

# **COVENANT HEALTH**

## ***Audited Consolidated Financial Statements (and Other Financial information)***

***Years Ended December 31, 2010 and 2009***





**COVENANT HEALTH**

*Audited Consolidated Financial Statements (and Other Financial Information)*

*Years Ended December 31, 2010 and 2009*

---

Independent Auditor's Report .....1

*Audited Consolidated Financial Statements*

Consolidated Balance Sheets .....3  
Consolidated Statements of Operations and Changes in Net Assets .....5  
Consolidated Statements of Cash Flows.....7  
Notes to Consolidated Financial Statements .....9

*Other Financial Information*

Schedule of Expenditures of Federal and State Awards .....33  
Notes to Schedule of Expenditures of Federal and State Awards .....36  
Report on Internal Control Over Financial Reporting and on Compliance and  
Other Matters Based on an Audit of Financial Statements Performed  
in Accordance with *Government Auditing Standards* .....38  
Report on Compliance with Requirements That Could Have a Direct and  
Material Effect on Each Major Program and on Internal Control Over Compliance  
in Accordance with OMB Circular A-133 .....40  
Schedule of Findings and Questioned Costs.....42  
Schedule of Prior Audit Findings .....44



## INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of  
Covenant Health:

We have audited the accompanying consolidated balance sheets of Covenant Health (Covenant) as of December 31, 2010 and 2009 and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended. These consolidated financial statements are the responsibility of Covenant's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Covenant Health as of December 31, 2010 and 2009 and the results of its operations, changes in net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated April 19, 2011, on consideration of Covenant's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

Our audits were conducted for the purpose of forming an opinion on the basic consolidated financial statements of Covenant taken as a whole. The accompanying schedule of expenditures of federal and state awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and the State of Tennessee Comptroller of the Treasury, and is not a required part of the basic consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audits of the basic consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated, in all material respects, in relation to the basic consolidated financial statements taken as a whole.

*Pushing Youkley & Associates, P.C.*

Knoxville, Tennessee  
April 19, 2011

## COVENANT HEALTH

### *Consolidated Balance Sheets* *(Dollars in Thousands)*

	<i>December 31,</i>	
	<i>2010</i>	<i>2009</i>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 28,541	\$ 15,799
Short-term investments	1,319	41,220
Assets limited as to use	23,603	22,898
Patient accounts receivable, less estimated allowances for uncollectible accounts of approximately \$57,300 in 2010 and \$44,700 in 2009	95,376	88,833
Other current assets	42,069	40,210
TOTAL CURRENT ASSETS	190,908	208,960
ASSETS LIMITED AS TO USE, less amounts required to meet current obligations	70,481	107,677
PROPERTY, PLANT AND EQUIPMENT, net of accumulated depreciation and amortization	634,859	558,048
<b>OTHER ASSETS</b>		
Long-term investments	820,767	703,341
Bond and note issuance costs, net of accumulated amortization of \$11,816 in 2010 and \$10,238 in 2009	21,168	22,746
Other assets	13,699	20,934
TOTAL OTHER ASSETS	855,634	747,021
	<u>\$ 1,751,882</u>	<u>\$ 1,621,706</u>

	<i>December 31,</i>	
	<i>2010</i>	<i>2009</i>
<b>LIABILITIES AND NET ASSETS</b>		
<b>CURRENT LIABILITIES</b>		
Trade accounts payable, accrued expenses and other liabilities	\$ 134,791	\$ 110,276
Accrued salaries, wages, compensated absences and amounts withheld	42,356	32,555
Estimated third-party payor settlements	11,875	13,508
Current portion of long-term debt and capital lease obligations	20,425	19,264
<b>TOTAL CURRENT LIABILITIES</b>	<b>209,447</b>	<b>175,603</b>
<b>LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, less current portion</b>	<b>666,890</b>	<b>671,757</b>
<b>OTHER LONG-TERM LIABILITIES</b>	<b>80,563</b>	<b>90,444</b>
<b>TOTAL LIABILITIES</b>	<b>956,900</b>	<b>937,804</b>
<b>COMMITMENTS AND CONTINGENCIES - Notes I and M</b>		
<b>NET ASSETS</b>		
Unrestricted	786,218	673,461
Temporarily restricted	8,764	10,441
<b>TOTAL NET ASSETS</b>	<b>794,982</b>	<b>683,902</b>
	<b>\$ 1,751,882</b>	<b>\$ 1,621,706</b>

## COVENANT HEALTH

### *Consolidated Statements of Operations and Changes in Net Assets* *(Dollars in Thousands)*

	<i>Year Ended December 31,</i>	
	<i>2010</i>	<i>2009</i>
Change in unrestricted net assets:		
Unrestricted revenue and support:		
Net patient service revenue	\$ 999,364	\$ 908,618
Other operating revenue	40,761	39,932
Net assets released from restrictions used for operations	2,593	2,343
<b>TOTAL REVENUE AND SUPPORT</b>	<b>1,042,718</b>	<b>950,893</b>
Expenses:		
Salaries and benefits	460,505	427,394
Supplies and other	491,730	439,100
Provision for depreciation and amortization	67,716	66,846
Interest	16,987	18,248
<b>TOTAL OPERATING EXPENSES</b>	<b>1,036,938</b>	<b>951,588</b>
<b>INCOME (LOSS) FROM OPERATIONS</b>	<b>5,780</b>	<b>(695)</b>
Non-operating gains (losses):		
Investment income	21,898	35,094
Other-than-temporary impairment losses (unrealized) on investments	-	(12,816)
Other	-	683
<b>NET NON-OPERATING GAINS</b>	<b>21,898</b>	<b>22,961</b>
<b>EXCESS OF REVENUE, GAINS AND SUPPORT OVER EXPENSES AND LOSSES FROM CONTINUING OPERATIONS</b>	<b>27,678</b>	<b>22,266</b>
Additional recognized gain on sale of previously discontinued operations - Note N	24,923	-
<b>EXCESS OF REVENUE, GAINS AND SUPPORT OVER EXPENSES AND LOSSES BEFORE CHANGE IN ACCOUNTING PRINCIPLE</b>	<b>52,601</b>	<b>22,266</b>
Change in accounting principle	(4,434)	-
<b>EXCESS OF REVENUE, GAINS AND SUPPORT OVER EXPENSES AND LOSSES</b>	<b>48,167</b>	<b>22,266</b>

	<i>Year Ended December 31,</i>	
	<i>2010</i>	<i>2009</i>
Change in net unrealized gains/losses on investments	23,207	46,410
Excess of assets acquired over liabilities assumed - Note M	37,726	-
Contributions of property	1,669	415
Net assets released from restrictions for capital additions	1,988	646
<b>INCREASE IN UNRESTRICTED NET ASSETS</b>	<b>112,757</b>	<b>69,737</b>
Change in temporarily restricted net assets:		
Restricted gifts and bequests	2,939	2,816
Investment income and realized/unrealized net losses on investments	(35)	(2)
Net assets released from restrictions	(4,581)	(2,989)
<b>DECREASE IN TEMPORARILY RESTRICTED NET ASSETS</b>	<b>(1,677)</b>	<b>(175)</b>
<b>INCREASE IN NET ASSETS</b>	<b>111,080</b>	<b>69,562</b>
<b>NET ASSETS, BEGINNING OF YEAR</b>	<b>683,902</b>	<b>614,340</b>
<b>NET ASSETS, END OF YEAR</b>	<b>\$ 794,982</b>	<b>\$ 683,902</b>

## COVENANT HEALTH

### *Consolidated Statements of Cash Flows* *(Dollars in Thousands)*

	<i>Year Ended December 31,</i>	
	<i>2010</i>	<i>2009</i>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Increase in net assets	\$ 111,080	\$ 69,562
Adjustments to reconcile increase in net assets to net cash provided by operating activities from continuing operations		
Provision for depreciation and amortization	67,716	66,846
Net realized and unrealized gains/losses on investments	(30,584)	(51,539)
Discount amortization on capital appreciation bonds	9,842	9,320
Property contributions	(1,669)	(415)
Change in accounting principle	4,434	-
Gain on sale of previously discontinued operations	(24,923)	-
Excess of assets acquired over liabilities assumed	(37,726)	-
Increase (decrease) in cash due to changes in:		
Net patient accounts receivable	4,414	6,669
Other current assets	278	(7,764)
Other assets	(1,806)	(2,486)
Trade accounts payable, accrued expenses and other liabilities	4,711	11,779
Accrued salaries, wages, compensated absences and amounts withheld	9,801	(2,540)
Estimated third-party payor settlements	(4,852)	7,528
Other long-term liabilities	(9,881)	860
Total adjustments	<u>(10,245)</u>	<u>38,258</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES FROM CONTINUING OPERATIONS	<u>100,836</u>	<u>107,820</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Capital expenditures	(101,090)	(114,632)
Purchases of investments	(315,170)	(342,595)
Proceeds from redemption or maturities of investments	268,754	303,412
Decrease in assets limited as to use	41,001	59,578
Investment in unconsolidated affiliates	(1,594)	(1,106)
Distributions from unconsolidated affiliates	5,215	2,881
NET CASH USED IN INVESTING ACTIVITIES FROM CONTINUING OPERATIONS	<u>(102,884)</u>	<u>(92,462)</u>

	<i>Year Ended December 31,</i>	
	<i>2010</i>	<i>2009</i>
Proceeds from sale of previously discontinued operations	<u>34,923</u>	-
NET CASH USED IN INVESTING ACTIVITIES	<u>(67,961)</u>	(92,462)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of debt and capital lease obligations	<u>(20,133)</u>	(18,976)
CASH USED IN FINANCING ACTIVITIES	<u>(20,133)</u>	(18,976)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	<u>12,742</u>	(3,618)
CASH AND CASH EQUIVALENTS, beginning of year	<u>15,799</u>	19,417
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 28,541</u>	<u>\$ 15,799</u>
SUPPLEMENTAL INFORMATION:		
Cash paid for interest	<u>\$ 10,374</u>	<u>\$ 13,331</u>
Cash paid for income taxes	<u>\$ 85</u>	<u>\$ 116</u>
Capital additions in accounts payable	<u>\$ 6,407</u>	<u>\$ 8,673</u>
Capital additions from capital lease obligations	<u>\$ 78</u>	<u>\$ 1,354</u>

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements (Dollars in Thousands)*

*Years Ended December 31, 2010 and 2009*

---

#### NOTE A--ORGANIZATION AND OPERATIONS

Covenant Health (Covenant) is a tax-exempt entity as an organization described under Section 501(c)(3) of the Internal Revenue Code. The operations of Covenant and its subsidiaries consist predominantly of the delivery of healthcare and healthcare related services in East Tennessee. Covenant provides management services to and is the sole member or majority shareholder of numerous controlled or subsidiary entities, the most significant of which are:

*Fort Sanders Regional Medical Center (FSRMC)* operates a 541-bed acute care facility located in Knoxville, Tennessee.

*Parkwest Medical Center (PMC)* operates 462 acute care beds, consisting of a 307-bed acute care facility located in Knoxville, Tennessee, a 155-bed inpatient and outpatient behavioral medicine facility in Louisville, Tennessee and a behavior medicine residential treatment facility which was sold to an unrelated third party in 2009. No significant gain or loss on the sale was recognized.

*Methodist Medical Center of Oak Ridge (MMC)* operates a 301-bed acute care facility located in Oak Ridge, Tennessee, and sponsors *Methodist Medical Center Foundation* which was formed primarily to raise funds on behalf of MMC.

*Morristown-Hamblen HealthCare System (MHHS)*, which was acquired by Covenant during 2010 (Note M), operates a 167-bed acute care hospital located in Morristown, Tennessee. MHHS owns interest in joint ventures of an ambulatory surgery center and cancer treatment center. MHHS is the sole member of *Morristown-Hamblen Health Foundation* whose purpose is primarily to raise funds on behalf of MHHS.

*LeConte Medical Center (LMC)* (formerly Fort Sanders Sevier Medical Center) operates a 133-bed acute care facility and also leases and operates an extended care facility located in Sevierville, Tennessee.

*Roane Medical Center (RMC)* leases and operates a 105-bed acute care facility located in Harriman, Tennessee (See Note I).

*Fort Loudoun Medical Center (FLMC)* leases and operates a 50-bed acute care facility located in Lenoir City, Tennessee (see Note I).

*The Thompson Cancer Survival Center (TCSC) and Subsidiary* is located in Knoxville, Tennessee, and operates specialty cancer treatment facilities and oncology physician practices.

## COVENANT HEALTH

*Notes to Consolidated Financial Statements - Continued*  
*(Dollars in Thousands)*

*Years Ended December 31, 2010 and 2009*

---

### NOTE A--ORGANIZATION AND OPERATIONS - Continued

*The Thompson Cancer Survival Center Foundation (TCSCF)* has been established to support TCSC's operations.

*Covenant Medical Management (CMM)* is a for-profit entity whose major operations include ownership of physician practices in East Tennessee and the provision of physician management and support services. CMM also has minority ownership in three surgery center joint ventures.

*Fortress Corporation (Fortress)* is a for-profit entity located in Knoxville, Tennessee, whose operations include daycare, a health and fitness facility and real estate services. Fortress also holds a minority interest in a long-term care facility and has a minority ownership in other joint ventures and partnerships.

*Covenant HomeCare (CHC)* is a not-for-profit entity which provides home health services in East Tennessee.

*Fort Sanders Foundation (FSF)* is a not-for-profit foundation formed to coordinate the fundraising and development activities of Covenant.

Covenant, FSRMC, PMC, MMC, FLMC, LMC, TCSC and CHC collectively comprise the Covenant Obligated Group (see Note F).

Covenant (or its subsidiaries) is a partner in numerous partnerships or joint ventures which are accounted for under the equity method of accounting. Covenant's ownership in the equity of these entities is included as part of Other Assets and Covenant's equity in the income of these entities totaled \$2,568 and \$3,480 for the years ended December 31, 2010 and 2009, respectively, and is included in Other Operating Revenue in the accompanying consolidated financial statements. Certain partners in these joint ventures are physicians that practice at Covenant facilities.

The following is combined, condensed, unaudited financial information related to these entities as of and for the years ended December 31, 2010 and 2009:

	<u>2010</u>		<u>2009</u>
Total assets	\$ 37,823	\$	25,253
Partner's capital/equity	15,549		15,072
Net income	6,717		7,253

---

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

*Years Ended December 31, 2010 and 2009*

---

#### NOTE A--ORGANIZATION AND OPERATIONS - Continued

Additionally, certain of Covenant's subsidiaries are obligated on all or a portion of the outstanding debt of several of these joint ventures totaling approximately \$4,200 at December 31, 2010. Management believes it is unlikely Covenant or its subsidiaries will be required to fund any guarantees.

#### NOTE B--SIGNIFICANT ACCOUNTING POLICIES

*Principles of Consolidation:* The accompanying consolidated financial statements include the accounts of Covenant and its subsidiaries after elimination of all significant intercompany accounts and transactions.

*Use of Estimates:* The preparation of the consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

*Cash and Cash Equivalents:* Cash and cash equivalents includes cash on-hand and in bank deposit accounts, as well as investments with original terms to maturity of less than ninety days, except amounts designated as assets limited as to use or included in investment portfolios. Covenant has cash deposits significantly in excess of Federal Deposit Insurance Corporation limits at December 31, 2010. Management believes that credit risk related to these deposits is minimal.

*Investments and Assets Limited as to Use:* All debt securities and marketable equity securities with readily determinable fair values are valued at fair value based on quoted market prices of identical or similar securities as of the date of the Consolidated Balance Sheets. Investments in collective trust funds are also valued at estimated fair value as determined by the fund manager, based on quoted market prices of the underlying investments which have readily determinable market values. Investments in alternative investments do not have a readily determinable fair value and are stated at cost or estimated fair value if determined to be other than temporarily impaired.

Investment portfolios are classified as current or long-term assets dependent upon the objectives of the portfolio relative to current operations. Assets limited as to use are primarily those held by bond trustees and consist primarily of bond proceeds designated for capital projects as well as amounts designated for debt service as required by bond indentures. Amounts required to meet current liabilities are shown as current assets in the Consolidated Balance Sheets.

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

*Years Ended December 31, 2010 and 2009*

---

#### NOTE B--SIGNIFICANT ACCOUNTING POLICIES - Continued

Investment income, including realized gains or losses and any other-than-temporary unrealized losses, is reported as non-operating gains (losses) in the Consolidated Statements of Operations and Changes in Net Assets. Realized gains and losses are computed using the specific-identification method of cost determination. The change in unrealized gains and losses for other-than-trading securities is excluded from "Excess of Revenue, Gains and Support Over Expenses and Losses from Continuing Operations" except for any other-than-temporary impairment losses.

*Inventories:* Inventories of medical supplies are stated at the lower of cost (average cost method) or market and are reported as Other Current Assets in the Consolidated Balance Sheets.

*Property, Plant and Equipment:* Property, plant and equipment is stated on the basis of cost or, if donated, at fair market value on the date of gift. Depreciation is provided over the estimated useful lives of the related assets principally under the straight-line method. Equipment held under capital lease obligations is amortized under the straight-line method generally over the shorter of the lease term or estimated useful life. Such amortization is included in the provision for depreciation and amortization in the consolidated financial statements.

Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. The amount capitalized is net of investment earnings on assets limited as to use derived from borrowings designated for capital assets. Costs of maintenance and repairs are expensed as incurred. Covenant periodically reviews property for indicators of potential impairment. If this review indicates that the carrying amount of these assets may not be recoverable, Covenant estimates the future cash flows expected to result from the operations of the asset and its eventual disposition. If the sum of these future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, a write-down to estimated fair value is recorded.

*Goodwill:* Goodwill, included in Other Assets in the Consolidated Balance Sheets, represents the difference between the costs of net tangible assets acquired and estimated fair value, at purchase date, and prior to 2010 was amortized under the straight-line method over various estimated useful lives. In 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2010-07, *Not-For-Profit Entities*, which eliminates the amortization of goodwill and requires a transitional and an annual impairment test. Management evaluated the remaining net book value of goodwill as of January 1, 2010 and determined that \$4,434 of goodwill was impaired based on analysis of future operations of the respective reporting units. This transitional impairment loss has been reported as a change in accounting principle in the Consolidated Statement of Operations and Changes in Net Assets for 2010. Remaining amounts of goodwill at December 31, 2010 are not significant.

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

*Years Ended December 31, 2010 and 2009*

---

#### NOTE B--SIGNIFICANT ACCOUNTING POLICIES - Continued

*Bond and Note Issuance Costs:* Bond and note issuance costs are amortized over the terms of the related debt issues under the straight-line method.

*Temporarily Restricted Net Assets:* Temporarily restricted net assets are those whose use has been limited by donors to a specific time period or purpose. The majority of temporarily restricted net assets are restricted to programs of specific Covenant entities.

*Net Patient Service Revenue/Receivables:* Net patient service revenue is reported on the accrual basis in the period in which services are provided at estimated net realizable amounts, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are reported on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined or additional information is obtained.

Patient accounts receivable are reported net of both an estimated allowance for uncollectible accounts and an estimated allowance for contractual adjustments. The contractual adjustment represents the difference between established billing rates and estimated reimbursement from Medicare, TennCare and other third-party payment programs. Current operations for 2010 and 2009 include an estimated provision for bad debts of approximately \$67,000 and \$55,300, respectively, included in Supplies and Other in the Consolidated Statements of Operations and Changes in Net Assets. The allowance for uncollectible accounts is estimated based upon the age of the patient accounts receivable, prior experience and any unusual circumstances (such as local, regional or national economic conditions) which affect the collectibility of receivables, including management's assumptions about conditions it expects to exist and courses of action it expects to take. Covenant's policy does not require collateral or other security for patient accounts receivable and Covenant routinely accepts assignment of, or is otherwise entitled to receive, patient benefits payable under health insurance programs, plans or policies.

*Uncompensated Care:* Covenant provides care without charge to patients who meet certain criteria under its charity care policy. Because Covenant does not pursue collection of amounts determined to qualify as charity care or standardized discounts, they are not reported as net patient revenue. Charges foregone, based on established rates, totaled approximately \$89,000 and \$76,700 in 2010 and 2009, respectively, including standardized discounts for certain uninsured patients. The estimated direct and indirect cost of providing these services totaled approximately \$24,900 and \$21,800 for the years ended December 31, 2010 and 2009, respectively. Such costs are determined using a ratio of cost to charges analysis with indirect cost allocated under a reasonable and systematic approach under the recently adopted FASB ASU 2010-23, *Measuring Charity Care for Disclosure*.

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued (Dollars in Thousands)*

*Years Ended December 31, 2010 and 2009*

---

#### NOTE B--SIGNIFICANT ACCOUNTING POLICIES - Continued

In addition to the charity care services described above, Covenant provides a number of other services to benefit the indigent for which little or no payment is received. Medicare, TennCare and certain other programs do not cover the full cost of providing care to beneficiaries of those programs. Covenant also provides services to the community at large for which it receives little or no payment.

*Estimated Malpractice Costs:* The provision for estimated medical malpractice claims includes estimates of the ultimate costs for reported claims and includes an estimate for claims incurred but not reported (See Note I).

*Income Taxes:* Covenant and certain of its subsidiaries or controlled entities are exempt from income taxes pursuant to Section 501(c)(3) of the Internal Revenue Code. Accordingly, no provision for income taxes on qualifying activities has been made for these entities in the accompanying consolidated financial statements. However, certain entities and operations are subject to income taxes which are accounted for in accordance with FASB Accounting Standards Codification (ASC) 740, *Income Taxes* (See Note G).

*Excess of Revenue, Gains and Support Over Expenses and Losses from Continuing Operations:* The Consolidated Statements of Operations and Changes in Net Assets includes the caption "Excess of Revenue, Gains and Support Over Expenses and Losses from Continuing Operations". Consistent with industry practice, changes in unrestricted net assets which are excluded from this caption include, but are not limited to, unrealized gains and losses (except losses which are determined to be other-than-temporary and on trading securities) and capital contributions. The excess of assets acquired over liabilities assumed related to hospital acquisitions are also excluded from "Excess of Revenue, Gains and Support Over Expenses and Losses from Continuing Operations."

*Fair Value of Financial Instruments:* The fair value of Covenant's financial instruments, other than certain investments which are discussed in Note D and long-term debt discussed in Note F, approximates their carrying value due to the nature and terms of these assets and liabilities. Patient accounts receivable; other assets; accounts payable, accrued expenses and other liabilities; accrued salaries, wages, compensated absences and other amounts withheld have short maturities or will otherwise be settled within a short period of time. The fair value of financial instruments reported as part of other long-term liabilities is not estimable, due to the unpredictable timing of the payments and the nature of the estimates involved (primarily estimated professional and worker's compensation liabilities and deferred revenue from a provider agreement discussed in Note N.)

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

#### *Years Ended December 31, 2010 and 2009*

---

#### NOTE B--SIGNIFICANT ACCOUNTING POLICIES - Continued

In January 2010, the FASB issued ASU 2010-06, *Fair Value Measurements and Disclosures (Topic 820) - Improving Disclosures about Fair Value Measurements* (ASU 2010-06). ASU 2010-06 requires new disclosures regarding significant transfers in and out of Levels 1 and 2, as well as information about activity in Level 3 fair value measurements (Note K). In addition, ASU 2010-06 clarifies existing disclosures regarding input and valuation techniques, as well as the level of disaggregation for each class of assets and liabilities. The adoption of ASU 2010-06 in 2011 is not expected to have an impact on the consolidated financial statements.

*Reclassifications:* Certain 2009 amounts have been reclassified in the consolidated financial statements to conform with the 2010 presentation.

*Subsequent Events:* Covenant has evaluated all events or transactions that occurred after December 31, 2010 through April 19, 2011, the issuance date of the consolidated financial statements. During this period management did not note any material recognizable subsequent events that required recognition or disclosure in the December 31, 2010 consolidated financial statements, other than as disclosed in Note O.

#### NOTE C--NET PATIENT SERVICE REVENUE/RECEIVABLES

Covenant has agreements with various third-party payors that provide for payments at amounts different from established rates. The difference between the rates charged and the estimated payments from third-party payors is recorded as a reduction of gross patient charges. Amounts recorded under certain of these contractual arrangements are subject to review and final determination by various program intermediaries. Management believes that adequate provision has been made for any adjustments which may result from such reviews. However, due to uncertainties in the estimates, it is at least reasonably possible that management's estimates will change in 2011, although the amount of the change cannot be estimated. Net patient service revenue for the year ended December 31, 2010 increased by approximately \$2,700 as a result of changes in adjustments of prior years' estimates or final settlements of prior periods. There was no significant impact of such adjustments in 2009. A summary of the payment arrangements with significant third-party payors follows:

*Medicare:* Services are rendered to patients under contractual arrangements with the Medicare program or its designated agents. At December 31, 2010 and 2009, approximately 47% and 41%, respectively, of Covenant's net patient accounts receivable were due from the Medicare program. The Medicare program pays for inpatient and most outpatient service on a prospective basis based upon the patient's clinical diagnosis and medical procedures utilized. Covenant also receives additional payments from Medicare based on the provision

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

*Years Ended December 31, 2010 and 2009*

---

#### NOTE C--NET PATIENT SERVICE REVENUE/RECEIVABLES - Continued

of services to a disproportionate share of TennCare and other low income patients, as well as other pass-through payments. The Medicare program continues to reimburse certain other services based on a percentage of cost up to predetermined cost limits. Certain other revenue, primarily from physician practices, is reimbursed based upon rate schedules. The Recovery Audit Contractors (RAC) program was created by legislation to detect and correct improper payments under the Medicare and Medicaid programs. Management believes that any amounts payable related to audits through the RAC programs will not have a significant impact on the consolidated financial statements. However, due to the uncertainties involved, management's estimate could change in the future.

*TennCare:* The State of Tennessee's Medicaid waiver program (TennCare) provides coverage through managed care organizations (MCOs) and Covenant has contracts with several of these MCOs. At December 31, 2010 and 2009, approximately 10% and 11%, respectively, of Covenant's net patient accounts receivable were from the TennCare program. TennCare reimbursement for both inpatient and outpatient services is based upon prospectively determined rates and per diems. During 2010 and 2009, Covenant received additional distributions under the TennCare Essential Access program and other programs designed to provide supplemental funding for services provided to TennCare patients. Future distributions under these programs are not guaranteed.

*Other:* Covenant has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, preferred provider organizations and employer groups. The basis for payment under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates. In addition, for uninsured patients, Covenant reduces charges from current rates based on average discounts provided to certain third-party payors.

#### NOTE D--INVESTMENTS AND ASSETS LIMITED AS TO USE

Investments consist of the following at December 31:

	<u>2010</u>		<u>2009</u>
<u>Short-Term Investment Portfolio</u>			
Cash and cash equivalents	\$ 797	\$	475
U.S. Government and Agency securities, including mortgage-backed securities	86		3,377
Municipal bonds	-		5,436

---

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

*Years Ended December 31, 2010 and 2009*

#### NOTE D--INVESTMENTS AND ASSETS LIMITED AS TO USE - Continued

	<i>2010</i>	<i>2009</i>
Corporate debt	95	31,932
Stock mutual funds	341	-
	<u>1,319</u>	<u>41,220</u>
<u>Long-Term Investment Portfolio</u>		
Cash and cash equivalents	7,180	2,026
U.S. Government and Agency securities, including mortgage-backed securities	111,618	93,672
U.S. Government inflation indexed securities	70,985	63,505
Municipal bonds	21,906	21,309
Corporate debt	299,087	229,096
Stock mutual funds	128,495	100,056
International equity securities	19,619	18,461
Collective trust funds	89,511	95,428
Alternative investments (cost)	72,366	79,788
	<u>820,767</u>	<u>703,341</u>
<u>Assets Limited as to Use</u>		
Cash, cash equivalents and commercial paper	29,864	20,666
U.S. Government and Agency securities, including mortgage-backed securities	23,378	68,486
Municipal bonds	6,938	10,423
Corporate debt	26,023	24,549
Other	7,881	6,451
	<u>94,084</u>	<u>130,575</u>
TOTAL INVESTMENTS AND ASSETS LIMITED AS TO USE	<u>\$ 916,170</u>	<u>\$ 875,136</u>

Collective trust funds and the alternative investments include ownership in various funds that are structured as limited liability companies, limited partnerships or offshore limited partnerships. The funds have a wide range of investment strategies with various levels of risk. Certain investments are managed by a company, an officer of which is a member of Covenant's Board of Directors.

Unrestricted investment income, gains and losses on assets limited as to use, cash equivalents and investments consists of the following for the years ended December 31, 2010 and 2009:

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

#### *Years Ended December 31, 2010 and 2009*

#### NOTE D--INVESTMENTS AND ASSETS LIMITED AS TO USE - Continued

	<u>2010</u>	<u>2009</u>
Investment Income:		
Interest and dividends	\$ 15,772	\$ 19,143
Net realized gains on sales of securities at fair value	4,686	19,995
Net realized gain (loss) on sales of securities at cost	3,068	(2,733)
	<u>23,526</u>	<u>36,405</u>
Less: Investment expenses	(1,628)	(1,311)
Investment income reported as non-operating	<u>\$ 21,898</u>	<u>\$ 35,094</u>
Other changes in unrestricted net assets:		
Change in net unrealized gains/losses on investments		
Debt and equity securities	\$ 16,754	\$ 19,956
Other investments	6,453	26,454
	<u>\$ 23,207</u>	<u>\$ 46,410</u>

During 2009, management determined that certain investments were other-than-temporarily impaired, including certain alternative investments. Accordingly, the related unrealized losses have been reported as a component of non-operating gains (losses). The age of gross unrealized losses on investments and assets limited as to use that are not considered other-than-temporarily impaired as of December 31, 2010 and 2009 are as follows:

	<u>Less Than 12 Months</u>		<u>Greater Than 12 Months</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
<b>December 31, 2010</b>						
U.S. Government and						
Agency securities	\$ 27,666	\$ (764)	\$ -	\$ -	\$ 27,666	\$ (764)
Municipal bonds	7,471	(63)	-	-	7,471	(63)
Corporate debt	7,532	(163)	4,955	(38)	12,487	(201)
International equity securities	3,975	(637)	2,331	(470)	6,306	(1,107)
Alternative investments	-	-	5,512	(2,018)	5,512	(2,018)
Total	<u>\$ 46,644</u>	<u>\$ (1,627)</u>	<u>\$ 12,798</u>	<u>\$ (2,526)</u>	<u>\$ 59,442</u>	<u>\$ (4,153)</u>

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

#### *Years Ended December 31, 2010 and 2009*

#### NOTE D--INVESTMENTS AND ASSETS LIMITED AS TO USE - Continued

	<i>Less Than 12 Months</i>		<i>Greater Than 12 Months</i>		<i>Total</i>	
	<i>Fair Value</i>	<i>Unrealized Losses</i>	<i>Fair Value</i>	<i>Unrealized Losses</i>	<i>Fair Value</i>	<i>Unrealized Losses</i>
<b>December 31, 2009</b>						
U.S. Government and Agency securities	\$ 29,005	\$ (167)	\$ 5,231	\$ (25)	\$ 34,236	\$ (192)
Municipal bonds	2,396	(7)	955	(26)	3,351	(33)
Corporate debt	15,477	(250)	-	-	15,477	(250)
International equity securities	1,940	(278)	2,805	(406)	4,745	(684)
Stock mutual funds	88,574	(2,524)	-	-	88,574	(2,524)
Alternative investments	3,268	(1,191)	4,590	(471)	7,858	(1,662)
	<u>\$ 140,660</u>	<u>\$ (4,417)</u>	<u>\$ 13,581</u>	<u>\$ (928)</u>	<u>\$154,241</u>	<u>\$ (5,345)</u>

Management believes, based on their analysis, that those investments listed above with unrealized losses at December 31, 2010 are not other-than-temporarily impaired. Such analysis includes industry outlooks and input from investment consultants. Due to uncertainties in the financial market, it is at least reasonably possible that management's estimate may change in 2011.

#### NOTE E--PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of the following at December 31, 2010 and 2009:

	<i>2010</i>	<i>2009</i>
Land and land improvements	\$ 53,184	\$ 48,984
Buildings and leasehold improvements	611,946	506,329
Equipment	573,243	560,598
Equipment held under capital leases	5,580	9,076
	<u>1,243,953</u>	<u>1,124,987</u>
Less: allowances for depreciation and amortization	<u>(694,053)</u>	<u>(693,702)</u>
	549,900	431,285
Projects in progress - Note I	84,959	126,763
	<u>\$ 634,859</u>	<u>\$ 558,048</u>

During 2010 and 2009, Covenant capitalized interest expense on projects totaling \$1,765 and \$401, net of investment earnings on acquisition fund assets of \$912 and \$3,199, respectively,

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

#### *Years Ended December 31, 2010 and 2009*

#### NOTE E--PROPERTY, PLANT AND EQUIPMENT - Continued

During 2010, Covenant wrote off approximately \$59,200 in substantially fully depreciated fixed assets which were no longer in service.

#### NOTE F--LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS

Long-term debt and capital lease obligations consist of the following at December 31, 2010 and 2009:

<i>Description</i>	<i>Maturities (at December 2010)</i>	<i>Rates</i>	<i>Outstanding Balance</i>	
			<i>2010</i>	<i>2009</i>
2006 Bonds	\$46,245 capital appreciation bonds due through 2042, net of discount of \$266 in 2010 and \$275 in 2009	5.01% to 5.08%	\$ 56,261	\$ 53,506
	\$160,500 variable rate securities, final maturity in 2046, net of discount of \$576 in 2010 and \$592 in 2009	Variable	159,924	159,908
2002 Bonds	\$15,170 of term bonds due through 2026 net of premium of \$378 and \$407 and discount of \$116 and \$124 in 2010 and 2009, respectively	5% to 5.5%	15,432	15,963
	\$82,617 capital appreciation bonds due through 2026	5.4% to 5.93%	129,871	122,776
	\$220,550 auction rate securities, final maturity in 2023 and 2033	Variable	220,550	221,800
1993 Bonds	\$95,030 serially through 2015, net of premium of \$767 in 2010 and \$1,137 in 2009	5.25% to 6.25%	95,797	111,927
Notes payable	Maturing through 2018	3.75% to 6.4%	7,892	3,002
Capitalized lease obligations	Maturing through 2014	4.47% to 6.00%	1,588	2,139
			687,315	691,021
Less: Current portion of long-term debt and capital lease obligations			(20,425)	(19,264)
			<u>\$ 666,890</u>	<u>\$ 671,757</u>

During 2006, Covenant issued \$206,745 of Hospital Revenue Refunding and Improvement Bonds (the 2006 Bonds) through The Health, Educational and Housing Facility Board of the County of Knox, Tennessee. The 2006 Bonds consist of \$46,245 of uninsured capital appreciation bonds maturing through January 2042 and \$160,500 of insured auction rate securities with a final maturity date of January 1, 2046. A portion of the proceeds from these bonds were used to refund portions of certain maturities of Covenant's 2002 Hospital Revenue Refunding and Improvement Bonds (the 2002 Bonds) and were deposited into an irrevocable escrow fund in amounts sufficient to pay all applicable principal maturities refunded. The

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued (Dollars in Thousands)*

#### *Years Ended December 31, 2010 and 2009*

---

#### NOTE F--LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS - Continued

principal amounts outstanding on the advanced refunded 2002 Bonds total \$18,455 at December 31, 2010.

Management believes that the escrow fund deposit relieves Covenant's responsibility as primary obligor on that portion of the 2002 Bonds and, accordingly, those obligations were derecognized in the Consolidated Balance Sheets. Activity in the irrevocable escrow account is restricted to transactions approved by the Trustee. The remaining portion of the proceeds were deposited into an acquisition fund for capital improvements of Covenant or used to pay issuance costs.

With respect to the 2006 variable rate securities, the interest rate is determined based on a daily interest rate as determined by the remarketing agent based upon comparable tax-exempt obligations and payable monthly. The average daily interest rate during 2010 and 2009 was 0.4% and 0.5%, respectively. The variable rate bonds are subject to mandatory tender for purchase on the first day of each interest period (monthly.) In conjunction with the remarketing of a portion of these bonds, Covenant entered into a Standby Bond Purchase Agreement with a bank, whereby the bank has agreed, subject to certain terms and conditions, to purchase any of these bonds which are tendered for purchase. This agreement expires on September 24, 2011. The remaining bonds are secured by an irrevocable letter of credit with the same bank. Covenant intends to renew or replace these arrangements prior to expiration. The variable rate bonds are subject to mandatory tender for purchase if Covenant should elect to convert to any other allowable interest rate mode or upon termination or replacement of either of the liquidity facilities. The scheduled payments of principal and interest are guaranteed by financial guarantee insurance policies.

With respect to the 2006 capital appreciation bonds, the maturity amount is \$222,465 and Covenant is accreting the difference between the principal amount and the maturity amount as interest expense over the term of the bonds using the bonds outstanding method. The capital appreciation bonds are subject to early redemption on or after January 1, 2017 at a redemption price equal to their compound accreted value as of the redemption date without premium. These 2006 capital appreciation bonds are secured by an interest in the gross receipts of the Obligated Group.

The 2006 Bonds are subject to extraordinary and early redemption. The 2006 Bonds are callable for redemption prior to maturity in the event of damage to or destruction of projects funded, as defined in the agreement. Covenant has requirements to make principal debt service payments on the outstanding 2006 Bonds ranging from \$25,800 in 2027 to \$30,700 in 2032.

During 2002, Covenant issued \$374,957 of Hospital Revenue Refunding and Improvement Bonds (the 2002 Bonds) through The Health, Educational and Housing Facility Board of the

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

#### *Years Ended December 31, 2010 and 2009*

---

#### NOTE F--LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS - Continued

County of Knox, Tennessee. The 2002 Bonds consisted of three issues of current interest bonds (both insured and uninsured) totaling \$62,640, maturing through 2026; \$82,617 of insured capital appreciation bonds maturing through January 1, 2026; and \$229,700 of insured auction rate securities with final maturity dates of January 1, 2023 and 2033. The proceeds from these bonds were deposited into an acquisition fund for future capital improvements of Covenant, as well as into irrevocable escrow funds in amounts sufficient to pay all future interest, principal and premium at applicable redemption dates for previously issued long-term debt, which was subsequently retired.

With respect to the 2002 auction rate (variable rate) securities, Covenant may elect to convert these bonds to fixed rate debt at any interest payment date. The maximum bond interest rate for the 2002 auction rate securities is based on various published indices, not to exceed the maximum lawful rate and averaged 0.5% and 0.8% for the years ended December 31, 2010 and 2009, respectively. In the event such conversion occurs, these bonds are subject to a mandatory tender to repurchase. These auction rate securities have been in a failed auction mode for a period of time and Covenant intends to refinance a portion of these securities (See Note O). With respect to the 2002 capital appreciation bonds, the maturity amount is \$224,430 and Covenant is accreting the difference between the principal amount and the maturity amount as interest expense over the term of the bonds using the bonds outstanding method. The 2002 auction rate securities are secured by an interest in the gross receipts of certain members of Covenant (the Obligated Group).

Certain of the 2002 bond issues described above are subject to early redemption. Those bond issues which are subject to early redemption require a premium be paid depending upon the timing of such redemption. Additionally, Covenant has requirements to make principal debt service fund payments related to the outstanding term bonds. Such principal payments relating to the 2002 bonds continue through 2026 and range from a minimum of \$865 in 2016 to a maximum of \$1,440 in 2025.

Under the terms of the various bond indentures, Covenant is subject to a number of affirmative and negative covenants, including restrictions on the incurrence of additional debt, the maintenance of specific debt service coverage ratios, and restrictions on the transfer of assets. In the event such covenants are not met, Covenant may be required to fund a debt service reserve fund, pledge assets as collateral or take other actions as required under the Master Trust Indenture. Management believes Covenant is in compliance with all such requirements at December 31, 2010.

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

#### *Years Ended December 31, 2010 and 2009*

---

#### NOTE F--LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS - Continued

The scheduled maturities and mandatory principal debt service payments of the long-term debt and capital lease obligations (excluding interest), exclusive of net unamortized original issue discounts and premiums, are as follows:

*Year Ending December 31,*

2011	\$ 20,425
2012	21,438
2013	20,822
2014	21,904
2015	24,564
Thereafter	<u>577,974</u>
	687,127
Net premiums	<u>188</u>
	<u><u>\$ 687,315</u></u>

#### NOTE G--INCOME TAXES

Fortress and CMM (the For-Profit Subsidiaries) file a group consolidated federal, and separate company state income tax returns and account for income taxes under the provisions of ASC 740, *Income Taxes*. As of December 31, 2010 and 2009, the For-Profit Subsidiaries have net operating loss carryforwards for federal income tax purposes of approximately \$29,900 and \$36,100, respectively, and for state purposes, approximately \$49,300 and \$49,900, respectively. These carryforward amounts relate to operating losses generated in prior years which expire through 2023. The remaining net operating loss carryforward may be offset against the future taxable income of each respective group or company.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of combined deferred taxes at December 31, 2010 and 2009 include deferred tax assets of approximately \$13,380 and \$15,510, respectively, related to net operating loss carryforwards. Other deferred tax assets total approximately \$5,700 and \$4,300 at December 31, 2010 and 2009, respectively, and relate to other temporary differences; primarily deferred salaries and book/tax differences in income from partnership investments.

Deferred tax liabilities of approximately \$92 and \$82 at December 31, 2010 and 2009, respectively, relate primarily to book/tax differences in depreciation and amortization. Valuation

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

#### *Years Ended December 31, 2010 and 2009*

---

#### NOTE G--INCOME TAXES - Continued

allowances have been established for all net deferred tax assets as of December 31, 2010 and 2009.

Covenant had no unrecognized tax benefits at December 31, 2010 and 2009. As such, no interest or penalties were recognized in the Consolidated Statements of Operations related to unrecognized tax benefits. At December 31, 2010, tax returns for 2007 through 2010 are subject to examination by the Internal Revenue Service. Covenant has no uncertain tax positions that would require financial statement recognition on disclosure under generally accepted accounting principles at December 31, 2010 or 2009.

#### NOTE H--RETIREMENT PLANS

Covenant sponsors defined contribution plans (401(k) and 403(b) plans) for substantially all full-time employees meeting specified age and service requirements. Under these plans, during 2010 and 2009, Covenant made a matching contribution up to 6% of participants' eligible wages. Additionally, Covenant sponsors a non-qualified retirement plan for certain members of management to defer a portion of their income. During 2010 and 2009, Covenant made a discretionary contribution of 4.5% of compensation, as defined, to this plan. Expense related to all retirement plans totaled approximately \$10,700 and \$10,400 in 2010 and 2009, respectively.

#### NOTE I--COMMITMENTS, CONTINGENCIES AND OTHER

*Professional Liability Insurance:* Covenant and subsidiaries maintain an insurance policy to protect from catastrophic medical malpractice or general liability exposure. This policy obligates Covenant for the first \$1,000 per occurrence for any claim (including claim expenses) made during the period per the Self-Insured Retention (SIR) policy. The total SIR obligation is \$14,000 annually. Beyond the SIR obligation, Covenant's policy of insurance provides a \$35,000 limit of insurance as protection for such insured liabilities. This limit of liability applies "per occurrence" and in the "annual aggregate" for any claims made during the policy period.

An estimated reserve for ultimate losses on claims reported and claims incurred but not reported is established (undiscounted) based upon an actuarial study and is included in accrued expenses or other long-term liabilities based on management's estimate of when such claims will be paid.

Covenant and its subsidiaries are named as defendants in various lawsuits and other actions claiming alleged damages. While the ultimate outcome of these proceedings is not presently determinable, it is the opinion of management that the claims will have no material adverse effect on the financial position or results of operations of Covenant.

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

*Years Ended December 31, 2010 and 2009*

---

#### NOTE I--COMMITMENTS, CONTINGENCIES AND OTHER - Continued

*Employee Benefits:* Covenant is self-insured for worker's compensation claims and records estimated amounts for reported claims, as well as a reserve for claims incurred but not reported, based on an actuarial study. Management's estimate of the amount of claims that will be paid in any subsequent year is included in accrued expenses and the remaining liability is reported as other long-term liabilities. Covenant is required by the Tennessee Self-Insured Workers' Compensation Program to maintain an irrevocable \$8,605 Letter of Credit as collateral for workers' compensation claims.

Covenant maintains a self-funded healthcare plan to provide reimbursement for covered expenses incurred by eligible employees and covered dependents. Covenant has recorded an estimated reserve for unpaid claims and claims incurred but not yet reported at December 31, 2010 and 2009.

*Projects in Progress:* Certain subsidiaries of Covenant were engaged in construction, renovation and information technology projects at December 31, 2010. Projects on which contracts have been signed have an estimated cost to complete of approximately \$18,000 at December 31, 2010.

*Physician Agreements:* Covenant (or its subsidiaries) has entered into contractual relationships with physicians. These contracts include management services agreements, employment contracts, clinical scholar agreements and practice assistance agreements. These contracts have terms of varying lengths. Some contracts guarantee certain base annual payments and may include additional incentives based on productivity levels.

*Municipal Leases:* FLMC leases its operating facility under a capital lease agreement with Loudon County, Tennessee. This facility is included as a part of buildings and leasehold improvements. Under the terms of the agreement with Loudon County, Tennessee (the County), Covenant completed construction of a replacement facility for FLMC during 2004. Covenant acquired land and constructed the facility on behalf of the County and has transferred title to the County. However, FLMC is leasing the new facility from the County for twenty years (at a nominal annual amount) with two renewal options for five years each and has recognized this facility as an asset of Covenant. Additionally, Covenant committed to spend a minimum of \$20,000 during the FLMC lease term on capital additions, physician recruitment or other community benefits.

Covenant also entered into an agreement with the City of Harriman, Tennessee, to lease and purchase certain assets, and assume certain liabilities, of Roane Medical Center. Under the terms of the agreement, Covenant has committed to invest a minimum of \$50,000 in the

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

#### *Years Ended December 31, 2010 and 2009*

---

#### NOTE I--COMMITMENTS, CONTINGENCIES AND OTHER - Continued

acquisition, development, construction and equipping of a new hospital facility. The lease of the current facility will terminate 90 days after completion of the new facility.

*Operating Leases:* Covenant has entered into certain non-cancelable leases for office space and equipment which require payments through 2015. Total rental expense for all operating leases was approximately \$8,300 and \$8,600 for the years ended December 31, 2010 and 2009, respectively. The following is a schedule of future minimum lease payments under non-cancelable lease agreements with remaining terms of at least one year, net of subleases, for the years ending December 31:

2011	\$	2,377
2012		2,136
2013		2,022
2014		1,912
2015		1,357
	\$	<u>9,804</u>

In addition, Covenant leases office space to physicians and others under various lease agreements with terms in excess of one year. Rental revenue recognized in each of the years 2010 and 2009 totaled approximately \$10,700. The following is a schedule of future minimum lease payments to be received for the years ending December 31:

2011	\$	8,060
2012		5,756
2013		4,517
2014		3,922
2015		3,060
Thereafter		12,358
	\$	<u>37,673</u>

*Union Service Agreements:* MMC participates in two separate union service agreements, the "RN Unit" agreement and the "Service and Technical Unit" agreement, which were signed in October 2009. The agreements are for a two-year period through October 2011. Both agreements provide a no strike and no lockout provision to protect both parties to the agreement.

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

*Years Ended December 31, 2010 and 2009*

---

#### NOTE I--COMMITMENTS, CONTINGENCIES AND OTHER - Continued

*Healthcare Industry:* The healthcare industry is subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, Medicare fraud and abuse and under provisions of the Health Insurance Portability and Accountability Act of 1996, patient records privacy and security. Recently, government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by healthcare providers, such as the Medicare Recovery Audit Contractor program. Violations of these laws and regulations could result in expulsion from government healthcare programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Compliance with such laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time. Federal, state and local governments have recently proposed numerous changes related to healthcare reform. Management continues to evaluate the impact of new or proposed legislation.

#### NOTE J--FAIR VALUE OF FINANCIAL INSTRUMENTS

Substantially all financial instruments' carrying value approximates fair value due to the nature or term of the instruments, except as described below. The following methods and assumptions were used to estimate the fair value of these other financial instruments:

*Investments in Alternative Investments:* The fair value of investments in alternative investments is determined based on the fair value of the underlying assets as determined by the fund manager.

*Long-Term Debt:* The fair value of long-term debt is estimated based upon quotes from brokers for tax-exempt bonds and discounted future cash flows using current market rates for other debt. For long-term debt with variable interest rates, the carrying value approximates fair value.

*Other Long-term Liabilities:* Other long-term liabilities consist of reserves for professional and workers' compensation liabilities and deferred gains related to the sale of a subsidiary (See Note N). The fair value of other long-term liabilities is not estimable, due to the uncertainties in determining the future payment date of liability claims and the unique nature of the deferred gains.

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

#### *Years Ended December 31, 2010 and 2009*

#### NOTE J--FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued

The estimated fair value of Covenant's significant financial instruments which have carrying values different from fair value is as follows at December 31, 2010 and 2009:

	2010		2009	
	<i>Carrying Value</i>	<i>Estimated Fair Value</i>	<i>Carrying Value</i>	<i>Estimated Fair Value</i>
Investments in alternative investments	\$ 72,366	\$ 84,983	\$ 79,788	\$ 87,612
Long-term debt (excluding capital leases)	685,728	675,305	688,882	681,593

#### NOTE K--FAIR VALUE MEASUREMENT

FASB Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures*, establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

- Level 1 - inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 - inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.
- Level 3 - inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The following table presents assets reported at fair value as of December 31, 2010 and 2009 and their respective classification under the valuation hierarchy:

	<i>Carrying Value</i>	<i>Quoted Prices in Active Markets (Level 1)</i>	<i>Significant Other Observable Inputs (Level 2)</i>	<i>Significant Unobservable Inputs (Level 3)</i>
Assets Measured at Fair Value on a Recurring Basis at December 31, 2010				
Investments in debt and equity securities	\$ 716,452	\$ 148,455	\$ 567,997	\$ -
Investments in collective trust funds	89,511	-	89,511	-

## COVENANT HEALTH

*Notes to Consolidated Financial Statements - Continued*  
*(Dollars in Thousands)*

*Years Ended December 31, 2010 and 2009*

### NOTE K--FAIR VALUE MEASUREMENT - Continued

	<i>Carrying Value</i>	<i>Quoted Prices in Active Markets (Level 1)</i>	<i>Significant Other Observable Inputs (Level 2)</i>	<i>Significant Unobservable Inputs (Level 3)</i>
Assets Measured at Fair Value on a Recurring Basis at December 31, 2009				
Investments in debt and equity securities	644,821	118,517	526,304	-
Investments in collective trust funds	95,428	-	95,428	-

There were no liabilities requiring disclosure under FASB ASC 820 at December 31, 2010 or 2009.

### NOTE L--EXPENSES BY FUNCTIONAL CLASSIFICATION

Expenses based upon functional classification are as follows for the year ended December 31, 2010 and 2009:

	<i>2010</i>	<i>2009</i>
Healthcare services	\$ 813,719	\$ 747,871
Administrative and general	169,710	153,032
Other	53,509	50,685
	\$ 1,036,938	\$ 951,588

### NOTE M--HOSPITAL ACQUISITION

Under terms of an agreement with Morristown-Hamblen Hospital Association, Covenant became the sole member of and acquired MHHS effective July 1, 2010. All corporate powers are exercised by or under the authority of, and the affairs of MHHS are managed under the direction of, the Covenant Board of Directors. The acquisition was undertaken to accomplish the shared vision of Covenant and MHHS to establish MHHS as a regional healthcare hub and to enhance the reputation of MHHS as the best place in its area for patients to receive care, physicians to practice medicine and employees to work. Covenant and MHHS expect to undertake and realize additional physician recruiting, improvements in clinical quality and patient satisfaction and capital investments. As a part of the agreement, Covenant committed to invest \$88,000 in capital and other projects, as defined, related to MHHS within seven years of the acquisition date.

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

#### *Years Ended December 31, 2010 and 2009*

---

#### NOTE M--HOSPITAL ACQUISITION - Continued

A condensed summary of the assets acquired and liabilities assumed, at their estimated fair value based on an independent valuation, and the excess of such assets over liabilities as reported in Covenant's 2010 Consolidated Statement of Operations and Changes in Net Assets, is as follows at July 1, 2010:

Current assets	\$	13,455
Property, plant and equipment		36,323
Other assets		<u>10,094</u>
Total Assets		59,872
Current liabilities		15,290
Notes payable and capital leases		<u>6,856</u>
Total Liabilities		<u>22,146</u>
Excess of Assets Acquired Over Liabilities Assumed	\$	<u>37,726</u>

Prior to the acquisition, Covenant advanced MHHS funds to repay all outstanding bond indebtedness of approximately \$29,900. This advance was repaid as part of the acquisition.

Operations of MHHS are included in the 2010 Consolidated Statement of Operations and Changes in Net Assets since the acquisition date and consist of the following:

Revenue and support	\$	47,932
Deficit of revenue, gains and support over expenses and losses and decrease in net asset		(410)

Supplemental, unaudited pro-forma information for MHHS for the years ended December 31, 2010 and 2009 is as follows:

	<u>2010</u>	<u>2009</u>
Revenue and support	\$ 96,635	\$ 92,256
Deficit of revenue, gains and support over expenses and losses	(972)	(1,476)
Change in net assets	55	(167)

## COVENANT HEALTH

*Notes to Consolidated Financial Statements - Continued*  
*(Dollars in Thousands)*

*Years Ended December 31, 2010 and 2009*

---

### NOTE N--DISCONTINUED OPERATIONS AND RELATED DEFERRED GAIN

In 2008, Covenant sold all of the outstanding Class A common stock and Class C common stock of PHP Companies, Inc. (PHP), a for-profit organization that operated an insurance corporation, as well as a licensed health maintenance organization for commercial health insurance products and Medicare risk products, and managed a health maintenance organization under the State of Tennessee's TennCare program, to Humana, Inc. (Humana).

The revenue, expenses and cash flows from PHP and Covenant's recognized gain on the sale were reflected as discontinued operations in prior financial statements.

The purchase price was subject to adjustments based on final settlement of estimates included in the consolidated balance sheet of PHP at October 31, 2008, including those related to future claims payments and audits thereof by governmental authorities or their agents and other parties. Management was not able to estimate such adjustments and no additional amounts were recorded in 2008 and 2009. During 2010, Covenant received \$34,923 as additional payment on these contingent settlements. Covenant recognized \$24,923 of this amount as additional gain on the sale of discontinued operations with the balance deferred in other current liabilities pending the result of additional claims audits. Additional sale proceeds as a result of future adjustments may also be received but management is not able to estimate the amount and timing of any additional settlement. Due to the uncertainties involved related to final settlements, it is at least reasonably possible that management's estimates related to amounts recognized and amounts deferred could change in the future.

In conjunction with the sale of PHP, Covenant entered into a seven-year Hospital System Participation Agreement (the Provider Agreement) with Humana. Under the terms of the Provider Agreement, Covenant has agreed to reimbursement rates for individuals covered by Humana's commercial and Medicare plans at rates below rates received from similar insurance programs, and has limits on future rate increases from Humana. As such, Covenant deferred the portion of the sale proceeds estimated to be compensation for entering into the Provider Agreement. Covenant estimated this deferral to be \$71,000, which is being amortized as part of net patient service revenue over the term of the Provider Agreement. During 2010 and 2009, Covenant recognized net patient service revenue totaling \$14,026 and \$6,429, respectively, related to amortization of amounts deferred under this Provider Agreement.

Additionally, as part of the sale of PHP, Covenant entered into an Administrative Services Agreement (ASO) with Humana for third party health claims administration for Covenant employees under a self-insured health plan for a period of eight years beginning January 1, 2009. Under the terms of the ASO, Covenant agreed to pay a fixed rate for these services at a rate that was higher than the then current rate. Covenant estimated the portion of the sale proceeds related to this agreement totaled \$6,100 which is being amortized and reported as a reduction of

## COVENANT HEALTH

### *Notes to Consolidated Financial Statements - Continued* *(Dollars in Thousands)*

#### *Years Ended December 31, 2010 and 2009*

---

#### NOTE N--DISCONTINUED OPERATIONS AND RELATED DEFERRED GAIN - Continued

health plan administration expenses over the term of the ASO Agreement. During 2010, Covenant recognized \$1,035 as a reduction of claims administration expense related to amortization of this ASO Agreement. No reduction of expenses related to the ASO was recognized during 2009 as the higher rates were not yet implemented.

#### NOTE O--SUBSEQUENT EVENT

On March 4, 2011, Covenant issued a tender offer to buy back its 2002 auction rate securities (Note F) at 85% of par. At the close of business on March 18, 2011, the tender closed and \$122,000 of the 2002 auction rate bonds were tendered at that price; the remaining 2002 auction rate securities will remain in the auction mode.

On March 21, 2011, Covenant issued \$103,700 of Hospital Revenue Refunding Bonds, Series 2011 (the 2011 Bonds) through The Health, Educational and Housing Facility Board of the County of Knox, Tennessee. The 2011 Bonds consist of uninsured variable rate bonds bearing interest at a weekly interest rate and maturing through January 1, 2033. The variable rate is determined by the remarketing agent and interest will be payable monthly. The 2011 Bonds are subject to tender for purchase and are secured by separate irrevocable direct pay letters of credit with a bank. The 2011 Bonds were used to finance the acquisition of the 2002D bonds (auction rate securities) tendered pursuant to the tender offer discussed above. Covenant will recognize a gain on the early extinguishment of that portion of the 2002 Bonds, which will be net of the unamortized bond insurance premium and other bond issuance costs associated with those bonds.

***Other Financial Information***

# COVENANT HEALTH

## Schedule of Expenditures of Federal and State Awards

Year Ended December 31, 2010

CFDA Number	State Grant Number (Funding Allocation)	Program Name (Program Period)	Grantor	Pass-Through Grantor Agency	Receivable (Unexpended) Balance at January 1, 2010	Receipts	Amounts Earned by Expenditures	Other	Receivable (Unexpended) Balance at December 31, 2010
<b>FEDERAL AND STATE AWARDS:</b>									
14.195	N/A (100% Federal)	Section 8 Housing Assistance Payments Program - Special Allocations (1/1/09 - 12/31/09)	U.S. Department of Housing and Urban Development	N/A	\$ 440	\$ -	\$ -	(440)	\$ -
<i>Total U.S. Department of Housing and Urban Development</i>					440	-	-	(440)	-
93.150	GR-08-21979-00 (100% Federal)	Recovery Services P.A.T.H (07/01/07 - 06/30/08)	U.S. Department of Health and Human Services	Tennessee Department of Mental Health/ Developmental Disabilities	3,201	-	-	-	3,201
93.150	GR-09-25081-00 (100% Federal)	Recovery Services P.A.T.H. (07/01/08 - 06/30/09)	U.S. Department of Health and Human Services	Tennessee Department of Mental Health/ Developmental Disabilities	(60)	-	-	-	(60)
93.150	GR-10-28262-00 (100% Federal)	Recovery Services P.A.T.H. (07/01/09 - 06/30/10)	U.S. Department of Health and Human Services	Tennessee Department of Mental Health/ Developmental Disabilities	22,753	35,551	19,385	-	6,587
93.150	GR-11-31993-00 (100% Federal)	Recovery Services P.A.T.H. (07/01/10 - 06/30/11)	U.S. Department of Health and Human Services	Tennessee Department of Mental Health/ Developmental Disabilities	-	10,568	16,041	-	5,473
93.226	FY10.523.006 (100% Federal)	Reducing Catheter-Associated Urinary Tract Infections in NICHE Hospitals (05/1/10 - 1/31/12)	U.S. Department of Health and Human Services	Regents of the University of Colorado	-	2,000	2,000	-	-
93.243	Z-07-033432-00 (100% Federal)	Mental Health Data Infrastructure Grant (04/01/07 - 06/30/09)	U.S. Department of Health and Human Services	Tennessee Department of Mental Health/ Developmental Disabilities	(616)	-	-	-	(616)
93.283	DG-07-02063-00 (100% Federal)	Block Grant for Pandemic Flu (6/01/07 - 08/30/07)	U.S. Department of Health and Human Services	Tennessee Department of Health	(497)	-	-	-	(497)
93.779	GR-10-29668 (100% Federal)	Centers for Medicare and Medicaid Services (CMS) Research, Demonstrations and Evaluations (7/1/09 - 6/30/11)	U.S. Department of Health and Human Services	Tennessee Department of Mental Health/ Developmental Disabilities	26,068	80,526	57,338	-	2,880
93.889*	U3RHSO3942-01-04 (100% Federal)	National Bioterrorism Hospital Preparedness Program (9/1/05 - 8/31/07)	U.S. Department of Health and Human Services	Tennessee Department of Health	(124)	-	-	-	(124)
93.889*	EP-U3R-07-001 (100% Federal)	National Bioterrorism Hospital Preparedness Program (9/1/07 - 8/31/09)	U.S. Department of Health and Human Services	Tennessee Department of Health	(15,394)	-	8,558	-	(6,836)

See notes to schedule of expenditures of federal and state awards.

**COVENANT HEALTH**

*Schedule of Expenditures of Federal and State Awards – Continued*

*Year Ended December 31, 2010*

<i>CFDA Number</i>	<i>State Grant Number (Funding Allocation)</i>	<i>Program Name (Program Period)</i>	<i>Grantor</i>	<i>Pass-Through Grantor Agency</i>	<i>Receivable (Unexpended) Balance at January 1, 2010</i>	<i>Receipts</i>	<i>Amounts Earned by Expenditures</i>	<i>Other</i>	<i>Receivable (Unexpended) Balance at December 31, 2010</i>
93.889*	EP-U3R-09-001 (100% Federal)	National Bioterrorism Hospital Preparedness Program (8/9/09 - 6/30/10)	U.S. Department of Health and Human Services	Tennessee Department of Health	(95,329)	99,980	195,002	-	(307)
93.889*	EP-U3R-09-001 (100% Federal)	National Bioterrorism Hospital Preparedness Program (7/1/10 - 6/30/11)	U.S. Department of Health and Human Services	Tennessee Department of Health	-	275,177	3,356	-	(271,821)
93.958	GR-10-29667-00 (91% Federal) (9% State)	Block Grants for Community Mental Health Services (7/01/09 - 6/30/10)	U.S. Department of Health and Human Services	Tennessee Department of Mental Health/ Developmental Disabilities	88,654	197,702	109,048	-	-
93.958	GR-11-32007-00 (100% Federal)	Block Grants for Community Mental Health Services (7/01/10 - 6/30/11)	U.S. Department of Health and Human Services	Tennessee Department of Mental Health/ Developmental Disabilities	-	5,867	11,156	-	5,289
93.959	Z-09-216606-00 (100% Federal)	Block Grants for Prevention and Treatment of Substance Abuse (07/01/08 - 06/30/10)	U.S. Department of Health and Human Services	Tennessee Department of Mental Health/ Developmental Disabilities	21,764	55,906	34,142	-	-
93.959	GR-11-33027-00 (100% Federal)	Block Grants for Prevention and Treatment of Substance Abuse (07/01/10 - 06/30/11)	U.S. Department of Health and Human Services	Tennessee Department of Mental Health/ Developmental Disabilities	-	8,949	92,016	-	83,067
<i>Total U.S. Department of Health and Human Services</i>					50,420	772,226	548,042	-	(173,764)
N/A	GR-10-28048-00 (100% State)	Mental Health MCU (7/01/09 - 6/30/10)	Tennessee Department of Mental Health/ Developmental Disabilities	N/A	19,185	128,120	108,935	-	-
N/A	GR-11-31830-00 (100% State)	Mental Health MCU (7/01/10 - 6/30/11)	Tennessee Department of Mental Health/ Developmental Disabilities	N/A	-	76,494	108,015	-	31,521
N/A	GR-11-32368-00 (100% State)	Block Grants for Community Mental Health Services (7/01/10 - 6/30/11)	Tennessee Department of Mental Health/ Developmental Disabilities	N/A	-	105,768	152,955	-	47,187
N/A	GR-10-28440-00 (100% State)	Mental Health Permanent Housing (7/01/09 - 6/30/10)	Tennessee Department of Mental Health/ Developmental Disabilities	N/A	28,750	56,386	27,636	-	-
N/A	GR-10-28753-00 (100% State)	Mental Health ILA (7/01/09 - 6/30/10)	Tennessee Department of Mental Health/ Developmental Disabilities	N/A	4,814	14,664	9,850	-	-
N/A	GR-10-29210-01 (100% State)	Mental Health Uninsured Comm Pts (7/01/09 - 6/30/10)	Tennessee Department of Mental Health/ Developmental Disabilities	N/A	84,750	303,814	219,064	-	-
N/A	GR-11-32728-00 (100% State)	Mental Health Uninsured Comm Pts (7/01/10 - 6/30/11)	Tennessee Department of Mental Health/ Developmental Disabilities	N/A	-	191,646	225,850	-	34,204

*See notes to schedule of expenditures of federal and state awards.*

**COVENANT HEALTH**

*Schedule of Expenditures of Federal and State Awards – Continued*

*Year Ended December 31, 2010*

<i>CFDA Number</i>	<i>State Grant Number (Funding Allocation)</i>	<i>Program Name (Program Period)</i>	<i>Grantor</i>	<i>Pass-Through Grantor Agency</i>	<i>Receivable (Unexpended) Balance at January 1, 2010</i>	<i>Receipts</i>	<i>Amounts Earned by Expenditures</i>	<i>Other</i>	<i>Receivable (Unexpended) Balance at December 31, 2010</i>
N/A	GR-10-28441-01 (100% State)	Mental Health BHSN (7/01/09 - 6/30/10)	Tennessee Department of Mental Health/ Developmental Disabilities	N/A	35,881	231,008	195,127	-	-
N/A	GR-11-31836-00 (100% State)	Mental Health BHSN (7/01/10 - 6/30/11)	Tennessee Department of Mental Health/ Developmental Disabilities	N/A	-	177,992	199,028	-	21,036
N/A	GR-09-24867-00 (100% State)	Service Coordination for TBI Survivors (07/01/08 - 06/30/09)	Tennessee Department of Health	N/A	(20,055)	-	20,055	-	-
N/A	GR-10-27789-00 (100% State)	Service Coordination for TBI Survivors (07/01/09 - 06/30/10)	Tennessee Department of Health	N/A	12,055	47,903	35,848	-	-
N/A	GR-11-32199-00 (100% State)	Service Coordination for TBI Survivors (7/01/10 - 6/30/11)	Tennessee Department of Health	N/A	-	16,405	24,405	-	8,000
<i>Total Other</i>					165,380	1,350,200	1,326,768	-	141,948
<b>TOTAL FEDERAL AND STATE AWARDS</b>					\$ 216,240	\$ 2,122,426	\$ 1,874,810	\$ (440)	\$ (31,816)

\*Denotes major program

**COVENANT HEALTH**

*Notes to Schedule of Expenditures of Federal and State Awards*

*Year Ended December 31, 2010*

**NOTE A--BASIS OF PRESENTATION**

The accompanying schedule of expenditures of federal and state awards includes the federal and state award activity of Covenant Health and subsidiaries and is presented on the accrual basis of accounting. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* and the Tennessee Comptroller of the Treasury. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic consolidated financial statements.

**NOTE B--FEDERAL AWARDS EXPENDED**

The accompanying schedule of expenditures of federal and state awards includes federal and state award activity organized by federal program. State pass-through funding is included as part of the total program activity, with state allocation percentages disclosed. Total federal awards expended were as follows for the year ending December 31, 2010:

Recovery Services P.A.T.H.	\$ 35,426
Reducing Catheter-Associated Urinary Tract Infections in NICHE Hospitals	2,000
Centers for Medicare and Medicaid Services (CMS) Research, Demonstrations and Evaluations	57,338
National Bioterrorism Hospital Preparedness Program	206,916
Block Grants for Community Mental Health Services	110,390
Block Grants for Prevention and Treatment of Substance Abuse	126,158
Total federal awards expended	<u>\$ 538,228</u>

**NOTE C--NATIONAL BIOTERRORISM HOSPITAL PREPAREDNESS AWARDS**

The following is a reconciliation of the National Bioterrorism Hospital Preparedness Awards by Covenant subsidiary:

<i>Entity</i>	<i>Program Period</i>	<i>Receivable (Unexpended) Balance at January 1, 2010</i>	<i>Receipts</i>	<i>Awards Earned by Expenditures</i>	<i>Receivable (Unexpended) Balance at December 31, 2010</i>
U3RHSO3942-01-04:					
Fort Sanders Regional Medical Center	9/1/05 - 8/31/07	\$ (124)	\$ -	\$ -	\$ (124)
Amounts as reported in the Schedule of Federal and State Awards		<u>\$ (124)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (124)</u>

**COVENANT HEALTH**

*Notes to Schedule of Expenditures of Federal and State Awards - Continued*

**Year Ended December 31, 2010**

**NOTE C--NATIONAL BIOTERRORISM HOSPITAL PREPAREDNESS AWARDS  
- Continued**

<i>Entity</i>	<i>Program Period</i>	<i>Receivable (Unexpended) Balance at January 1, 2010</i>	<i>Receipts</i>	<i>Awards Earned by Expenditures</i>	<i>Receivable (Unexpended) Balance at December 31, 2010</i>
EP-U3R-07-001					
Fort Sanders Regional Medical Center	9/1/07 - 8/31/09	\$ (15,394)	\$ -	\$ 8,558	\$ (6,836)
Amounts as reported in the Schedule of Federal and State Awards		\$ (15,394)	\$ -	\$ 8,558	\$ (6,836)
EP-U3R-09-001:					
Fort Sanders Regional Medical Center	8/9/09 - 6/30/10	\$ (52,508)	\$ -	\$ 52,201	\$ (307)
Parkwest Medical Center	8/9/09 - 6/30/10	(42,821)	-	42,821	-
Methodist Medical Center	8/9/09 - 6/30/10	-	38,900	38,900	-
LeConte Medical Center	8/9/09 - 6/30/10	-	20,432	20,432	-
Roane Medical Center	8/9/09 - 6/30/10	-	20,648	20,648	-
Fort Loudon Medical Center	8/9/09 - 6/30/10	-	20,000	20,000	-
Amounts as reported in the Schedule of Federal and State Awards		\$ (95,329)	\$ 99,980	\$ 195,002	\$ (307)
EP-U3R-09-001:					
Fort Sanders Regional Medical Center	7/1/10 - 6/30/11	\$ -	\$ 69,769	\$ -	\$ (69,769)
Parkwest Medical Center	7/1/10 - 6/30/11	-	55,168	3,000	(52,168)
Methodist Medical Center	7/1/10 - 6/30/11	-	52,185	-	(52,185)
Morristown-Hamblen Health System	7/1/10 - 6/30/11	-	37,427	-	(37,427)
LeConte Medical Center	7/1/10 - 6/30/11	-	20,628	-	(20,628)
Roane Medical Center	7/1/10 - 6/30/11	-	20,000	356	(19,644)
Fort Loudon Medical Center	7/1/10 - 6/30/11	-	20,000	-	(20,000)
Amounts as reported in the Schedule of Federal and State Awards		\$ -	\$ 275,177	\$ 3,356	\$ (271,821)

**NOTE D--CONTINGENCIES**

Covenant's federal programs are subject to financial and compliance audits by grantor agencies which, if instances of material noncompliance are found, may result in disallowed expenditures and affect Covenant's continued participation in specific programs. The amount, if any, of expenditures which may be disallowed by the grantor agencies cannot be determined at this time. Covenant believes such amounts, if any, to be immaterial.



REPORT ON INTERNAL CONTROL OVER FINANCIAL  
REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED  
ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN  
ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

To the Board of Directors of  
Covenant Health:

We have audited the consolidated financial statements of Covenant Health (Covenant) as of and for the year ended December 31, 2010, and have issued our report thereon dated April 19, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Covenant's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of Covenant's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of Covenant's internal control over financial reporting.

*A deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. *A material weakness* is a deficiency or combination of deficiencies, in internal controls such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Covenant's consolidated financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which

could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the audit committee, management, the Board of Directors of Covenant Health, and federal and state awarding agencies and pass-through entities and the State of Tennessee Comptroller of the Treasury and is not intended to be and should not be used by anyone other than these specified parties.

*Bushing Yorkley Associates, P.C.*

Knoxville, Tennessee  
April 19, 2011



REPORT ON COMPLIANCE WITH REQUIREMENTS THAT COULD HAVE A DIRECT  
AND MATERIAL EFFECT ON EACH MAJOR PROGRAM AND ON INTERNAL  
CONTROL OVER COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133

To the Board of Directors of  
Covenant Health:

Compliance

We have audited Covenant Health's (Covenant) compliance with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) *Circular A-133 Compliance Supplement* that could have a direct and material effect on its major federal program for the year ended December 31, 2010. Covenant's major federal program is identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of Covenant's management. Our responsibility is to express an opinion on Covenant's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Covenant's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on Covenant's compliance with those requirements.

In our opinion, Covenant Health complied, in all material respects, with the requirements referred to above that could have a direct and material effect on its major federal program for the year ended December 31, 2010.

Internal Control Over Compliance

The management of Covenant is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts and grants applicable to federal programs. In planning and performing our audit, we considered Covenant's internal control over compliance with the requirements that could have a direct and material

effect on a major federal program to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Covenant's internal control over compliance.

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

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

This report is intended solely for the information and use of the audit committee, management, the Board of Directors of Covenant Health, and federal awarding agencies and pass-through entities and the State of Tennessee Comptroller of the Treasury and is not intended to be and should not be used by anyone other than these specified parties.

*Bushing Yoakley & Associates, P.C.*

Knoxville, Tennessee  
April 19, 2011

## COVENANT HEALTH

### *Schedule of Findings and Questioned Costs*

*Year Ended December 31, 2010*

---

#### Section I - Summary of Auditor's Results

##### *Consolidated Financial Statements*

1. The auditor's report expresses an unqualified opinion on the consolidated financial statements of Covenant Health.
2. No significant deficiencies relating to the audit of the consolidated financial statements are reported in the *Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards*. In addition, we noted no findings that are required to be reported under *Government Auditing Standards*.
3. No instances of noncompliance material to the consolidated financial statements of Covenant Health which would be required to be reported in accordance with *Government Auditing Standards* were disclosed during the audit.

##### *Federal Awards*

4. No significant deficiencies, findings or questioned costs relating to the audit of the major federal award program are reported in the *Report on Compliance with Requirements That Could Have a Material and Direct Effect on Each Major Program and on Internal Control Over Compliance in Accordance with OMB Circular A-133* or in this schedule.
5. The auditor's report on compliance for the major federal award program for Covenant Health expresses an unqualified opinion on its major federal program.
6. No audit findings relative to the major federal award program for Covenant Health are reported in this Schedule in accordance with Section 510(a) of OMB Circular A-133.
7. The program tested as a major program is as follows:

<u>Name</u>	<u>CFDA #</u>
National Bioterrorism Hospital Preparedness Program	93.889

8. The threshold for distinguishing Types A and B programs was \$300,000.
9. Covenant Health qualified as a low-risk auditee.

**COVENANT HEALTH**

*Schedule of Findings and Questioned Costs - Continued*

*Year Ended December 31, 2010*

---

**Section II - Financial Statement Findings**

None.

**Section III - Federal Award Findings and Questioned Costs**

None.

**COVENANT HEALTH**

*Schedule of Prior Audit Findings*

*Year Ended December 31, 2010*

---

There were no prior audit findings.