Partners HealthCare System, Inc. and Affiliates

Consolidated Financial Statements
September 30, 2012 and 2011

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Report of Independent Auditors

To the Board of Directors of
Partners HealthCare System, Inc. and Affiliates

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, changes in net assets and cash flows present fairly, in all material respects, the financial position of Partners HealthCare System, Inc. and its Affiliates at September 30, 2012 and 2011, and the results of their operations, their changes in net assets and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of Partners HealthCare System, Inc. and Affiliates' management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In August 2010, the FASB issued Accounting Standards Update No.2010-24, Presentation of Insurance Claims and Related Insurance Recoveries. Under this new standard, anticipated insurance recoveries and estimated liabilities for medical malpractice claims or similar contingent liabilities should be presented separately on the balance sheet. The standard is effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. Partners HealthCare System, Inc. and its Affiliates adopted this guidance during 2012, and included such presentation on the balance sheet at September 30, 2012.

PricewaterhouseCoopers LLP

December 14, 2012

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Partners HealthCare System, Inc. and Affiliates
Consolidated Balance Sheets
Years Ended September 30, 2012 and 2011

(dollars in thousands)	**2012**	**2011**
Assets		
Current assets		
Cash and equivalents	$ 486,932	$ 439,537
Investments	1,256,984	1,256,257
Collateral held under securities lending arrangements	105,985	157,872
Current portion of investments limited as to use	1,735,373	1,309,628
Patient accounts receivable, net of allowance for bad debts (2012 - $111,850; 2011 - $101,902)	775,918	729,076
Research grants receivable	121,758	127,210
Other current assets	273,668	276,449
Receivable for settlements with third-party payers	48,265	33,379
Total current assets	4,804,883	4,329,408
Investments limited as to use, less current portion	2,325,279	2,077,403
Long-term investments	890,097	833,815
Pledges receivable, net and contributions receivable from trusts, less current portion	168,096	209,257
Property and equipment, net	3,885,858	3,944,757
Other assets	548,768	110,503
Total assets	$ 12,622,981	$ 11,505,143
Liabilities and Net Assets		
Current liabilities		
Current portion of long-term obligations	$ 293,322	$ 294,829
Accounts payable and accrued expenses	603,013	548,829
Accrued compensation and benefits	612,607	555,536
Collateral due under securities lending arrangements	105,985	157,872
Current portion of accrual for settlements with third-party payers	44,759	93,990
Unexpended funds on research grants	171,136	161,777
Total current liabilities	1,830,822	1,812,833
Other liabilities		
Accrual for settlements with third-party payers, less current portion	7,861	6,382
Accrued professional liability	441,404	80,908
Accrued employee benefits	1,625,024	1,241,562
Interest rate swaps liability	398,340	375,202
Accrued other	196,911	195,881
	2,669,540	1,899,935
Long-term obligations, less current portion	2,839,940	2,338,788
Total liabilities	7,340,302	6,051,556
Commitments and contingencies		
Net assets		
Unrestricted	4,131,437	4,331,876
Temporarily restricted	777,012	783,798
Permanently restricted	374,230	337,913
Total net assets	5,282,679	5,453,587
Total liabilities and net assets	$ 12,622,981	$ 11,505,143

The accompanying notes are an integral part of these consolidated financial statements.

Partners HealthCare System, Inc. and Affiliates
Consolidated Statements of Operations
Years Ended September 30, 2012 and 2011

(dollars in thousands)	2012	2011
Operating revenue		
Net patient service revenue, net of provision for bad debts (2012 - $123,725 ; 2011 - $101,118)	$ 6,828,189	$ 6,342,273
Direct academic and research revenue	1,176,002	1,175,548
Indirect academic and research revenue	362,595	355,953
Other revenue	614,551	607,338
Total operating revenue	8,981,337	8,481,112
Operating expenses		
Employee compensation and benefits	4,864,713	4,629,275
Supplies and other expenses	2,113,614	1,964,080
Direct academic and research expenses	1,176,002	1,175,548
Depreciation and amortization	418,330	397,199
Interest	103,413	82,193
Asset impairment charge	114,356	-
Total operating expenses	8,790,428	8,248,295
Income from operations	190,909	232,817
Nonoperating gains (expenses)		
Income from investments	136,875	33,512
Change in fair value of nonhedging interest rate swaps	(11,881)	(35,868)
Gifts and other, net of fundraising and other expenses	(44,352)	(39,545)
Academic and research gifts, net of expenses	80,784	72,872
Total nonoperating gains, net	161,426	30,971
Excess of revenues over expenses	352,335	263,788
Other changes in net assets		
Change in net unrealized appreciation on marketable investments	95,701	(115,943)
Change in fair value of hedging interest rate swaps	(11,258)	(67,932)
Funds utilized for property and equipment	62,679	104,648
Change in funded status of defined benefit plans	(700,088)	(244,139)
Other	192	263
Decrease in unrestricted net assets	$ (200,439)	$ (59,315)

The accompanying notes are an integral part of these consolidated financial statements.

Partners HealthCare System, Inc. and Affiliates
Consolidated Statements of Changes in Net Assets
Years Ended September 30, 2012 and 2011

(dollars in thousands)	**Unrestricted**	**Temporarily Restricted**	**Permanently Restricted**	**Total**
Net assets at October 1, 2010	$ 4,391,191	$ 824,426	$ 310,891	$ 5,526,508
Increases (decreases)				
Income from operations	232,817	-	-	232,817
Income (loss) from investments	33,512	(6,490)	449	27,471
Gifts and other	(39,545)	65,326	24,041	49,822
Academic and research gifts, net of expenses	72,872	-	-	72,872
Change in net unrealized appreciation on marketable investments	(115,943)	(20,688)	851	(135,780)
Change in fair value of interest rate swaps				
Nonhedging	(35,868)	-	-	(35,868)
Hedging	(67,932)	-	-	(67,932)
Funds utilized for property and equipment	104,648	(76,827)	-	27,821
Change in funded status of defined benefit plans	(244,139)	-	-	(244,139)
Other	263	(1,949)	1,681	(5)
Change in net assets	(59,315)	(40,628)	27,022	(72,921)
Net assets at September 30, 2011	4,331,876	783,798	337,913	5,453,587
Increases (decreases)				
Income from operations	190,909	-	-	190,909
Income (loss) from investments	136,875	2,980	(211)	139,644
Gifts and other	(44,352)	(10,104)	34,383	(20,073)
Academic and research gifts, net of expenses	80,784	-	-	80,784
Change in net unrealized appreciation on marketable investments	95,701	27,928	900	124,529
Change in fair value of interest rate swaps				
Nonhedging	(11,881)	-	-	(11,881)
Hedging	(11,258)	-	-	(11,258)
Funds utilized for property and equipment	62,679	(26,204)	-	36,475
Change in funded status of defined benefit plans	(700,088)	-	-	(700,088)
Other	192	(1,386)	1,245	51
Change in net assets	(200,439)	(6,786)	36,317	(170,908)
Net assets at September 30, 2012	$ 4,131,437	$ 777,012	$ 374,230	$ 5,282,679

The accompanying notes are an integral part of these consolidated financial statements.

Partners HealthCare System, Inc. and Affiliates
Consolidated Statements of Cash Flows
Years Ended September 30, 2012 and 2011

(dollars in thousands)	**2012**	**2011**
Cash flows from operating activities		
Change in net assets	$ (170,908)	$ (72,921)
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Change in funded status of defined benefit plans	700,088	244,139
Asset impairment charge, net of cash portion	112,379	-
Loss on refunding of debt	54	2,613
Change in fair value of interest rate swaps	23,139	103,800
Depreciation and amortization	418,330	397,199
Provision for bad debts	123,725	101,118
Receipt of contributed securities	(23,707)	(28,790)
Loss on disposal of property	1,489	1,627
Net realized and change in unrealized appreciation on investments	(326,822)	44,668
Restricted contributions and investment income	(103,153)	(85,670)
Cash premium received upon issuance of bonds	22,181	12,854
Increase (decrease) in cash resulting from a change in		
Patient accounts receivable	(170,567)	(131,814)
Research grants receivable	5,452	5,302
Other current assets	18,350	(22,668)
Pledges receivable and contributions receivable from trusts	25,592	(47,579)
Other assets	(84,983)	2,926
Accounts payable and accrued expenses	54,184	(48,087)
Accrued compensation and benefits	55,269	26,173
Settlements with third-party payers	(62,638)	56,868
Unexpended funds on research grants	9,359	9,264
Accrued employee benefits and other	(304,956)	6,305
Net cash provided by operating activities	321,857	577,327
Cash flows from investing activities		
Purchase of property and equipment	(471,082)	(590,281)
Proceeds from sale of property	913	3,393
Purchase of investments	(1,955,070)	(1,832,903)
Proceeds from sales of investments	1,574,969	1,420,484
Net cash used for investing activities	(850,270)	(999,307)
Cash flows from financing activities		
Payments on long-term obligations	(44,366)	(39,644)
Proceeds from long-term obligations, net of financing costs	576,632	419,642
Decrease in auction rate securities holdings	30,000	-
Deposits into refunding trusts	(89,611)	(231,070)
Restricted contributions and investment income	103,153	85,670
Net cash provided by financing activities	575,808	234,598
Net increase (decrease) in cash and equivalents	47,395	(187,382)
Cash and equivalents at beginning of year	439,537	626,919
Cash and equivalents at end of year	$ 486,932	$ 439,537

The accompanying notes are an integral part of these consolidated financial statements.

(dollars in thousands)

1. Organization and Community Benefit Commitments

Partners HealthCare System, Inc. (PHS) is the sole member of The Massachusetts General Hospital (MGH), Brigham and Women's Health Care, Inc. (BWHC), NSMC HealthCare, Inc. (NSMC), Newton-Wellesley Health Care System, Inc. (NWHCS), Partners Continuing Care, Inc. (PCC) and Partners International Medical Services, LLC (PIMS). PHS appoints the two physicians who are the members of Partners Community HealthCare, Inc. (PCHI). The individual serving as the PHS President and Chief Executive Officer is the sole member of Partners Harvard Medical International, Inc. (PHMI). As more fully described below, effective October 1, 2012, PHS became the sole member of Neighborhood Health Plan, Incorporated (NHP). PHS, together with all of its affiliates, is referred to as "Partners HealthCare."

Partners HealthCare currently operates two tertiary and six community acute care hospitals in eastern Massachusetts, one facility providing inpatient and outpatient mental health services and four facilities providing inpatient and outpatient services in rehabilitation medicine and long-term care. Partners HealthCare also operates physician organizations and practices, a home health agency, nursing homes, and a graduate level program for health professions. Partners HealthCare provides services to patients primarily from the Greater Boston area as well as New England and beyond. In addition, Partners HealthCare is a nonuniversity-based nonprofit private medical research enterprise and is a principal teaching affiliate of the medical and dental schools of Harvard University.

PHS is a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code (IRC). All affiliates of PHS, except for PCHI, PIMS and Newton-Wellesley Physician Hospital Organization, Inc. (NWPHO), are also tax-exempt organizations under Section 501(c)(3) of the IRC. Accordingly, no provision for income taxes related to these tax-exempt entities has been made. PCHI and NWPHO are taxable entities and PIMS is a single member LLC that is disregarded for income tax purposes. As of September 30, 2012, PCHI has available net operating loss carryforwards of approximately $31,000 for income tax purposes, expiring in 2018 through 2024.

Neighborhood Health Plan Acquisition

On September 14, 2012 the Massachusetts Division of Insurance approved the acquisition of NHP by Partners HealthCare effective October 1, 2012. NHP is a licensed, not-for-profit managed care organization founded in 1986 that provides health insurance products to the Medicaid, Commonwealth Care (a health insurance program for uninsured adults who meet income and other eligibility requirements) and commercial populations. NHP is a tax-exempt organization under Section 501(c)(4) of the IRC.

With NHP, Partners HealthCare will have the ability and flexibility to develop innovative patient and family centered models of care and craft new initiatives aimed at better managing care of complex conditions. Both NHP and Partners HealthCare believe that combining the experience and expertise of both organizations will result in a stronger patient experience and address growing needs for care coordination and management, health equity, and the ability to help curb health care costs.

(dollars in thousands)

The effective date of the acquisition is October 1, 2012. The following table presents supplemental pro forma information as if the acquisition of NHP had occurred on October 1, 2010 for the years ended September 30, 2011 and September 30, 2012.

	Unaudited Pro Forma Consolidated Results	
	Years Ended September 30,	
	2012	2011
Total operating revenue	10,083,180	9,535,949
Excess of revenues over expenses	355,361	277,014

The unaudited pro forma consolidated results were prepared using the acquisition accounting method and are based on the historical financial information of Partners HealthCare and NHP for the 12-month period ended September 30, 2012 and 2011. The historical financial information has been adjusted to give effect to the pro forma events that are (i) directly attributable to the acquisition and (ii) factually supportable. The unaudited pro forma consolidated results are not necessarily indicative of what the consolidated results actually would have been had the acquisition been completed on October 1, 2010. In addition, the unaudited pro forma consolidated results do not purport to project the future excess of revenues over expenses of the consolidated entity nor do they reflect the expected realization of any cost savings associated with the acquisition. The unaudited pro forma consolidated results reflect the following pro forma adjustments:

– Elimination of interest expense on NHP’s surplus note because the note was paid off as part of the acquisition (approximately $204 in 2012 and $219 in 2011).

– Reductions of $562 and $2,002 of costs incurred in 2012 and 2011, respectively, which are directly attributable to the acquisition, and which do not have a continuing impact on the consolidated operating results. Included in these costs are advisory, legal and regulatory costs incurred by both Partners HealthCare and NHP.

Community Benefit
Partners HealthCare’s community benefit programs include working with communities to address a number of public health issues including racial disparities, alcohol and substance abuse among young people, infant mortality, domestic violence and cancer. Partners HealthCare provides economic opportunity for low income Boston residents by helping people advance into nursing and other healthcare careers through its public school partnerships and workforce development programs. In addition, twenty-one community health centers are licensed by or affiliated with Partners HealthCare entities and provide high quality, culturally competent primary care and access to Partners HealthCare’s hospitals. Partners HealthCare invests in these health centers’ infrastructure, programming and operation and also helps with relocation, renovation and other capital requirements.

(dollars in thousands)

The Massachusetts Attorney General's Community Benefits Guidelines direct health maintenance organizations and nonprofit acute care hospitals to prepare annual reports documenting the status and level of their community benefit programs and initiatives. These annual reports serve the important purpose of providing the public with access to useful information about these programs and initiatives. Partners HealthCare files its report annually with the Massachusetts Attorney General. The report summarizes community benefit activities on a systemwide basis. In addition, each of the acute care hospitals within Partners HealthCare has a community benefit planning and service delivery structure and files separate community benefit reports. Partners HealthCare's nonacute care hospitals also file community benefit reports annually.

Uncompensated Care
Partners HealthCare provides care to all patients regardless of their ability to pay. The cost of providing that care is reflected in the statements of operations. The cost related to those patients for which Partners HealthCare receives either partial or no reimbursement for healthcare services provided is summarized as follows:

State Programs
Uncompensated Care
Free care services are partially reimbursed to acute care hospitals through the statewide Health Safety Net (HSN, formerly known as the Uncompensated Care Pool) established by the Massachusetts Health Care Reform Law (Chapter 58 of the Acts of 2006). A portion of the funding for the HSN is paid by hospitals through a statewide hospital assessment levied each year by the Massachusetts Legislature. All acute care hospitals in the state are assessed their share of this total statewide hospital assessment amount ($160,000 in 2012 and 2011) based on each hospital's charges for private sector payers. Partners HealthCare's hospitals report this assessment as a deduction from net patient service revenue.

Hospitals are reimbursed for free care based on claims for eligible patients and eligible services that are submitted to and adjudicated by the HSN. Rates of payment are based on Medicare rates and payment policies. The HSN is projected to be under-funded by approximately $133,200 and $85,000 in 2012 and 2011, respectively, with approximately $36,400 and $21,300 in 2012 and 2011, respectively, allocated to Partners HealthCare's hospitals. This shortfall is allocated to hospitals based on their share of total statewide patient care costs. Each hospital's share of the overall state shortfall cannot exceed its total free care reimbursement. Hospitals with a high proportion of free care and government funding receive more favorable reimbursement, including limiting their shortfall allocation to no more than 15% of their payments for free care. In aggregate, Partners HealthCare's acute care hospitals received uncompensated care funding covering 40% of the estimated cost of free care provided in 2012 and 43% of the estimated cost in 2011, excluding the assessment.

Medicaid
Medicaid is a means-tested health insurance program jointly funded by state and federal governments. States administer the program and set rules for eligibility, benefits and provider payments within broad federal guidelines. The program provides health care coverage to low-income children and families, pregnant women, long-term unemployed adults, seniors and persons with disabilities. Eligibility is determined by a variety of factors, which include income relative to the federal poverty line, age and immigrant status and assets.

(dollars in thousands)

Medicaid payments to Partners HealthCare do not cover the full cost of services provided. In aggregate, reimbursement from Medicaid covered 58% and 64% of the estimated cost of services provided in 2012 and 2011.

Federal Program
Medicare
Medicare is a federally sponsored health insurance program for people age 65 or older, under age 65 with certain disabilities and any age with end-stage renal disease. For many years, Medicare payments have not kept pace with increases in the cost of care provided at many hospitals. Additionally, payments to physicians have seen little or no increases over the past several years. Compounding this shortfall in payments is the shift of care from higher paying inpatient services to lower paying outpatient services.

Consequently, Medicare payments to Partners HealthCare also do not cover the full cost of services provided. In aggregate, reimbursement from Medicare covered 76% of the estimated cost of services provided in 2012 and 75% of the estimated cost of services provided in 2011.

For free care, Medicaid and Medicare, the total estimated cost of services provided by Partners HealthCare exceeded the net reimbursement received under these programs by $985,545 and $907,342 for the years ended September 30, 2012 and 2011, respectively. The estimated cost of services provided is either obtained directly from a costing system or based on an entity specific ratio of cost to gross charges. In the latter case, cost is derived by applying this ratio to gross charges associated with providing care to free care, Medicaid and Medicare patients. The following summarizes, by program, the cost of services provided, net reimbursement and cost of services in excess of reimbursement for each year:

	Years Ended September 30, 2012	Years Ended September 30, 2011
Cost of services provided		
Free Care, including assessment payment to HSN of $53,550 and $50,553 in 2012 and 2011, respectively	$ 170,005	$ 159,453
Medicaid	710,019	684,345
Medicare	2,293,150	2,165,444
	$ 3,173,174	$ 3,009,242
Net reimbursement		
Free Care	$ 37,469	$ 36,482
Medicaid	408,395	438,107
Medicare	1,741,765	1,627,311
	$ 2,187,629	$ 2,101,900
Cost of services in excess of reimbursement		
Free Care	$ 132,536	$ 122,971
Medicaid	301,624	246,238
Medicare	551,385	538,133
	$ 985,545	$ 907,342

(dollars in thousands)

Bad Debts
In addition to free care and inadequate funding from the Medicaid and Medicare programs, there are significant losses related to self-pay patients who fail to make payment for services rendered or insured patients who fail to remit co-payments and deductibles as required under the applicable health insurance arrangement. The provision for bad debts of $123,725 in 2012 and $101,118 in 2011 represents charges for services provided that are deemed to be uncollectible. The estimated cost of providing these services was approximately $39,936 and $30,495 for 2012 and 2011, respectively.

2. Summary of Significant Accounting Policies

Basis of Accounting
The accompanying consolidated financial statements have been prepared on the accrual basis of accounting and include the accounts of PHS and its affiliates. Significant interaffiliate accounts and transactions have been eliminated.

Use of Estimates
The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates are made in the areas of patient accounts receivable, research grants receivable, pledges receivable, investments, receivables and accruals for settlements with third-party payers, accrued professional liability, accrued compensation and employee benefits, interest rate swaps and accrued other.

Fair Value of Financial Instruments
The fair value of financial instruments approximates the carrying amount reported in the consolidated balance sheets for cash and equivalents, investments, investments limited as to use, collateral held under securities lending arrangements, patient accounts receivable, research grants receivable, accounts payable, collateral due under securities lending arrangements and interest rate swaps. More information can be found in Note 4, Fair Value Measurements.

Cash and Equivalents
Cash and equivalents represent money market and highly liquid debt instruments with a maturity at the date of purchase of three months or less. Most of Partners HealthCare's banking activity, including cash and equivalents, is maintained with several national banks and from time to time cash deposits exceed federal insurance limits. It is Partners HealthCare's policy to monitor these banks' financial strength on an ongoing basis and no losses have been experienced to date.

Investments
Investments in equity securities with readily determinable fair values and all investments in debt securities (marketable investments) are measured at fair value based on quoted market prices. The change in net unrealized appreciation on these marketable investments is excluded from excess of revenues over expenses.

(dollars in thousands)

Alternative investments, including hedge funds and private equities, do not have readily ascertainable market values. Alternative investments are valued by the investment manager and assessed for reasonableness by management using the following methodology: investments in securities sold short or traded on a national securities exchange are valued based on quoted market prices; investments in securities that are not traded and restricted securities of public companies are valued based on amounts reported by the fund manager and evaluated by management. The reported value of these investments represents the amount Partners HealthCare would expect to receive if it liquidated its investments at the balance sheet date on a nondistressed basis. Investments in hedge funds, private equity, private debt and other private partnerships (collectively, private partnerships) for which Partners HealthCare owns more than 5% of the overall investment are generally recorded as equity method investments. The change in value of equity method investments is included in excess of revenues over expenses as a component of income from investments. All other investments are recorded at cost.

Income from investments (including realized gains and losses, change in value of equity method investments, interest, dividends and endowment income distributions) is included in excess of revenues over expenses unless the income or loss is restricted by donor or law. Income from investments is reported net of investment-related expenses.

Investments whose cost exceeds fair value are reviewed each quarter to determine whether these investments are other-than-temporarily impaired. Externally managed marketable investments with fair value below cost are considered to be other-than-temporarily impaired and, accordingly, the unrealized depreciation is recognized as realized losses through a write-down in the cost basis of these investments. All other investments are subject to a further review, which considers factors including the anticipated holding period for the investment and the extent and duration of below cost valuation. A similar write-down is recorded when the impairment on these investments has been judged to be other-than-temporary.

Depending on any donor-imposed restrictions on the underlying investments, the amount of the write-down is reported as a realized loss in either temporarily restricted net assets or in excess of revenues over expenses as a component of income from investments, with no adjustment in the cost basis for subsequent recoveries in fair value.

Partners HealthCare has an endowment spending policy for pooled endowment funds. A fixed distribution rate for spending is determined each year which will come from either income and/or net accumulated appreciation in fair value.

Investments Limited as to Use
Investments limited as to use primarily include assets whose use is contractually limited by external parties as well as assets set aside by the boards (or management) for identified purposes and over which the boards (or management) retain control such that the boards (or management) may, at their discretion, subsequently use such assets for other purposes. Certain investments corresponding to deferred compensation are accounted for such that all income and appreciation (depreciation) is recorded as a direct addition (reduction) to the asset balance and corresponding liability balance.

(dollars in thousands)

Securities Loaned
Investments that have been loaned to another institution are reported as pledged assets within investments in the consolidated financial statements. Cash or investments held by the custodian on behalf of Partners HealthCare as collateral on the securities lending transaction are also reported as assets on the balance sheet. Because the collateral must be returned in the future, a corresponding liability is also reported in the consolidated financial statements.

Derivative Instruments
Derivatives are recognized on the balance sheet at fair value. Partners HealthCare designates at inception whether the derivative contract is considered hedging or nonhedging for accounting purposes. For hedges, Partners HealthCare formally documents at inception all relationships between hedging instruments and hedged items, as well as its risk management objectives and strategies for undertaking various accounting hedges. Partners HealthCare uses its derivatives which are designated as hedging for accounting purposes as cash flow hedges. Cash flow hedges are used to minimize the variability in cash flows of interest-bearing liabilities or forecasted transactions caused by changes in interest rates. Changes in the fair value of derivatives designated for hedging activities that are highly effective as hedges are excluded from excess of revenues over expenses. Hedge ineffectiveness, if any, is recorded in excess of revenues over expenses. For nonhedging derivatives, changes in the fair value are recorded in excess of revenues over expenses.

Patient Accounts Receivable
Partners HealthCare receives payments for services rendered from federal and state agencies (under the Medicare and Medicaid programs), managed care payers, commercial insurance companies and patients. Patient accounts receivable are reported net of contractual allowances and reserves for denials, uncompensated care and doubtful accounts. The level of reserves is based upon management's assessment of historical and expected net collections, business and economic conditions, trends in federal and state governmental and private employer health care coverage and other collection indicators.

Research Grants Receivable
Partners HealthCare receives research funding from departments and agencies of the U.S. Government, industry and corporate sponsors and other private sponsors. Research grants receivable include amounts due from these sponsors of externally funded research. The amounts have been billed or are billable to the sponsor, or in limited circumstances, represent accelerated spending in anticipation of future funding. Research grants receivable are reported net of reserves for uncollectible accounts.

Property and Equipment
Property and equipment is reported on the basis of cost less accumulated depreciation. Donated items are recorded at fair value at the date of contribution. All research grants received for capital are recorded in the year of expenditure as a change in net assets. Property and equipment is reviewed for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. Depreciation of property and equipment is calculated by use of the straight-line method at rates intended to depreciate the cost of assets over their estimated useful lives, which generally range from three to forty years. Interest costs incurred on borrowed funds during the period of construction of capital assets are capitalized, net of any interest earned, as a component of the cost of acquiring those assets.

(dollars in thousands)

In March 2012, Partners HealthCare made a strategic decision related to a change in scope and direction for its clinical information systems. In making that decision, management reassessed information system projects currently underway, including a system-wide patient administrative system, and concluded that certain costs that had been capitalized no longer had future value. Accordingly, an impairment charge of $114,356, which relates to actual amounts incurred and capitalized in previous periods, has been recorded in the year ended September 30, 2012.

Asset Retirement Obligations
Asset retirement obligations, reported in accrued other, are legal obligations associated with the retirement of long-lived assets. These liabilities are initially recorded at fair value and the related asset retirement costs are capitalized by increasing the carrying amount of the related assets by the same amount as the liability. Asset retirement costs are subsequently depreciated over the useful lives of the related assets. Partners HealthCare records changes in the liability resulting from the passage of time and revisions to either the timing or the amount of the original liability estimate. Partners HealthCare reduces these liabilities when the related obligations are settled.

Other Assets
Other assets consist of long-term receivables, deferred financing costs, intangible assets, prepaid ground rent, malpractice insurance receivables (See Note 10), investments in healthcare related limited partnerships and benefit assets for over-funded defined benefit plans. Deferred financing costs are amortized over the terms of the related obligations. The carrying value of other assets is reviewed if the facts and circumstances suggest that it may be impaired.

Compensated Absences
In accordance with formal policies concerning vacation and other compensated absences, accruals of $205,957 and $196,299 were recorded as of September 30, 2012 and 2011, respectively.

Unexpended Funds on Research Grants
Research grants received in advance of corresponding grant expenditures are accounted for as a direct addition to investments limited as to use and unexpended funds on research grants.

Self-Insurance Reserves
Partners HealthCare is generally self-insured for employee healthcare, disability, workers' compensation and certain other employee benefits. These costs are accounted for on an accrual basis to include estimates of future payments for claims incurred.

Net Assets
Permanently restricted net assets include the historical dollar amounts of gifts and the income and gains on such gifts which are required by donors to be permanently retained. Temporarily restricted net assets include gifts and the income and gains on permanently restricted net assets which can be expended but for which restrictions have not yet been met. Such restrictions include purpose restrictions where donors have specified the purpose for which the net assets are to be spent, or time restrictions imposed by donors or implied by the nature of the gift (capital projects, pledges to be paid in the future, life income funds) or by interpretations of law (gains available for appropriation but not appropriated in the current period). Unrestricted net assets include all of the remaining net assets of Partners HealthCare. See Note 12 for further information on the composition of restricted net assets.

(dollars in thousands)

Realized gains and losses are classified as unrestricted net assets unless they are restricted by the donor or law. Unless permanently restricted by the donor, realized gains and unrealized net appreciation on permanently restricted gifts are classified as temporarily restricted until appropriated for spending by Partners HealthCare in accordance with policies established by Partners HealthCare and the Massachusetts Uniform Prudent Management of Institutional Funds Act (UPMIFA). Net losses on permanently restricted endowment funds are classified as a reduction to unrestricted net assets until such time as the fair value of these funds exceeds historical cost.

Gifts and Grants

Unconditional promises to give cash and other assets to Partners HealthCare are reported at fair value at the date the promise is received. Conditional promises to give are recognized when the conditions are substantially met. Gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted gifts in the accompanying financial statements.

Gifts of long-lived assets with explicit restrictions that specify use of assets and gifts of cash or other assets that must be used to acquire long-lived assets are reported as additions to temporarily restricted net assets if the assets are not placed in service during the year.

Grants and contracts normally provide for the recovery of direct and indirect costs, subject to audit. Partners HealthCare recognizes revenue associated with direct and indirect costs as direct costs are incurred. The recovery of indirect costs is based on predetermined rates for U.S. Government grants and contracts and negotiated rates for other grants and contracts.

Statement of Operations

All activities of Partners HealthCare deemed by management to be ongoing, major and central to the provision of healthcare services, teaching and research activities are reported as operating revenue and expenses. Other activities are deemed to be nonoperating and include unrestricted gifts (net of fundraising expenses), net change in unexpended academic and research gifts, change in fair value of nonhedging interest rate swaps, and substantially all income (loss) from investments. Academic and research gifts largely consist of donor contributions (and the related investment income including realized gains and losses) designated to support the clinical, teaching or research efforts of a physician or department as directed by the donor. These gifts are reported as unrestricted, net of related support expenses, when donor restrictions are of a general nature that are inherent in the normal activities of the organization.

Partners HealthCare recognizes changes in third-party payer settlements and other estimates in the year of the change in estimate. For the years ended September 30, 2012 and 2011, adjustments to prior year estimates resulted in an increase to income from operations of $111,169 and $7,377, respectively. The $111,169 increase in income from operations for the year ended September 30, 2012 is comprised of $48,290 in favorable settlements with commercial payers and $62,879 in favorable settlements from government payers, including $27,146 associated with Partners HealthCare's share of a Department of Health Services settlement to compensate hospitals nationwide for past underpayments related to an error in Medicare's "rural floor" budget neutrality adjustment.

(dollars in thousands)

Effective October 1, 2007, the Centers for Medicare and Medicaid Services (CMS) adopted the MS-DRG patient classification system (MS-DRGs) for inpatient services to better recognize severity of illness in Medicare payment rates for acute care hospitals. The adoption of MS-DRGs resulted in the expansion of the number of diagnosis related groups (DRGs), a system of classifying patients for purposes of inpatient reimbursement. By increasing the number of DRGs and more fully taking into account patients' severity of illness in Medicare payment rates for acute care hospitals, the use of MS-DRGs encourages hospitals to improve their documentation and coding of patient diagnoses. CMS has determined that the adoption of the MS-DRGs has increased aggregate payments to hospitals due to additional documentation and coding without a corresponding increase in actual patient severity of illness.

CMS is required by its enabling statute to maintain budget neutrality by prospectively adjusting the Medicare payment rate to eliminate the effect of changes in DRG classification that do not reflect real changes in case-mix. Congress mandated that CMS recoup any overpayments made to hospitals in 2008 and 2009 resulting from increased coding and documentation. CMS has calculated the overpayments, net of rate reductions already assessed against hospitals, to be 1.9% in 2008 and an additional 2% in 2009. CMS recouped these overpayments through equal rate reductions in 2011 and 2012.

In 2010, Partners HealthCare recorded the estimated overpayment amounts received of $38,509 as deferred revenue, to be amortized into net patient service revenue in 2011 and 2012 to offset the rate reductions. Management believes this accounting treatment better reflects the financial impact of this rate methodology and more accurately presents the recognition of revenue. For the years ended September 30, 2012 and 2011, amortization amounted to $19,254 and $19,255, respectively.

The statement of operations include excess of revenues over expenses. Changes in unrestricted net assets which are excluded from excess of revenues over expenses include change in net unrealized appreciation on marketable investments, change in fair value of hedging interest rate swaps, contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for acquisition of such assets) and change in funded status of defined benefit plans.

Net Patient Service Revenue

Partners HealthCare maintains agreements with CMS of the United States Department of Health and Human Services (DHHS) under the Medicare program, The Commonwealth of Massachusetts (the Commonwealth) under the Medicaid program and various managed care payers that govern payment for services rendered to patients covered by these agreements. The agreements generally provide for per case or per diem rates or payments based on discounted charges for inpatient care and discounted charges or fee schedules for outpatient care. Certain contracts also provide for payments that are contingent upon meeting agreed upon quality and efficiency measures.

(dollars in thousands)

Partners HealthCare recognizes patient service revenue associated with services provided to patients who have third-party payer coverage on the basis of contractual rates for the services rendered. For uninsured patients that do not qualify for charity care, Partners HealthCare recognizes revenue on the basis of its standard rates (subject to discounts) for services provided. On the basis of historical experience, a significant portion of Partners HealthCare's uninsured patients are unable or fail to pay for the services provided. Consequently, Partners HealthCare records a provision for bad debts related to uninsured patients in the period the services are provided. For the year ended September 30, 2012, uninsured patients that do not qualify for charity care comprised 3% of net patient service revenue net of contractual allowances and before the provision for bad debts.

Net patient service revenue includes estimated retroactive revenue adjustments due to future audits, reviews and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews and investigations. Contracts, laws and regulations governing the Medicare, Medicaid and HSN programs (Note 1) and managed care payer arrangements are 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. A portion of the accrual for settlements with third-party payers has been classified as long-term because such amounts, by their nature or by virtue of regulation or legislation, will not be paid within one year.

Charity Care
Partners HealthCare provides either full or partial charity care to patients who cannot afford to pay for their medical services based on income and family size. Charity care is generally available to qualifying patients for medically necessary services. Partners HealthCare reports certain bad debts related to emergency services as charity care. Charity care is reported at gross charges with an offsetting allowance, as there is no expectation of collection. Accordingly, there is no net patient service revenue related to charity care.

Other Revenue
Other revenue includes institutional revenue (for example, billing for services provided to other healthcare providers), royalties and management services.

Adoption of New Accounting Guidance
In August 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2010-24 (ASU 2010-24), *Presentation of Insurance Claims and Related Insurance Recoveries*, as an amendment to ASC Topic 954. ASU 2010-24 requires that medical malpractice claims, which include costs associated with litigating or settling claims, be accrued when the incidents that give rise to the claims occur and that companies should not net insurance recoveries against the related claim liability. Partners HealthCare adopted ASU 2010-24 as of October 1, 2011. Adoption of ASU 2010-24 had no impact on excess of revenues over expenses. Refer to Note 10, Professional Liability Insurance, for more information.

In August 2010, the FASB issued *Health Care Entities*; *Measuring Charity Care for Disclosure* (ASU 2010-23), which clarified the disclosure of charity care provided by healthcare organizations, providing that such disclosure should be measured using cost and that related reimbursements recorded should also be separately disclosed. Partners HealthCare had already adopted the provisions of ASU 2010-23 in its financial reporting.

(dollars in thousands)

Reclassification
Certain amounts in the 2011 financial statements have been reclassified to conform with the 2012 presentation.

3. Investments and Investments Limited as to Use

Investments are either separately invested or included in pooled investment funds. The Partners HealthCare System Pooled Investment Accounts (Partnership) is structured as a single general partnership composed of four investment pools, with PHS and substantially all of its affiliates participating in the pools as partners. Each partner's interest in the Partnership is based on its underlying investments in one or more of the four separate pools. Amounts included in the investment pools are accounted for using the fair value method whereby each partner is assigned a number of units based on the fair value of the assets of a pool at the time of entry of the funds into the pool. Current fair value is used to determine the number of units allocated to additional amounts placed in a pool and to value withdrawals from a pool. Income from investments of the pools, including realized gains and losses, is allocated on a unitized basis to a partner based on the partner's share of units in a pool.

The Partnership invests in private partnerships whose assets include equity, fixed income and other investments. As of September 30, 2012, Partners HealthCare has unfunded commitments of approximately $348,030 which will be drawn down by the various general partners over the next several years. The maximum annual drawdown is expected to be less than 2% of investments and investments limited as to use.

Investments and investments limited as to use are recorded in the balance sheet as follows:

	September 30, 2012	September 30, 2011
Current assets		
Investments	$ 1,256,984	$ 1,256,257
Current portion of investments limited as to use	1,735,373	1,309,628
	2,992,357	2,565,885
Investments limited as to use, less current portion	2,325,279	2,077,403
Long-term investments	890,097	833,815
	$ 6,207,733	$ 5,477,103

(dollars in thousands)

Investments limited as to use consist of the following:

	September 30, 2012		September 30, 2011	
	Current Portion	Long-Term Portion	Current Portion	Long-Term Portion
Internally designated funds				
Reserved for capital expenditures	$ 804,234	$ -	$ 557,475	$ -
Unexpended academic and research gifts	-	1,932,845	-	1,699,107
Deferred compensation	-	167,397	-	146,429
Other	581,250	185,216	466,216	199,399
	1,385,484	2,285,458	1,023,691	2,044,935
Externally limited funds				
Unexpended funds on research	171,136	-	161,777	-
Contributions held for others	3,428	-	8,116	-
Professional liability trust fund	-	39,821	-	32,468
Held by trustees under debt and other agreements	175,325	-	116,044	-
	349,889	39,821	285,937	32,468
	$ 1,735,373	$ 2,325,279	$ 1,309,628	$ 2,077,403

Investments and investments limited as to use are reported at either fair value or on the equity or cost methods of accounting. The composition of these investments, segregated between pooled investments and those that are separately invested, is as follows:

	September 30, 2012			
	At Fair Value	On Equity Method	On Cost Method	Total
Pooled investments				
Invested cash equivalents	$ 50,258	$ -	$ -	$ 50,258
Separately managed investments	2,165,550	-	-	2,165,550
Mutual funds	646,358	-	-	646,358
Commingled funds	522,574	-	-	522,574
Private partnerships	-	690,286	1,700,243	2,390,529
	3,384,740	690,286	1,700,243	5,775,269
Separately invested				
Invested cash equivalents	149,238	-	-	149,238
Equities	16,323	-	9,196	25,519
U.S. Government and domestic fixed income securities	5,169	-	-	5,169
Mutual funds	169,875	-	-	169,875
Other	9,194	-	73,469	82,663
	349,799	-	82,665	432,464
	$ 3,734,539	$ 690,286	$ 1,782,908	$ 6,207,733

(dollars in thousands)

Separately managed investments include cash and equivalents of $281,109, equities of $395,146 and fixed income securities of $1,489,295 as of September 30, 2012.

	September 30, 2011			
	At Fair Value	On Equity Method	On Cost Method	Total
Pooled investments				
Invested cash equivalents	$ 96,455	$ -	$ -	$ 96,455
Separately managed investments	1,912,574	-	-	1,912,574
Mutual funds	424,600	-	-	424,600
Commingled funds	372,376	-	-	372,376
Private partnerships	-	634,061	1,552,506	2,186,567
	2,806,005	634,061	1,552,506	4,992,572
Separately invested				
Invested cash equivalents	215,548	-	-	215,548
Equities	24,548	-	7,136	31,684
U.S. Government and domestic fixed income securities	5,109	-	-	5,109
Mutual funds	148,396	-	-	148,396
Other	8,597	-	75,197	83,794
	402,198	-	82,333	484,531
	$ 3,208,203	$ 634,061	$ 1,634,839	$ 5,477,103

Separately managed investments include cash and equivalents of $152,444, equities of $410,817 and fixed income securities of $1,349,313 as of September 30, 2011.

For the private partnerships reflected in the balance sheet at cost, the difference (unrecorded net unrealized appreciation) between the value reported by the investment managers and the cost for these investments was $648,893 and $509,436 as of September 30, 2012 and 2011, respectively.

(dollars in thousands)

The fair value and gross unrealized depreciation of investments and investments limited as to use, with a fair value less than cost, that are not deemed to be other-than-temporarily impaired at September 30, 2012 are as follows:

	Less than 12 Months		12 Months or Greater	
	Fair Value	Gross Unrealized Depreciation	Fair Value	Gross Unrealized Depreciation
Pooled investments				
Mutual funds	$ -	$ -	$ 113,461	$ (43,291)
Commingled funds	44,658	(125)	99,956	(6,879)
	44,658	(125)	213,417	(50,170)
Separately invested				
Equities	488	(11)	6,639	(4,129)
U.S. Government and domestic fixed income securities	-	-	1,548	(662)
External trusts	-	-	7,429	(1,173)
	488	(11)	15,616	(5,964)
	$ 45,146	$ (136)	$ 229,033	$ (56,134)

In addition, for certain private partnerships recorded at cost, gross unrealized depreciation amounted to $23,919 as of September 30, 2012, with $18,421 of that amount unrealized for 12 months or greater.

Based on management's quantitative and qualitative assessment, investments whose cost exceeds fair value are not considered to be other-than-temporarily impaired at September 30, 2012. Management believes these investments will recover their values and there is no intention to liquidate these positions.

(dollars in thousands)

Investment income and gains (losses) from cash and equivalents, investments (including long-term) and investments limited as to use are comprised of the following:

	Years Ended September 30, 2012	Years Ended September 30, 2011
Unrestricted		
Dividends, interest and other income	$ 58,122	$ 52,117
Endowment income distributions, net of reinvested gains	30,714	28,020
Net realized gains (losses) on investments		
Realized gains	158,560	202,563
Other-than-temporary impairment	(41,099)	(84,887)
Change in value of equity method investments	46,856	(47,554)
Recovery (losses) on endowment funds	2,324	(1,857)
Total investment activity included in excess of revenues over expenses	255,477	148,402
Change in net unrealized appreciation on marketable investments	95,701	(115,943)
Total unrestricted investment activity	351,178	32,459
Temporarily restricted		
Dividends and interest income	3,738	4,498
Endowment income distributions	(36,668)	(33,388)
Net realized gains (losses) on investments		
Realized gains	30,695	52,109
Other-than-temporary impairment	(6,709)	(17,753)
	(8,944)	5,466
Change in value of equity method investments	11,924	(11,956)
Change in net unrealized appreciation on marketable investments	30,252	(22,545)
(Recovery) losses on endowment funds	(2,324)	1,857
	39,852	(32,644)
Total temporarily restricted investment activity	30,908	(27,178)
Permanently restricted		
Dividends and interest income	47	2
Net (losses) realized gains on investments	(258)	447
Change in net unrealized appreciation on marketable investments	900	851
Total permanently restricted investment activity	689	1,300
	$ 382,775	$ 6,581

(dollars in thousands)

Investment income (loss) included in operating results and excess of revenues over expenses is comprised of the following:

	Years Ended September 30, 2012	Years Ended September 30, 2011
Investment income included in operations and reported in Other revenue	$ 10,997	$ 10,477
Investment income included in nonoperating gains (expenses) and reported in		
Income from investments	136,875	33,512
Academic and research gifts, net of expenses	107,605	104,413
Total investment activity included in excess of revenues over expenses	$ 255,477	$ 148,402

Securities Lending

The Partnership may lend securities to qualified financial institutions through a program administered by the Partnership custodian. All loans are callable at any time and are fully collateralized. Income is earned based on the collateral held and invested during the period of lending. Cash collateral requirements are 102% and 105% for domestic and foreign securities, respectively. The custodian continually monitors borrowers' creditworthiness and protects against borrower default through full indemnification. If a borrower failed to return a loaned security whose market value has increased over the amount in collateral, the custodian will cover the difference. The custodian will also cover operational losses, such as the failure of the borrower to make substitute dividend payments to the lender.

The fair value of loaned securities and related collateral at September 30, 2012 and 2011 is as follows:

	2012		2011	
	Loaned Securities	Collateral	Loaned Securities	Collateral
Equities, U.S. government, domestic and foreign fixed income securities	$ 102,785	$ 105,985	$ 151,454	$ 157,872

Income generated by the Partnership from securities lending arrangements was $490 and $291 for the years ended September 30, 2012 and 2011, respectively.

(dollars in thousands)

4. Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (also referred to as exit price). Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. In determining fair value, the use of various valuation approaches, including market, income and cost approaches, is permitted.

Fair Value Hierarchy
A fair value hierarchy has been established based on whether the inputs to valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the reporting entity's assumptions about the inputs market participants would use. The fair value hierarchy requires the reporting entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. In addition, for hierarchy classification purposes, the reporting entity should not look through the form of an investment to the nature of the underlying securities held by an investee.

The hierarchy is described below.

Level 1 Valuations using quoted prices in active markets for identical assets or liabilities. Valuations of these products do not require a significant degree of judgment. Level 1 assets and liabilities primarily include debt and equity securities that are traded in an active exchange market.

Level 2 Valuations using observable inputs other than Level 1 prices such as quoted prices in active markets for similar assets or liabilities; quoted prices for identical or similar assets or liabilities in markets that are not active; broker or dealer quotations; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities primarily include debt securities with quoted prices that are traded less frequently than exchange-traded instruments as well as debt securities and derivative contracts whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data.

Level 3 Valuations using unobservable inputs that are supported by little or no market activity and are significant to the fair value of the assets or liabilities. Level 3 includes assets and liabilities whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques reflecting the reporting entity's assumptions about the assumptions market participants would use as well as those requiring significant management judgment.

(dollars in thousands)

Valuation Techniques

Pooled investments (except for private partnerships, which are reported on either the equity method or cost method of accounting), separately invested cash equivalents, debt and equity securities, and collateral held under securities lending arrangements are classified within Level 1 or Level 2 of the fair value hierarchy as they are valued using quoted market prices, broker or dealer quotations, or other observable pricing sources. Certain types of investments are classified within Level 3 of the fair value hierarchy because they have little or no market activity and therefore have little or no observable inputs with which to measure fair value.

The valuation of interest rate swaps is determined using widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities.

The following tables summarize fair value measurements at September 30, 2012 and 2011 for financial assets and liabilities measured at fair value on a recurring basis:

		Fair Value Measurements Using		
	Fair Value at September 30, 2012	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Pooled investments				
Invested cash equivalents	$ 50,258	$ 8,742	$ 41,516	$ -
Separately managed investments	2,165,550	1,270,525	895,025	-
Mutual funds	646,358	646,358	-	-
Commingled funds	522,574	-	522,574	-
	3,384,740	1,925,625	1,459,115	-
Separately invested				
Invested cash equivalents	149,238	149,238	-	-
Equities	16,323	14,027	2,296	-
U.S. Government and domestic fixed income securities	5,169	3,749	1,420	-
Mutual funds	169,875	169,875	-	-
Other	9,194	121	-	9,073
	349,799	337,010	3,716	9,073
	$ 3,734,539	$ 2,262,635	$ 1,462,831	$ 9,073
Collateral held under securities lending arrangements	$ 105,985		$ 105,985	
Liabilities				
Interest rate swaps	$ 398,340		$ 398,340	

(dollars in thousands)

	Fair Value at September 30, 2011	Fair Value Measurements Using: Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Pooled investments				
Invested cash equivalents	$ 96,455	$ 26,216	$ 70,239	$ -
Separately managed investments	1,912,574	1,091,142	821,432	-
Mutual funds	424,600	424,600	-	-
Commingled funds	372,376	-	372,376	-
	2,806,005	1,541,958	1,264,047	-
Separately invested				
Invested cash equivalents	215,548	215,548	-	-
Equities	24,548	20,343	2,298	1,907
U.S. Government and domestic fixed income securities	5,109	3,599	1,510	-
Mutual funds	148,396	148,396	-	-
Other	8,597	121	-	8,476
	402,198	388,007	3,808	10,383
	$ 3,208,203	$ 1,929,965	$ 1,267,855	$ 10,383
Collateral held under securities lending arrangements	$ 157,872		$ 157,872	
Liabilities				
Interest rate swaps	$ 375,202		$ 375,202	

For the years ended September 30, 2012 and 2011, the changes in the fair value of the assets measured using significant unobservable inputs (Level 3) were comprised of the following:

	2012	2011
Balance at beginning of year	$ 10,383	$ 11,321
Total gains (losses)		
Dividends and interest income	58	49
Net realized gains on investments	581	468
Change in net unrealized appreciation on investments	86	405
Purchases	9	4
Sales	(2,044)	(1,864)
Balance at end of year	$ 9,073	$ 10,383

The net unrealized gain on Level 3 investments held at September 30, 2012 was $575.

(dollars in thousands)

5. Pledges Receivable and Contributions Receivable from Trusts

Pledges receivable represent unconditional promises to give and are net of allowances for uncollectible amounts. Pledges are recorded at the present value of their estimated future cash flows. Pledges collectible within one year are classified as other current assets, net of allowances, and total $109,766 and $94,197 as of September 30, 2012 and 2011, respectively. Estimated cash flows due after one year are discounted using published treasury bond and note yields that are commensurate with estimated collection risks. The blended discount rate was 0.4% and 0.6% for 2012 and 2011, respectively. Pledges are expected to be collected as follows:

	September 30, 2012	September 30, 2011
Amounts due		
Within one year	$ 128,865	$ 119,913
In one to five years	136,811	181,895
In more than five years	18,418	19,770
Total pledges receivable	284,094	321,578
Less: Unamortized discount	2,566	4,254
	281,528	317,324
Less: Allowance for uncollectibles	29,452	42,075
Net pledges receivable	252,076	275,249
Contributions receivable from trusts	25,786	28,205
	$ 277,862	$ 303,454

6. Property and Equipment

Property and equipment consists of the following:

	September 30, 2012	September 30, 2011
Land and land improvements	$ 160,838	$ 157,601
Buildings and building improvements	4,854,254	4,700,716
Equipment	1,276,372	1,286,770
Construction in progress	490,567	466,432
	6,782,031	6,611,519
Accumulated depreciation	(2,896,173)	(2,666,762)
Property and equipment, net	$ 3,885,858	$ 3,944,757

Depreciation expense for the years ended September 30, 2012 and 2011 was $415,593 and $389,738, respectively. Interest costs, net of interest earned, aggregating $16,754 and $20,800 were capitalized in 2012 and 2011, respectively.

(dollars in thousands)

For the years ended September 30, 2012 and 2011, fully depreciated assets with an original cost of $186,182 and $170,282, respectively, were written off.

7. Long-Term Obligations

Long-term obligations issued by PHS and its affiliates consist of the following:

	September 30, 2012	2011
Massachusetts Health and Educational Facilities Authority (Authority) Revenue Bonds		
Partners HealthCare System Series B, average fixed interest rate of 5.25%, final maturity in 2012	$ -	$ 72,831
Partners HealthCare System Series C, average fixed interest rate of 5.00%, final maturity in 2013	3,960	12,857
Partners HealthCare System Series D, variable interest rate of 0.18% and 0.11% at September 30, 2012 and 2011, respectively, final maturity in 2038	103,500	104,655
Partners HealthCare System Series E, average fixed interest rate of 5.00%, final maturity in 2023	5,633	22,937
Partners HealthCare System Series F, issued in multiple subseries, average fixed interest rate of 5.00%, variable interest rate of 0.29% and 0.38% at September 30, 2012 and 2011, respectively, final maturity in 2040	378,097	384,242
Partners HealthCare System Series G, issued in multiple subseries, average fixed interest rate of 4.91%, variable interest rate of 0.36% at September 30, 2012 and 2011, final maturity in 2047	454,084	461,627
Partners HealthCare System Series H, variable interest rate of 0.16% and 0.20% at September 30, 2012 and 2011, respectively, final maturity in 2042	171,154	171,148
Partners HealthCare System Series I, issued in multiple subseries, average fixed interest rate of 4.75%, variable interest rate of 0.17% and 0.10%, at September 30, 2012 and 2011, respectively, final maturity in 2044	228,792	229,148
Partners HealthCare System Series J, average fixed interest rate of 4.99%, final maturity in 2039	491,118	508,599
Partners HealthCare System Series P, variable interest rate of 0.18% and 0.11% at September 30, 2012 and 2011, respectively, final maturity in 2027	150,000	150,000
Massachusetts Development Finance Agency (Agency) Revenue Bonds		
Partners HealthCare System Series K, issued in multiple subseries, average fixed interest rate of 4.19%, variable interest rate of 0.44% and 0.40% at September 30, 2012 and 2011, respectively, final maturity in 2046	434,775	435,453
Partners HealthCare System Series L, average fixed interest rate of 4.92%, final maturity in 2041	352,937	-
Partners HealthCare System Series 2007 taxable bonds, fixed interest rate of 6.26%, final maturity in 2037	100,000	100,000
Partners HealthCare System Series 2011 taxable bonds, fixed interest rate of 3.44%, final maturity in 2021	250,000	-
Other obligations	7,125	6,952
Capital lease obligations	2,087	3,168
Total long-term obligations net of premiums and discounts	3,133,262	2,663,617
Less current portion	293,322	294,829
Less auction rate securities held	-	30,000
	$ 2,839,940	$ 2,338,788

(dollars in thousands)

As of September 30, 2012 and 2011, respectively, Partners HealthCare was holding $0 and $30,000 of the Series F and Series G Revenue Bonds issued as auction rate securities (ARS). Although not legally extinguished, the bonds held by Partners HealthCare have been reflected as extinguished under generally accepted accounting principles.

Aggregate maturities and payments of long term obligations during the next five years and thereafter, and other amounts classified as current liabilities, are as follows:

	Scheduled Maturities	Bonds Supported by Partners HealthCare Liquidity	Total
2013	$ 51,662	$ 241,660	$ 293,322
2014	45,321	-	45,321
2015	55,760	-	55,760
2016	63,295	-	63,295
2017	64,124	-	64,124
Thereafter	2,611,440	-	2,611,440
	$ 2,891,602	$ 241,660	$ 3,133,262

The scheduled maturities represent annual payments as required under debt repayment schedules. The current portion of long-term obligations includes the payments scheduled to be made in 2013 along with variable rate bonds supported by Partners HealthCare liquidity. The variable rate bonds supported by Partners HealthCare liquidity provide the bondholder with an option to tender the bonds to Partners HealthCare. Accordingly, these bonds are classified as a current liability.

The fair value of long-term obligations was $3,377,755 and $2,796,802 as of September 30, 2012 and 2011, respectively. The carrying amount of the variable rate debt is a reasonable estimate of its fair value. The fair value of the fixed rate debt is estimated based on quoted market prices for the same or similar issues.

Interest expense approximates interest paid, net of capitalized interest, during the years ended September 30, 2012 and 2011.

Taxable Bonds
In December 2011, PHS issued Partners HealthCare System Taxable Bonds Series 2011 of $250,000. The bond proceeds, net of issuance costs of $1,632, were used to make a voluntary contribution to Partners HealthCare's defined benefit pension plans.

Agency Revenue Bonds
In January 2012, PHS issued Partners HealthCare System Series L Revenue Bonds of $331,320 plus bond premium of $22,181. The bond proceeds, net of issuance costs of $3,056, were used to finance certain capital projects totaling $260,834 and to refund a portion of Partners HealthCare System Series B Revenue Bonds ($73,205), a portion of Partners HealthCare System Series C

(dollars in thousands)

Revenue Bonds ($5,279) and a portion of Partners HealthCare System Series E Revenue Bonds ($11,127) all of which were issued as fixed rate bonds.

In January 2011, PHS issued Partners HealthCare System Series K Revenue Bonds of $423,165 plus bond premium of $12,854. The bond proceeds, net of issuance costs of $3,523, were used to finance certain capital projects totaling $201,331 and to refund a portion of Partners HealthCare System Series C Revenue Bonds ($32,467) that were issued as fixed rate bonds, and a portion of Partners HealthCare System Series D Revenue Bonds ($198,698) that were issued as VRDBs. The Series K Bonds were issued in multiple subseries, including $100,000 of VRDBs supported by standby bond purchase agreements, $74,775 of index floating rate bonds, $118,195 of term rate bonds and $130,195 of fixed rate bonds.

As of September 30, 2012, approximately $10,370 of refunded revenue bonds, which are considered extinguished for accounting purposes, remain outstanding and will be fully redeemed in 2013.

Partners HealthCare Series 2007 and 2011 taxable bonds, the Authority's Series B through J bonds and the Agency's Series K and L bonds and the Series P loan to PHS, (collectively, PHS Bonds) are unsecured general obligations of PHS supported by guarantees from BWHC, The Brigham and Women's Hospital, Inc. (BWH), MGH and The General Hospital Corporation (the General) which may be suspended under certain conditions.

PHS bond agreements contain certain covenants, including a minimum debt service coverage ratio and limitations on additional indebtedness and asset transfers.

Credit Agreement
Partners HealthCare maintains a $150,000 Credit Agreement (the Agreement) with several banks that provides access to same day funds. Advances under the Agreement bear a variable rate of interest based on the London Interbank Offered Rate (LIBOR). There were no amounts outstanding under the Agreement as of September 30, 2012. The Agreement expires in June 2017.

Derivatives - Interest Rate Swaps
Partners HealthCare uses derivative financial instruments principally to manage interest rate risk and has entered into derivatives to lock in fixed rates for anticipated issuances and refundings of debt. By using derivative financial instruments to manage the risk of changes in interest rates, Partners HealthCare 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 has a liability to Partners HealthCare, which creates credit risk. Partners HealthCare minimizes its credit risk by entering into derivative agreements with several counterparties and requiring the counterparty to post collateral for the benefit of Partners HealthCare based on the credit rating of the counterparty and the fair value of the derivative contract. When the fair value of a derivative contract is negative, Partners HealthCare has a liability to the counterparty and, therefore, it does not possess credit risk. Under certain circumstances Partners HealthCare may be required to post collateral for the benefit of the counterparty. Market risk is the adverse 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.

(dollars in thousands)

Partners HealthCare utilizes interest rate swaps to manage fluctuations in cash flows resulting from interest rate risk on certain of its variable rate revenue bonds. These bonds expose Partners HealthCare to variability in interest payments due to changes in interest rates. Management believes that it is prudent to limit the variability of its interest payments. To meet this objective and to take advantage of low interest rates, Partners HealthCare entered into various interest rate swap agreements involving the exchange of fixed rate payments by Partners HealthCare for variable rate payments from several counterparties based on a percentage of LIBOR.

The following is a summary of the outstanding positions under these interest rate swap agreements at September 30, 2012:

Effective Date	Notional Amount	Maturity	Rate Paid	Rate Received	Hedging Status
5/1/03	$ 150,000	7/1/35	4.40%	67% 1-month LIBOR	Nonhedging
7/1/03	27,100	7/1/15	5.11%	67% 6-month LIBOR	Hedging
7/1/05	150,000	7/1/40	3.63%	67% 1-month LIBOR	Nonhedging
7/1/05	49,700	7/1/25	5.11%	67% 6-month LIBOR	Hedging
7/1/07	150,000	7/1/42	3.46%	67% 1-month LIBOR	Nonhedging
7/1/09	100,000	7/1/44	3.71%	67% 1-month LIBOR	Hedging
7/1/11	100,000	7/1/46	3.74%	67% 1-month LIBOR	Hedging
7/1/13	100,000	7/1/48	3.80%	67% 1-month LIBOR	Hedging
7/1/15	100,000	7/1/50	3.80%	67% 1-month LIBOR	Hedging
7/1/17	100,000	7/1/52	3.74%	67% 1-month LIBOR	Hedging

Partners HealthCare designates its interest rate swaps that are used to minimize the variability in cash flows of interest-bearing liabilities or forecasted transactions caused by changes in interest rates as hedging instruments at the inception of each contract, with the intention of maintaining hedge accounting treatment over the term of the agreement. However, circumstances may arise whereby the variability in cash flows exceeds the threshold for hedging qualification or the structure of the bonds is changed, resulting in de-designation of the hedge. Partners HealthCare de-designated $450,000 of its interest rate swaps when they ceased to qualify for hedge accounting.

Hedging swaps are designated as cash flow hedges; accordingly, the change in fair value of the effective portion of the hedge is reflected as a change in unrestricted net assets and the ineffective portion of the hedge is reflected as a component of nonoperating gains (expenses) in the consolidated statements of operations. Nonhedging swaps are either swaps that have been de-designated as hedges or not designated as hedging instruments at the inception of the agreement; accordingly, the change in fair value is recorded as a component of nonoperating gains (expenses) in the consolidated statements of operations.

(dollars in thousands)

The fair value of interest rate swaps is as follows:

Balance Sheet Location	September 30, 2012	September 30, 2011
Derivatives designated as hedging instruments		
Interest rate swaps liability	$ 223,788	$ 210,354
Derivatives not designated as hedging instruments		
Interest rate swaps liability	174,552	164,848
	$ 398,340	$ 375,202

The effects of interest rate swaps on the consolidated statements of operations are as follows:

Statement of Operations Location	Amount of Gain (Loss) Recognized in Changes in Unrestricted Net Assets Years Ended September 30, 2012	2011	Amount of Gain (Loss) Recognized in Excess of Revenues Over Expenses Years Ended September 30, 2012	2011
Derivatives designated as hedging instruments				
Change in fair value of hedging interest rate swaps	$ (12,076)	$ (68,750)	$ -	$ -
Amortization of swaption premiums	-	-	1,471	1,483
Hedge ineffectiveness	-	-	(2,830)	534
Derivatives not designated as hedging instruments				
Change in fair value of nonhedging interest rate swaps	-	-	(9,704)	(37,067)
Reclassification of net asset balance upon hedge de-designation	818	818	(818)	(818)
	$ (11,258)	$ (67,932)	$ (11,881)	$ (35,868)

Partners HealthCare's interest rate swaps contracts contain provisions that require collateral to be posted if the fair value of the swaps exceeds certain thresholds. The collateral thresholds reflect the current credit ratings issued by major credit rating agencies on Partners HealthCare's and the counterparty's debt. Declines in Partners HealthCare's or the counterparty's credit ratings would result in decreases in the collateral thresholds and consequently, the potential for additional collateral postings by Partners HealthCare or the counterparty. As of September 30, 2012 and 2011, the aggregate fair value of all interest rate swaps was a liability of $398,340 and $375,202, respectively, for which Partners HealthCare had posted collateral of $133,383 and $115,777, respectively. Partners HealthCare has established procedures to ensure that liquidity is available to meet collateral posting requirements.

(dollars in thousands)

Upon the occurrence of certain events of default or termination events identified in the derivative contracts, either Partners HealthCare or the counterparty could terminate the contracts in accordance with their terms. Termination results in the payment of a termination amount by one party that attempts to compensate the other party for its economic losses. If interest rates at the time of termination are lower than those specified in the derivatives contract, Partners HealthCare will make a payment to the counterparty. Conversely, if interest rates at such time are higher, the counterparty will make a payment to Partners HealthCare.

Derivatives - Other
Partners HealthCare also enters into options and futures primarily as hedges on securities and indices primarily related to foreign currency. Forward contracts are used as currency hedges. These agreements are limited in use and generally do not exceed one year and are included in separately invested investments.

8. Commitments

Leases
Partners HealthCare has capital and noncancelable operating leases for certain buildings and equipment. Minimum future lease commitments under noncancelable leases for the next five years and thereafter are as follows:

	Capital Leases	Operating Leases
2013	$ 1,126	$ 170,060
2014	833	157,082
2015	252	142,767
2016	-	170,891
2017	-	109,146
Thereafter	-	443,969
Total lease payments	2,211	$ 1,193,915
Less amount representing interest	124	
Capital lease obligations at September 30, 2012	$ 2,087	

Rental expense under operating leases approximated $169,317 in 2012 and $162,895 in 2011.

Construction Projects
BWH is constructing a building (the Brigham Building for the Future or BBF) and a parking garage (the Brigham Patient Parking project or BPP). The BBF will expand research and clinical space on the BWH campus, with a focus on the Neuroscience and Musculoskeletal programs, and increase flexibility for future campus redevelopment while allowing for lease consolidation. Phase 1 of the project, which involves preparing the site and constructing two smaller facilities to be used by the Commonwealth, is substantially complete with accumulated costs of $69,890 as of September 30, 2012 and outstanding contracts of $6,783. The associated land is leased to BWH by the Commonwealth through 2105. Planning for Phase 2 (construction of the BBF) is ongoing with construction to begin in 2013. Phase 2 cost is expected to be approximately $499,000, with occupancy scheduled for late 2017.

(dollars in thousands)

BPP locates a 400 space parking facility under BWH's 15 Francis Street entrance. BPP eliminates a parking shortage on campus and also satisfies commitments to the community and regulators. BPP includes a "greening" landscaped park over the garage as required by the City of Boston. BPP's total project cost is expected to be approximately $63,500. Construction is underway with accumulated costs of approximately $14,556 as of September 30, 2012 and outstanding construction contracts of approximately $29,098, with the garage opening scheduled for late 2013.

In October 2005, PHS paid $4,750 in exchange for the development rights to certain parcels of land in Charlestown, Massachusetts (Yards End), the planned site of a new facility for Spaulding Rehabilitation Hospital Corporation (Spaulding). As of September 30, 2012, costs incurred in connection with the new facility approximated $170,898 with approximately $28,257 in outstanding construction contracts. The total project cost is expected to be approximately $225,000 with occupancy scheduled for 2013.

9. Pension and Postretirement Healthcare Benefit Plans

Substantially all employees of Partners HealthCare are covered under various noncontributory defined benefit pension plans and various defined contribution pension plans. In addition, certain affiliates provide subsidized healthcare benefits for retired employees on a self-insured basis, with the benefit obligation being partially funded. These retiree healthcare benefits are administered through an insurance company and are accounted for on the accrual basis, which includes an estimate of future payments for claims incurred.

Total expense for these plans consists of the following:

	Years Ended September 30, 2012	2011
Defined benefit plans	$ 172,800	$ 174,282
Defined contribution plans	131,781	125,449
Postretirement healthcare benefit plans	8,875	8,297
	$ 313,456	$ 308,028

(dollars in thousands)

Information regarding benefit obligations, plan assets, funded status, expected cash flows and net periodic benefit cost follows within this footnote.

Benefit Obligations

Change in Benefit Obligations	Defined Benefit Pension Plans 2012	Defined Benefit Pension Plans 2011	Postretirement Healthcare Benefit Plans 2012	Postretirement Healthcare Benefit Plans 2011
Benefit obligations at beginning of year	$ 3,346,936	$ 2,999,341	$ 113,682	$ 101,267
Service cost	190,453	180,806	4,730	4,365
Interest cost	184,042	171,716	5,561	5,083
Plan amendments	2,278	3,202	-	-
Actuarial loss	796,201	71,026	14,733	1,762
Benefits paid	(74,249)	(72,526)	(4,816)	(4,577)
Expenses paid	(4,497)	(6,629)	-	-
Employee contributions	-	-	6,454	5,782
Benefit obligations at end of year	$ 4,441,164	$ 3,346,936	$ 140,344	$ 113,682

The accumulated benefit obligation for all defined benefit pension plans at the end of 2012 and 2011 was $4,148,507 and $3,129,352, respectively.

Weighted-Average Assumptions Used to Determine End of Year Benefit Obligation	Defined Benefit Pension Plans 2012	Defined Benefit Pension Plans 2011	Postretirement Healthcare Benefit Plans 2012	Postretirement Healthcare Benefit Plans 2011
Discount rate	4.15%	5.30%	2.65% - 4.15%	4.15% - 5.30%
Rate of compensation increase				
Professional staff	4.45%	4.45%	N/A	N/A
Other than professional staff	3.00% - 3.50%	3.00% - 3.50%	N/A	N/A
Healthcare cost trend rate for next year	N/A	N/A	7.00%	7.50%
Rate to which the cost trend rate is to decline	N/A	N/A	5.00%	5.00%
Year that rate reaches the ultimate trend rate	N/A	N/A	2017	2017

Assumed healthcare cost trend rates have a significant effect on the amounts reported for the healthcare plans. A one-percentage-point change in assumed healthcare cost trend rates would have the following effect:

	One-Percentage-Point Increase	One-Percentage-Point Decrease
Effect on postretirement benefit obligation	$ 1,294	$ (1,193)

(dollars in thousands)

Plan Assets

Change in Plan Assets	Defined Benefit Pension Plans 2012	Defined Benefit Pension Plans 2011	Postretirement Healthcare Benefit Plans 2012	Postretirement Healthcare Benefit Plans 2011
Fair value of plan assets at beginning of year	$ 2,368,991	$ 2,261,997	$ 33,334	$ 27,302
Actual return on plan assets	310,042	10,667	6,194	250
Employer contributions	514,597	175,482	4,816	4,577
Employee contributions	-	-	6,454	5,782
Benefits paid	(74,249)	(72,526)	(4,816)	(4,577)
Expenses paid	(4,497)	(6,629)	-	-
Fair value of plan assets at end of year	$ 3,114,884	$ 2,368,991	$ 45,982	$ 33,334

The assets of the defined benefit pension plans are aggregated in a single master trust (Master Trust) and managed as one asset pool. The investment objective for the Master Trust is to achieve the highest reasonable total return after considering (i) plan liabilities, (ii) funding status and projected cash flows, (iii) projected market returns, valuations and correlations for various asset classes and (iv) Partners HealthCare's ability and willingness to incur market risk.

Oversight of the management of Partners HealthCare's investable assets, including the Master Trust, is provided by the Investment Committee of the PHS Board of Directors. The Committee seeks to add incremental returns by manager selection and asset allocation (increasing/decreasing allocations within allowable ranges based on current and projected valuations). The Committee is supported by a professional staff, an outside investment consultant and a pension actuarial consultant.

Partners HealthCare utilizes a policy benchmark allocation that balances projected returns, correlations and volatility of various asset classes within the overall risk tolerance. The allocations are actively managed based on relative valuations among and within asset classes and the perceived ability of managers to outperform passive benchmarks. Exposure by asset class is the sum of the net exposures reported by each manager. Asset performance is monitored monthly and the portfolio is rebalanced if asset classes exceed explicit ranges.

(dollars in thousands)

The following table presents the policy benchmark allocation components (and allowable ranges) and the reported exposures of the Master Trust:

	September 30, 2012		September 30, 2011	
	Policy Benchmarks	Reported Exposures	Policy Benchmarks	Reported Status
Domestic equity	24 %	25 %	22 %	17 %
Foreign developed equity	20	22	22	18
Emerging markets equity	6	13	6	10
Private equity	10	10	10	10
Total equity (+/- 15%)	60 %	70 %	60 %	55 %
Fixed income (+/- 10%)	20	8	20	20
Inflation defensive (+/- 10%)	10	6	10	7
Cash and other (+/- 10%)	10	16	10	18
	100 %	100 %	100 %	100 %

Inflation defensive strategies include investments in real estate assets, commodities, timber and inflation protection bonds. Other exposures include currency and volatility based strategies.

Within the Master Trust, assets are allocated to managers with investment mandates that may range from a single sub-asset class to very broad mandates; with restrictions that range from long-only to unconstrained; and with management structures ranging from separately managed funds to mutual/commingled funds to private partnerships. Less market sensitive managers employ absolute return, long/short equity and diversified strategies, which in the aggregate are expected to generate positive returns on a consistent basis. Investment risks (concentration, correlation, valuation, liquidity, leverage, mandate compliance, etc.) are measured at the manager level as well as the pool level. The active risk of the Master Trust is determined by a statistical regression of the most recent two (2) year return series to that of the policy benchmark.

The following table presents the capital allocations by manager mandate within the Master Trust. Some managers, particularly Real assets and Less market sensitive managers, invest allocated capital among multiple policy benchmark asset classes.

	September 30, 2012		September 30, 2011	
	Dollars	Percentage	Dollars	Percentage
Traditional U.S. equity	$ 435,240	14 %	$ 277,916	12 %
Traditional foreign developed equity	303,320	10	354,587	15
Traditional emerging markets equity	346,731	11	197,301	8
Private equity	219,446	7	179,604	8
Real assets	321,706	10	273,148	11
Less market sensitive managers	1,005,007	32	737,876	31
Fixed income managers	483,434	16	348,559	15
	$ 3,114,884	100 %	$ 2,368,991	100 %

(dollars in thousands)

The postretirement healthcare benefit plans assets are commingled funds, with the objective of achieving returns to satisfy plan obligations and with a level of volatility commensurate with Partners HealthCare's overall financial profile.

The following table presents plan assets, by form of ownership, as of September 30, 2012 and 2011 measured at fair value on a recurring basis using the fair value hierarchy defined in Note 4:

		Fair Value Measurements Using		
	Fair Value at September 30, 2012	**Quoted Prices in Active Markets for Identical Items (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Defined Benefit Pension Plans				
Invested cash equivalents	$ 5,053	$ 5,053	$ -	$ -
Separately managed investments	636,901	463,234	173,667	-
Mutual funds	403,749	403,749	-	-
Commingled funds	351,562	-	351,562	-
Private partnerships	1,717,619	-	963,376	754,243
	3,114,884	872,036	1,488,605	754,243
Postretirement Healthcare Benefit Plans				
Commingled funds	45,982	3,748	38,924	3,310
Total plan assets	$ 3,160,866	$ 875,784	$ 1,527,529	$ 757,553

		Fair Value Measurements Using		
	Fair Value at September 30, 2011	**Quoted Prices in Active Markets for Identical Items (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Defined Benefit Pension Plans				
Invested cash equivalents	$ 38,976	$ 38,976	$ -	$ -
Separately managed investments	475,085	324,664	150,421	-
Mutual funds	157,353	157,353	-	-
Commingled funds	240,171	-	240,171	-
Private partnerships	1,457,406	-	842,368	615,038
	2,368,991	520,993	1,232,960	615,038
Postretirement Healthcare Benefit Plans				
Commingled funds	33,334	1,670	28,361	3,303
Total plan assets	$ 2,402,325	$ 522,663	$ 1,261,321	$ 618,341

(dollars in thousands)

In evaluating the level at which Partners HealthCare's private partnerships have been classified within the fair value hierarchy, management has assessed factors including, but not limited to price transparency, the ability to redeem these investments at net asset value at the measurement date, and the existence or absence of certain restrictions at the measurement date. Investments in private partnerships generally have limited redemption options for investors and, subsequent to final closing, may or may not permit subscriptions by new or existing investors. These entities may also have the ability to impose gates, lockups, and other restrictions on an investor's ability to readily redeem out of their investment interest in the fund. At September 30, 2012 and 2011, certain private partnerships where Partners HealthCare has the ability and the right to redeem interests within the next twelve months have been classified as Level 2 investments in the plan assets' fair value table.

During the years ended September 30, 2012 and 2011, the change in the fair value of the plan assets measured using significant unobservable inputs (Level 3) is comprised of the following:

	2012	2011
Balance at beginning of year	$ 618,341	$ 543,460
Total gains		
Dividends and interest income	2,984	2,965
Net realized gains on investments	21,307	6,972
Change in net unrealized appreciation on investments	28,244	37,011
Purchases	111,867	53,606
Sales	(26,043)	(23,711)
Transfers in (out) of Level 3	853	(1,962)
Balance at end of year	$ 757,553	$ 618,341

The net unrealized gain on Level 3 investments held at September 30, 2012 was $221,980.

(dollars in thousands)

Funded Status

The funded status of the plans recognized in the balance sheet and the amounts recognized in unrestricted net assets, follows:

	Defined Benefit Pension Plans		Postretirement Healthcare Benefit Plans	
End of Year	**2012**	**2011**	**2012**	**2011**
Fair value of plan assets at measurement date	$ 3,114,884	$ 2,368,991	$ 45,982	$ 33,334
Benefit obligations at measurement date	(4,441,164)	(3,346,936)	(140,344)	(113,682)
Funded status	$ (1,326,280)	$ (977,945)	$ (94,362)	$ (80,348)
Amounts recognized in the balance sheet consist of				
Noncurrent assets	$ -	$ -	$ 1,157	$ 543
Current liabilities	(2,597)	(718)	(3,636)	(3,715)
Long-term liabilities	(1,323,683)	(977,227)	(91,883)	(77,176)
	$ (1,326,280)	$ (977,945)	$ (94,362)	$ (80,348)
Amounts not yet recognized in net periodic benefit cost and included in unrestricted net assets consist of				
Actuarial net loss (gain)	$ 1,636,265	$ 946,565	$ 30,525	$ 20,571
Prior service cost (credit)	13,192	12,760	(62)	(62)
	$ 1,649,457	$ 959,325	$ 30,463	$ 20,509
Amounts recognized in unrestricted net assets consist of				
Current year actuarial (gain) loss	$ 723,124	$ 262,448	$ 11,026	$ 3,544
Amortization of actuarial gain (loss)	(33,424)	(22,597)	(1,091)	(903)
Current year prior service cost (credit)	2,278	3,203	-	-
Amortization of prior service (cost) credit	(1,846)	(1,577)	21	21
	$ 690,132	$ 241,477	$ 9,956	$ 2,662

At the end of 2012 and 2011, the projected benefit obligation, accumulated benefit obligation and fair value of plan assets for pension plans with an accumulated benefit obligation in excess of plan assets were as follows:

Accumulated Benefit Obligation in Excess of Plan Assets	**2012**	**2011**
Projected benefit obligation	$ 4,441,164	$ 3,346,936
Accumulated benefit obligation	4,148,507	3,129,352
Fair value of plan assets	3,114,884	2,368,991

(dollars in thousands)

Expected Cash Flows

Information about the expected cash flows for the defined benefit and postretirement healthcare benefit plans is as follows:

	Defined Benefit Pension Plans	Postretirement Healthcare Benefit Plans	
Expected employer contributions			
2013	$ 472,897	$ 5,819	
			Medicare Subsidy
Expected benefit payments (receipts)			
2013	$ 174,147	$ 6,124	$ (305)
2014	175,920	6,675	(291)
2015	194,827	7,099	(274)
2016	209,074	7,503	(255)
2017	226,375	7,972	(236)
2018–2022	1,364,888	33,325	(877)

Net Periodic Benefit Cost

	Defined Benefit Pension Plans 2012	Defined Benefit Pension Plans 2011	Postretirement Healthcare Benefit Plans 2012	Postretirement Healthcare Benefit Plans 2011
Service cost	$ 190,453	$ 180,806	$ 4,730	$ 4,365
Interest cost	184,042	171,716	5,561	5,083
Expected return on plan assets	(236,965)	(202,414)	(2,486)	(2,033)
Amortization of				
Prior service cost (credit)	1,846	1,577	(21)	(21)
Actuarial net (gain) loss	33,424	22,597	1,091	903
Net periodic benefit cost	$ 172,800	$ 174,282	$ 8,875	$ 8,297

Amounts expected to be amortized from unrestricted net assets into net periodic benefit cost during the year ending September 30, 2013 are as follows:

	Defined Benefit Pension Plans	Postretirement Healthcare Benefit Plans
Actuarial net loss	$ 106,484	$ 1,781
Prior service cost (credit)	2,182	(21)

(dollars in thousands)

Weighted-Average Assumptions Used to Determine Net Periodic Pension and Postretirement Cost	Defined Benefit Pension Plans		Postretirement Healthcare Benefit Plans	
	2012	2011	2012	2011
Discount rate	5.30%	5.50%	4.15% - 5.30%	4.00% - 5.50%
Expected return on plan assets	8.25%	8.25%	7.50%	7.50%
Rate of compensation increase				
Professional staff	4.45%	4.95%	N/A	N/A
Other than professional staff	3.00% - 3.50%	3.00% - 4.00%	N/A	N/A
Healthcare cost trend rate for this year	N/A	N/A	7.50%	8.00%
Rate to which the cost trend rate is to decline	N/A	N/A	5.00%	5.00%
Year that rate reaches the ultimate trend rate	N/A	N/A	2017	2017

Partners HealthCare uses a long term return assumption which is validated annually by obtaining long term asset return, volatility and correlation projections for relevant asset class indexes; modifying volatility and correlations to reflect the actual historical experience of the active managers; calculating the expected return using benchmark weights and indexes; and comparing the return assumption to the sum of the expected return and the historical outperformance of the actual return versus the benchmark. Partners HealthCare regularly monitors the active risk of the Master Trust by a statistical regression of the return series of the actual portfolio to that of the policy benchmark.

Assumed healthcare cost trend rates have a significant effect on the amounts reported for the healthcare plans. A one-percentage-point change in assumed healthcare cost trend rates would have the following effect:

	One-Percentage-Point Increase	One-Percentage-Point Decrease
Effect on service and interest cost	$ 70	$ (65)

10. Professional Liability Insurance

Partners HealthCare insures substantially all of its professional and general liability risk on a claims-made basis in cooperation with other healthcare organizations in the Greater Boston area through a captive insurance company, Controlled Risk Insurance Company Ltd. (CRICO). PHS owns 10% of CRICO. The investment is accounted for on the cost basis of accounting. The policies cover claims made during their respective terms, but not those occurrences for which claims may be made after expiration of the policy, except for certain tail liabilities which CRICO has assumed on an occurrence basis through December 31, 2012. Management intends to renew its coverage on a claims-made basis and has no reason to believe that it will be prevented from such renewal.

Partners HealthCare follows the accounting policy of establishing reserves to cover the ultimate costs of medical malpractice claims, which include costs associated with litigating or settling claims. The liability also includes an estimated tail liability, established to cover all malpractice claims incurred but not reported to the insurance company as of the end of the year. The total malpractice liability of $441,404 at September 30, 2012 is presented as accrued professional liability in the consolidated balance sheets. These reserves have been recorded on a discounted basis using an interest rate of 2.75% and 3.75% at September 30, 2012 and 2011, respectively.

(dollars in thousands)

Partners HealthCare also recognizes an insurance receivable from CRICO, at the same time that it recognizes the liability, measured on the same basis as the liability, subject to the need for a valuation allowance for uncollectible amounts. The insurance receivable of $351,382 at September 30, 2012 is reported as a component of other assets in the consolidated balance sheets.

Management is not aware of any claims against Partners HealthCare or factors affecting CRICO that would cause the expense for professional liability risks to vary materially from the amount provided.

11. Concentration of Credit Risk

Financial instruments that potentially subject Partners HealthCare to concentration of credit risk consist of patient accounts receivable, research grants receivable, pledges receivable, certain investments and interest rate swaps.

Partners HealthCare receives a significant portion of its payments for services rendered from a limited number of government and commercial third-party payers, including Medicare, Medicaid, Blue Cross and Blue Shield of Massachusetts, Harvard Pilgrim Health Care and Tufts Health Plan. Research funding is provided through many government and private sponsors. Pledges receivable are due from multiple donors. Partners HealthCare assesses the credit risk for pledges based on history and the financial wherewithal of donors, most of which are individuals or organizations well known to Partners HealthCare.

Investments, which include government and agency securities, stocks and corporate bonds, and private partnerships and other investments are not concentrated in any corporation or industry or with any single counterparty. Alternative investments are less liquid than Partners HealthCare's other investments. The reported values of the alternative investments may differ significantly from the values that would have been used had a ready market for those securities existed. These instruments may contain elements of both credit and market risk. Such risks include, but are not limited to, limited liquidity, absence of oversight, dependence upon key individuals, emphasis on speculative investments and nondisclosure of portfolio composition.

Partners HealthCare minimizes the credit risk it is exposed to under interest rate swap agreements by utilizing several counterparties and requiring the counterparties to post collateral for the benefit of Partners HealthCare when the fair value of the swap is positive. Partners HealthCare minimizes its counterparty risk by contracting with six counterparties, none of which accounts for more than 30% of the aggregate notional amount of the swap contracts.

(dollars in thousands)

12. Restricted Net Assets

Restricted net assets are available for the following purposes:

	September 30, 2012	September 30, 2011
Temporarily restricted		
Charity care	$ 95,576	$ 91,123
Buildings and equipment	121,584	131,300
Clinical care, research and academic	559,852	561,375
	777,012	783,798
Permanently restricted		
Charity care	$ 19,326	$ 19,101
Buildings and equipment	2,433	2,433
Clinical care, research and academic	352,471	316,379
	$ 374,230	$ 337,913

Endowment

Partners HealthCare's endowment consists of over 1,000 individual funds established for a variety of purposes. The endowment includes both donor-restricted endowment funds and funds designated by the boards to function as endowments. As required by generally accepted accounting principles, net assets associated with endowment funds, including funds designated by the boards to function as endowments, are classified and reported as restricted or unrestricted based on the existence or absence of donor-imposed restrictions.

Partners HealthCare has interpreted UPMIFA as requiring the preservation of the value of the original gift of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, Partners HealthCare classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts donated to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by Partners HealthCare in a manner consistent with the standard of prudence prescribed by UPMIFA. In accordance with UPMIFA, Partners HealthCare considers several factors in making a determination to appropriate or accumulate donor-restricted endowment funds. These factors include: the duration and preservation of the fund; the purposes of the organization and the donor-restricted endowment fund; general economic conditions; the possible effect of inflation and deflation; the expected total return from income and the appreciation of investments; other resources of the organization; and the investment policies of the organization.

(dollars in thousands)

Endowment Funds with Deficits
From time to time, the value of assets associated with individual donor-restricted endowment funds may fall below the value of the initial and subsequent donor gift amounts. When such endowment deficits exist, they are classified as a reduction to unrestricted net assets. Deficits of this nature reported in unrestricted net assets were $1,231 and $3,556 at September 30, 2012 and 2011, respectively. These deficits resulted from unfavorable market fluctuations that occurred after the investment of new permanently restricted contributions or subsequent endowment additions.

The following presents the endowment net asset composition by type of fund as of September 30, 2012 and 2011 and the changes in endowment assets for the years ended September 30, 2012 and 2011:

Endowment Net Asset Composition by Type of Fund as of September 30, 2012	**Unrestricted**	**Temporarily Restricted**	**Permanently Restricted**	**Total**
Donor-restricted endowment funds	$ (1,231)	$ 433,316	$ 359,985	$ 792,070
Board-designated endowment funds	854,968	-	-	854,968
Total funds	$ 853,737	$ 433,316	$ 359,985	$ 1,647,038

Changes in Endowment Net Assets for the Year Ended September 30, 2012	**Unrestricted**	**Temporarily Restricted**	**Permanently Restricted**	**Total**
Endowment net assets at September 30, 2011	$ 794,151	$ 404,753	$ 323,736	$ 1,522,640
Investment return				
Investment income	3,808	3,868	56	7,732
Net realized and unrealized appreciation (depreciation)	85,996	62,513	561	149,070
Total investment return	89,804	66,381	617	156,802
Contributions	11,295	135	34,387	45,817
Appropriation of endowment assets for expenditure	(37,005)	(37,319)	-	(74,324)
Other changes	(4,508)	(634)	1,245	(3,897)
Total changes	59,586	28,563	36,249	124,398
Endowment net assets at September 30, 2012	$ 853,737	$ 433,316	$ 359,985	$ 1,647,038

Endowment Net Asset Composition by Type of Fund as of September 30, 2011	**Unrestricted**	**Temporarily Restricted**	**Permanently Restricted**	**Total**
Donor-restricted endowment funds	$ (3,556)	$ 404,753	$ 323,736	$ 724,933
Board-designated endowment funds	797,707	-	-	797,707
Total funds	$ 794,151	$ 404,753	$ 323,736	$ 1,522,640

(dollars in thousands)

Changes in Endowment Net Assets for the Year Ended September 30, 2011	**Unrestricted**	**Temporarily Restricted**	**Permanently Restricted**	**Total**
Endowment net assets at October 1, 2010	$ 805,480	$ 431,757	$ 298,168	$ 1,535,405
Investment return				
Investment income	3,262	3,667	13	6,942
Net realized and unrealized appreciation (depreciation)	6,344	2,955	(208)	9,091
Total investment return	9,606	6,622	(195)	16,033
Contributions	5,384	-	24,082	29,466
Appropriation of endowment assets for expenditure	(34,715)	(33,431)	-	(68,146)
Other changes	8,396	(195)	1,681	9,882
Total changes	(11,329)	(27,004)	25,568	(12,765)
Endowment net assets at September 30, 2011	$ 794,151	$ 404,753	$ 323,736	$ 1,522,640

Conditional Pledge

During 2009, the General signed an agreement (Ragon Agreement) with The Massachusetts Institute of Technology (MIT), The President and Fellows of Harvard College (Harvard) and The Phillip T. and Susan M. Ragon Foundation (Ragon Foundation) to establish the Phillip T. and Susan M. Ragon Institute (Ragon Institute) as a joint research center of the General, MIT and Harvard with the purpose of harnessing the potential of the immune response to combat and conquer human diseases, integrating biomedical research with emerging engineering technologies (with the main initial focus being the development of an AIDS vaccine) and educating and training scientists. The Ragon Foundation committed to provide funding for the Ragon Institute of $100,000 over ten years through the General (as the administrative home for the Ragon Institute), beginning retroactively on January 1, 2008. The Ragon Foundation has the ability to slow, suspend or eliminate funding based on restrictions described in the Ragon Agreement. Additionally, any funding not paid by December 31, 2017 will no longer be due by the Ragon Foundation. Due to the conditions within the Ragon Agreement, funding is recognized when received, with no pledge receivable recorded for the balance of the commitment.

Through September 30, 2012, total funding of $54,000 was received, with $10,000 received for the year ended September 30, 2012, and total net expenses of $38,331 were incurred, including $9,980 for the year ended September 30, 2012. As of September 30, 2012, unspent funding of $15,669 has been recorded as temporarily restricted net assets, to be released to unrestricted net assets after qualifying expenses have been incurred.

(dollars in thousands)

13. Functional Expenses

Total operating expenses by function are as follows:

	Years Ended September 30, 2012	Years Ended September 30, 2011
Healthcare services	$ 6,449,354	$ 5,926,833
Research and academic	1,538,597	1,531,501
General and administrative	802,477	789,961
	$ 8,790,428	$ 8,248,295

14. Contingencies

Partners HealthCare is subject to complaints, claims and litigation which have risen in the normal course of business. In addition, Partners HealthCare is subject to reviews and investigations by various federal and state government agencies to assure compliance with applicable laws, some of which are subject to different interpretations. Governmental review of compliance by healthcare institutions, including Partners HealthCare, has increased.

15. Subsequent Events

Partners HealthCare has assessed the impact of subsequent events through December 14, 2012, the date the audited financial statements were issued. During this period, there were no subsequent events that require adjustment to the audited financial statements. In November 2012, Partners HealthCare issued $400,000 Senior Notes in a private placement with institutional investors, the proceeds of which will be used for general corporate purposes, at a fixed rate of 4.11% with principal due in 2052. Other than the issuance of the Senior Notes and the acquisition described in Note 1, there were no other events that require disclosure in the notes to the audited financial statements.