

# UPMC AUDITED CONSOLIDATED FINANCIAL STATEMENTS

YEAR ENDED JUNE 30, 2010

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# REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors  
UPMC  
Pittsburgh, Pennsylvania

We have audited the accompanying consolidated balance sheets of UPMC as of June 30, 2010 and 2009, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of UPMC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentations. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of UPMC at June 30, 2010 and 2009, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), UPMC's internal control over financial reporting as of June 30, 2010, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated September 15, 2010, expressed an unqualified opinion thereon.

*Ernst & Young LLP*

Pittsburgh, Pennsylvania  
September 15, 2010

## CONSOLIDATED BALANCE SHEETS

	2010	June 30 2009
<i>(In thousands)</i>		
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 158,067	\$ 176,910
Patient accounts receivable, net of allowance for uncollectible accounts of \$81,441 in 2010 and \$72,446 in 2009	458,239	402,798
Other receivables	328,565	321,209
Other current assets	96,413	95,841
Total current assets	1,041,284	996,758
Board-designated, restricted, trustee, and other investments	3,051,536	2,836,647
Beneficial interests in foundations	273,997	252,524
Property, buildings, and equipment:		
Land and land improvements	281,502	246,055
Buildings and fixed equipment	3,640,401	3,312,393
Movable equipment and internal-use software development costs	1,881,548	1,732,174
Capital leases	183,590	175,730
Construction in progress	164,388	229,230
	6,151,429	5,695,582
Less allowance for depreciation	(2,953,004)	(2,674,007)
	3,198,425	3,021,575
Other assets	352,810	354,034
Total assets	\$ 7,918,052	\$ 7,461,538
<b>LIABILITIES AND NET ASSETS</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 314,806	\$ 337,892
Accrued salaries and related benefits	335,447	296,020
Current portion of insurance reserves	292,256	243,439
Current portion of long-term obligations	139,370	270,027
Other current liabilities	206,096	178,843
Total current liabilities	1,287,975	1,326,221
Long-term obligations:		
Revenue bonds	2,933,818	2,774,535
Notes payable and other	45,972	57,321
	2,979,790	2,831,856
Pension liability	300,352	275,063
Long-term insurance reserves	174,260	157,396
Other long-term liabilities	143,503	115,391
Total liabilities	4,885,880	4,705,927
Net assets:		
Unrestricted	2,615,201	2,348,877
Restricted	416,971	406,734
Total net assets	3,032,172	2,755,611
Total liabilities and net assets	\$ 7,918,052	\$ 7,461,538

See accompanying notes.

## CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS

Year Ended June 30	2010	2009
<i>(In thousands)</i>		
<b>UNRESTRICTED NET ASSETS</b>		
Revenues:		
Net patient service revenue	\$ 4,424,252	\$ 4,247,647
Insurance enrollment revenue	3,042,021	2,903,799
Other revenue	580,194	569,168
Total operating revenues	8,046,467	7,720,614
Expenses:		
Salaries, professional fees, and employee benefits	2,993,634	2,867,863
Supplies, purchased services, and general	4,196,218	4,090,088
Depreciation and amortization	389,893	364,274
Provision for bad debts	234,690	206,886
Total operating expenses	7,814,435	7,529,111
Operating income (excluding asset impairment charge and income tax expense)	232,032	191,503
Asset impairment charge	(14,224)	-
Operating income	217,808	191,503
Income tax expense	(2,256)	(7,755)
After-tax operating income	215,552	183,748
Investing and financing activities:		
Investment revenue (loss)	290,539	(597,043)
Interest expense	(119,909)	(88,520)
Loss on extinguishment of debt	(28,270)	(1,876)
Gain (loss) from investing and financing activities	142,360	(687,439)
Nonoperating loss	(850)	(5,818)
Excess of revenues over expenses (expenses over revenues)	357,062	(509,509)
Other changes in unrestricted net assets:		
Increase in postretirement benefits liabilities	(88,819)	(227,171)
Assets released from restriction for capital purchases	7,952	5,407
Distributions and pledged support from foundations for capital	-	60,573
Other changes in unrestricted net assets	(9,871)	-
Increase (decrease) in unrestricted net assets	266,324	(670,700)
<b>RESTRICTED NET ASSETS</b>		
Contributions	10,806	9,900
Net realized and unrealized (losses) gains in investments	595	(13,870)
Assets released from restriction for operations and capital purchases	(19,200)	(29,273)
Net increase (decrease) in beneficial interests in foundations	18,036	(126,522)
Increase (decrease) in restricted net assets	10,237	(159,765)
Increase (decrease) in net assets	276,561	(830,465)
Net assets, beginning of year	2,755,611	3,586,076
Net assets, end of year	\$ 3,032,172	\$ 2,755,611

See accompanying notes.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

Year Ended June 30	2010	2009
<i>(In thousands)</i>		
<b>OPERATING ACTIVITIES</b>		
Increase (decrease) in net assets	\$ 276,561	\$ (830,465)
Adjustments to reconcile increase (decrease) in net assets to net cash provided by operating activities:		
Depreciation and amortization	389,893	364,274
Asset impairment charge	14,224	–
Increase in postretirement benefits liabilities <sup>A</sup>	88,819	227,171
(Increase) decrease in beneficial interests in foundations	(18,036)	126,522
Restricted contributions and investment income	(11,401)	3,971
Net (increase) decrease in trading securities	(186,624)	308,805
Changes in operating assets and liabilities	(51,883)	29,018
Net cash provided by operating activities	501,553	229,296
<b>INVESTING ACTIVITIES</b>		
Purchase of property and equipment (net of disposals)	(355,109)	(546,299)
Acquisition of controlling interests in businesses	(81,268)	–
Other investments	(13,829)	(9,406)
Net (increase) decrease in investments designated as nontrading	(28,265)	17,354
Net decrease in other assets	1,309	1,675
Net cash used in investing activities	(477,162)	(536,676)
<b>FINANCING ACTIVITIES</b>		
Repayments of long-term obligations	(1,231,583)	(129,913)
Borrowings of long-term obligations	1,176,948	541,268
Restricted contributions and investment income (loss)	11,401	(3,971)
Net cash (used in) provided by financing activities	(43,234)	407,384
(Decrease) increase in cash and cash equivalents	(18,843)	100,004
Cash and cash equivalents, beginning of year	176,910	76,906
Cash and cash equivalents, end of year	\$ 158,067	\$ 176,910

<sup>A</sup> Includes a cash contribution to the pension plans of \$125,307 and \$31,180 during the years ended June 30, 2010 and 2009, respectively.

See accompanying notes.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

## 1. ORGANIZATIONAL OVERVIEW AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

UPMC is a Pennsylvania nonprofit corporation and is exempt from federal income tax pursuant to Section 501(a) of the Internal Revenue Code ("Code") as an organization described in Section 501(c)(3) of the Code. Headquartered in Pittsburgh, Pennsylvania, UPMC is one of the leading medical centers in the United States. UPMC is an integrated global health enterprise that has the medical expertise, geographic reach, and financial stability to develop models of excellence that are transforming health care nationally and internationally. UPMC comprises nonprofit and for-profit entities offering medical and health care related services, including health insurance products. UPMC is closely affiliated with the University of Pittsburgh ("University") and partners with the University's Schools of the Health Sciences to deliver outstanding patient care, train tomorrow's health care specialists and biomedical scientists, and conduct groundbreaking research to advance the understanding of the causes and course of disease. These goals are realized through shared academic and research objectives.

The accompanying consolidated financial statements include the accounts of UPMC and its subsidiaries. The consolidated financial statements are comprised of domestic and foreign nonprofit and for profit entities that maintain separate books and records as part of their legal incorporation. Intercompany accounts and transactions are eliminated in consolidation.

### Cash and Cash Equivalents

Cash and cash equivalents consist primarily of cash and investments, which are so near to maturity (maturity of three months or less when purchased) that they present insignificant risk of changes in value.

### Net Patient Service Revenue and Accounts Receivable

Net patient service revenue is reported at estimated net realizable amounts in the period in which services are provided. The majority of UPMC's services are rendered to patients under Medicare, Highmark Blue Cross Blue Shield ("Highmark"), and Medical Assistance programs. Reimbursement under these programs is based on a combination of prospectively determined rates and historical costs. Amounts received under Medicare and Medical Assistance programs are subject to review and final determination by program intermediaries or their agents.

Provisions for adjustments to net patient service revenue are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. Net patient service revenue for 2010 and 2009 was increased by approximately \$5,152 and \$22,257, respectively, for prior-year settlements.

In 2010 and 2009, respectively, the percentage of net patient service revenue derived from Medicare was approximately 30% and 31%, from Highmark was approximately 26% and 25% and from Medical Assistance programs was approximately 11% and 13%.

Laws and regulations governing the Medicare and Medical Assistance programs are extremely complex and subject to interpretation. Compliance with such laws and regulations are subject to government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medical Assistance programs. As a result, there is at least a reasonable possibility that the recorded estimates may change by a material amount in the near term.

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

Significant concentrations of patient accounts receivable at June 30, 2010 and 2009, include: Medicare 33% and 32%, Highmark 16% and 19%, and Medical Assistance 17% and 18%, respectively. The provision for bad debts is based upon management's assessment of historical and expected net collections considering historical business and economic conditions, trends in health care coverage, and other collection indicators. Periodically throughout the year, management assesses the adequacy of the allowance for uncollectible accounts based upon historical write-off experience by payor category. The results of this review are then used to make any modifications to the provision for bad debts to establish an appropriate allowance for uncollectible accounts.

## Board-Designated, Restricted, Trusteed, and Other Investments

Substantially all of UPMC's investments in debt and equity securities are classified as trading. This classification requires UPMC to recognize unrealized gains and losses on substantially all of its investments in debt and equity securities as investment revenue (loss) in the consolidated statements of operations and changes in net assets. UPMC's investments in debt and equity securities that are donor-restricted assets are designated as nontrading. Unrealized gains and losses on donor-restricted assets are recorded as changes in restricted net assets in the consolidated statements of operations and changes in net assets. Gains and losses on the sales of securities are determined by the average cost method. Realized gains and losses are included in investment revenue (loss) in the consolidated statements of operations and changes in net assets.

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value using quoted market prices or model-driven valuations. These investments predominantly include those maintained in Master Trust Funds ("MTF") and are summarized as nonalternative investments in Note 4.

Investments in limited partnerships that invest in marketable securities (hedge funds) are reported using the equity method of accounting based on information provided by the respective partnership. The values provided by the respective partnerships are based on historical cost, appraisals, or other estimates that require varying degrees of judgment. Generally, UPMC's holdings reflect net contributions to the partnership and an allocated share of realized and unrealized investment income and expenses. The investments may individually expose UPMC to securities lending, short sales, and trading in futures and forward contract options and other derivative products. UPMC's risk is limited to its carrying value. Amounts can be divested only at specified times. The financial statements of the limited partnerships are audited annually, generally as of December 31. These investments are summarized as alternative investments in Note 4.

Investments in limited partnerships that invest in nonmarketable securities (private equity) are primarily recorded at cost if the ownership percentage is less than 5% and are reported using the equity method of accounting if the ownership percentage is greater than 5%. These investments are periodically evaluated for impairment. These investments are summarized as alternative investments in Note 4.

Effective January 2009, UPMC terminated its securities lending program whereby the bank trustee of the MTF allowed various brokers to borrow certain designated securities secured primarily with cash collateral. The assets in the program at that time have been substantially liquidated.

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

## Financial Instruments

Cash and cash equivalents and investments recorded at fair value aggregate \$1,801,142 and \$1,709,552 at June 30, 2010 and 2009, respectively. The fair value of these instruments is based on market prices as estimated by financial institutions. The fair value of long-term debt at June 30, 2010 and 2009 is \$3,136,038 and \$2,997,055, respectively, based on market prices as estimated by financial institutions. The fair value of amounts owed to counterparties under derivative contracts at June 30, 2010 and 2009, is \$28,162 and \$125,922, respectively, based on pricing models that take into account the present value of estimated future cash flows.

## Beneficial Interests in Foundations

Several of UPMC's subsidiary hospitals have foundations that, according to their bylaws, were formed for the exclusive purpose of supporting and furthering the mission of the respective hospital. The foundations are separate corporations and are not liable for the obligations of UPMC, including any claims of creditors of any UPMC entities. The net assets of certain foundations are included in the consolidated balance sheets as beneficial interests in foundations and restricted net assets because the hospitals' use of these assets is at the discretion of the foundations' independent board of directors.

Beneficial interests in foundations of \$273,997 and \$252,524 and the net assets of the other foundations of \$50,369 and \$54,941 as of June 30, 2010 and 2009, respectively, are not pledged as collateral for UPMC's debt.

## Property, Buildings, and Equipment

Property, buildings, and equipment are recorded at cost or, if donated or impaired, at fair market value at the date of receipt or impairment. Interest cost incurred on borrowed funds (net of interest earned on such funds) during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

Costs associated with the development and installation of internal use software are expensed or capitalized depending on whether they are incurred in the preliminary project stage, application development stage, or postimplementation stage.

Depreciation is computed using the straight-line method at rates designed to amortize the assets over their estimated useful lives (predominantly ranging from 3 to 40 years) and includes amortization related to capitalized leases. Certain newly constructed buildings have estimated useful lives up to 60 years.

## Asset Impairment

UPMC evaluates the recoverability of the carrying value of long-lived assets by reviewing long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable and adjusts the asset cost to fair value if undiscounted cash flows are less than the carrying amount of the asset.

## Other Assets

Investments in individual entities in which UPMC has the ability to exercise significant influence but does not control, generally 20% to 50% ownership, are reported using the equity method of accounting. All other noncontrolled investments are carried at cost. Other assets include approximately \$77,891 and \$75,894 at June 30, 2010 and 2009, respectively, relating to investments in partnerships that provide health care, management, and other goods and services to UPMC, its affiliates, and the community at large.

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

## Goodwill

Goodwill represents the excess of the cost of an acquired entity over the net of the amounts assigned to the fair value of assets acquired and liabilities assumed. Goodwill is amortized on a straight-line basis over a period of 40 years. Goodwill and other intangible assets are recorded in UPMC's consolidated balance sheets as other assets.

## Health Insurance Revenue and Costs

UPMC's insurance subsidiaries (collectively, "Health Plans") provide health care services on a prepaid basis under various contracts. The Health Plans provide medical services to subscribing participants under agreements that provide for capitated payments based on the number of subscribing enrollees, regardless of the medical services actually performed. Insurance enrollment revenues are recognized as income in the period in which enrollees are entitled to receive health care services. Enrollment revenue includes approximately 77% and 75% for the years ended June 30, 2010 and 2009, respectively, from Medicare and Medical Assistance.

Health care costs were approximately \$2,587,197 and \$2,585,517, of which \$758,732 and \$658,858 were eliminated in consolidation representing medical services, performed by other UPMC entities for the years ended June 30, 2010 and 2009, respectively. Such costs are included in supplies, purchased services, and general expenses. These costs include estimates of payments to be made on claims reported as of the balance sheet date and estimates of health care services rendered but not reported to the Health Plans. Such estimates include the cost of services that will continue to be rendered after the balance sheet date when the Health Plans are obligated to remit payment for such services in accordance with contract provisions or regulatory requirements. Current accrued insurance reserves include approximately \$222,790 and \$174,643 at June 30, 2010 and 2009, respectively, relating to estimates of claims payable for health care services.

Unrestricted net assets required to meet statutory requirements of the Health Plans were \$204,678 and \$184,683 at June 30, 2010 and 2009, respectively.

## Derivatives

UPMC uses derivatives to modify the interest rates and manage risks associated with its asset allocation and outstanding debt. UPMC records derivative financial instruments, such as interest rate swaps, as assets or liabilities in the consolidated balance sheets at fair value. The accounting for changes in the fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. UPMC has entered into interest rate swap agreements to convert a portion of fixed rate debt to a variable interest rate. UPMC also entered into interest rate swap agreements that convert a portion of its variable rate debt to fixed rate debt. None of UPMC's swaps outstanding as of June 30, 2010 and 2009, are designated as hedging instruments and as such, changes in fair value are recognized in investing and financing activities as investment revenue (loss) in the consolidated statements of operations and changes in net assets.

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

## Restricted Net Assets

Unconditional promises to give cash and other assets are reported at fair value as of the date the promise is received. Conditional promises to give are reported at fair value at the date the condition is met. Contributions are reported as restricted if they are received with donor stipulations that limit the use of the donated assets.

Restricted net assets include \$157,464 and \$162,478 of permanently restricted net assets held in perpetuity at June 30, 2010 and 2009, respectively. The remainder of restricted net assets is temporarily restricted and primarily represents beneficial interests in foundations that support research and other health care programs. Temporarily restricted net assets are limited by donors and the foundations to a specific time period or purpose. Temporarily restricted net assets are reclassified to unrestricted net assets and included in the consolidated statements of operations and changes in net assets as other revenue or assets released from restriction for capital purchases when the restriction is met.

## Nonoperating Loss

Nonoperating loss includes costs not directly associated with patient care, related patient services, or other activities not relating to the core operations of UPMC's business.

## Excess of Revenues Over Expenses (Expenses Over Revenues)

The consolidated statements of operations and changes in net assets include excess of revenues over expenses (expenses over revenues) as a performance indicator. Excess of revenues over expenses (expenses over revenues) includes all changes in unrestricted net assets except for contributions and distributions from foundations for the purchase of property and equipment, adjustments for pension liability, discontinued operations, and the cumulative effect of changes in accounting principles.

## Use of Estimates

The preparation of financial statements, in conformity with accounting principles generally accepted in the United States, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

## Reclassifications

Certain reclassifications were made to the 2009 accompanying financial statements to conform to the 2010 presentation. These reclassifications had no impact on the change in net assets or excess of expenses over revenues previously reported.

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

## New Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board ("FASB") issued Statement No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*. Statement 168 establishes the FASB Accounting Standards Codification ("ASC," also collectively known as the "Codification") as the single source of authoritative U.S. generally accepted accounting principles ("GAAP") to be applied by nongovernmental entities. The Codification was developed to organize GAAP pronouncements by topic so that users can more easily access authoritative accounting guidance. It is organized by topic, subtopic, section, and paragraph, each of which is identified by a numerical designation. Statement 168 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. UPMC adopted Statement 168 beginning with its quarter ended September 30, 2009. Accounting references have been updated, and therefore Statement of Financial Accounting Standards ("SFAS") references, where applicable, have been replaced with ASC references.

Effective July 1, 2008, UPMC adopted ASC 820-10, *Fair Value Measurements and Disclosures* ("ASC 820-10"), for all financial instruments accounted for at fair value on a recurring basis. The effective date of ASC 820-10 was subsequently extended for nonfinancial assets and liabilities by ASC 820-10-65, *Transition and Open Effective Date Information*; therefore, UPMC fully adopted all of the provisions of this topic effective July 1, 2009. ASC 820-10 establishes a new framework for measuring fair value and expands related disclosures. ASC 820-10 requires fair value to be determined based on the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market in an orderly transaction between market participants.

In May 2009, the FASB issued new guidance, *Not-for-Profit Organizations: Mergers and Acquisitions*. This standard provides not-for-profit organizations with specific guidance on accounting for mergers and acquisitions, including determining whether a combination between two or more not-for-profit entities is a merger or an acquisition, how to account for each, and the disclosures that should be made. The guidance is to be applied prospectively to mergers with merger dates on or after December 15, 2009, and to acquisitions with acquisition dates on or after the beginning of the first annual reporting period beginning on or after December 15, 2009. Earlier application is prohibited. UPMC will apply the guidance provided by this standard to acquisitions occurring after July 1, 2010. Beginning on July 1, 2010, UPMC will apply the transition provisions of the guidance in *Not-for-Profit Organizations: Mergers and Acquisitions*, which will require UPMC to test goodwill for impairment annually or more frequently if events or circumstances indicate that the carrying value of an asset may not be recoverable, rather than amortized.

## 2. SIGNIFICANT TRANSACTIONS

On October 31, 2001, UPMC entered into an Integration and Affiliation Agreement ("Children's Agreement") with Children's Hospital of Pittsburgh ("Children's") and Children's Hospital Foundation ("Children's Foundation") whereby UPMC became the sole corporate member of Children's. The Children's Agreement, as amended and supplemented, included UPMC's commitment to pay the costs of constructing a new hospital and pediatric research facility for Children's ("New Children's Facilities") up to a total of \$621,800. The New Children's Facilities opened during the year ended June 30, 2009. The Children's Foundation agreed to fund \$96,800 toward the total cost of the construction project. As of June 30, 2010, the remaining commitment of the Children's Foundation toward the funding of the New Children's Facilities is approximately \$40,660. Payment of the additional funding commitment is to be received no later than five years from the completion of construction.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

The Children's Foundation also agreed to provide annual financial support for a minimum of 20 years (beginning in 2001) for pediatric care, research, and/or education computed at 5% of the rolling average of the corpus (defined as the value of all of the Foundation's assets less any funds held by the Foundation where the donor has directed a different spending provision.) In advance of the fiscal year, the Children's Foundation computes the rolling average of the prior calendar year to determine the 5% payment for the upcoming fiscal year. The amount of support for 2010 and 2009 was \$14,738 and \$13,569, respectively.

Effective January 1, 2008, Pittsburgh Mercy Health System ("PMHS") transferred ownership of Mercy Hospital of Pittsburgh ("MHP") and its associated physician practices to UPMC in a transaction that designates UPMC as the sole corporate member of MHP (the "Transaction"). The Transaction was designed to continue the 160-year-old mission of MHP by operating the renamed UPMC Mercy under the Catholic directives as overseen by the Diocese of Pittsburgh.

Pursuant to the Transaction, PMHS retained sponsorship of its cash accumulation pension plan. UPMC agreed to indemnify and hold harmless PMHS for any and all funding deficits related to the plan as determined actuarially each year on the anniversary of the effective date of the Transaction. UPMC recorded a nonoperating expense of \$850 and \$5,818 during the years ended June 30, 2010 and 2009, respectively, to reflect a funding deficit related to PMHS' cash accumulation plan as of December 31, 2009 and 2008, respectively. The plan is expected to be terminated no later than December 31, 2011.

In February 2008, UPMC entered into a series of agreements with the Beacon Medical Group, Limited, Dublin, Ireland ("BMG") pursuant to which it purchased a 25% equity ownership position in Beacon Hospital Sandyford Limited, a hospital in Dublin, Ireland ("Beacon Hospital"). UPMC also entered into an agreement to manage the operations of Beacon Hospital. BMG owned the remaining 75% of Beacon Hospital and 100% of the company that owned the facility (including the land) in which Beacon Hospital operates.

In August 2009, UPMC and BMG executed agreements to restructure the ownership of BMG and Beacon Hospital (the "Restructuring"). BMG was subsequently renamed UPMC Beacon Sandyford Limited ("UPMC Beacon"). Pursuant to the Restructuring, UPMC now holds a 66.7% ownership position in UPMC Beacon. Additionally, UPMC acquired a 40% interest in three companies intending to develop private co-located hospitals on the grounds of public hospitals in each of Limerick, Cork, and Beaumont, Ireland. In exchange for the aforementioned interest in UPMC Beacon and the interest in the co-location projects, UPMC made a cash payment of €15,000 (\$21,458) at closing, a cash payment of €5,000 (\$7,402) in November 2009, and a final cash payment of €5,000 (\$7,408) in February 2010.

The Restructuring has been accounted for as a step acquisition purchase by UPMC with the assets acquired and liabilities assumed recorded at their fair market values as of the date of UPMC's original investment and as of the effective date of the Restructuring. The total consideration exchanged in the Restructuring in excess of the fair value of the net assets acquired has been recorded as goodwill. As of June 30, 2010, UPMC's consolidated balance sheet includes \$45,251 of net goodwill related to the Restructuring. The Restructuring resulted in an increase to UPMC's long-term debt of €137,000 (\$167,250). UPMC provided up to €18,000 (\$21,974) of short-term debt to be used for working capital. As of June 30, 2010, the revolving facility was fully drawn. Both the long-term debt and short-term revolving facility balances are included in the consolidated long-term obligations disclosed in Note 6.

The results of operations less minority interest expense of UPMC Beacon are included in UPMC's consolidated statements of operations and changes in net assets beginning August 26, 2009.

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

In October 2009, UPMC's Board of Directors approved management's plan to close its Braddock facility effective January 31, 2010. Clinical operations at Braddock began shifting to other UPMC facilities beginning in November 2009, and a significant number of Braddock employees were relocated to other UPMC facilities. UPMC evaluated the recoverability of the carrying value of Braddock's long-lived assets and recorded an asset impairment charge of \$14,224 in its statements of operations for the year ended June 30, 2010, to reflect the limited alternative use of the Braddock facility following its closure.

In April 2010, the Braddock Borough Council approved a redevelopment plan that includes the demolition of the existing facility to make way for a proposed mixed-use site to include senior citizen housing, physicians' offices and job retraining classrooms. UPMC has committed to fund the costs of demolition as well as a portion of the redevelopment project.

In November 2009, UPMC acquired a controlling interest in Chartwell Pennsylvania LP ("Chartwell") through the acquisition of an additional 45% interest in the partnership in exchange for \$45,000 (the "Additional Chartwell Acquisition"). Chartwell provides home infusion and specialty pharmacy services in western Pennsylvania, West Virginia, and southeast Ohio and is a core component of UPMC's continuum of post-acute home-based care. As a result of the Additional Chartwell Acquisition, UPMC's total ownership in Chartwell increased to 83%. Accordingly, the financial position of Chartwell has been included in UPMC's consolidated balance sheet as of June 30, 2010.

The Additional Chartwell Acquisition has been accounted for as a step acquisition purchase by UPMC with the assets acquired and liabilities assumed recorded at their fair market values as of the date of UPMC's original investment and as of the effective date of the Additional Chartwell Acquisition. The total consideration exchanged in excess of the fair value of the net assets acquired has been recorded as goodwill. As of June 30, 2010, UPMC's consolidated balance sheet includes \$39,614 of net goodwill related to the Additional Chartwell Acquisition.

The results of operations less minority interest expense of Chartwell are included in UPMC's consolidated statements of operations and changes in net assets beginning November 17, 2009.

### 3. CHARITY CARE

UPMC's patient acceptance policy is based on its mission and its community service responsibilities. Accordingly, UPMC accepts patients in immediate need of care, regardless of their ability to pay. UPMC does not pursue collection of amounts determined to qualify as charity care based on established policies of UPMC. These policies define charity services as those services for which no payment is due for all or a portion of the patient's bill from the patient. For financial reporting purposes, charity care is excluded from net patient service revenue. The amount of charity care provided, determined on the basis of charges, was \$237,474 and \$230,920 for the years ended June 30, 2010 and 2009, respectively.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

## 4. CASH AND INVESTMENTS

Following is a summary of cash and investments included in the consolidated balance sheets:

	2010	June 30 2009
Internally designated:		
Funded depreciation	\$ 10,945	\$ 10,142
Employee benefit and workers' compensation self-insurance programs	21,328	17,116
Professional and general liability insurance program	242,513	204,362
Health insurance programs	407,716	348,843
	682,502	580,463
Externally designated:		
Trusteed assets for capital and debt service payments	175,545	314,990
Donor-restricted assets	128,722	100,457
	304,267	415,447
Investments on loan under securities lending arrangements	–	6,448
Other long-term investments	2,064,767	1,834,289
Board-designated, trustee, and other investments	3,051,536	2,836,647
Cash and cash equivalents	158,067	176,910
	\$ 3,209,603	\$ 3,013,557

Following is a summary of the composition of cash and investments. The table below shows all of UPMC's investments including nonalternative investments measured at fair value and alternative investments using either the cost or equity method of accounting.

	2010	June 30 2009
Cash and cash equivalents	\$ 158,067	\$ 176,910
Nonalternative investments:		
Fixed income	929,986	936,051
Domestic equity	203,219	158,412
International equity	451,930	382,762
Public real estate	28,164	29,441
Commodities	29,776	25,976
	1,643,075	1,532,642
Alternative investments:		
Long/short equity	321,277	239,078
Absolute return	196,947	196,897
Private equity	681,862	639,867
Private real estate	105,196	130,602
Natural resources	103,179	97,561
	1,408,461	1,304,005
	\$ 3,209,603	\$ 3,013,557

*continued*

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

Investments are primarily maintained in MTF and administered using a bank as trustee. As of June 30, 2010, 126 external investment managers handled the investment of cash and investments. Of these firms, 13 manage equity investments, 8 manage fixed income investments, and 105 manage alternative investment strategies including hedge funds and private equity limited partnerships. The largest allocation to any alternative investment manager is \$37,290. Certain managers use various equity and interest rate derivatives. These instruments are subject to various risks similar to nonderivative financial instruments including market, credit, liquidity, operational, and foreign exchange risk. As of June 30, 2010 and 2009, UPMC had remaining commitments to invest approximately \$588,885 and \$765,040, respectively, in private equity limited partnerships at various times and amounts, at the discretion of the investment managers, over the next ten years.

As of June 30, 2010 and 2009, respectively, UPMC had total investments recorded at cost of \$791,184 and \$761,774. These investments include private equity limited partnerships recorded at cost, as well as assets recorded as other assets in the consolidated balance sheets.

Investment return from cash and investments is comprised of the following for the years ended June 30, 2010 and 2009, respectively:

Year Ended June 30	2010	2009
Interest income	\$ 23,221	\$ 21,370
Dividend income	15,528	23,494
Net securities lending revenue	–	518
Net realized gains (losses) on sales of securities	86,666	(241,350)
	125,415	(195,968)
Unrealized investment gains (losses)	153,011	(213,126)
Impairment losses on limited partnerships	(39,326)	(93,492)
Net losses on direct investments	(426)	(10,088)
Derivative contracts mark to market	69,976	(63,239)
	183,235	(379,945)
Total investment gain (loss)	308,650	(575,913)
Traditional investment manager and trustee fees	(18,111)	(21,130)
Investment revenue (loss)	\$ 290,539	\$ (597,043)

Certain of UPMC's investments in debt and equity securities are designated as nontrading (donor-restricted assets). As of June 30, 2010 and 2009, respectively, UPMC had nontrading investments of \$128,722 and \$100,457. At June 30, 2010 and 2009, respectively, \$90,173 and \$47,549 of these investments were in an unrealized loss position. Unrealized losses on these investments were \$1,272 and \$7,175, respectively.

*continued*

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

In managing the UPMC investment strategy, an important consideration is to ensure sufficient liquidity. While UPMC's relationships with its external investment managers vary in terms of exit provisions, a percentage of the agreements allow ready access to underlying assets which are generally liquid and marketable. Investment liquidity as of June 30, 2010, is shown below:

Liquidity Availability	Cash and Cash Equivalents	Nonalternative Investments	Alternative Investments	Total
Within three days	\$ 158,067	\$ 1,563,998	\$ –	\$ 1,722,065
Within 30 days	–	79,077	–	79,077
Within 60 days	–	–	51,022	51,022
Within 90 days	–	–	112,814	112,814
More than 90 days	–	–	1,244,625	1,244,625
Total	\$ 158,067	\$ 1,643,075	\$ 1,408,461	\$ 3,209,603

## 5. CREDIT ARRANGEMENTS

UPMC has a revolving line and letter of credit facility (the "Revolving Facility") with an available line of \$300,000. The Revolving Facility expires on October 25, 2011. The Revolving Facility is used to manage cash flow during the year and to provide for a consolidated method of issuing various letters of credit for certain business units. A note to secure UPMC's repayment obligation with respect to the Revolving Facility was issued under the 1995 UPMC Master Trust Indenture ("1995 UPMC MTI") and is secured by a pledge of and security interest in UPMC parent corporation's gross revenues and UPMC Presbyterian Shadyside's gross revenues as members of the obligated group under the 1995 UPMC MTI.

Advances may be variable rate based on the prime rate or the Federal Funds effective rates, or advances may be fixed on the date of the advance based on the British Bankers' Association Interest Settlement Rate and the reserve requirement on Eurocurrency liabilities. No amounts were outstanding under the Revolving Facility as of June 30, 2010 and 2009.

As of June 30, 2010, UPMC has issued \$94,015 of letters of credit under the Revolving Facility. These letters of credit predominantly support the capital requirements of certain insurance subsidiaries and the self-insured workers' compensation liability.

In addition to the Revolving Facility described above, UPMC has a revolving credit facility with an available line of €18,000 (\$21,974) that is used to support the working capital needs of UPMC Beacon as described in Note 2. This line was fully drawn at June 30, 2010.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

## 6. LONG-TERM OBLIGATIONS AND INTEREST RATE SWAPS

Long-term obligations consist of the following:

	2010	June 30 2009
Fixed rate revenue bonds	\$ 2,014,562	\$ 2,373,337
Variable rate revenue bonds	780,618	623,753
Revolving facility	21,974	–
Capital leases and other	243,452	84,106
Par value of long-term obligations	3,060,606	3,081,196
Net premium and other	58,554	20,687
	3,119,160	3,101,883
Less current portion	(139,370)	(270,027)
Total long-term obligations	\$ 2,979,790	\$ 2,831,856

Revenue instruments outstanding represent funds borrowed by the UPMC parent corporation and various subsidiaries pursuant to loan agreements and lease and sublease financing arrangements with governmental authorities. The bonds were used for the purchase, construction, and renovation of hospital facilities, certain buildings and equipment, as well as the extinguishment of debt. Capital leases and other consist of capital leases that are secured by certain equipment and properties.

In March 2010, UPMC restructured \$645,820 of existing variable rate debt into \$262,565 of fixed rate debt, \$148,470 bank letter of credit debt, and \$234,785 of unenhanced variable rate debt. UPMC also refinanced \$470,410 of fixed rate debt for present value savings. A loss of \$28,270 was recorded related to the extinguishment of debt, representing the unamortized portion of debt issuance costs and any original issue discount or premium on the retired debt. Additionally, UPMC terminated ten of its interest rate swap agreements in connection with the restructuring.

The fixed rate revenue instruments bear interest at fixed coupon rates ranging from 2.50% to 6.00% and 3.76% to 6.25% in 2010 and 2009, respectively. The average interest cost for the variable rate instruments was 0.70% and 1.63% during fiscal years 2010 and 2009, respectively. Revenue instruments have varying principal payments and final maturities from 2010 through 2039. Certain revenue bonds are secured by bond insurance (\$184,701 and \$515,407 in 2010 and 2009, respectively). Reimbursement agreements (\$230,000 and \$186,435 in 2010 and 2009, respectively) provide loans to UPMC in the amount necessary to purchase a portion of the variable rate demand revenue bonds if not remarketed. The agreements have expiration and repayment dates beyond June 30, 2011.

Revenue instruments in the aggregate amount of debt outstanding of \$2,772,424 and \$2,828,202 as of June 30, 2010 and 2009, respectively, are issued under the 1995 UPMC MTI. Included in this amount are instruments totaling \$2,590,222 and \$1,944,523 as of June 30, 2010 and 2009, respectively, which are also secured under the 2007 UPMC MTI. The instruments are secured by a pledge of and security interest in gross revenues of each of the respective MTI obligated groups. Certain amounts borrowed under the 1995 UPMC MTI are loaned to certain subsidiary corporations pursuant to loan and contribution agreements and require the transfer of subsidiary funds to the parent corporation in the event of failure to satisfy the UPMC parent corporation liquidity covenant.

*continued*

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

The various indebtedness agreements contain restrictive covenants, the most significant of which are the maintenance of minimum debt service coverage and liquidity ratios, and restrictions as to the incurrence of additional indebtedness and transfers of assets.

Aggregate maturities of long-term obligations for the next five years, assuming remarketing of UPMC's variable rate debt, are as follows:

2011	\$	139,370
2012		221,329
2013		115,746
2014		111,591
2015		289,847

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Interest paid, net of amounts capitalized, on all obligations was \$131,883 and \$101,857 during the years ended June 30, 2010 and 2009, respectively. Capitalized interest of \$2,625 and \$12,802 was recorded in 2010 and 2009, respectively.

UPMC has interest rate-related derivative instruments to manage its exposure on its debt instruments and its asset allocation. By using derivative financial instruments to manage these risks, UPMC exposes itself to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contracts. When the fair value of a derivative contract is positive, the counterparty owes UPMC, which creates credit risk for UPMC. When the fair value of a derivative contract is negative, UPMC owes the counterparty and, therefore, it does not incur credit risk. UPMC minimizes the credit risk in derivative instruments by entering into transactions that require the counterparty to post collateral for the benefit of UPMC based on the credit rating of the counterparty and the fair value of the derivative contract. If UPMC has a derivative in a liability position, UPMC's credit is a risk and FAS 157 fair market values could be adjusted downward. Market risk is the effect on the value of a financial instrument that results from a change in interest rates. The market risk associated with interest rate changes is managed by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken. Management also mitigates risk through periodic reviews of their derivative positions in the context of UPMC's total blended cost of capital.

UPMC maintains interest rate swap programs on a variety of its revenue bonds in order to manage its interest rate risk. To meet this objective and to take advantage of low interest rates, UPMC entered into various interest rate swap agreements to manage interest rate risk. The notional amount under each interest rate swap agreement is reduced over the term of the respective agreement to correspond with reductions in various outstanding bond series.

During the term of these agreements, the fixed to floating rate swaps convert fixed rate debt to a variable rate; the total return swaps lower the fixed coupon on the underlying debt in exchange for the movement of value on the underlying debt; the floating to fixed rate swaps convert variable rate debt to a fixed rate and the basis swaps convert the interest rate on underlying LIBOR-based bonds to the Securities Industry and Financial Markets Association Municipal Swap Index ("SIFMA Index").

Under the floating rate and basis swaps, UPMC pays a rate equal to the SIFMA Index, an index of seven-day, high-grade, tax-exempt variable rate demand obligations. The SIFMA Index rates ranged from 0.15% to 0.43% (weighted average rate of 0.28%) in 2010 and from 0.34% to 7.96% (weighted average rate of 1.39%) in 2009.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

The following table summarizes UPMC's interest rate swap agreements:

Swap	Expiration Date	UPMC Receives	UPMC Pays	Notional Amount at	
				2010	June 30 2009
Floating to fixed	2025	68% one-month LIBOR	3.6%	\$ 147,005	\$ 152,680
Basis	2021	67% three-month LIBOR plus .2077%	SIFMA Index	53,905	53,905
Basis	2037	67% three-month LIBOR plus .3217%	SIFMA Index	46,095	46,095
Fixed to floating	Terminated	4.16%	SIFMA Index	-	81,300
Total return	Terminated	1.12%	0.0%	-	81,300
Fixed to floating	Terminated	4.264%	SIFMA Index	-	100,000
Fixed to floating	Terminated	4.264%	SIFMA Index	-	65,000
Total return	Terminated	1.051%	0.0%	-	100,000
Total return	Terminated	0.956%	0.0%	-	65,000
Total return	Terminated	4.85%	SIFMA Index	-	75,000
Fixed to floating	Terminated	3.913%	SIFMA Index	-	117,740
Total return	Terminated	1.712%	0.0%	-	117,740
Fixed to floating	Terminated	5.7605%	Two times SIFMA minus 67% of one-month LIBOR	-	98,115
				\$ 247,005	\$ 1,153,875

After giving effect to the above derivative transactions, UPMC's variable rate debt was approximately 20% and 33% of the total debt outstanding as of June 30, 2010 and 2009, respectively.

In addition to the interest rate swaps shown above, UPMC has an equity index swap which expires in 2011. UPMC receives a return based on the S&P 500, and pays the three-month LIBOR rate plus six basis points. The notional amount was \$50,000 at June 30, 2010 and 2009.

The fair value of UPMC's derivative instruments at June 30, 2010 and 2009, was classified in the balance sheets as follows:

	June 30	
	2010	2009
Other assets	\$ -	\$ 33,790
Long-term obligations	(27,578)	(125,922)

*continued*

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

The effects of changes in the fair value of the derivative instruments on the consolidated statements of operations and changes in net assets for the years ended June 30, 2010 and 2009, are as follows:

Type of Derivative	Classification of Gain (Loss) Recognized in Excess of Revenues Over Expenses (Expenses Over Revenues)	Amount of Gain (Loss) Recognized in Excess of Revenues Over Expenses (Expenses Over Revenues)	
		2010	2009
Interest rate contracts	Investment revenue (loss)	\$ 76,425	\$ (71,896)
Equity index contract	Investment revenue (loss)	(6,449)	5,156

UPMC's derivative instruments contain provisions that require UPMC's debt to maintain an investment grade credit rating from certain major credit rating agencies. If UPMC's debt were to fall below investment grade, it would be in violation of these provisions, and the counterparties to the derivative instruments could request payment or demand immediate and ongoing full overnight collateralization on derivative instruments in net liability positions. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that are in a liability position at June 30, 2010 and 2009, is \$21,129 and \$125,922, respectively, for which UPMC has posted collateral of \$0 and \$66,963, respectively, in the normal course of business. If the credit-risk-related contingent features underlying these agreements were triggered to the fullest extent on June 30, 2010, UPMC would be required to post an additional \$23,853 of collateral to its counterparties. Pursuant to master netting arrangements, UPMC offsets the fair value of amounts recognized for derivative instruments, including the right to reclaim or obligation to return cash collateral from/to counterparties.

### 7. FAIR VALUE MEASUREMENTS

As of June 30, 2010, UPMC held certain assets that are required to be measured at fair value on a recurring basis. These include cash and cash equivalents and certain board-designated, restricted, trustee, and other investments and derivative instruments. UPMC's alternative investments are measured using either the cost or equity method of accounting and are therefore excluded from the fair value hierarchy table presented herein.

The valuation techniques used to measure fair value are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs are generally unsupported by market activity. The three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value, include:

- *Level 1* - Quoted prices for identical assets or liabilities in active markets.
- *Level 2* - Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-driven valuations whose inputs are observable or whose significant value drivers are observable.
- *Level 3* - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

The following table represents UPMC's fair value hierarchy for its financial assets (cash and investments) and liabilities measured at fair value on a recurring basis as of June 30, 2010. The interest rate swaps are valued using internal models, which are primarily based on market observable inputs including interest rate curves. When quoted market prices are unobservable for fixed income securities, quotes from independent pricing vendors based on recent trading activity and other relevant information including market interest rate curves, referenced credit spreads and estimated prepayment rates where applicable are used for valuation purposes. These investments are included in Level 2 and include corporate fixed income, government bonds, and mortgage- and asset-backed securities. Public real estate that has a limited liability company structure is classified as Level 2. The net asset value has been derived using quoted market prices for the underlying securities.

	Level 1	Level 2	Level 3	Total Carrying Amount
<b>ASSETS</b>				
Cash and cash equivalents	\$ 158,067	\$ –	\$ –	\$ 158,067
Fixed income	500,164	429,822	–	929,986
Domestic equity	201,594	1,625	–	203,219
International equity	367,733	84,197	–	451,930
Public real estate	28,164	–	–	28,164
Commodities	29,776	–	–	29,776
<b>Total assets</b>	<b>\$ 1,285,498</b>	<b>\$ 515,644</b>	<b>\$ –</b>	<b>\$ 1,801,142</b>
Derivative instruments (interest rate swaps)	–	(27,578)	–	(27,578)
<b>Total liabilities</b>	<b>\$ –</b>	<b>\$ (27,578)</b>	<b>\$ –</b>	<b>\$ (27,578)</b>

### 8. PENSION PLANS

UPMC and its subsidiaries maintain defined benefit pension plans (the "Plans"), defined contribution plans, and nonqualified pension plans that cover substantially all of UPMC's employees. Under the defined contribution plans, employees may elect to contribute a percentage of their salary, which is matched in accordance with the provisions of the plans. Contributions to the nonqualified pension plans are based on a percentage of salary or contractual arrangements. Total expense relating to the aforementioned pension plans was \$117,129 and \$88,339 for the years ended June 30, 2010 and 2009, respectively. Total expense related to the defined contribution plans and nonqualified plans was \$35,626 and \$45,387 for the years ended June 30, 2010 and 2009, respectively. Effective July 1, 2009, UPMC reduced the employer matching contribution to the defined contribution plan, the UPMC Savings Plan, by one percent. UPMC expects to reinstate the one percent match in January 2011.

Benefits under the Plans vary and are generally based upon the employee's earnings and years of participation. It is UPMC's policy to meet the requirements of the Employee Retirement Income Security Act of 1974 ("ERISA") and the Pension Protection Act of 2006. UPMC's policy is to contribute amounts sufficient to, among other things, avoid Pension Benefit Guaranty Corporation variable premiums. Contributions made to the Plans were \$125,307 and \$31,180 for the years ended June 30, 2010 and 2009, respectively. Additionally, UPMC made a contribution of \$134,646 to the Plans in August 2010 to comply with its policy for the 2010 plan year.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

The table below sets forth the accumulated benefit obligation, the change in the projected benefit obligation, and the change in the plan assets of the Plans. The table also reflects the funded status of the Plans as well as recognized and unrecognized amounts in the consolidated balance sheets.

	2010	June 30 2009
Accumulated benefit obligation	\$ 991,948	\$ 822,298
<b>CHANGE IN PROJECTED BENEFIT OBLIGATION</b>		
Projected benefit obligation at beginning of year	\$ 833,427	\$ 755,401
Service cost	55,064	49,571
Interest cost	53,044	49,898
Plan amendments	-	(38)
Actuarial loss	120,044	27,022
Benefits paid	(51,355)	(48,427)
Projected benefit obligation at end of year	1,010,224	833,427
<b>CHANGE IN PLAN ASSETS</b>		
Fair value of plan assets at beginning of year	558,364	719,281
Actual return on plan assets	77,556	(143,670)
Employer contributions	125,307	31,180
Benefits paid	(51,355)	(48,427)
Fair value of plan assets at end of year	709,872	558,364
Accrued pension liability	\$ 300,352	\$ 275,063

Included in unrestricted net assets at June 30, 2010 and 2009, respectively, are the following amounts that have not yet been recognized in net periodic pension cost:

	2010	June 30 2009
Unrecognized prior service credit	\$ 9,975	\$ 15,135
Unrecognized actuarial loss	(394,967)	(331,041)
Net transition asset	26	33
	\$ (384,966)	\$ (315,873)

Changes in plan assets and benefit obligations recognized in unrestricted net assets during 2010 include:

Current year actuarial loss	\$ 91,674
Amortization of actuarial gain	(27,746)
Amortization of prior service credit	5,159
Amortization of transition obligation	6
	\$ 69,093

No plan assets are expected to be returned to UPMC during the year ending June 30, 2011.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

The components of net periodic pension cost for the Plans were as follows:

Year Ended June 30	2010	2009
Service cost	\$ 55,064	\$ 49,571
Interest cost	53,044	49,898
Expected return on plan assets	(49,186)	(55,609)
Recognized net actuarial loss	27,746	4,259
Amortization of prior service credit	(5,159)	(5,137)
Amortization of transition asset	(6)	(30)
Net periodic pension cost	\$ 81,503	\$ 42,952

The actuarial assumptions used to determine the benefit obligations and net periodic pension cost for the Plans are as follows:

	2010	June 30	2009
Discount rates:			
Used for benefit obligations	5.19%		6.70%
Used for net periodic pension cost	6.70%		6.95%
Expected rate of compensation increase:			
Used for benefit obligations	3.75%		3.75%
Used for net periodic pension cost	3.75%		3.75%
Expected long-term rate of return on plan assets	8.00%		8.00%
Interest crediting rate	3.94%		4.95%

The change in discount rate from 6.70% to 5.19% and the change in interest crediting rate from 4.95% to 3.94% increased the projected benefit obligation by \$100,138.

The following pension benefit payments, which reflect expected future service, as appropriate, are expected to be paid in the years ending June 30:

2011	\$ 87,966
2012	81,189
2013	84,951
2014	88,646
2015	90,988
2016–2020	488,541

UPMC employs a total return investment approach whereby a mix of equities and fixed income investments are used to maximize the long-term return of plan assets subject to accepting a prudent level of risk. Risk tolerance is established through careful consideration of plan liabilities, plan funded status, and corporate financial condition. The investment portfolio contains a diversified blend of equity, fixed-income, and alternative investments. Equity investments are diversified across United States and non-United States corporate stocks, as well as growth, value, and small and large capitalizations. Other assets such as real estate, private equity, and hedge funds are used to enhance long-term returns while improving portfolio diversification. UPMC's external investment managers may use derivatives to gain market exposure in an efficient and timely manner. Investment risk is measured and monitored on an ongoing basis through quarterly investment portfolio reviews, annual liability measurements, and periodic asset/liability studies.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

As of June 30, 2010, UPMC employed 81 external investment managers to handle the investment of the assets in the pension portfolio. Of these, 13 managers manage equity investments, 3 manage fixed income investments, and 65 managers oversee alternative investment strategies. The largest allocation to any alternative investment manager is \$12,470.

The following is a summary of the pension plan asset allocations at June 30, 2010 and 2009:

	2010	2009	Target
<b>Nonalternative investments:</b>			
Fixed income	15.1%	16.2%	12.0%
Domestic equity	15.0%	10.5%	14.0%
International equity	19.9%	22.4%	20.0%
Public real estate	1.8%	2.0%	1.0%
Commodities	1.4%	1.5%	1.0%
<b>Total nonalternative investments</b>	<b>53.2%</b>	<b>52.6%</b>	<b>48.0%</b>
<b>Alternative investments:</b>			
Long/short equity	9.5%	8.3%	12.0%
Absolute return	8.3%	8.7%	8.0%
Private equity	23.4%	23.3%	19.0%
Private real estate	2.8%	4.6%	8.0%
Natural resources	2.8%	2.5%	5.0%
<b>Total alternative investments</b>	<b>46.8%</b>	<b>47.4%</b>	<b>52.0%</b>
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

All of the Plans' assets are measured at fair value, including its alternative investments. The same levels of the fair value hierarchy as described in Note 7 are used to categorize the Plans' assets. Corporate debt instruments and fixed income/bonds are valued using pricing models, quoted prices of securities with similar characteristics, or discounted cash flows. The fair value of common/collective trust funds is determined by the issuer sponsoring such funds by dividing the fund's net assets at fair value by its units outstanding at the valuation dates. Partnership interests are valued using Net Asset Value ("NAV") which is based on the unit values of the interests as determined by the issuer sponsoring such interests dividing the fund's net assets at fair value by its units outstanding at the valuation dates.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

The fair values of the Plans' assets at June 30, 2010, by asset category and by the level of inputs used to determine fair value, were as follows:

	Level 1	Level 2	Level 3	Total
<b>ASSETS</b>				
Cash	\$ 97	\$ –	\$ –	\$ 97
Equity securities:				
Domestic equity	210,636	–	–	210,636
International equity	119,346	–	–	119,346
U.S. REITS	12,715	–	–	12,715
Corporate debt instruments	–	358	–	358
Common collective trusts	–	34,668	–	34,668
Private equity and hedge partnerships:				
Private real estate	–	–	20,251	20,251
Private natural resources	–	–	19,538	19,538
Private equity buyout and venture funds	–	–	166,479	166,479
Hedge fund partnerships	–	–	126,249	126,249
	342,794	35,026	332,517	710,337
<b>LIABILITIES</b>				
Net payables	(465)	–	–	(465)
Plans' assets at fair value	\$ 342,329	\$ 35,026	\$ 332,517	\$ 709,872

Changes in the fair value of the Plans' Level 3 assets for the year ended June 30, 2010, were as follows:

	Level 3
Balance, June 30, 2009	\$ 265,053
Actual return on plan assets:	
Related to assets still held at the reporting date	8,384
Related to assets sold during the period	23,193
Purchases, sales, issuances and settlements (net)	35,887
Balance, June 30, 2010	\$ 332,517

### 9. PROFESSIONAL AND GENERAL LIABILITY INSURANCE

UPMC is insured for professional and general liability losses through wholly owned, multiprovider insurance companies ("Captives"). The Captives provide primary and excess professional liability coverage on an occurrence basis to UPMC subsidiaries and excess professional liability coverage on a claims-made basis to employed physicians of UPMC subsidiaries and other entities not included in the consolidated financial statements.

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# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

Certain insurance agreements have retrospective clauses that permit additional premiums or refunds to be made based on actual experience. The reserve for professional and general liability indemnity losses and loss adjustment expenses is determined using individual case-based evaluations and statistical analyses and represents an estimate of reported claims and claims incurred but not reported. Those estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, management believes that the reserves for professional and general liability losses and loss adjustment expenses are reasonable. The estimates are reviewed and adjusted as necessary as experience develops or new information becomes known. Such adjustments are included in current operations. Reserves for professional and general liability losses and loss adjustment expenses of approximately \$211,244 and \$193,626 discounted at 2.25% and 2.50% were recorded as of June 30, 2010 and 2009, respectively. The effect of the change in discount rate from 2.50% to 2.25% increased the reserves for professional and general liability losses by approximately \$1,000. At June 30, 2010 and 2009, respectively, \$53,799 and \$53,403 of the loss reserves are included in current accrued insurance reserves and \$157,445 and \$140,223 are reported as accrued long-term insurance reserves.

The Medical Care Availability and Reduction of Error (“MCARE”) Act was enacted by the legislature of the Commonwealth of Pennsylvania (“Commonwealth”) in 2002. This Act created the MCARE Fund, which replaced The Pennsylvania Medical Professional Liability Catastrophe Loss Fund (the “Medical CAT Fund”), as the agency for the Commonwealth to facilitate the payment of medical malpractice claims exceeding the primary layer of professional liability insurance carried by UPMC and other health care providers practicing in the Commonwealth.

The MCARE Fund is funded on a “pay as you go basis” and assesses health care providers, based on a percentage of the rates established by the Joint Underwriting Association (also a Commonwealth agency) for basic coverage. The MCARE Act of 2002 provides for a further reduction to the current MCARE coverage of \$500 per occurrence to \$250 per occurrence and the eventual phase-out of the MCARE Fund, subject to the approval of the PA Insurance Commissioner. To date, the PA Insurance Commissioner has deferred the change in coverage and eventual phase-out of the MCARE Fund to future years.

## 10. WORKERS' COMPENSATION SELF-INSURANCE

UPMC is self-insured for workers' compensation losses up to a maximum limit of \$1,000 per occurrence. Losses incurred over this limit are covered by a supplemental catastrophic policy up to specified limits with a commercial insurer. Estimated accruals for workers' compensation were \$25,933 and \$22,597 discounted at 4.00% and 3.75% as of June 30, 2010 and 2009, respectively.

## 11. RELATED-PARTY TRANSACTIONS

UPMC purchases and sells certain services from and to the University. The most significant payment to the University is for physician services whereby the University, acting as a common paymaster, invoices UPMC for the clinical services rendered by certain faculty and medical residents. Payments to the University related to physician services amounted to \$130,129 and \$130,110 for the years ended June 30, 2010 and 2009, respectively.

UPMC provides direct financial support to the University to sustain the research and academic medical enterprise of the University. Payments to the University related to research and academic support amounted to \$101,996 and \$95,174 for the years ended June 30, 2010 and 2009, respectively.

*continued*

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

UPMC has various facility rental agreements with the University. UPMC received rent income of \$15,698 and \$15,131 and incurred rent expense of \$10,364 and \$10,575 related to rental arrangements with the University for the years ended June 30, 2010 and 2009, respectively, which are also included in Note 12.

The University subcontracts with UPMC to perform research activity. Payments from the University related to research activity were \$40,765 and \$41,661 for the years ended June 30, 2010 and 2009, respectively.

UPMC has equity investments in entities that sell and purchase various patient care related services to and from UPMC. Payments to equity investment entities were \$32,775 and \$76,432 for the years ended June 30, 2010 and 2009, respectively. Revenues from equity investment entities were \$46,102 and \$52,577 for the years ended June 30, 2010 and 2009, respectively.

Receivables and payables are settled with affiliated entities in the normal course of business. Other receivables include \$8,013 and \$13,994 as of June 30, 2010 and 2009, respectively, relating to amounts due from affiliates in connection with these transactions.

## 12. OPERATING LEASES AND OTHER LONG-TERM AGREEMENTS

UPMC has entered into certain long-term agreements with respect to facilities, equipment, and services with affiliated and other entities. The terms of the agreements generally range from 1 to 25 years with renewal options up to 15 years. Total expense under these agreements was \$106,108 and \$108,661 for the years ended June 30, 2010 and 2009, respectively, for all long-term agreements.

Future payments under noncancelable long-term agreements for the next five years are \$72,229 in 2011, \$51,759 in 2012, \$38,862 in 2013, \$30,503 in 2014, \$18,462 in 2015, and \$125,319, thereafter. Approximately 7% of total future payments are subject to adjustment based upon inflation or mutual negotiations. Approximately 3% of these payments are due to the University.

## 13. INCOME TAXES

As of June 30, 2010, the for-profit entities of UPMC had gross federal net operating loss ("NOL") carryforwards of \$269,341 (expiring in years 2012 through 2030) and gross state NOL carryforwards of \$119,831 (expiring in years 2019 through 2030) that are available to offset future taxable income. Utilization of the state NOL carryforwards in any one year is limited to the greater of \$3,000 or 12.5% of taxable income on an annual basis per company. During the year ended June 30, 2010, UPMC realized tax benefits of \$1,900 from the use of NOL carryforwards. Net deferred tax assets of \$118,493, primarily related to NOL carryforwards, have a valuation allowance recorded against them of \$112,905 due to the uncertainty of realizing these benefits in the future.

The following table presents deferred tax assets as of June 30:

	2010	2009
Deferred tax assets:		
Federal NOL	\$ 91,576	\$ 90,462
Accrued benefits	6,067	6,348
Alternative minimum tax credit carryover and other	20,850	25,052
	118,493	121,862
Less valuation allowance	(112,905)	(116,274)
	\$ 5,588	\$ 5,588

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

## 14. FUNCTIONAL EXPENSES

UPMC provides general health care services primarily to residents within its geographic location and supports research and education programs. For the years ended June 30, 2010 and 2009, expenses related to providing these services were as follows:

	2010	2009
Hospital health care services, including health insurance costs	\$ 5,615,159	\$ 5,391,869
Other health care services	1,173,454	1,064,760
Academic and research activities	341,133	333,762
Administrative support	850,198	842,689
	<u>\$ 7,979,944</u>	<u>\$ 7,633,080</u>

## 15. COMMITMENTS

In December 2000, UPMC entered into a long-term agreement with a software vendor in connection with a systemwide technology initiative to improve the quality of patient care through the development of a real-time patient electronic health record providing for clinical documentation and order entry. Under the amended terms of the agreement, UPMC will receive the right to the license, installation, upgrade, and maintenance related to all current fixed fee software through December 2019. As of June 30, 2010, there were future purchase commitments of \$25,950 related to software upgrades and maintenance payable in equal annual installments through December 2019.

In April 2005, UPMC entered into an eight-year, joint development agreement with IBM to transform UPMC's information technology infrastructure and to create new technology solutions. UPMC's technology infrastructure was reengineered to an on-demand computing model that is geared toward innovation, yet adaptable and flexible to meet ongoing business needs and growth. In return for these products and services, UPMC contractually committed \$317,000 over eight years, payable roughly in equal monthly installments. As of June 30, 2010, \$103,500 of this commitment remained.

During 2007 and 2006, UPMC entered into several co-development agreements with various software and technology vendors and a local university to invest in the development of medical technologies and information systems to enhance health care delivery. The total amount committed is \$86,880. As of June 30, 2010, \$59,730 of this commitment remained unfulfilled.

In December 2007, UPMC pledged \$100,000 to the Pittsburgh Promise Foundation. The Pittsburgh Promise Foundation, which operates as a Type I Supporting Organization, supporting the Pittsburgh Foundation, is charged with creating and managing an endowment fund to (a) help eligible students graduating from Pittsburgh Public Schools to further their education after high school by funding certain tuition costs regardless of needs or income, and (b) enhance the growth, stability, and economic development of the city of Pittsburgh by providing a sustainable incentive for families with school-aged children to remain in, and to move into, the city of Pittsburgh to take advantage of scholarship funding for postsecondary education. The initial \$10,000 was an unconditional pledge. The remaining \$90,000 is designated to match contributions provided by other organizations and individual donors over a nine-year period beginning in fiscal year 2009. UPMC will match \$2.00 for every \$3.00 contributed, with a yearly match obligation not to exceed \$10,000. As of June 30, 2010, \$72,561 of the total pledge is considered a conditional promise to give.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS)

## 16. CONTINGENCIES

UPMC is involved in litigation and responding to requests for information from governmental agencies occurring in the normal course of business. Certain of these matters are in the preliminary stages and legal counsel is unable to estimate the potential effect, if any, upon operations or financial condition of UPMC. Management believes that these matters will be resolved without material adverse effect on UPMC's financial position or results of operations. However, the ultimate outcome and effect on UPMC's financial statements is unknown.

During August 2007, UPMC received a request for information from the Civil Division of the Department of Justice relating to an investigation into the health insurance and hospital services market in and around Pittsburgh including any potentially anticompetitive agreements. This request covers several prior years. At this time, no specific violations, claims, or assessments have been made. Management is cooperating with the information requests and believes that the matter will be resolved without any material adverse effect on UPMC's financial position or results of operations. However, the ultimate outcome and effect on UPMC's financial statements is unknown.

In March and April 2009, several related class action lawsuits were filed against UPMC and certain of its affiliates in the Federal District Court for the Western District of Pennsylvania and the Court of Common Pleas for Allegheny County, Pennsylvania. The Federal District Court cases allege violations of The Fair Labor Standards Act ("FLSA") on the basis that certain employees were not paid for all hours that they worked and were not properly paid overtime and, further, that these actions also violated the Employee Retirement Income Security Act ("ERISA") and the Racketeer Influenced and Corrupt Organizations Act ("RICO"). The state court actions allege violations of the Pennsylvania Minimum Wage Act, The Wage Payment and Collection Act, and common law on the same factual basis noted above. The lawsuits seek recovery of alleged unpaid wages and benefits and other monetary damages and costs. UPMC does not believe that the allegations have any merit and that the matter will be resolved without any material adverse effect on UPMC's financial position or results of operations. However, the ultimate outcome and effect on UPMC's financial statements is unknown.

In April 2009, a lawsuit was filed by West Penn Allegheny Health System ("WPAHS") against UPMC and Highmark, Inc. in the Federal District Court for the Western District of Pennsylvania ("District Court"). WPAHS alleged that UPMC and Highmark violated the Sherman Antitrust Act and that UPMC tortiously interfered with WPAHS' existing and prospective business relations. WPAHS sought equitable relief and unspecified compensatory, treble, and punitive damages. In October 2009, WPAHS' lawsuit was dismissed by the District Court. In November 2009, WPAHS appealed the District Court's dismissal. UPMC does not believe that WPAHS' complaint or its appeal has any merit, and expects that the matter will be resolved without any material adverse effect on UPMC's financial position or results of operations. However, the ultimate outcome and effect on UPMC's financial statements is unknown.

## 17. SUBSEQUENT EVENTS

Management evaluated subsequent events through September 15, 2010, the date the financial statements were issued.

On August 31, 2010, UPMC and the Hamot Health Foundation ("Hamot") Board of Trustees signed a nonbinding letter of intent to negotiate an affiliation. Hamot and UPMC have agreed to conditions of a prospective affiliation that, among other things, will provide Hamot with a financial investment of \$300,000 over a 10-year period that will support expansion and enhancement of medical services for the communities that Hamot serves. The proposed affiliation is subject to further due diligence by UPMC and certain regulatory approvals.

