SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION dba MERCY CARE PLAN

FINANCIAL STATEMENTS AND ADDITIONAL INFORMATION

Years Ended June 30, 2012 and 2011

SOUTHWEST CATHOLIC
HEALTH NETWORK CORPORATION
dba MERCY CARE PLAN

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Years Ended June 30, 2012 and 2011

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of

SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION
dba MERCY CARE PLAN

We have audited the accompanying statements of financial position of ***Southwest Catholic Health Network Corporation (SCHN) dba Mercy Care Plan*** as of June 30, 2012 and 2011, and the related statements of activities and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of SCHN's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with U.S. generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the 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 SCHN's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ***Southwest Catholic Health Network Corporation dba Mercy Care Plan*** at June 30, 2012 and 2011, and the results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Mayer Hoffman McCann P.C.

Phoenix, Arizona
October 22, 2012

SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION
dba MERCY CARE PLAN

STATEMENTS OF FINANCIAL POSITION

June 30, 2012 and 2011
(In thousands)

A S S E T S

	2012	2011
CURRENT ASSETS		
Cash and cash equivalents	$ 109,048	$ 144,696
Short-term investments	38,270	36,604
Receivables:		
Reinsurance receivables, net of allowance for doubtful accounts of $6,496 for 2012 and $6,922 for 2011	31,698	41,549
Reconciliation receivables, net of allowance for doubtful accounts of $3,197 for 2012 and $0 for 2011	9,737	8,042
Capitation and supplement receivables	7,843	17,575
Pharmacy receivable	4,659	2,414
Third party liability receivable, net of allowance for doubtful accounts of $1,601 for 2012 and $1,183 for 2011	6,000	5,966
Interest receivable	910	957
Provider advances, net of allowance for doubtful accounts of $1,797 for 2012 and $1,100 for 2011	13,441	13,103
Due from Aetna	2,976	-
Risk share settlement	2,735	-
Prepaid assets	378	247
TOTAL CURRENT ASSETS	227,695	271,153
RECONCILIATION RECEIVABLES, less current portion	1,702	3,272
RISK SHARE SETTLEMENT, less current portion	5,033	1,101
LONG-TERM INVESTMENTS	159,919	159,224
TOTAL ASSETS	$ 394,349	$ 434,750

L I A B I L I T I E S A N D N E T A S S E T S

	2012	2011
CURRENT LIABILITIES		
Medical claims payable	$ 147,703	$ 166,187
Reconciliation payable	31,705	51,263
Deferred capitation revenue	25,360	-
Due to Aetna	-	11,793
Other current liabilities	8,997	8,326
Risk share settlement	-	9,068
TOTAL CURRENT LIABILITIES	213,765	246,637
UNRESTRICTED NET ASSETS	180,584	188,113
TOTAL LIABILITIES AND NET ASSETS	$ 394,349	$ 434,750

See Notes to Financial Statements

SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION
dba MERCY CARE PLAN

STATEMENTS OF ACTIVITIES AND CHANGES IN NET ASSETS

Years Ended June 30, 2012 and 2011
(In thousands)

	2012	2011
OPERATING REVENUES		
Capitation premiums	$ 1,604,990	$ 1,764,251
Delivery/HIV-AIDS supplement	57,317	61,932
Reinsurance	72,490	98,873
Other, primarily third party recoveries	4,594	5,423
TOTAL OPERATING REVENUES	1,739,391	1,930,479
HEALTH CARE EXPENSES		
Hospitalization	351,704	452,510
Medical compensation	295,630	349,012
Ancillary and other medical services	641,403	669,845
Institutional	147,640	120,810
Home and community based services	135,854	112,294
TOTAL HEALTH CARE EXPENSES	1,572,231	1,704,471
GENERAL AND ADMINISTRATIVE EXPENSES	119,554	145,451
PREMIUM TAX EXPENSE	27,600	32,209
TOTAL EXPENSES	1,719,385	1,882,131
OPERATING INCOME	20,006	48,348
NONOPERATING INCOME (EXPENSE)		
Investment income	9,246	10,287
Investment fees	(1,052)	(947)
Other income	139	-
TOTAL NONOPERATING INCOME	8,333	9,340
EXCESS OF REVENUE OVER EXPENSES	28,339	57,688
REALIZED GAIN ON SETTLEMENT OF PENSION PLAN	-	579
CHANGE IN NET ASSETS PRIOR TO UNREALIZED GAINS (LOSSES) ON INVESTMENTS	28,339	58,267
UNREALIZED (LOSSES) GAINS ON INVESTMENTS	(5,868)	11,057
CHANGE IN NET ASSETS PRIOR TO DISTRIBUTIONS	22,471	69,324
DISTRIBUTIONS TO SPONSOR ORGANIZATIONS	(30,000)	(60,000)
CHANGE IN NET ASSETS	(7,529)	9,324
NET ASSETS, BEGINNING OF YEAR	188,113	178,789
NET ASSETS, END OF YEAR	$ 180,584	$ 188,113

See Notes to Financial Statements

SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION
dba MERCY CARE PLAN

STATEMENTS OF CASH FLOWS

Years Ended June 30, 2012 and 2011
(In thousands)

	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Change in net assets prior to distributions	$ 22,471	$ 69,324
Adjustments to reconcile change in net assets prior to distributions to net cash provided by operating activities:		
Bad debt expense (recoveries)	(2,563)	18,414
Net unrealized losses (gains) on investments	5,868	(11,057)
Net realized gains on investments	(3,849)	(4,762)
Change in operating assets and liabilities:		
Decrease (increase) in:		
Reinsurance receivables	10,277	4,021
Reconciliation receivables	2,709	(20,983)
Capitation and supplement receivables	9,732	93,924
Pharmacy receivable	(2,245)	2,919
Third party liability receivable	(34)	(724)
Interest receivable	47	69
Provider advances	(1,035)	2,921
Due from Aetna	(2,976)	-
Prepaid assets	(131)	55
Increase (decrease) in:		
Medical claims payable	(18,484)	340
Reconciliation payable	(19,558)	21,018
Deferred capitation revenue	25,360	-
Due to Aetna	(11,793)	2,183
Other current liabilities	671	(628)
Risk share settlement	(15,735)	(4,628)
Net cash (used in) provided by operating activities	(1,268)	172,406
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of investments	(129,037)	(135,712)
Proceeds from sale of investments	124,657	131,389
Net cash used in investing activities	(4,380)	(4,323)
CASH FLOWS FROM FINANCING ACTIVITIES		
Distributions to sponsor organizations	(30,000)	(60,000)
Net cash used in financing activities	(30,000)	(60,000)
NET CHANGE IN CASH AND CASH EQUIVALENTS	(35,648)	108,083
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	144,696	36,613
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 109,048	$ 144,696

See Notes to Financial Statements

(1) Company operations and significant accounting policies

Company operations - Southwest Catholic Health Network Corporation dba Mercy Care Plan (SCHN, or the Plan) is a nonprofit corporation, whose sponsor organizations are Dignity Health (Dignity), formerly known as Catholic Healthcare West, and Carondelet Health Network (Carondelet), collectively the "sponsors." SCHN provides medical care under various contracts with the Arizona Health Care Cost Containment System (AHCCCS), a department of the state of Arizona charged with administering health care for the state's indigent population. SCHN provides medical coverage under the AHCCCS contract for the following populations:

- AHCCCS Acute - Members eligible under Title XIX Medicaid program and Title XXI program requirements
- Arizona Long Term Care System (ALTCS) - Provide institutional care, home and community based services and behavioral health services to the long term care members
- AHCCCS Healthcare Group (HCG) - Provide coverage primarily to small businesses

SCHN also provides medical care to qualified members through a contract with the Arizona Department of Economic Security, Division of Developmental Disabilities (DES/DDD).

SCHN operates a Medicare Advantage Plan (Medicare Advantage) with the Centers for Medicare and Medicaid Services (CMS), offering medical and prescription drug benefits to qualified members. Medicare Advantage operates as a special needs plan under CMS guidelines. The populations covered under Medicare Advantage are members who are eligible for both Medicare and Medicaid coverage. Virtually all of the members of Medicare Advantage receive their Medicaid benefits through one of SCHN's AHCCCS contracts.

SCHN has entered into a management agreement with Aetna through June 30, 2013, which automatically renews for successive one-year periods. Under the terms of the agreement, SCHN pays a monthly fee to Aetna, as defined in the agreement, to cover the employee salary and benefit costs and general and administrative expenses incurred to operate the Plan. SCHN paid management fees per the agreement of approximately $116,478,000 and $142,193,000 for the years ended June 30, 2012 and 2011, respectively.

The agreement provides for a share of risk of the results of operations. Subject to certain performance measures, amounts will either be due from or due to Aetna. Additionally, the agreement provides for supplemental compensation to be received from Aetna upon meeting certain performance measures. At June 30, 2012 and 2011, net amounts due from (to) Aetna were approximately $2,976,000 and ($11,793,000), respectively, relating to these provisions in the agreement.

A summary of the Plan's significant accounting policies follows:

Basis of presentation - The accompanying financial statements have been prepared in accordance with FASB ASC 954-205, *Health Care Entities – Presentation of Financial Statements*. SCHN's financial statements are also presented in accordance with FASB ASC 958-205, *Not-for-Profit Entities – Presentation of Financial Statements.* Under FASB ASC 958-205, SCHN is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets and permanently restricted net assets. As of June 30, 2012 and 2011, there were no temporarily restricted or permanently restricted net assets.

(1) Company operations and significant accounting policies (continued)

Capitation premiums - The Plan receives from AHCCCS, DES/DDD and CMS fixed capitation payments, generally in advance, based on certain rates for each member enrolled with the Plan. The Plan is required to provide all covered health care services to their members, regardless of the cost of care. If there are funds remaining, the Plan retains the funds as profit; if the costs are higher than the amount of capitation payments, the Plan absorbs the loss. Capitation premiums are recognized in the month that enrollees are entitled to health care services. Certain provisions of the AHCCCS Acute, HCG, DDD and ALTCS contracts include a risk band whereby SCHN and the AHCCCS programs share in the profits and losses of the contract, as defined in the respective contracts (reconciliation revenue). SCHN has recorded an estimate of the reconciliation revenue, within capitation premiums, based on the operational performance of the AHCCCS Acute, HCG, DDD and ALTCS lines of business. The Plan may recover certain losses for those cases eligible for reinsurance payments. Medicare Advantage capitation premiums received in the month prior to enrollee coverage are deferred and recognized in revenue in the succeeding month. During fiscal years 2012 and 2011, the Plan received approximately $25,360,000 and $0, respectively, Medicare Advantage capitation premiums related to future enrollee coverage. Accordingly, these funds are included in deferred capitation revenue in the accompanying statements of financial position.

Capitation is paid prospectively as well as for prior period coverage (PPC). The PPC period is from the first day of the month of member's application to the time of enrollment with a contracted health plan. The risk under PPC is shared by both the Plan and AHCCCS for the contract year ending September 30, 2012 and 2011. AHCCCS reconciles the actual PPC medical costs to the PPC capitation paid during the contract year.

The Plan shares risk with AHCCCS and DES/DDD for specific populations as follows:

- Acute Prospective
- Title XIX Waiver Group Prospective
- Acute Prior Period Coverage
- ALTCS Prior Period Coverage
- DDD
- Health Care Group Risk Based Performance
- Home and Community Based Services
- Share of Cost

Reconciliation balances are stated at the amount management expects to collect or pay. As of June 30, 2012, the Plan recorded a reconciliation receivable of $11,439,000 and a reconciliation payable of $31,705,000. As of June 30, 2011, the Plan recorded a reconciliation receivable of $11,314,000 and a reconciliation payable of $51,263,000. Reconciliation receivable and payable amounts pertaining to separate contracting agencies cannot be offset against reconciliation receivable and payable balances of a different contracting agency, and as such, amounts have been presented separately as a payable and receivable balance on the accompanying statements of financial position. Management provides for probable uncollectible amounts through a charge to earnings and a credit to a valuation allowance based on its assessment of the current status of individual balances. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to reconciliation receivables. At June 30, 2012 and 2011, reconciliation receivables were net of an allowance for doubtful accounts of approximately $3,197 and $0, respectively.

(1) Company operations and significant accounting policies (continued)

Delivery supplemental revenue - Delivery supplemental revenue is reimbursement from AHCCCS intended to cover the expenses related to deliveries. Such premiums are recognized in the month that services are rendered. The Plan earned approximately $57,286,000 and $61,912,000 of this supplemental revenue in fiscal 2012 and 2011, respectively.

HIV-AIDS supplemental revenue - HIV-AIDS supplemental revenue is reimbursement DDD intended to help defray the costs of HIV/AIDS drugs. Such premiums are recognized in the month that services are rendered. The Plan earned approximately $31,000 and $20,000 of this supplemental revenue in fiscal years 2012 and 2011, respectively.

Reinsurance revenue - AHCCCS and DES/DDD provide a stop-loss reinsurance program for the Plan for partial reimbursement of reinsurable covered medical services incurred for members. The program includes a deductible, which varies based on the Plan’s enrollment and the eligibility category of the members. AHCCCS and DES/DDD reimburse the Plan based on a coinsurance amount for reinsurable covered services incurred above the deductible. SCHN contracts with a commercial reinsurer to provide reinsurance for the Medicare Advantage Plan. Reinsurance revenue is stated at the actual and estimated amounts due to SCHN pursuant to the AHCCCS Acute, DES/DDD, HCG, ALTCS and Medicare Advantage Plan contracts. Below are the reinsurance thresholds by line of business:

Line of Business	Annual Deductible Effective October 1, 2011	Annual Deductible Effective October 1, 2010	Coinsurance
AHCCCS Acute – Prospective Only	$ 20,000	$ 20,000	75%
Title XIX Waiver Group – Prospective Only	20,000	20,000	75
DES/DDD	20,000	20,000	75
DES/DDD Ventilator Dependent	No deductible	No deductible	100
ALTCS w/Medicare	20,000	20,000	75
ALTCS w/o Medicare	30,000	30,000	75

Line of Business	Annual Deductible Effective July 1, 2011	Annual Deductible Effective July 1, 2010	Coinsurance
HCG – Effective July 1, 2011 and 2010	$ 225,000	$ 165,000	90%

Line of Business	Annual Deductible Effective January 1, 2012	Annual Deductible Effective January 1, 2011	Coinsurance
Medicare Advantage – effective January 1, 2012 and 2011	$ 750,000	$ 500,000	90%

(1) Company operations and significant accounting policies (continued)

To be eligible for reinsurance billing, qualified healthcare expenses must be incurred during the contract year. Reinsurance revenue is recorded based on actual billed reinsurance claims adjusted for medical cost completion factors and SCHN's historical collection experience. Reinsurance revenue is subject to review by AHCCCS, DES/DDD, and the Medicare Advantage Plan's commercial reinsurer, and as a result, there is at least a reasonable possibility that recorded reinsurance revenue will change by a material amount in the near future.

Reinsurance receivable is the expected payment from AHCCCS, DES/DDD, and the Medicare Advantage Plan's commercial insurer to the Plan for certain enrollees whose qualifying medical expenses paid by the Plan were in excess of specified deductible limits. Reinsurance receivables are stated at the amount management expects to collect. Management provides for probable uncollectible amounts through a charge to earnings and a credit to a valuation allowance based on its assessment of the current status of individual balances. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to reinsurance receivable. At June 30, 2012 and 2011, reinsurance receivable was net of an allowance for doubtful accounts of approximately $6,496,000 and $6,922,000, respectively.

Cash and cash equivalents - Cash includes cash deposits in banks and cash equivalents. SCHN considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. Amounts at each institution are insured in limited amounts by the Federal Deposit Insurance Corporation (FDIC).

Pharmacy receivable - SCHN receives rebates from pharmaceutical companies based on the volume of drugs purchased. SCHN records a receivable and a reduction of health care expenses for estimated rebates due based on purchase information. During the years ended June 30, 2012 and 2011, health care expenses were reduced by approximately $10,907,000 and $8,220,000 of rebates, respectively. At June 30, 2012 and 2011, management believes these receivables are fully collectible and accordingly, an allowance has not been established.

Third party liability receivable - In cases such as motor vehicle accidents and worker's compensation claims, a third party insurer may be liable for a claim. When SCHN pays claims on behalf of its members and determines a third party insurance company is ultimately responsible for that claim, it estimates a receivable and recoups the claim cost from the third party insurer. Third party liability receivables are stated at the amount management expects to collect. Management provides for probable uncollectible amounts through a charge to earnings and a credit to a valuation allowance based on its assessment of the current status of individual balances. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to third party liability receivable. At June 30, 2012 and 2011, third party liability receivable was net of an allowance for doubtful accounts of approximately $1,601,000 and $1,183,000, respectively.

Provider advances - Upon request, SCHN may advance monies to high-volume providers based on cash flow needs and timing of claims payments. Advances are stated at the amount management expects to collect or offset against future claims. Advances are non-interest bearing and are expected to be settled within 12 months. Management provides for probable uncollectible amounts through a charge to earnings and a credit to a valuation allowance based on its assessment of the current status of individual balances. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to provider advances receivable. At June 30, 2012 and 2011, provider advance receivables were net of an allowance for doubtful accounts of approximately $1,797,000 and $1,100,000, respectively.

(1) Company operations and significant accounting policies (continued)

Investments - Investments are recorded in accordance with FASB ASC 958-320, *Investments-Debt and Equity Securities* and FASB ASC 958-325, *Not-for-Profit Entities Investments – Other*. Under FASB ASC 958-320 and FASB ASC 958-325, SCHN reports investments in equity securities that have readily determinable fair values, and all investments in debt securities at fair value based on quoted market prices. Investment securities without quoted market prices are valued at estimated fair value using appropriate valuation methods that consider the underlying assets. SCHN's investment portfolio is managed by professional investment managers within guidelines established by SCHN's Board of Directors which, as a matter of policy, limits the amounts which may be invested in any one issuer or type of investment.

Investment securities in general, are exposed to various risks, such as interest rate, credit, and overall market volatility. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the near term could materially affect account balances and the amounts reported in the accompanying financial statements.

Investment income - Investment income consists of interest, dividends, and realized gains and losses on investments. Interest is recognized on the accrual basis, and dividends are recorded as earned on the ex-dividend date. Interest income on mortgage- and asset-backed securities is determined on the effective yield method based on estimated principal repayments. Accrual of income is suspended for bonds and mortgage loans that are in default or when the receipt of interest payments is in doubt. Accrual of income has not been suspended for any bonds or mortgage loans during the years ended June 30, 2012 and 2011. SCHN has a policy to review and identify investments with declines in value that would be considered to be other-than-temporary. Such other-than-temporary declines, if significant, are accounted for as realized losses (See Note 3).

Risk share settlement - The risk share settlement represents expected payments to be paid to or received from CMS in connection with the pharmacy component of Medicare Advantage. This balance is reviewed and monitored by management and adjusted as necessary as experience develops or new information becomes available. Such adjustments are netted against the capitation premiums on the statements of activities and changes in net assets. The pharmacy risk share settlement for calendar year 2012 and 2011, recorded at June 30, 2012, is expected to be finalized in late 2013 and 2012, respectively.

Health Care Group - medical loss ratio reconciliation - Effective January 1, 2011, HCG issued an amendment to its contract to include a provision for application of Plan operating profits over six percent (6%) to any outstanding reconciliation receivable balance. If the annual operating profit for SCHN exceeds six percent (6%), the amount in excess shall be applied to reduce the reconciliation receivable balance. The amount used to reduce the reconciliation receivable balance for fiscal 2012 and 2011 was approximately $2,187,000 and $1,302,000, respectively.

Premium deficiency reserve - SCHN evaluates possible losses on its contracts through the end of each contract year. If necessary, a premium deficiency reserve is recorded within medical claims payable on the statement of financial position. As of June 30, 2012 and 2011, no premium deficiency reserve was considered necessary.

Healthcare service cost recognition - The costs of providing hospitalization, medical compensation, ancillary and other medical services, institutional, and home and community based services are accrued in the period in which the service is provided to eligible recipients based in part on estimates, including an accrual for services incurred but not yet reported to SCHN.

(1) <u>Company operations and significant accounting policies (continued)</u>

The estimate for unreported services payable is developed using actuarial methods based on historical experience and are continually reviewed by management and adjusted as necessary based on current claims data, and medical cost completion factors. Such adjustments are included in health care expenses in the statements of activities and changes in net assets in each period when necessary. While management believes the amount is adequate, the ultimate liability may be in excess of or less than the amount provided. There is at least a reasonable possibility that the recorded estimates will change by a material amount, in the near future.

Management's use of estimates - The preparation of the financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates include reconciliation receivables/payables, risk share settlements, the allowances for doubtful accounts and the estimate for medical claims payable.

Premium taxes - SCHN is subject to a 2% tax on all payments received from AHCCCS for premiums, reinsurance, and reconciliations.

Income taxes - Southwest Catholic Health Network Corporation dba Mercy Care Plan qualifies as a tax exempt organization under Section 501(c)(3) of the Internal Revenue Code (the "Code") and, therefore, there is no provision for income taxes included in the accompanying financial statements. Income determined to be unrelated business taxable income (UBTI) would be taxable.

FASB ASC 740-10, *Income Taxes*, relates to the accounting for uncertainty income taxes which requires the application of a "more likely than not" threshold recognition and de-recognition of uncertain tax positions in operations in the year of such change. SCHN evaluates their uncertain tax positions, if any, on a continual basis through review of their policies and procedures, review of their regular tax flings, and discussions with outside experts. At June 30, 2012 and 2011, SCHN did not have any uncertain tax positions.

SCHN's Federal Exempt Organization Business Income Tax Returns (Form 990) for 2009, 2010, and 2011 are subject to examination by the IRS, generally for the three years after they were filed. As of the date of this report, the fiscal 2012 tax returns had not yet been filed.

Performance indicator - The statement of activities includes the performance indicator operating income. The performance indicator excludes nonoperating income (expense), net unrealized investment gains (losses), and gain on settlement of pension plan, which is consistent with industry practice.

Recent accounting pronouncement - In July 2011, the FASB issued Accounting Standards Update No. 2011-07, *Health Care Entities* (Topic 954) – *Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities* ("ASU 2011-07"). ASU 2011-07 requires healthcare entities to change the presentation of their statements of operations by reclassifying any provision for bad debts associated with patient service revenue from an operating expense to a deduction from patient service revenue. ASU 2011-07 also requires enhanced disclosure about policies for recognizing revenue and assessing bad debts. ASU 2011-07 is effective for interim and annual reporting periods ending after December 31, 2012. The adoption of ASU 2011-07 is not expected to have a significant impact on the Plan's operations.

(1) Company operations and significant accounting policies (continued)

Subsequent events - SCHN has evaluated subsequent events through October 22, 2012, which is the date the financial statements were available to be issued. See Note 9 for contract extensions. No other subsequent events requiring disclosure were identified.

(2) Reconciliation

Reconciliation balances are recorded as a net receivable or payable on the statement of financial position by line of business. HCG is recorded as a short term/long term receivable. At June 30, 2011, reconciliation receivables are considered to be collectible in full; therefore, an allowance for doubtful accounts is not considered necessary. A summary of the balances by line of business for the years ended June 30 are as follows (in thousands):

	2012		2011	
	Reconciliation Receivable	Reconciliation Payable	Reconciliation Receivable	Reconciliation Payable
Acute	$ 8,086	$ 24,592	$ 3,215	$ 45,201
ALTCS	3,535	-	1,564	264
DDD	-	7,113	-	5,798
HCG	3,015	-	6,535	-
Total	14,636	31,705	11,314	51,263
Allowance for doubtful accounts	(3,197)	-	-	-
Total, net	11,439	31,705	11,314	51,263
Less current portion	(9,737)	(31,705)	(8,042)	(51,263)
Non-current portion	$ 1,702	$ -	$ 3,272	$ -

Amounts expected to be collected from HCG are as follows (in thousands):

2013	$ 1,314
2014	1,702
Total	$ 3,016

(3) Investments

The cost and fair value of SCHN's investments by type at June 30 are as follows (in thousands):

	2012		2011	
	Cost	Fair Value	Cost	Fair Value
Short-term:				
Marketable equity securities	$ 26,353	$ 26,353	$ 24,214	$ 24,214
Corporate bonds	12,415	11,917	8,293	8,167
U.S. Government securities	-	-	4,370	4,223
	38,768	38,270	36,877	36,604
Long-term:				
Marketable equity securities	67,296	71,366	62,193	71,941
U.S. Government securities	16,892	16,953	9,529	9,684
Corporate bonds	55,114	57,227	57,588	59,504
Mortgage-backed securities	12,387	12,563	16,042	16,354
Preferred securities	1,551	1,810	1,551	1,741
	153,240	159,919	146,903	159,224
	$ 192,008	$ 198,189	$ 183,780	$ 195,828

(3) Investments (continued)

Investment income for the years ended June 30 is comprised of the following (in thousands):

	2012	2011
Revenue (included in nonoperating investment income):		
Interest and dividend income	$ 5,397	$ 5,525
Realized gains on investments	3,849	4,762
	$ 9,246	$ 10,287

Management continually reviews its investment portfolio and evaluates whether declines in the fair value of securities should be considered other-than-temporary. Factored into this evaluation are the general market conditions, the issuer's financial condition and near-term prospects, conditions in the issuer's industry, the recommendation of advisors and the length of time and extent to which the market value has been less than cost. During the years ended June 30, 2012 and 2011, SCHN recorded no losses for other-than-temporary declines in the fair value of investments.

The following table summarizes the unrealized losses on investments held at June 30, 2012 (in thousands):

	Less than twelve months		Twelve months or longer		Total	
Description of securities	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
U.S. Government securities	$ -	$ -	$ 9,085	$ 8	$ 9,085	$ 8
Marketable equity securities	-	-	21,476	3,229	21,476	3,229
Corporate bonds	11,038	504	14,827	322	25,865	826
Mortgage-backed securities	-	-	2,969	4	2,969	4
Preferred securities	-	-	-	-	-	-
Total	$ 11,038	$ 504	$ 48,357	$ 3,563	$ 59,395	$ 4,067

The following table summarizes the unrealized losses on investments held at June 30, 2011 (in thousands):

	Less than twelve months		Twelve months or longer		Total	
Description of securities	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
U.S. Government securities	$ 4,223	$ 148	$ 2,396	$ 6	$ 6,619	$ 154
Marketable equity securities	-	-	16,590	1,798	16,590	1,798
Corporate bonds	5,115	163	24,050	338	29,165	501
Mortgage-backed securities	-	-	5,870	23	5,870	23
Preferred securities	-	-	-	-	-	-
Total	$ 9,338	$ 311	$ 48,906	$ 2,165	$ 58,244	$ 2,476

(3) Investments (continued)

Long-term investments can be liquidated without significant penalty within twenty-four hours, and are considered short-term for purposes of calculating current ratios under AHCCCS reporting guidelines.

(4) Fair value measurements

FASB ASC 820, *Fair Value Measurements and Disclosures,* establishes a common definition for fair value to be applied to U.S. generally accepted accounting principles requiring use of fair value, establishes a framework for measuring fair value, and expands disclosures about such fair value measurements. FASB ASC 820 establishes a hierarchy for ranking the quality and reliability of the information used to determine fair values. The statement requires that assets and liabilities carried at fair value be classified and disclosed in one of the following three categories:

Level 1: Inputs to the valuation methodology are unadjusted quoted prices 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 financial instrument.

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

The following table sets forth by level, within the fair value hierarchy, SCHN's investments at fair value as of June 30, 2012 (in thousands):

	(Level 1)	(Level 2)	(Level 3)	Total
U.S. government securities	$ 16,953	$ -	$ -	$ 16,953
Marketable equity securities				
U.S. large cap	71,366	-	-	71,366
Money market mutual funds	17,825	-	-	17,825
Other	8,528	-	-	8,528
Total marketable equity securities	97,719	-	-	97,719
Corporate bonds	69,144	-	-	69,144
Mortgage-backed securities	-	12,563	-	12,563
Preferred securities	1,810	-	-	1,810
Total	$ 185,626	$ 12,563	$ -	$ 198,189

(4) Fair value measurements (continued)

The following table sets forth by level, within the fair value hierarchy, SCHN's investments at fair value as of June 30, 2011 (in thousands):

	(Level 1)	(Level 2)	(Level 3)	Total
U.S. government securities	$ 13,906	$ -	$ -	$ 13,906
Marketable equity securities				
U.S. large cap	70,525	-	-	70,525
Emerging markets	1,415	-	-	1,415
Money market mutual funds	17,802	-	-	17,802
Other	6,413	-	-	6,413
Total marketable equity securities	96,155	-	-	96,155
Corporate bonds	67,672	-	-	67,672
Mortgage-backed securities	-	16,354	-	16,354
Preferred securities	1,741	-	-	1,741
Total	$ 179,474	$ 16,354	$ -	$ 195,828

The Plan currently has no other financial instruments subject to fair value measurement.

For financial instruments not addressed previously and not reported at fair value, the carrying amounts approximate fair value because of the short maturities of the following: cash and cash equivalents, receivables, provider advances, due from Aetna, risk share settlement, medical claims payable, reconciliation payable, due to Aetna, and other current liabilities.

(5) Medical claims payable

At June 30, 2012 and 2011, claims outstanding to third parties for health care services provided to members, including estimates for incurred but not reported claims, were approximately $148 million and $166 million, respectively. The balances at June 30, 2012 and 2011 were certified by an actuary. Activity in the liability for medical claims payable and health care expense for the years ended June 30, 2012 and 2011 is as follows (in thousands):

	2012	2011
Balance at July 1	$ 166,187	$ 165,847
Incurred related to:		
Current year	1,409,642	1,456,418
Prior years	(9,553)	(22,954)
Total incurred	1,400,089	1,433,464
Paid related to:		
Current year	(1,267,533)	(1,297,073)
Prior years	(151,040)	(136,051)
Total paid	(1,418,573)	(1,433,124)
Balance at June 30	$ 147,703	$ 166,187

Estimates for incurred claims are based on historical enrollment, cost trends, and consider operational changes. Future actual results will typically differ from the estimates. Differences could be due to factors such as an overall change in medical expenses per member or a change in client mix affecting medical costs due to the addition of new members.

(5) Medical claims payable (continued)

The liability for claims unpaid at June 30, 2011 exceeded the actual claims incurred related to fiscal year 2011 and prior by approximately $10 million or 6%. The liability for claims unpaid at June 30, 2010 exceeded the actual claims incurred related to fiscal year 2010 and prior by approximately $23 million or 14%. The primary drivers for favorable claim development include member mix changes, active cost and encounter management, lower than anticipated member utilization, a shift from more costly inpatient and re-admittance utilization to physician office visits, inpatient unit cost reductions related to state-mandated outlier reform, increased speed of claims processing, and an increased initiative to recoup provider overpayments. SCHN continues to incur claims for prior periods. The medical claims payable is adjusted each period end as more information becomes available.

Estimated third-party subrogation included as a reduction to medical and hospital expenses in the accompanying statements of activities and changes in net assets at June 30, 2012 and 2011 totaled approximately $4,523,000 and $5,860,000, respectively.

(6) Related party transactions

SCHN paid approximately $60,185,000 in 2012 and $87,176,000 in 2011 to Dignity and approximately $17,116,000 in 2012 and $19,781,000 in 2011 to Carondelet for hospitalization and other medical services provided to its members. These balances include net prospective provider advance payments made to Dignity and Carondelet. At June 30, 2012, provider advances to Dignity and Carondelet amounted to approximately $7,885,000 and $423,000, respectively. At June 30, 2011 provider advances to Dignity and Carondelet amounted to approximately $8,959,000 and $1,080,000, respectively. During the year ended June 30, 2012 and 2011, SCHN made net asset distributions each year of $15,000,000 and $30,000,000 to both Dignity and Carondelet, respectively. The distributions were approved by AHCCCS.

(7) Retirement benefits

SCHN had a noncontributory defined benefit pension plan (Pension Plan) covering all eligible employees. All employees were covered on the first day of the month coincident with the completion of one year of service. Pension Plan benefits were based on the employee's career compensation.

Effective May 31, 2002, the Pension Plan was frozen based on salaries earned through April 30, 2002. SCHN continued to make annual contributions to the defined benefit pension plan in amounts sufficient to meet the minimum funding requirements of the Employment Retirement Income Security Act (ERISA). In July 2006, the Board of Directors of SCHN voted to terminate the Pension Plan. On April 5, 2010, the IRS approved the termination of the SCHN Pension Plan. The Pension Plan was unfunded by approximately $1,772,000 as of June 30, 2010 which was accrued for in other current liabilities on the statement of financial position. In April 2011, SCHN purchased a non-participating single premium group annuity contract for approximately $4,656,000 from Prudential Insurance Company of America ("Prudential") to settle the Pension Plan. To facilitate the purchase, SCHN transferred the Pension Plan assets totaling approximately $3,590,000 and approximately $1,066,000 of cash to Prudential. As a result of the transaction, SCHN reduced the $1,772,000 unfunded Pension Plan liability in the other current liabilities on the statement of financial position and recognized a gain on the statement of activities and changes in net assets on the transaction of approximately $579,000 during the year ended June 30, 2011.

(8) Commitments and contingencies

Letters of credit - At June 30, 2012 and 2011, SCHN has irrevocable standby letters of credit to satisfy the AHCCCS Acute, DES/DDD and ALTCS general performance bond requirements. Total amounts available are $61,650,000 at June 30, 2012 and 2011. No draws have been made on the letters of credit as of June 30, 2012 and 2011. The letters of credit are collateralized by certain investments of SCHN totaling approximately $159,919,000. The letters of credit are subject to current ratio and days claims outstanding covenants calculated on a quarterly basis.

To meet Medicare requirements, SCHN has entered into demand note agreements dated January 1, 2006 with Dignity and Carondelet which allows SCHN to draw, upon demand, up to a combined maximum amount of $10,000,000. There were no draws on the note agreements as of June 30, 2012 and 2011.

Contract compliance - Under the terms of the AHCCCS and Medicare Advantage (MCA) contracts, SCHN is required to meet certain financial covenants for both AHCCCS and CMS products. As of June 30, 2012 and 2011, SCHN is in compliance with the AHCCCS covenants. At June 30, 2012 and 2011, SCHN meets the MCA financial covenants.

Litigation - Periodically, SCHN is involved in litigation and claims arising in the normal course of operations. In the opinion of management based on consultation with legal counsel, losses, if any, from these matters are covered by insurance or are immaterial. Management believes that any resulting liability, if any, will not materially affect SCHN's financial position.

Healthcare regulation - 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, and Medicare and Medicaid fraud and abuse. 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. Management believes that SCHN is in compliance with fraud and abuse laws and regulations, as well as other applicable government laws and regulations. Compliance with such laws and regulations can be subject to future reviews and interpretation as well as regulatory actions unknown or unasserted at this time.

Health reform legislation at both the federal and state levels continues to evolve. Changes continue to impact existing and future laws and rules. Such changes may impact the way the Plan does business, restrict revenue and enrollment growth in certain products and market segments, restrict premium growth rates for certain products and market segments, increase medical, administrative and capital costs, and expose the Plan to increased risk of loss or further liabilities. The Plan's operating results, financial position and cash flows could be adversely impacted by such changes.

(9) Concentration of credit risk

Future contract awards are contingent upon the continuation of the AHCCCS Acute, DES/DDD, HCG, and ALTCS programs by the State of Arizona and SCHN's ability and desire to retain its status as a contractor under these programs. The AHCCCS Acute contract is effective through September 30, 2012, with one additional one year renewal options. The ALTCS contract will expire on September 30, 2014, with two additional one year renewal options. The DES/DDD contract was renewed through September 30, 2012. The HCG contract is effective through December 31, 2012. The Medicare Advantage contract is renewed annually by CMS. Failure to renew these contracts could have a significant impact on operations.

ADDITIONAL INFORMATION

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INDEPENDENT AUDITORS' REPORT ON ADDITIONAL INFORMATION

To the Board of Directors of

SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION
dba MERCY CARE PLAN

We have audited the financial statements of ***Southwest Catholic Health Network Corporation dba Mercy Care Plan*** as of and for the years ended June 30, 2012 and 2011, and our report thereon dated October 22, 2012, which expressed an unqualified opinion on those financial statements, appears on page 1. Our audits were conducted for the purpose of forming an opinion on the 2012 and 2011 financial statements as a whole. The financial information on pages 18 and 19 are presented for purposes of additional analysis and are not a required part of the 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 financial statements. The information has been subjected to the auditing procedures applied in the audits of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with U.S. generally accepted auditing standards. In our opinion, the information is fairly stated in all material respects in relation to the financial statements taken as a whole.

Mayer Hoffman McCann P.C.

Phoenix, Arizona
October 22, 2012

SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION
dba MERCY CARE PLAN

SUPPLEMENTAL STATEMENT OF FINANCIAL POSITION

June 30, 2012
(In thousands)

ASSETS

	Acute	DES/DDD	HCG	ALTCS	Medicare	Total
CURRENT ASSETS						
Cash and cash equivalents	$ 109,048	$ -	$ -	$ -	$ -	$ 109,048
Short-term investments	19,072	2,248	271	14,782	1,897	38,270
Receivables:						
Reinsurance receivables, net	20,426	662	-	10,524	86	31,698
Reconciliation receivables, net	4,889	-	1,313	3,535	-	9,737
Capitation and supplement receivables	1,033	-	-	31	6,779	7,843
Pharmacy receivable	1,875	95	33	178	2,478	4,659
Third party liability receivable, net	5,040	120	60	780	-	6,000
Interest receivable	454	53	6	352	45	910
Provider advances, net	7,838	2,261	253	1,917	1,172	13,441
Due from Aetna	1,645	95	26	405	805	2,976
Risk share settlement	-	-	-	-	2,735	2,735
Prepaid assets	378	-	-	-	-	378
Intercompany	(67,892)	1,882	4,144	17,762	44,104	-
TOTAL CURRENT ASSETS	103,806	7,416	6,106	50,266	60,101	227,695
RECONCILIATION RECEIVABLES, less current portion	-	-	1,702	-	-	1,702
RISK SHARE SETTLEMENT, less current portion	-	-	-	-	5,033	5,033
LONG-TERM INVESTMENTS	79,698	9,392	1,131	61,769	7,929	159,919
TOTAL ASSETS	$ 183,504	$ 16,808	$ 8,939	$ 112,035	$ 73,063	$ 394,349

LIABILITIES AND NET ASSETS

	Acute	DES/DDD	HCG	ALTCS	Medicare	Total
CURRENT LIABILITIES						
Medical claims payable	$ 73,517	$ 2,793	$ 869	$ 48,140	$ 22,384	$ 147,703
Reconciliation payable	24,592	7,113	-	-	-	31,705
Deferred capitation revenue	-	-	-	-	25,360	25,360
Other current liabilities	3,934	37	1	2,807	2,218	8,997
TOTAL CURRENT LIABILITIES	102,043	9,943	870	50,947	49,962	213,765
UNRESTRICTED NET ASSETS	81,461	6,865	8,069	61,088	23,101	180,584
TOTAL LIABILITIES AND NET ASSETS	$ 183,504	$ 16,808	$ 8,939	$ 112,035	$ 73,063	$ 394,349

SOUTHWEST CATHOLIC HEALTH NETWORK CORPORATION
dba MERCY CARE PLAN

SUPPLEMENTAL STATEMENT OF ACTIVITIES AND CHANGES IN NET ASSETS

Year Ended June 30, 2012
(In thousands)

	Acute	DES/DDD	HCG	ALTCS	Medicare	Total
OPERATING REVENUES						
Capitation premiums	$ 882,737	$ 36,270	$ 10,147	$ 369,352	$ 306,484	$ 1,604,990
Delivery/HIV-AIDS supplement	57,286	31	-	-	-	57,317
Reinsurance	44,796	953	36	25,614	1,091	72,490
Other, primarily third party recoveries	3,812	16	60	392	314	4,594
TOTAL OPERATING REVENUES	988,631	37,270	10,243	395,358	307,889	1,739,391
HEALTH CARE EXPENSES						
Hospitalization	219,869	5,624	1,894	20,844	103,473	351,704
Medical compensation	244,315	3,482	1,967	9,476	36,390	295,630
Ancillary and other medical services	420,768	25,035	4,336	56,273	134,991	641,403
Institutional	-	-	-	147,640	-	147,640
Home and community based services	-	-	-	135,854	-	135,854
TOTAL HEALTH CARE EXPENSES	884,952	34,141	8,197	370,087	274,854	1,572,231
GENERAL AND ADMINISTRATIVE EXPENSES	66,610	3,404	617	21,611	27,312	119,554
PREMIUM TAX EXPENSE	19,710	-	-	7,890	-	27,600
TOTAL EXPENSES	971,272	37,545	8,814	399,588	302,166	1,719,385
OPERATING INCOME (LOSS)	17,359	(275)	1,429	(4,230)	5,723	20,006
NONOPERATING INCOME (EXPENSE)						
Investment income	4,605	546	64	3,572	459	9,246
Investment fees	(567)	(57)	(7)	(373)	(48)	(1,052)
Other income	139	-	-	-	-	139
TOTAL NONOPERATING INCOME	4,177	489	57	3,199	411	8,333
CHANGE IN NET ASSETS PRIOR TO UNREALIZED LOSSES ON INVESTMENTS	21,536	214	1,486	(1,031)	6,134	28,339
UNREALIZED LOSSES ON INVESTMENTS	(3,782)	(360)	(70)	(1,327)	(329)	(5,868)
CHANGE IN NET ASSETS PRIOR TO DISTRIBUTIONS	17,754	(146)	1,416	(2,358)	5,805	22,471
DISTRIBUTIONS TO SPONSOR ORGANIZATIONS	(10,000)	-	-	(20,000)	-	(30,000)
CHANGE IN NET ASSETS	7,754	(146)	1,416	(22,358)	5,805	(7,529)
NET ASSETS, BEGINNING OF YEAR	73,707	7,011	6,653	83,446	17,296	188,113
NET ASSETS END OF YEAR	$ 81,461	$ 6,865	$ 8,069	$ 61,088	$ 23,101	$ 180,584