealer quotations or alternative pricing sources with reasonable levels of price transparency. If quoted prices are not available, other accepted valuation methodologies, such as interest rates, observable yield curves and spreads may be used to determine fair value. Level 2 includes auction rate securities, investments in marketable corporate debt securities, U.S. government and agency debt securities, and certain mutual funds that permit daily redemptions but whose NAV is not published. Auction rate securities are estimated using the income approach. This approach uses estimation techniques to determine the estimated future cash flows of the respective asset or liability expected by a market participant and discounts those cash flows back to present value. Level 2 also includes investments in certain private entities that calculate NAV per share, or its equivalent, if the System has the ability to redeem its investment with the investee at the stated NAV at the measurement date or shortly thereafter. Investments in Level 3 include other nonreadily marketable alternative investments, such as investments in private equity funds and hedge funds where the System's investments are subject to lock up periods and other longer-term liquidity restrictions and are reported at fair value based on the use of inputs that are unobservable in the public market.

The fair values of Level 3 investments have been estimated by management based on all available data, including information provided by third-party pricing vendors, fund managers and general partners. Alternative investments are recorded at fair value based on the NAV as a practical expedient, as provided by the respective general partner or fund administrator of the individual alternative investment funds. The System believes the fair value of alternative investments in the consolidated balance sheet is a reasonable estimate of its ownership interest in the alternative investment funds. As part of the System's overall valuation process, management evaluates these third-party methodologies to ensure that they are representative of exit prices in the security's principal markets.

These valuation methods may produce a fair value estimate that may not be reflective of future fair values. Furthermore, while the System believes that its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine fair value could result in a materially different estimate of fair value at the reporting date. See note 4 for additional details related to the System's investments.

(p) Deferred Financing Costs

Deferred financing costs are amortized over the period the debt is outstanding using the straight-line method, which approximates the effective interest method. Amortization of deferred financing costs totaled $174 at June 30, 2014. Accumulated amortization totaled $503 as of June 30, 2014.

(q) Bond Premiums/(Discounts)

Bond premiums/(discounts) are amortized to interest and expense as direct additions/(reductions) of the carrying values of the related debt instruments from which the discounts or premiums arose. Bond premiums/(discounts) are amortized to interest expense over the period during which the debt is outstanding using the straight-line method, which approximates the effective interest method.

(r) Estimated Self-Insurance Costs

The provision for estimated self-insured claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported. The System self-insures its medical malpractice, general liability, and workers' compensation risks. Reserve estimates are subject to the impact of changes in claim trends as well as prevailing social, economic and legal conditions. The ultimate net cost of settling these liabilities may vary from the estimated amounts. Accordingly, reserve estimates are continually reviewed and updated, and any resulting adjustments are reflected in the performance indicator.

(s) Derivative Instruments

The System follows accounting guidance on derivative financial instruments that is based on whether the derivative instrument meets the criteria for designation as cash flow and for designating a derivative as a hedge includes the assessments of the instruments effectiveness in risk reduction, matching the derivative instrument to its underlying transactions and the assessment of the probability that the underlying transaction will occur. All of the System's derivative financial instruments are interest rate swap agreements without hedge accounting designation.

Entering into interest rate swap agreements involves, to varying degrees, elements of credit, default, prepayments and market risk in excess of the amounts recognized on the consolidated balance sheet. Such risks involved the possibility that there will be no liquid market for these arrangements, the counterpart to these arrangements may default on its obligations to perform, and there may be unfavorable changes in interest rates. The System does not hold derivative instruments for the purpose of managing credit risk and enters into derivative transactions with high quality counterparties.

The interest rate swap agreements entered into by the System are adjusted to market value monthly at the close of the accounting period based upon quotations from the counter parties. The change in market value is recorded in the consolidated statement of operations within excess of revenues, gain and other support over expenses.

(t) Income Taxes

The System is a not-for-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code and is exempt from federal income taxes on related income pursuant to Section 501(a) of the Code. On such a basis, the exempt entities do not incur liability for federal income taxes, except in the case of unrelated business income.

The System evaluates uncertain tax positions using a two-step approach for recognizing and measuring tax benefits taken or expected to be taken in an unrelated business activity tax return and disclosures regarding uncertainties in tax positions. No adjustments to the consolidated financial statements were required as a result of this evaluation.

(u) Deferred Compensation

The System was a party to a deferred compensation plan that provided retirement benefits to certain individuals employed by the System. Assets were deposited pursuant to this agreement such that the market value of the assets approximates the related accrued deferred compensation liability and include cash and cash equivalents and mutual funds. The plan is no longer active. No new participants or any additional contributions are allowed. The original contributions were funded entirely by the participating employees through payroll deferral.

(v) Uncompensated Care and Community Service

The System provides services to patients who meet the criteria of its charity service policy without charge or at amounts less than the established rates. Criteria for charity care consider the patient's family income, family size and ability to pay. Individuals who qualify for charity care do not have insurance or other coverage.

The System maintains records to identify and monitor the level of charity care and community service it provides. These records include the amount of charges foregone based on established rates for services, and supplies furnished under its charity care, community service policies and the estimated cost of those services.

Charges foregone for uncompensated care as determined in accordance with the System's policies were approximately $16,190 in 2014. Direct and indirect costs to provide these services were approximately $5,828 for the year ended 2014. The estimated costs were based on a calculation, which multiplied the cost to charge ratio by the gross charges associated with providing uncompensated care to patients. The cost to charge ratio was obtained from our most recently filed Medicare Cost report.

Additionally, the System sponsors certain other service programs and charity services, which provide substantial benefit to the broader community. Such programs include services to needy populations requiring special services and support, community service programs and charity services, as well as health promotion and education.

The System's community service includes the Medical Assistance program, which makes payment for services provided to families with dependent children, the aged, the blind and the permanently and totally disabled, whose income and resources are insufficient to meet the costs of necessary medical services. Payments from the Medical Assistance program are generally less than the System's charge of providing the service.

(Continued)

In addition, community service represents the cost to deliver services to the community, net of any payment received for those services. Included in these services are the System's subsidies of outpatient clinics, education of medical professionals who work with various health care providers in the community upon graduation and community mental health programs. The System also sponsors health fairs and other wellness programs throughout the community.

(w) Future service obligations

The Highlands' annually calculates the present value of the net cost of future services using a discount rate of 5.5% and compares that amount with the balance of deferred revenue from entrance fees. If the present value of the net cost of future services and the use of facilities exceeds the deferred revenue from entrance fees, a liability would be recorded (obligation to provide future services and use of facilities) with the corresponding charge to income. As a result of the calculation, the present value of the net cost of future services did not exceed deferred revenue; accordingly, no obligation was recorded at June 30, 2014.

(3) Net Patient Service Revenue

The System has agreements with third-party payors that provide for payments at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows.

(a) Medicare

Inpatient acute care and rehabilitation services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Outpatient services are reimbursed by Medicare under the Ambulatory Payment Classification System. The System is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by the System and audits thereof by the Medicare fiscal intermediary. The System's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review by a peer review organization under contract with Medicare. The System's Medicare cost reports have been closed and settled by the Medicare fiscal intermediary through June 30, 2010.

(b) Medicaid

On December 29, 2010, the Pennsylvania Department of Public Welfare (DPW) received approval from the Centers for Medicare & Medicaid Services for the state plan amendments pursuant to Act 49 of 2010, passed by the Pennsylvania General Assembly on July 3, 2010, which established a new inpatient hospital fee for service payment system, new supplemental payments and the waiver to establish the statewide Quality Care Assessment. DPW also received approval on final language for the DPW contracts with managed care organizations. The estimated net impact on the System for the year ended June 30, 2014, was $8,203 (based on total payment increases of $21,942 offset by assessments of $13,739).

(Continued)

(c) Non-Governmental Payers

Inpatient services rendered by non-governmental payers are reimbursed at negotiated rates. The System continues to be reimbursed for outpatient services at a negotiated percentage of covered charges.

(d) Workers' Compensation

The payment method by which all employers and/or insurers of workers' compensation policies will pay for the services provided by health care providers to employees covered by workers' compensation is a percentage of the Medicare payment for these services.

(e) Other Contractual Arrangements

The System has various payment agreements with preferred provider organizations and health maintenance organizations. The basis for payment under these agreements includes discounts from established charges.

The health care industry is subject to numerous laws and regulations of federal, state and local governments. Compliance with these laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at the time. Recently, government activity has increased with respect to investigations and allegations concerning possible violations by health care providers of fraud and abuse statutes and regulations, which could result in the imposition of significant fines and penalties as well as significant repayments for patient services previously billed.

(Dollars in thousands)

(4) Assets Whose Use is Limited and Investments

Assets whose uses are limited and that are required for obligations classified as current liabilities are reported as current assets. The composition of assets whose uses are limited at June 30, 2014, is set forth in the following tables.

Self-insurance funding arrangements		
Professional liability		
Cash and cash equivalents	$	7,351
U.S. Government securities		5,745
Corporate bonds		5,505
Mutual funds		77
Total professional liability		18,678
Workers' compensation		
Cash and cash equivalents		593
U.S. Government securities		3,676
Corporate bonds		4,172
Mutual funds		1,770
Total workers' compensation		10,211
Total assets whose use is limited under self-insurance funding arrangements	$	28,889
Revenue bond indentures – debt service requirements		
Cash and cash equivalents	$	3,107
Total assets whose use is limited under revenue bond indentures - debt service requirements	$	3,107
By board for capital improvements and under regulatory requirements		
Cash and cash equivalents	$	8,526
State and municipal government securities		9,618
Corporate and foreign bonds		70
Common, foreign, and preferred stock		5,465
Mutual funds		485,627
Fixed income securities		349,698
Hedge, private equity, common collective trust funds		185,526
Total assets whose use is limited by the board for capital improvements and under regulatory requirements	$	1,044,530

(Dollars in thousands)

Temporarily restricted funds		
Cash and cash equivalents	$	667
Total temporarily restricted funds		667
Restricted investments		
Cash and cash equivalents	$	140
U.S. Government securities		1,920
Corporate and foreign bonds		713
Common, foreign, and preferred stock		6,016
Mutual funds		485
Beneficial interest in trusts		15,088
Total restricted investments	$	24,362

A summary of the System's total investment return for the year ended 2014 as reflected in the consolidated statement of operations and changes in net assets is as follows:

Interest, dividends, and realized gains (losses) on investments	$	35,832
Change in unrealized gains on non-alternative investments		64,080
Change in unrealized gains on alternative investments		27,289

The System's investments include a variety of financial instruments; the related values as presented in the consolidated financial statements are subject to various market fluctuations, which include changes in the equity markets, interest rate environment and general economic conditions.

The System performs an annual impairment analysis of its investments. On June 30, 2014, there were twelve investments with a fair value of $57.9 million that were in an unrealized loss position totaling $2.9 million. The unrealized losses on these investments were caused by general market conditions. These twelve investments were written down in an other-than-temporary-impairment and this $2.9 million loss is shown as an offset to investment income on the consolidated statement of operations.

(Continued)

(Dollars in thousands)

The following table presents cost and fair value of assets whose use is limited and investments for June 30, 2014:

		Fair value	Cost
Cash and cash equivalents	$	20,384	20,307
State and municipal government securities		9,618	9,736
Corporate and foreign bonds		10,460	10,530
Common, preferred, and foreign stock		11,481	6,632
U.S. Government securities		11,341	11,005
Mutual funds		487,959	403,129
Fixed income securities		349,698	344,681
Hedge, private equity, and common collective trust funds		185,526	161,066
Beneficial interest in trusts		15,088	12,581
Total	$	1,101,555	979,667

The following table represents the fair value measurement levels for all assets and liabilities, which the System has recorded at fair value:

		Fair value June 30, 2014	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant other unobservable inputs (Level 3)
Assets					
Cash and cash equivalents	$	20,384	20,384	—	—
State and municipal government securities		9,618	—	9,618	—
Corporate and foreign bonds		10,460	—	10,460	—
Common, preferred, and foreign stock		11,481	11,481	—	—
U.S. Government securities		11,341	—	11,341	—
Mutual funds		487,959	442,462	45,497	—
Fixed income securities		349,698	345,997	3,701	—
Hedge, private equity, and common collective trust funds		185,526	—	6,220	179,306
Beneficial interest in trusts		15,088	—	—	15,088
Total investments	$	1,101,555	820,324	86,837	194,394
Liabilities					
Swap contracts	$	52,550	—	52,550	—

(Dollars in thousands)

Following is the summary of the inputs and valuation techniques as of the year ended 2014 for valuing Level 2 and Level 3 financial instruments:

Financial instrument	Input	Valuation technique
State and municipal government securities	Broker/dealer	Market
Corporate and foreign bonds	Broker/dealer	Market
U.S. Government securities	Broker/dealer	Market
Mutual funds	NAV	Market/income
Auction rate securities	Broker/dealer	Income
Hedge funds, private equity, and common collective trust funds	NAV	Market/income
Swap contracts	Broker/dealer	Market

The following table represents the change in fair value for which fair value was measured under Level 3:

		Hedge funds, private equity, and common collective trust funds	Beneficial interests in trusts	State and municipal government securities	Private equity securities
Fair value at June 30, 2013	$	143,339	13,289	9,717	40,150
Purchases		29,142	—	—	8,607
Sales		(54,464)	—	(250)	(9,251)
Realized gains		7,061	—	—	—
Net change in unrealized gains/(losses)		5,733	1,799	151	8,989
Transfer		—	—	(9,618)	—
Fair value at June 30, 2014	$	130,811	15,088	—	48,495

Transfers between levels occur when there is a change in the observability of significant inputs. A transfer between Level 1 and Level 2 generally occurs when the availability of quoted prices changes or when market activity of an investment significantly changes to active or inactive. A transfer between Level 2 and Level 3 generally occurs when the underlying inputs become, or can no longer be, corroborated with market observable data. Transfers between levels are recognized on the date they occur. For the year ended June 30, 2014, there were no transfers out of Level 1. During FY2014, investments held in Auction Rate Securities in the amount of $9,618 which were previously classified as Level 3 were transferred to Level 2.

(Continued)

Disclosure – Fair Value Measurements of Investments in Certain Entities that Calculate Net Asset Value per Share (or its Equivalent) as of June 30, 2014, and do not have a readily determinable value:

		Fair value	Unfunded commitments	Redemption frequency (if eligible)	Redemption notice period
		(in millions)			
a - Equity long/short hedge funds	$	8.8	—	Quarterly, annually	30-90 days
b - Event driven hedge funds		12.2	—	Quarterly, annual rolling	60 days
c - Global opportunities hedge fund		3.1	—	Quarterly	45 days
d - Multi-strategy hedge funds		72.2	—	Quarterly, semi-annually, annually, bi-annually on anniversary	60 – 120 days
e - Real assets		6.4	—	Annually	90 days
f - Real estate funds		37.7	6.0	N/A	N/A
g - Private equity funds		38.9	17.0	N/A	N/A
Total	**$**	**179.3**	**23.0**		

a. This class includes investments in hedge funds that invest both long and short in U.S. and foreign common stocks. Management of the hedge funds has the ability to shift investments from value to growth strategies, from small to large capitalization stocks and from a net long position to a net short position. The fair values of the investments in this class have been estimated using the net asset value per share of the investments as a practical expedient.

b. This class includes investments in hedge funds that invest in equities and bonds to profit from economic, political and government driven events. A majority of the investments are targeted at economic policy decisions. The fair values of the investments in this class have been estimated using the net asset value per share of the investments as a practical expedient.

c. This class includes investments in hedge funds that hold investments in U.S. and non-U.S. common stocks in the health care, energy, information technology, utilities and telecommunications sectors. The fair values of the investments in this class have been estimated using the net asset value per share of the investments as a practical expedient.

d. This class invests in hedge funds that pursue multiple strategies to diversify risks and reduce volatility. The fair values of the investments in this class have been estimated using the net asset value per share of the investments as a practical expedient. Investments representing approximately 23% of the value of the investments in this class are bi-annually redeemed and sell orders have been placed. These will be redeemed in September 2014 and May 2015. The remaining restriction period for these investments ranges from quarterly to annually.

(Dollars in thousands)

e. This class includes a fund with direct investments in base and precious metals and investment securities of miners and associated mining equipment. This fund has a 90-day redemption notice period, which whereby 1/3 of the fund will pay out with the remaining 2/3 paying out in the second and third year, respectively. A sale order has been placed on this fund and the first 1/3 payout occurred in September 2014.

f. This class includes real estate funds that invest in U.S. and non-U.S. residential and commercial properties as well as distressed real estate. The fair values of the investments in this class have been estimated using the net asset value of the System's ownership interest in partners' capital as a practical expedient. $16.9 million of these funds have a 90-day redemption notice, but the fund manager can only accommodate redemption requests as liquid assets allow. The remaining funds will receive distributions from each fund as the underlying investments of the funds are liquidated. It is estimated that the underlying assets of these funds will be liquidated over the next 7 to 10 years, although these funds may liquidate early in the event of purchase by a third party or initial public offering.

g. This class includes private equity funds. These investments cannot be redeemed with the funds. Instead, the nature of the investments in this class is that distributions are received through the liquidation of the underlying assets of the fund. These funds are managed by two of the System's advisors with particular private equity experience in secondary market dealing. These funds could be subject to redemption to a third party buyer, but at June 30, 2014, no funds were currently being evaluated this way. The fair values of the investments in this class have been estimated using the net asset value of the System's ownership interest in partners' capital as a practical expedient.

(5) Property, Plant and Equipment

Property, plant and equipment and related accumulated depreciation at June 30, 2014:

Land and land improvements	$	65,623
Buildings and improvements		567,804
Fixed equipment		271,127
Movable equipment		432,109
Construction in progress		97,547
Property, plant and equipment before depreciation and amortization		1,434,210
Less: Accumulated depreciation and amortization		(735,919)
Property, plant and equipment, net	$	698,291

Depreciation expense was $90,704 for the year ended June 30, 2014.

(Dollars in thousands)

In August 2013, the Board of Directors of the System approved construction of a clinical building. The building sets forth plans for capital expenditures of more than $330,000 over a three year period, and includes significant capital improvements to the Reading Hospital's West Reading campus, 24 surgical suites, including six hybrid operating rooms; eight minor procedure rooms; and reception and recovery areas for individuals. As of June 30, 2014, the remaining commitments on construction contracts is approximately $316,000.

(6) Long-term Debt

Long-term debt at June 30, 2014 consists of:

		Carrying value	Fair value (Level 2)
Berks County Municipal Authority Hospital Revenue Bond Series of 2012, net of unamortized discount and premium	$	478,070	485,381
Berks County Municipal Authority Hospital Revenue Bond Series of 2009, net of unamortized discount		114,308	132,132
Berks County Municipal Authority Hospital Revenue Bond Series of 1993		2,450	2,518
Term loans		1,985	1,985
Total long-term debt		596,813	622,016
Less: Amounts due within one year		(7,074)	
Long-term debt, net of current portion	$	589,739	

Under the terms of the various debt agreements, the System is required to maintain certain deposits with a trustee. Such deposits are included with assets whose use is limited in the consolidated balance sheet. The various agreements also place limits on the incurrence of additional borrowings and require that the System satisfy certain measures of financial performance as long as the debt is outstanding. The System was in compliance with these covenants at June 30, 2014.

(Continued)

(Dollars in thousands)

Scheduled principal repayments on long-term debt are as follows for the year ending 2014:

2015	$	7,074
2016		5,274
2017		5,529
2018		5,751
2019		6,440
Thereafter		562,261
Total long-term debt		592,329
Plus: Unamortized net premium/discounts		4,484
Long-term debt, net of unamortized premiums/discount	$	596,813

The Parent and the Hospital (the Obligated Group) have borrowed funds through revenue bonds issued by the Berks County Municipal Authority. The proceeds were used in part to finance certain facilities of the Obligated Group. The revenue bonds are secured by a pledge of revenue of the Obligated Group. For account purposes, the revenue bonds are treated as though they are the debt of the entity which received the proceeds.

(a) Berks County Municipal Authority Hospital Revenue Bond Series of 2012

On June 28, 2012, The Berks County Municipal Authority (Authority) issued $473,275 (notional) of Revenue Bonds in four series, 2012 A, B, C, and D.

The Authority issued $160,065 of Fixed Rate Serial Revenue Bonds (2012 A) for the purpose of refunding the Dauphin Country General Authority Hospital Revenue Bond Series 1994A, Berks County Bond Series 1998 and 2008. Mandatory annual principal redemptions by the System for the 2012 A bonds due November 1, 2039, through November 1, 2044, range from $7,590 to $33,555 with final maturity on November 1, 2044. Effective interest rate of the bonds range from 4.23% to 4.50%.

The Authority issued $91,775 of Variable Rate Serial Revenue bonds (2012 B) for the purpose of refunding the Authority Series 2009 A-5. Mandatory annual principal redemptions by the System for the 2012 B bonds due November 1, 2035, through November 1, 2039, range from $3,225 to $24,955 with final maturity on November 1, 2039. Interest on these bonds is calculated on a SIFMA Municipal Index rate plus a fixed spread of 1.50%. The SIFMA rate at June 30, 2014, was 0.06%.

The Authority issued a $47,235 Floating Rate Bond (2012 C) used to refund the Series 2009 A-4 and a $174,000 Floating Rate Bond (2012 D) used to Refund the Series 2009 A-1 and A-2. Both Series 2012 C and 2012 D were privately placed with commercial banks. Mandatory monthly principal redemptions by the System for the 2012 C bonds commenced on August 1, 2012, through July 1, 2022, and range from $39 to $129 with final maturity date on July 1, 2022. Interest on these bonds is calculated using a one-month London Interbank Offered Rate Index rate (LIBOR) plus a fixed spread of 1.20% multiplied by an Applicable Factor of 70.0%. The one-month LIBOR rate at June 30, 2014, was .15%.

Mandatory annual principal redemptions by the System for the 2012 D bonds due November 1, 2022, through November 1, 2035, range from $8,625 to $21,120 with final maturity on November 1, 2035. Interest on these bonds is calculated on a SIFMA Municipal Index rate plus a fixed spread of 0.70%. The SIFMA rate at June 30, 2014, was .06%.

(b) Berks County Municipal Authority Hospital Revenue Bond Series of 2009

Series 2009 A-1, A-2, A-4, and A-5 were refunded on June 28, 2012, with the aforementioned Bond Series 2012. The 2009 A-3 bond remains outstanding.

The 2009 A-3 bonds were issued on July 15, 2009. The Authority issued $133,665 of Fixed Rate Revenue Bonds, Series 2009 A-3 for the primary purpose of redeeming $115,520 of 2001 Bonds and $14,965 for major renovation projects.

The 2009 A-3 bonds are comprised of $44,285 of serial bonds and $89,380 of term bonds. The serial bonds are due in installments payable November 1, 2009, through 2019, with payments ranging from $120 to $4,895. The term bonds are due on November 1 of 2024, 2031 and 2039, with payments ranging from $820 to $9,380. The effective interest rate on the serial bonds ranges from 3% to 5% and 5.25% to 5.75% for the term bonds.

(c) Berks County Municipal Authority Hospital Revenue Bond Series of 1993

On June 1, 1993, the Authority issued Hospital Revenue Bonds, Series of 1993 (1993 Bonds) for the primary purpose of providing funds for the advance refunding of the Berks County Municipal Authority Hospital Revenue Bonds Series of 1986 (1986 Bonds), the retirement of certain other indebtedness, and the funding of certain medical and computer equipment to be located on Hospital premises.

Remaining mandatory annual principal redemptions by the Hospital for the 1993 Bonds are $2,450 in FY2015 when the Bond matures on October 1, 2014. A bond fund held at the bond trustee is fully funded to pay for the maturity. All mandatory redemptions are at par value. The Hospital granted to the Authority a security interest in certain assets and substantially all revenues as collateral for its obligation under the indenture.

The stated interest rates of the remaining 1993 Bonds at June 30, 2014, is 5.7%.

(d) Term Loans

Effective retroactive to January 1, 2004, the Hospital replaced NMG Limited Partnership as the borrower on three promissory notes. The Hospital was previously the guarantor for the notes. The original notes were issued as follows: $2,100 due March 31, 2020, $2,000 due December 31, 2019, and $165 due March 31, 2006. In conjunction with the assumption of debt, the Hospital received assets, which have been purchased with the proceeds from the debt.

Mandatory annual principal redemptions by the Hospital for the notes for the 2015-2019 period range from $282 to $407 in 2019. The interest rate is calculated based upon the one-month LIBOR plus a spread of 1.70%. This LIBOR rate was .15% at June 30, 2014.

(e) Line of Credit

At June 30, 2014, the Hospital has an unused line of credit in the amount of $10,000. Letter of credit draws or direct borrowing from this facility is charged an interest rate of 1-month LIBOR plus 1.50%. A separate line of credit in the amount of $500 is open between M&T and The Highlands of Wyomissing. This amount is undrawn at June 30, 2014. Draws on this letter of credit are at the bank's prime rate plus 2.0%. Total combined open and undrawn lines at June 30, 2014 amounted to $3,595. During FY2014, the System closed several letters of credit and opened a new letter of credit for the Hospital facilities expansion that broke ground in FY2014.

(7) Interest Rate Swaps

The System has in the past used derivative instruments, such as interest rate swaps, to manage certain interest rate exposures. Derivative instruments are viewed as risk management tools by the System and are not used for trading and speculative purposes.

When quoted market prices are not available, the valuation of derivative instruments is determined using widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each leg of the derivative. This analysis reflects the contractual terms of the derivatives, including interest rate curves and implied volatilities. The estimates of fair value valuation are made by swap counterparties using a standardized methodology based on observable market inputs. As part of the System's overall valuation process, management evaluates this counterparty valuation methodology to ensure that it is representative of exit prices in the principal markets. These future net cash flows, however, are susceptible to change primarily due to fluctuations in interest rates. As a result, the estimated values of these derivatives will change over time as cash is received and paid and as interest rates change. As these changes occur, they may have a positive or negative impact on estimated valuations.

The System has classified its interest rate swaps in Level 2 of the fair value hierarchy, as the significant inputs to the overall valuations are based on market-observable data or information derived from or corroborated by market-observable data. For over-the-counter derivatives that trade in liquid markets such as interest rate swaps, model inputs (i.e., contractual terms, market prices, yield curves, credit curves, and measures of volatility) can generally be verified, and model selection does not involve significant management judgment.

(Dollars in thousands)

The fair market value of the swap contracts were as follows as of June 30, 2014:

Classification of derivatives included in liabilities on the consolidated balance sheet		**Fair market value**
Derivatives not designated as hedging instrument:		
2008 bond issuance	$	419
2005 bond issuance		4,230
2002 bond issuance		20,203
2001 bond issuance		25,981
1997 bond issuance		280
1992 bond issuance		1,057
Term loans		380
Total swap contracts	$	52,550

Changes in fair value of swap contracts in the consolidated statement of operations totaled $7,309 for the year ended June 30, 2014. The net amount paid or received under the swap contracts is recorded in the consolidated statement of operations as net cash settlement payments and totaled $11,559 for the year ended June 30, 2014.

In connection with the 2008 bond issuance, the System entered into two basis swaps by which the System pays SIFMA and receives an average of 0.85% of three-month LIBOR. Notional amount of these basis swaps is $171.2 million and the three-month LIBOR rate at June 30, 2014, was 0.23%.

In connection with the 2005 bond issuance, the System entered into an interest rate swap agreement with a third party. The swap economically converts the variable rate obligation of the 2005 bonds to a fixed rate of 3.584%. Notional amount of the swap is $36 million.

In connection with the 2001 and 2002 bonds issuances, the System entered into two interest rate swap agreements with a third party. The swaps economically convert the variable rate obligations of the 2001 and 2002 bonds to a fixed rate of 4.30% and 4.69%, respectively. Notional amounts of the swaps are $137.1 million and $72.8 million.

On June 26, 2006, the System entered into an interest rate swap agreement on the 2001, 2002, and 2005 bond issuances, which were effective as of August 4, 2006. The swap has a variable effective interest rate at 68% of the LIBOR.

In connection with the 2002 bond issuance, the System entered into two interest rate swap agreements. The swaps effectively convert the variable rate obligation of the Series A and B Bonds to fixed rates of 4.69% and 6.28%, respectively. Notional amounts of the swaps are $4.5 million and $6.7 million.

In connection with the 1997 bond issuance, the System entered into an interest rate swap agreement that was effective as of May 26, 2005. The swap effectively converts the variable rate obligation of the Bonds to a fixed rate of 3.397%. Notional amount of the swap is $4.8 million.

In connection with the 1992 bond issuance, the System entered into an interest rate swap agreement, which was effective as of May 26, 2005. The swap effectively converts the variable rate obligation of the Bonds to a fixed rate of 3.607%. Notional amount of the swap is $7.5 million.

In connection with the term loans, the System assumed two interest rate swap agreements with a third party. The swaps effectively convert the variable obligations to fixed rates of 9.13% for the $2,100 note and 9.06% for the $2,000 note. The fair value of the interest rate swap agreements is the amount at which they would be settled based on estimates of market rates, which was a liability of $380 at June 30, 2014.

The change in the fair value of the interest rate swap agreements and the interest expense associated with these swaps are recorded in other nonoperating gains(losses) on the consolidated statement of operations.

(8) Retirement Plans

Substantially, all employees of the System are covered under a qualified noncontributory defined benefit pension plan. Pension costs are funded as accrued except when not permitted by regulations, such as full funding limitations. Unfunded prior service costs are amortized over an initial term of thirty years.

(Dollars in thousands)

The System is transitioning the current defined benefit plan structure into a defined contribution plan. Employees hired on or after July 1, 2013 are enrolled in the defined contribution plan. Current defined benefit participants will continue to accrue benefits in the existing defined benefit plan until June 30, 2016. On July 1, 2016, the participant benefits will remain accrued and all employees will then convert to and begin to accumulate funds under the defined contribution plan.

Obligations and Funded Status at June 30, 2014 for the Plan:

Change in projected benefit obligation		
Benefit obligation at beginning of year	$	430,536
Service cost		17,114
Interest cost		22,555
Actuarial loss		37,869
Benefits paid		(12,958)
Benefit obligation at end of year	$	495,116
Change in plan assets		
Fair value of plan assets at beginning of year	$	317,908
Actual return on assets		35,380
Employer contributions		18,209
Benefits paid		(12,958)
Fair value of plan assets at end of year	$	358,539

The accumulated benefit obligations for the Plan totaled $491,095 for 2014.

Amounts recognized in the consolidated balance sheet consist of:

		2014
Accrued pension	$	136,577
Total accrued liability	$	136,577
Amounts recognized in net assets consist of:		
Net actuarial loss	$	108,894
Pension cost charged to net assets	$	108,894

(Continued)

(Dollars in thousands)

Net periodic benefit cost components include the following:

		2014
Service cost – benefits earned during the period	$	17,114
Interest cost on projected benefit obligation		22,555
Expected return on plan assets		(25,681)
Amortization of net gain		1,146
Net periodic pension cost charged to operations	$	15,134

Other changes in plan assets and benefit obligations recognized in unrestricted net assets:

		2014
Net loss	$	31,573
Amortization of net loss		(1,146)
Total recognized in unrestricted net assets	$	30,427
Total recognized in net periodic benefit cost and unrestricted net assets	$	45,561

The amounts expected to be amortized from unrestricted net asset to net periodic pension costs during fiscal year 2015 are a net loss of $1,903 and a prior service cost of $0.

Weighted average assumptions used to determine benefit obligations at June 30, 2014:

Discount rate	4.80%
Rate of compensation increase	3.00%
Measurement date	6/30/2014

Weighted-average assumptions used to determine net periodic benefit cost for years ended June 30, 2014:

Discount rate	5.32%
Expected long-term return on plan assets	8.00%
Rate of compensation increase	3.00%

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

(Dollars in thousands)

(a) Plan Assets

Reading Hospital Pension Plan weighted average actual asset allocations and target allocations as of June 30, 2014 by asset category are as follows:

Asset category	**Target**	**Actual**
Cash and cash equivalents	0.0%	2.0%
Mutual funds	0.0%	34.0%
Fixed income	27.5%	6.0%
Equity investments	50.0%	3.0%
Alternate investments	22.5%	55.0%
	100.0%	100.0%

The overall investment objective of the Plan is to provide a return on investment consistent with the Plan's spending needs and to prevent erosion of purchasing power by inflation. Achievement of the return will be sought from an investment strategy that provides an opportunity for superior returns within acceptable levels of risk and volatility of returns.

The following tables represent the fair value measurement levels for all assets and liabilities, which the Hospital has recorded at fair value:

	Fair value June 30, 2014	**Quoted prices in active markets for identical assets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant other unobservable inputs (Level 3)**
Assets				
Cash and cash equivalents	$ 6,729	6,729	—	—
State and local government securities	7,709	—	7,709	—
Mutual funds	120,353	120,353	—	—
Equities	13,311	13,311	—	—
Fixed income securities	12,884	12,884	—	—
Hedge, private equity, and common collective trust funds	197,553	—	66,532	131,021
Total investments	$ 358,539	153,277	74,241	131,021

(Dollars in thousands)

The following table represents the nonreadily marketable investments and auction rate securities for which fair value was measured under Level 3:

		Hedge funds, private equity, and common collective trust funds	State and municipal government securities
Fair value at July 1, 2013	$	131,529	8,875
Purchases		42,869	—
Sales		(53,870)	(300)
Realized gains		4,110	—
Net change in unrealized gains/(losses)		6,383	(866)
Transfers		—	(7,709)
Fair value at June 30, 2014	$	131,021	—

Transfers between levels occur when there is a change in the observability of significant inputs. A transfer between Level 1 and Level 2 generally occurs when the availability of quoted prices changes or when market activity of an investment significantly changes to active or inactive. A transfer between Level 2 and Level 3 generally occurs when the underlying inputs become, or can no longer be, corroborated with market observable data. Transfers between levels are recognized on the date they occur. For the year ended June 30, 2014, there were no transfers out of Level 1. During FY2014 investments held in Auction Rate Securities in the amount of $7,709 which were previously classified as Level 3 were transferred to Level 2.

(b) Contributions

The Reading Hospital expects to contribute the minimum required contribution during the 2015 fiscal year to the Plan, which is estimated to be $ 24,082.

(c) Estimated Future Benefit Payments

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

Years ending June 30:		
2015	$	14,416
2016		16,070
2017		18,548
2018		20,507
2019		22,231
2020–2024		138,133

(Dollars in thousands)

(9) Related Party Transactions

Other receivables from affiliated organizations at June 30, 2014 consist of:

Springridge, LLC	$	639
Berkshire Health Partners		204
Central Pennsylvania Homecare Inc		7
Total receivables from affiliated organizations	$	850

These amounts are all noninterest bearing with no stated repayment terms.

Included in other assets are the following investments in affiliates at June 30, 2014 consist of:

CPAL	$	350
Quest		71
Springridge, LLC		1,221
RBPT		224
Horizon		542
Affilia Home Health (formerly VNA Community Care Services)		7,709
BHP		1,044
Allspire		1,000
Total investments in affiliated organizations	$	12,161

(10) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets at fair value are available for the following purposes at June 30, 2014:

Various health care services	$	667

Permanently restricted net assets at fair value at June 30, 2014 are restricted to:

Permanent endowment funds, the interest and dividend income from which is expendable to support health care services	$	7,517
Funds held in trust by others		15,088
Total permanently restricted net assets	$	22,605

(11) Insurance Arrangements

The System participates in the Pennsylvania Medical Care Availability and Reduction of Error Fund or Mcare Fund established under the Commonwealth of Pennsylvania. The Mcare Fund presently provides coverage excess of up to $500 to the System’s primary per occurrence retention (which is currently $500) with annual aggregate coverage of $1,500.

(Continued)

(Dollars in thousands)

The System established a self-insurance trust fund to provide protection against professional liability claims. The trust is actuarially funded on an annual basis to provide single limit professional liability coverage of $500 per occurrence and $2,500 in the annual aggregate for the Hospital and certain employees. For incidents occurring since April 30, 2009, the System purchased commercial insurance to provide coverage on a claims-made basis in an amount up to $25,000 in excess of a total retention of $3,000, $500 primary; $500 Mcare excess and a $2,000 self-insured buffer. The adoption of the ASU 2010-24 *Presentation of Insurance Claims and Related Insurance Recoveries*, had no impact on the System's financial performance or cash flows. Claim liabilities are no longer netted by insurance recoveries. For the year ended June 30, 2014, the insurance recoverable amount was $27,750, which is included in other assets on the consolidated balance sheet. Funding requirements of the plan are subject to increase depending on the plan's claim experience. Premium payments for the Mcare Fund are based upon each individually licensed healthcare provider's rating with the Joint Underwriters Association and the amount of the surcharge to be assessed is determined by the Mcare Fund on an annual basis. The System's annual surcharge premium for participation in the Mcare Fund was $2,122 for the year ended June 30, 2014.

Additionally, the System self-insures its workers' compensation and minor general liability risks. The System's self-insurance plan has been reviewed and approved by the Commissioner of Insurance of Pennsylvania. The System purchases excess workers' compensation insurance for all controlled entities of the hospital with statutory limits over a self-retention of $1,000 per occurrence subject to a policy maximum of $1,000 for the policy period. The System has established a trust fund for the payment of workers' compensation benefits.

Reserves for self-insurance claims at June 30, 2014 are summarized as follows:

Professional liability claims payable	$	61,214
Workers' compensation		14,267
Total self-insurance claims reserve		75,481
Less: Current portion		35,722
Self-insurance claims reserve, net of current portion	$	39,759

(12) Commitment and Contingencies

(a) Operating Leases

The System leases equipment and facilities under operating leases expiring at various dates through May 2026. Total rental expense under all operating leases was $7,951 for the year ended 2014.

(Dollars in thousands)

The following table summarizes future minimum rental commitments under noncancelable operating leases with initial or remaining terms of more than one year:

Years ending June 30:		
2015	$	6,570
2016		4,727
2017		3,726
2018		2,879
2019 and thereafter		15,418

(b) Obligation to Provide Future Services

The Highlands annually calculates the present value of the estimated net cost of future services and use of facilities to be provided to current residents and compares that amount with the balance of deferred entrance fee revenue. If the present value of the net cost of future services and use of facilities exceeds the deferred revenue, a liability is recorded with the corresponding charge to income. For the year ended 2014, the estimated present value of the net cost of future services and use of facilities is less than the deferred entrance fee revenue; thus, no liability has been recorded.

(c) Litigation

The System and its controlled entities are involved in certain litigation, which involves professional and general liability. In the opinion of management and legal counsel, the ultimate liability, if any, will not have a material effect on the consolidated financial condition of the Parent and its controlled entities.

(d) Regulatory Compliance

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The System believes that it is in compliance with all applicable laws and regulations through the year ended 2014. Compliance with such laws and regulations can be subject to government review and interpretation as well as significant regulatory action, including fines, penalties, and exclusion from the Medicare and Medicaid programs.

(13) Concentrations of Credit Risk

Financial instruments, which potentially subject the System to concentrations of credit risk, consist primarily of cash, cash equivalents, investments, and accounts receivable.

Management periodically evaluates the credit standing of the financial institutions with which they maintain their cash, cash equivalents, and investments. Amounts held in its accounts often exceed the federally insured levels.

The fair value of the System’s investments is subject to various market fluctuations, which include changes in the interest rate environment and general economic conditions.

(Dollars in thousands)

The System grants credit to its patients and other third-party payors, primarily Medicare, Medical Assistance, Blue Cross, and various commercial insurance companies. The System maintains reserves for potential credit losses and such losses have historically been within management's expectations. The mix of receivables from patients and third-party payors as of June 30, 2014 was as follows:

Medicare	25%
Medical assistance	10%
Blue Cross	31%
Commercial insurance	21%
Self-pay	7%
Other	6%
	100%

The activity in the allowance for uncollectible accounts is summarized as follows for the year ended June 30, 2014:

Beginning balance (as restated)	$	59,866
Provision for uncollectible accounts		30,334
Write-offs		(21,169)
Ending balance	$	69,031

(14) Functional Expenses

The System considers health program services and general/administrative to be its primary functional categories for purposes of expense classification. General/administrative includes information systems, general corporate management, advertising and marketing. Functional categories of expenses for the year ended June 30, 2014 are as follows:

Health program services	$	854,725
General/administrative		76,612
Total functional expenses	$	931,337

(15) Beginning Net Assets Adjustment

During 2014, management discovered an error of $56,333 relating to the valuation of patient accounts as of June 30, 2013. The performance indicator, excess of revenue, gains and other support over expenses for the year ended June 30, 2013 was overstated by $56,333. The 2014 consolidated financial statements reflect this adjustment as a reduction in amounts previously reported as beginning unrestricted net assets as of June 30, 2013.

(16) Subsequent Events

The Company has evaluated subsequent events through November 24, 2014, the date the consolidated financial statements were available to be issued. Management reviews and identifies subsequent events through participation at meetings of the Board of Directors and their subcommittees.

On August 1, 2014, Reading Hospital purchased the remaining 60% interest of Reading Berks Physical Therapy, LLC ("RBPT"). The purchase price was $1,895. All Reading Berks Physical Therapy locations will now be consolidated into Reading Hospital Outpatient Therapy. This acquisition will allow patients to experience a wider variety of services at a total of nine Reading Hospital Outpatient Therapy locations around Berks County.

READING HEALTH SYSTEM AND SUBSIDIARIES

Consolidated Schedule of Expenditures of Federal Awards

Year ended June 30, 2014

Federal Grantor/Program or Cluster Title	Federal CFDA number	Pass-thru entity identification number	Federal expenditures
Student Financial Assistance Cluster:			
U.S. Department of Education:			
Federal Direct Student Loans	84.268		$ 1,894,610
Federal Pell Grant Program	84.063		570,468
Total Student Financial Assistance Cluster			2,465,078
Research and Development Cluster:			
U.S. Department of Health and Human Services:			
Blood Diseases and Resources Research			
Passed through the University of Washington	93.839	WU-09-338	17,250
Total Research and Development Cluster			17,250
Other Programs:			
U.S. Department of Health and Human Services:			
Grants to Provide Outpatient Early Intervention Services with Respect to HIV Disease	93.918		341,776
Affordable Care Act (ACA) Primary Care Residency Expansion Program	93.510		778,613
National Bioterrorism Hospital Preparedness Program			
Passed through the Pennsylvania Office of Public Health Preparedness	93.889	605659	49,233
Block Grants for the Prevention and Treatment of Substance Abuse			
Passed through the Pennsylvania Department of Drug and Alcohol Programs	93.959	67044	44,340
Substance Abuse and Mental Health Services Projects of Regional and National Significance			
Passed through the Council on Chemical Abuse	93.243	62121	995
Department of Housing and Urban Development:			
Supportive Housing Program:			
Passed through the Council on Chemical Abuse	14.235	62121	2,541
Total Other Programs			1,217,498
Total Expenditures of Federal Awards			$ 3,699,826

See accompanying notes to conolidated schedule of expenditures of federal awards.

(1) Basis of Presentation

The accompanying Consolidated Schedule of Expenditures of Federal Awards (the Schedule) includes the federally funded activities of Reading Health System and Subsidiaries and is presented on the accrual basis of accounting. The School of Health Sciences at Reading Health System (School) provides a program of classroom and clinical preparation for the nursing profession and other allied health professionals. The information in this Schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations.* Therefore, some amounts presented in this Schedule may differ from amounts presented in, or used in the preparation of the basic financial statements.

PART II
REPORTS ON INTERNAL CONTROL AND COMPLIANCE

KPMG LLP
1601 Market Street
Philadelphia, PA 19103-2499

Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

The Board of Directors of
Reading Health System:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the consolidated financial statements of Reading Health System and Subsidiaries, which comprise the consolidated balance sheet as of June 30, 2014, and the related consolidated statements of operations, changes in net assets, and cash flows for the year then ended, and the related notes to the consolidated financial statements, and have issued our report thereon dated November 24, 2014.

Internal Control Over Financial Reporting

In planning and performing our audit of the consolidated financial statements, we considered Reading Health System and Subsidiaries' internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of Reading Health System and Subsidiaries' internal control. Accordingly, we do not express an opinion on the effectiveness of Reading Health System and Subsidiaries' internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying schedule of findings and questioned costs, we identified certain deficiencies in internal control that we consider to be a material weakness.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described as item 2014-001 in the accompanying schedule of findings and questioned costs to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Reading Health System and Subsidiaries' consolidated financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Reading Health System and Subsidiaries' Response to Findings

Reading Health System and Subsidiaries' response to the findings identified in our audit is described in the accompanying schedule of findings and questioned costs. Reading Health System and Subsidiaries'' response was not subjected to the auditing procedures applied in the audit of the consolidated financial statements and, accordingly, we express no opinion on the response.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of Reading Health System and Subsidiaries' internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Reading Health System and Subsidiaries' internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

KPMG LLP

Philadelphia, Pennsylvania
November 24, 2014

KPMG LLP
1601 Market Street
Philadelphia, PA 19103-2499

Independent Auditor's Report on Compliance for Each Major Federal Program; Report on Internal Control Over Compliance; and Report on Schedule of Expenditures of Federal Awards Required by OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*

The Board of Directors of
Reading Health System:

Report on Compliance for Each Major Federal Program

We have audited Reading Health System and Subsidiaries' compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on Reading Health System and Subsidiaries' major federal program for the year ended June 30, 2014. Reading Health System and Subsidiaries' major federal program is identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its federal programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for Reading Health System and Subsidiaries' major federal program based on our audit of the types of compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Reading Health System and Subsidiaries' compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for the major federal program. However, our audit does not provide a legal determination of Reading Health System and Subsidiaries' compliance.

Opinion on Major Federal Program

In our opinion, the Reading Health System and Subsidiaries' complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on its major federal program for the year ended June 30, 2014.

Other Matters

The results of our auditing procedures disclosed instances of noncompliance, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as item 2014-002. Our opinion on the major federal program is not modified with respect to these matters.

Reading Health System and Subsidiaries' response to the noncompliance finding identified in our audit is described in the accompanying schedule of findings and questioned costs. Reading Health System and Subsidiaries' response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.

Report on Internal Control Over Compliance

Management of Reading Health System and Subsidiaries' is responsible for establishing and maintaining effective internal control over compliance with the types of compliance requirements referred to above. In planning and performing our audit of compliance, we considered Reading Health System and Subsidiaries' internal control over compliance with the types of requirements that could have a direct and material effect on its major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for its major federal program and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Reading Health System and Subsidiaries' internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. A significant deficiency in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, we identified a deficiency in internal control over compliance, as described in the accompanying schedule of findings and questioned costs as item 2014-002 that we consider to be a significant deficiency.

Reading Health System and Subsidiaries' response to internal control over compliance finding identified in our audit is described in the accompanying schedule of findings and questioned costs. Reading Health System and Subsidiaries' response was not subjected to the auditing procedures applied in the audit of compliance and, accordingly, we express no opinion on the response.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of OMB Circular A-133. Accordingly, this report is not suitable for any other purpose.

Report on Schedule of Expenditures of Federal Awards Required by OMB Circular A-133

We have audited the consolidated financial statements of Reading Health System and Subsidiaries' as of and for the year ended June 30, 2014, and have issued our report thereon dated November 24, 2014, which contained an unmodified opinion on those financial statements. Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the schedule of expenditures of federal awards is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

KPMG LLP

Philadelphia, Pennsylvania
March 13, 2015

PART III
FINDINGS

Section I – Summary of Auditor's Results

Financial Statements

(i)	Type of auditor's report issued	Unmodified
(ii)	Internal control over financial reporting:	
	Material weakness(es) identified?	Yes (2014-001)
	Significant deficiency(ies) identified?	None reported
(iii)	Noncompliance material to financial statements noted?	No

Federal Awards

(iv)	Internal control over major federal programs:	
	Material weakness(es) identified	No
	Significant deficiency(ies) identified?	Yes (2014-002)
(v)	Type of auditors' report issued on compliance for major federal programs	Unmodified
(vi)	Any audit findings disclosed that are required to be reported in accordance with Section 510(a) of Circular A-133?	Yes
(vii)	Identification of major federal programs:	

CFDA number(s)	Name of Federal Program or Cluster
84.268, 84.063	Student Financial Aid Cluster

Dollar threshold used to distinguish between type A and type B programs:	$300,000
Auditee qualified as a low-risk auditee?	Yes

Section II – Financial Statement Findings

Finding 2014-001

Criteria and Condition

Generally Accepted Accounting Principles (GAAP) require that accounts receivable be stated at net realizable value. Contractual adjustments, discounts, and an estimated provision for bad debt expense are to be recorded initially in the period the services are provided. The components of the internal control framework as promulgated by the Committee on Sponsoring Organizations (COSO) include risk assessment, control environment, control activities, information and communication as well as monitoring.

Based upon our inquiries with management and personnel in the billing and finance departments, along with inspections of supporting documentation, we were unable to determine that appropriate information and communication and control activities exist to monitor and ensure the recording of accounts receivable at net realizable value. We found that there appeared to be inadequate reports generated from the newly implemented billing system to enable management to monitor the status of accounts receivable as they move through the revenue cycle process (billed, unbilled, denied, suspended, etc). Finally, it appeared there was inadequate reporting, and a lack of adequate key performance indicators, in order to facilitate the appropriate level of monitoring.

Cause and Effect

Due to the implementation of a new electronic records and billing subledger system and turnover of key personnel within the billing and collection processes, accounts receivable as of June 30, 2014 were not recorded at net realizable value which resulted in an audit difference and management's decision to increase the allowance for doubtful accounts and which resulted in a charge of $43,670,000 to the income statement for the year ended June 30, 2014.

Recommendation

We recommend that management evaluate the controls and activities currently in place surrounding the revenue cycle process and implement the following suggested controls and procedures (among others) to ensure accounts receivable are recorded at net realizable value:

- Ensure the billing system is appropriately applying contractual allowances at the time of billing
- Formalize an allowance for doubtful accounts reserving methodology based upon historical collections
- Review the allowance for doubtful accounts reserve on a periodic basis through a cash "run out"
- Assess information from the billing subledger system to enhance users ability to perform adequate control monitoring of the allowance for doubtful accounts reserve setting methodology
- Monitor "open tickets" in the EPIC system and their status of completion

Views of Responsible Officials and Planned Corrective Actions

Management's views and corrective action plan are included at the end of this report.

Section III – Federal Award Findings and Questioned Costs

Finding 2014-002: Enrollment reporting was not completed timely

Federal Agency:	U.S. Department of Education
Program:	Federal Direct Student Loans
CFDA number:	84.268
Award Year:	July 1, 2013 to June 30, 2014

Criteria

Under the Federal Family Education Loan (FFEL) and Direct Loan programs, schools must complete and return within 30 days the Enrollment Reporting roster file [formerly the Student Status Confirmation Report (SSCR)] placed in their Student Aid Internet Gateway (SAIG) mailboxes sent by the U.S. Department of Education (ED) via the National Student Loan Data System (NSLDS) *(OMB No. 1845-0035)*. The institution must update for changes in student status, report the date the enrollment status was effective, enter the new anticipated completion date, and submit the changes electronically through the batch method or the NSLDS web site.

Unless the school expects to complete its next roster within 60 days, the school must notify the lender or the guaranty agency within 30 days, if it discovers that a student who received a loan either did not enroll or ceased to be enrolled on at least a half-time basis (FFEL, 34 CFR Section 682.610; Direct Loan, 34 CFR Section 685.309).

Condition

We tested the accuracy of the School's roster file by selecting a sample of 40 students that graduated, withdrew, dropped out, or enrolled but never attended during the audit period. We compared the data in the NSLDS Enrollment Timeline and to the student's academic files to ensure that the student's status change was communicated timely to NSLDS.

We noted for 33 out of 40 students selected that the time that elapsed between the date of the student's status change to when the enrollment update was received by NSLDS exceeded 60 days, ranging in 20 to 41 days past the required reporting timeframes. Of the 33 students, 31 graduated in July 2013 and two withdrew in July 2013, prior to the School's implementation of its corrective action plan related to the prior year finding.

Questioned Costs

None noted.

Effect

Prior to July 2014, information on changes in enrollment status was not received by NSLDS within the required timeframe.

Cause

Enrollment changes within the School's records were not submitted to the National Student Clearinghouse (NSC), a third party servicer, timely during the year under audit as there was not a formal procedure in place to ensure timely reporting.

Recommendation

We recommend that the School continue performing the procedures it has implemented to ensure the timely reporting of enrollment changes to NSLDS, including manually reconciling student status changes to NSC and NSLDS on at least a monthly basis.

Views of Responsible Officials and Planned Corrective Actions

Management's views and corrective action plan are included at the end of this report.

Summary Schedule of Prior Audit Findings

2013-01

Status-Corrective action taken.

2013-02

Status-Corrective action taken.

2013-03

Status-Corrective action taken.

2013-04

Status-Finding repeated in the current year as Finding 2014-002.

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Management's Views and Corrective Action Plan

Finding 2014-001

Response

Management concurs with the finding and notes it was not related to internal controls related to the management of federal funds.

Corrective Action Plan

Management has acted on the recommendations related to the finding. Corrective action plans include:

- Calculating contractuals on a monthly basis for financial reporting
- Reserving all accounts receivable aged over 180 days as uncollectible
- Performing cash lookbacks on a monthly basis on the open accounts receivable
- Engaging an external expert to perform a quarterly review of accounts receivable valuation

Contact Person Responsible for Corrective Action

Drew Lerman, Vice President, Finance

Anticipated Completion date

September 2014 through June 2015

Finding 2014-002

Response

Management concurs with the finding.

Corrective Action Plan

As a result of the corrective action plan of the prior year finding , copies of the submitted data file by the Registrar to NSC are maintained by the IT Administrator and/or the Director of Financial Aid and Budget and will be reviewed monthly to resolve discrepancies timely. It is also noted that the School supplied the auditors with documentation that the prior year's corrective action has been put into place and verified that the 140 July 2014 graduates were certified and reported timely on 8/4/14.

Contact Person Responsible for Corrective Action

Robin Hall, Director of Financial Aid

Anticipated Completion date

August 2014