

PHI

Consolidated Financial Statements

December 31, 2003 and 2002

(With Independent Auditor's Report Thereon)

PHI

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Certification of Chief Executive and Chief Financial Officers


We are responsible for the enclosed financial statements and supporting information of PHI as of December 31, 2003 and 2002. We believe they are presented fairly and accurately.


The accuracy and completeness of financial information depends on our systems, process, and most importantly our integrity. We are responsible for our financial integrity and systems. We place a high value on each of these, and believe that our processes and people produce the results that can be trusted.

Financial statements report our financial condition and results using numbers and prescribed rules. They also include a significant amount of information that is required by financial reporting standards. We have also disclosed additional information that we feel is important to create a complete picture of PHI's financial condition. We believe that all of the information contained in this report is accurate and can be trusted by the financial community, PHI's constituents, and the general public.

Financial statements alone can never reflect the breadth and depth of the services that are provided every day by the entire PHI family. They do not reflect our most significant assets, our employees and volunteers. They also do not include our most important result; compassionate care provided to seniors in need of healthcare, housing, and other supportive services. We believe that we continue to successfully fulfill our financial and non-financial mission, extending a proud tradition of ministry that extends for more than 75 years.

Finally, we believe in openly and honestly sharing information. Please feel free to contact either of us if you have questions on any part of this report, or if we can be of further assistance in interpreting PHI's mission.


Stephen Proctor
Chief Executive Officer
PHI


Jeffrey J. Davis
Chief Financial Officer
PHI

Independent Auditor's Report

The Board of Trustees
PHI:

We have audited the accompanying consolidated statements of financial position of PHI and affiliates (collectively the Corporation), as of December 31, 2003 and 2002, and the related consolidated statement of activities and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the financial statements of Geneva House, Inc., and Presbyterian Apartments, Inc., affiliates of PHI, which statements reflect total assets constituting 1.09 and 1.23 percent and total revenues constituting .57 and .92 percent, of the related 2003 and 2002 consolidated totals, respectively. We also did not audit the 2002 financial statements of Continuing Care Rx, Inc., an affiliate of PHI, whose statements reflect total assets constituting 3.46 percent and total revenues constituting 26.49 percent, of the related consolidated total. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates to the amounts included for Geneva House, Inc., Presbyterian Apartments, Inc. and Continuing Care Rx is based solely on the reports of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit 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 consolidated financial statement presentation. We believe that our audits and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of PHI and affiliates as of December 31, 2003 and 2002 and the results of their operations, changes in their net assets and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Beard Miller Company LLP

Lancaster PA
February 27, 2004

PHI

Consolidated Statements of Financial Position

December 31, 2003 and 2002

Assets	2003	2002
Current assets:		
Cash and cash equivalents	\$ 4,098,528	2,913,815
Investments	29,293,698	24,690,919
Accounts receivable, net	10,076,711	10,354,657
Assets whose use is limited - current portion	1,177,213	1,231,541
Pledges receivable, current portion	123,922	-
Interest receivable	182,278	257,742
Inventory	2,409,421	1,896,685
Prepaid expenses and other current assets	1,068,071	976,453
Total current assets	48,429,842	42,321,812
Assets whose use is limited, net of current portion	9,962,848	7,849,027
Assets whose use is limited, construction funds held by trustee	9,927,751	-
Pledges receivable, net of current portion	1,012,699	-
Property and equipment (net of accumulated depreciation of \$92,057,494 and \$85,102,124)	146,328,745	151,020,427
Assets held in trust by others	6,771,590	6,544,558
Unamortized deferred costs:		
Deferred marketing costs, net of accumulated amortization of \$1,741,496 and \$1,518,393	773,076	996,180
Deferred financing costs, net of accumulated amortization of \$562,978 and \$385,441	3,961,662	2,645,793
Goodwill, net of accumulated amortization of \$21,737 and \$517,201	194,950	2,094,227
Other assets	34,901	773,634
Total assets	\$ 227,398,064	214,245,658

See accompanying notes to consolidated financial statements.

PHI

Consolidated Statements of Financial Position

December 31, 2003 and 2002

Liabilities and Net Liabilities	2003	2002
Current liabilities:		
Accounts payable	\$ 8,829,868	8,047,111
Swap termination fee payable	1,795,000	—
Accrued expenses - other	7,462,646	6,711,424
Notes payable	5,228,136	6,979,585
Current portion of annuities payable	136,922	110,327
Accrued interest	641,600	631,318
Current maturities of long-term debt	2,870,846	3,270,073
Total current liabilities	26,965,018	25,749,838
Resident deposits	1,717,217	1,634,530
Deferred revenue - entrance fees	62,067,004	62,308,322
Deferred revenue - other	129,801	—
Fair value of interest rate hedges	705,573	3,280,199
Annuities payable	801,120	605,128
Long-term debt, less current maturities:	138,656,096	125,294,228
Total liabilities	231,041,829	218,872,245
Net (liabilities) assets:		
Unrestricted	(16,067,488)	(14,802,001)
Temporarily restricted	3,793,923	2,208,001
Permanently restricted	8,629,800	7,967,413
Total net liabilities	(3,643,765)	(4,626,587)
Total liabilities and net liabilities	\$ 227,398,064	214,245,658

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Activities

Years ended December 31, 2003 and 2002

	2003	2002
Revenues, gains, and other support:		
Resident services, including amortization of entrance fees of \$7,743,552 and \$7,232,918	\$ 94,547,595	90,531,396
Sales of other services and materials	39,869,684	31,646,397
Net rental income	1,213,328	1,213,541
Interest and dividend income	1,391,198	1,833,656
Realized (losses) gains on investments	(123,792)	411,715
Gifts and bequests	672,667	1,080,363
Net assets released from restrictions	342,139	372,521
Total revenues, gains, and other support	137,912,819	127,089,589
Expenses:		
Nursing services	29,667,823	28,192,710
Rehabilitation	3,055,841	2,961,599
Recreation and special services	3,076,144	2,788,991
Pharmacy	140,379	(210,332)
Social services	384,198	351,239
Physician services	232,469	201,764
Patient medical services	918,609	791,014
Food services	11,341,585	10,951,068
Building operations and maintenance	10,173,502	9,240,925
Housekeeping	2,781,485	2,623,810
Laundry and linen	1,139,606	1,074,151
Cost of sales, other services, and materials	28,068,815	22,778,625
General and administrative	23,695,664	20,889,055
Employee benefits	5,073,073	4,345,542
Interest	7,018,797	7,611,294
Depreciation	8,588,829	8,626,981
Amortization	740,120	520,257
Change in fair value of interest rate hedges	(2,574,626)	1,684,344
Loss on extinguishment of debt	76,944	1,357,591
Realized loss on interest rate swap termination	1,795,000	-
Change in estimated life of goodwill	1,734,123	-
Total expenses	137,128,380	126,780,628
Change in unrestricted net assets (liabilities) before unrealized gains (losses) on investments, loss on discontinued operations and taxes	784,439	308,961
Unrealized gains (losses) on investments	1,203,060	(1,129,406)
Loss on discontinued operations	(1,973,363)	(1,558,798)
Taxes on income of for-profit subsidiary	(1,279,623)	(692,337)
Change in unrestricted net assets (liabilities)	(1,265,487)	(3,071,580)

See accompanying notes to consolidated financial statements.

(Continued)

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Consolidated Statements of Activities

Years ended December 31, 2003 and 2002

	<u>2003</u>	<u>2002</u>
Temporarily restricted net assets:		
Contributions, grants and bequests	1,771,602	454,927
Interest and dividend income	72,005	72,569
Unrealized gain (loss) on investments	84,454	(327,800)
Net assets released from restrictions	<u>(342,139)</u>	<u>(372,521)</u>
Change in temporarily restricted net assets	<u>1,585,922</u>	<u>(172,825)</u>
Permanently restricted net assets:		
Contributions	433,884	286,495
Change in fair value of assets held in trust by others	<u>228,503</u>	<u>(918,284)</u>
Change in permanently restricted net assets	<u>662,387</u>	<u>(631,789)</u>
Change in net assets (liabilities)/stockholder's equity	982,822	(3,876,194)
Net liabilities, beginning of year	<u>(4,626,587)</u>	<u>(750,393)</u>
Net liabilities, end of year	<u>\$ (3,643,765)</u>	<u>(4,626,587)</u>

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Cash Flows

Years ended December 31, 2003 and 2002

	<u>2003</u>	<u>2002</u>
Cash flows from operating activities:		
Change in net assets (liabilities)	\$ 982,822	(3,876,194)
Adjustments to reconcile change in net assets (liabilities) to net cash provided by operating activities:		
Depreciation	8,744,996	9,191,540
Proceeds from entrance fees and deposits	13,306,217	11,790,307
Amortization of entrance fees	(7,743,552)	(7,232,918)
Realized gains on sale of fixed assets	(438,619)	(172,635)
Loss on extinguishment of debt	76,944	1,357,591
Change in assets held in trust by others	(429,082)	(355,108)
Change in fair value of interest rate hedges	(779,626)	1,684,344
Unrealized (gains) losses on investments	(1,516,017)	2,490,610
Realized losses (gains) on investments	123,792	(411,715)
Realized loss on interest rate swap	(1,795,000)	-
Contributions restricted for long-term purposes	(264,034)	(286,495)
Amortization of deferred costs	700,874	504,563
Amortization of bond discount	41,606	36,009
Change in estimated life of goodwill	1,734,123	-
Changes in assets and liabilities:		
Decrease (increase) in accounts receivable	277,946	(1,352,686)
Increase in pledges receivable	(1,136,621)	-
Decrease (increase) in other assets	209,844	(20,893)
Increase in accounts payable	782,757	1,131,747
Swap termination fee payable	1,795,000	-
Increase (decrease) in accrued expenses and deferred revenue-other	891,305	(417,203)
Net cash provided by operating activities	<u>15,565,675</u>	<u>14,060,864</u>
Cash flows from investing activities:		
Acquisition of property and equipment, net of disposals	(7,640,338)	(5,039,033)
Net proceeds from sale of property and equipment	4,007,318	3,022,280
Purchases of investments	(15,359,042)	(11,964,505)
Proceeds from sale of investments	12,318,946	7,143,128
Financing costs incurred	(1,568,729)	(764,141)
Deposits out of reserve for replacements	-	(46,751)
Cash (used in) provided by assets whose use is limited	<u>(11,955,652)</u>	<u>1,486,829</u>
Net cash used in investing activities	<u>(20,197,497)</u>	<u>(6,162,193)</u>

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Cash Flows

Years ended December 31, 2003 and 2002

	<u>2003</u>	<u>2002</u>
Cash flows from financing activities:		
Refunds of entrance fees and deposits	(5,721,296)	(4,580,502)
Principal payments on and redemptions of long-term debt	(17,896,035)	(5,129,147)
Proceeds from issuance of long-term debt	30,698,694	—
Net repayments of notes payable	(1,751,449)	(199,295)
Contributions restricted for long-term purposes	264,034	286,495
Purchase of treasury stock	—	(645,000)
Decrease in annuities payable	222,587	233,731
Net cash provided by (used in) financing activities	<u>5,816,535</u>	<u>(10,033,718)</u>
Net increase (decrease) in cash and cash equivalents	1,184,713	(2,135,047)
Cash and cash equivalents, beginning of year	<u>2,913,815</u>	<u>5,048,862</u>
Cash and cash equivalents, end of year	<u>\$ 4,098,528</u>	<u>2,913,815</u>

Supplemental disclosure of noncash investing and financing activities:

During 2003, the Corporation refunded the Kent County Series 1996, Series 1998 and Series 1999 bonds by issuing the \$10,000,000 Series 2003 bonds.

During 2002, the Corporation refunded the Series 1996 bonds and a portion of the Series 1998 bonds by issuing the \$27,500,000 Series 2002 bonds.

See accompanying notes to consolidated financial statements.

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Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(1) General Information

PHI (Corporation), a not-for-profit corporation, is the parent corporation of Presbyterian Homes, Inc., Presbyterian Housing and Services Corporation (PHSC), Presbyterian Health Services, Inc. (PHSI), Presbyterian Senior Living Services, Inc. (PSLSI), Presbyterian Apartments, Inc. (PAI), and Geneva House, Inc. (GHI), which are 100 percent controlled affiliates of PHI. In addition, the Corporation holds all of the 3,000 outstanding common shares, and Presbyterian Homes, an affiliate of PHI, held all of the 500 outstanding preferred shares of Continuing Care Rx, Inc. (CCRx). The Corporation also owns 50 percent of Prelude Systems, Inc., a technical services organization (Note 5). The Corporation serves as a management company for the above affiliates and is governed by a Board of Trustees. Some of the members of the Board of Trustees are also members of the Board of Directors of certain affiliate corporations. The Corporation provides management services to its various affiliates, which do business primarily in Pennsylvania, but also in Maryland, Ohio and Delaware.

(2) Summary of Significant Accounting Policies

(a) Basis of Accounting

These consolidated financial statements have been prepared to focus on the Corporation as a whole. All material intercompany transactions have been eliminated.

These financial statements, which are presented on the accrual basis of accounting, have been prepared to focus on the Corporation as a whole and to present balances and transactions according to the existence or absence of donor-imposed restrictions.

Revenues are reported as increases in unrestricted net assets unless use of the related assets is limited by donor-imposed restrictions. Expenses are reported as decreases in unrestricted net assets. Gains and losses on investments and other assets or liabilities are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulation or by law.

(b) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the Corporation has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the Corporation in perpetuity, the interest and dividend income from which is used for the charitable purpose.

(c) Donor Restrictions

The Corporation reports gifts of cash and other assets as restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or the purpose to which the donation is restricted is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of activities as net assets released from restrictions. Donor restricted contributions whose restrictions are met within the same year as received are reflected as unrestricted contributions in the accompanying financial statements.

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Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(c) Donor Restrictions (continued)

The Corporation reports non-cash gifts as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, the Corporation reports expirations of donor restrictions when the donated or acquired long-lived assets are placed in service.

Contributions, including unconditional promises to give, are recognized as revenues when the promise to give is first made. Conditional promises to give are not recognized until they become unconditional, that is when the conditions upon which they depend are substantially met. Contributions of assets other than cash are recorded at their estimated fair value as of the date of contribution.

(d) Cash and Cash Equivalents

The Corporation considers all liquid investments with a maturity of three months or less when purchased to be cash equivalents for purposes of the statements of cash flows. At times during the years ended December 31, 2003 and 2002, cash balances may have exceeded the federally insured limit of \$100,000.

(e) Accounts Receivable

Accounts receivable are shown net of an estimated allowance for doubtful accounts, as follows:

	<u>2003</u>	<u>2002</u>
Total accounts receivable	\$ 11,812,492	12,101,664
Less: allowance for doubtful accounts	<u>(1,735,781)</u>	<u>(1,747,007)</u>
Net accounts receivable	<u>\$ 10,076,711</u>	<u>10,354,657</u>

An allowance for doubtful accounts is established based on management's assessment of the collectibility of specific resident's accounts and the aging of accounts receivable.

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Notes to Consolidated Financial Statements
December 31, 2003 and 2002

(f) Pledges Receivable

During 2003, a pledge was made to Presbyterian Homes, Inc. for \$1,500,000. The organization received \$52,000 of the gift in 2003 and the remaining balance will be paid over the next nine years. The Corporation recorded this pledge at the net present value less a discounted uncollectible amount of 5%.

	<u>2003</u>
Pledges receivables	\$ 1,448,219
Less: unamortized discount	<u>(266,566)</u>
Subtotal	1,181,653
Less: allowance for uncollectibles	<u>(45,032)</u>
Net pledges receivables	\$ <u><u>1,136,621</u></u>

Pledges receivable as of December 31, 2003 is as follows:

Amounts due in:	
Less than one year	\$ 150,000
One to five years	750,000
More than five years	<u>548,219</u>
	\$ <u><u>1,448,219</u></u>

(g) Statements of Cash Flows

Interest paid during the years ended December 31, 2003 and 2002 was \$6,888,484 and \$8,116,658, respectively. Interest of \$341,400 was capitalized in 2003. Purchases of assets under capital lease arrangements during the years ended December 31, 2003 and 2002 were \$118,316 and 122,448 respectively. Cash paid for income taxes during the years ended December 31, 2003 and 2002 were \$1,222,934 and \$620,247, respectively.

(h) Deferred Costs

The Corporation has deferred the marketing costs incurred in connection with acquiring initial continuing care contracts for its independent living facilities. When the independent living units are substantially occupied, these costs are amortized on a straight-line basis over a period approximating the average life expectancy of the initial residents occupying the units.

The Corporation has deferred the costs incurred for obtaining the proceeds of its long-term debt arrangements. These costs are being amortized over the term of the related financings using the straight-line method which approximates the effective interest method.

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Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(i) ***Property and Equipment***

Property and equipment are stated at cost or, if donated, at fair market value on the date of donation. The Corporation's policy is to capitalize items in excess of \$1,500 or for a group of items totaling \$1,000 or more. Depreciation is being provided on the straight-line method over the estimated useful lives of the assets.

Depreciable lives are determined as follows:

Land improvements	15-25 years
Buildings and improvements	10-45 years
Departmental equipment, furniture and fixtures	5-25 years
Furniture	5-15 years
Vehicles	5 years

(j) ***Investments***

Investments in marketable equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the statements of financial position. A decline in market value of any investment below cost that is deemed to be other than temporary results in a reduction in carrying amount to fair value. The impairment is charged to realized loss and a new cost basis for the investment is established. For the years ended December 31, 2003 and 2002, no amounts were charged to realized loss.

(k) ***Inventories***

Inventories are stated at the lower of cost (first-in, first-out) or market.

(l) ***Assets Held in Trust by Others***

The Corporation has been named as a beneficiary of several trusts which are administered and controlled by independent trustees. The trusts are recorded as contribution revenue when the Corporation is notified of the trust's existence. The Corporation receives the earnings from these trusts whose principal is to be held in perpetuity. The earnings from the trust are reported as investment income, increasing unrestricted net assets.

Assets held in trust by others are valued at the estimated fair value of the underlying investments. The change in the fair value of assets held in trust by others is reported as permanently restricted unrealized gains or losses on investments.

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Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(l) Assets Held in Trust by Others (continued)

Also included in funds held in trust by others are contributions receivable from charitable remainder trusts that are held by independent trustees. Periodic payments are made to annuitants and the remaining corpus will revert to the Corporation upon the death of the annuitant. These annuities are recorded at the present value of the annuity amount discounted at the contract rate over the estimated remaining life of the annuitant.

A summary of these funds at December 31 is as follows:

	<u>2003</u>	<u>2002</u>
Assets held in trust by others	\$ 5,956,725	5,604,947
Contributions receivable from remainder trusts	<u>814,865</u>	<u>939,611</u>
	<u>\$ 6,771,590</u>	<u>6,544,558</u>

(m) Costs of Borrowing

Interest cost incurred on borrowed funds less interest income on these funds during the period of construction of capital assets is capitalized as a component of construction-in-progress. Interest of \$341,400 was capitalized in 2003.

(n) Assets Whose Use is Limited

Assets whose use is limited primarily include assets held by a trustee under the terms of various bond indentures. Amounts required to meet current obligations of the Corporation have been reclassified in the statement of financial position as current assets.

(o) Deferred Revenue – Entrance Fees

Entrance fees collected from residents at move-in pursuant to a resident and care agreement are initially recorded as deferred revenue. The non-refundable portion of the fees is amortized to income over the estimated remaining life expectancy of each resident. The portion of the fee refundable upon reoccupancy is amortized on a straight-line basis over the remaining useful life of the applicable facility. The agreements provide for potential death or termination refunds of the non-refundable portion if reoccupancy occurs before the contractual amortization is completed in accordance with the terms of the agreements. The remaining amount of unamortized, nonrefundable entrance fees is recorded as revenue upon a resident's death or termination of the contract. In November 2003, the Maryland Department of Aging approved for Presbyterian Senior Living Services, Inc., for single residents both 25% nonrefundable and 50% nonrefundable entrance fee contracts, which the Community has adopted in 2004 in addition to continued use of the 100% refundable contract. An application is pending to offer these same contracts at Presbyterian Senior Living Services, Inc. to married couples.

The amount of entrance fees refundable to residents at December 31, 2003 and 2002 under contractual refund provisions was approximately \$55,617,500 and \$53,342,000, respectively.

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Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(p) *Resident Deposits*

Entrance fees and waiting list deposits received from prospective residents prior to occupancy under Residence and Care Agreements are included in resident deposits in the statement of financial position. These deposits are transferred to deferred revenue upon occupancy of the related units.

(q) *Goodwill*

Goodwill, which represents the excess of purchase price over fair value of net assets acquired from Presbyterian Senior Services Inc., was being amortized on a straight-line basis over the expected period to be benefited, 15 years for December 31, 2002. Generally accepted accounting standards require management to periodically evaluate amortization to determine whether later events and circumstances warrant revised estimates of useful lives. During 2003, it was determined that the goodwill had no remaining useful life and the remaining unamortized balance of \$1,734,123 was written off.

Goodwill, primarily arising from CCRx's original purchase of an existing business, has been amortized on a straight-line basis over an estimated life of forty years. Due to the Company's adoption of Statement of Financial Accounting Standards No. 142 (SFAS 142), *Goodwill and Other Intangible Assets*, amortization of goodwill under the straight-line method ceased beginning January 1, 2002. In accordance with SFAS 142, the Company will test its goodwill annually for impairment losses. Future amortization of goodwill will be recorded in accordance with the Company's testing and evaluation of such impairment losses. Based on the Company's testing, no impairment losses have been recorded during the years ended December 31, 2003 and 2002.

(r) *Estimated Obligation to Provide Future Services to Continuing Care Residents*

At certain Continuing Care Retirement Communities, the Corporation provides health care coverage for certain residents under the terms of a Residence and Care Agreement. The Corporation annually estimates the present value of the net cost of future services and the use of facilities to be provided to current residents covered by Residence and Care Agreements and compares that amount to the balance of deferred entrance fees. If the present value of the net cost of future services and the use of facilities exceeds the deferred entrance fees, a liability is recorded (estimated obligation to provide future services to continuing care residents, in excess of amounts received or to be received). Management's assumptions used in the estimate may vary by facility. Assumptions made in these estimates include a 4% inflation rate for nursing costs, a 4% inflation rate for other operating costs, and 6% discount rate based on the approximate cost of borrowing for the Corporation. At December 31, 2003 and 2002, management's estimation resulted in no obligation in excess of recorded amounts to provide future services to continuing care residents.

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Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(s) ***Resident Services Revenue and Business Concentration***

Resident services revenue is reported at the estimated net realizable amount to be received from patients and others including Medicare, Delaware Medicaid, Maryland Medicaid and Pennsylvania Medicaid and other third party payors for services rendered. The Corporation derives a significant portion of its revenue from federal and state reimbursement programs with a significant majority of state reimbursement from Pennsylvania Medicaid. All of the skilled nursing facilities operated by the Corporation are certified to receive benefits under Medicare and Medicaid.

The reimbursement methodology for a variety of health care providers has changed significantly as a result of provisions contained in the Balanced Budget Act of 1997 ("Budget Act"). The Budget Act provides for a prospective payment system ("PPS") for Medicare reimbursement for skilled nursing services (rather than the retrospective cost-based methodology in place prior to July 1, 1998). Skilled nursing facilities are paid a federal per diem rate for covered services, which include routine and ancillary services and most capital-related costs. Medicare reimbursement is subject to audit and retroactive adjustment in future periods. In conjunction with PPS, consolidated billing for Medicare Part A Services is required for skilled nursing facilities. Under consolidated billing for Medicare Part A Services, facilities must bill Medicare for all of the services residents receive, including all therapy services.

Nursing services provided to Pennsylvania Medicaid beneficiaries are paid at prospectively determined rates per day. These rates vary according to a resident classification system that is based on clinical diagnostic and other factors and the reimbursement methodology is subject to various limitations and adjustments. The Corporation's current concentration of skilled nursing facilities in Pennsylvania exposes it to the risk of changes in Medicaid reimbursement in this state.

Nursing services provided to Maryland Medicaid beneficiaries are cost-reimbursed to the extent of established ceiling limits. These rates vary according to a resident classification system that is based on clinical diagnosis and other factors. The Corporation's existence in Maryland exposes it to the risk in Medicaid reimbursement in this state.

Revenues from Medicare and Pennsylvania, Maryland and Delaware Medicaid (Medicaid) represent approximately 40% and 38% of consolidated revenues for 2003 and 2002, respectively. Medicare and Medicaid receivables represent approximately 54% and 52% of consolidated accounts receivable at December 31, 2003 and 2002.

(t) ***Fundraising Expenses***

Fundraising expenses incurred by the Corporation are included in general and administrative on the statement of activities. Total fundraising expenses were \$391,943 and \$280,480 for 2003 and 2002, respectively.

(u) ***Charity Care***

The Corporation provides care to residents, who meet certain criteria under its charity care policy, at amounts less than its established rates. Charity care is recorded as a reduction of revenue.

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Notes to Consolidated Financial Statements
December 31, 2003 and 2002

(v) ***Tax Status***

PHI is tax exempt under Section 501(c)(3) of the Internal Revenue Code.

CCRx is a for-profit entity that provides for federal and state income taxes on items included in the statements of operations, regardless of the period when such taxes are payable. Deferred income taxes are recorded in accordance with Financial Accounting Standards Board (FASB) Statement No. 109, "Accounting for Income Taxes," and result from temporary differences in recognition of income and expense for tax and financial statement purposes. The source of those temporary differences are related to depreciation methods, bad debt reserves, inventory reserves, accrued vacation, prepaid expenses and deferred compensation. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely that not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. CCRx had a deferred tax asset of \$43,452 and a tax liability of \$37,069 for 2003 and 2002, respectively. These amounts are included in prepaid expense and other current assets and accrued expenses-other, respectively.

(w) ***Workers' Compensation***

Accrued expenses include a provision for estimated self-insured workers' compensation claims for both reported claims not yet paid and claims incurred but not reported.

(x) ***Use of Estimates***

The preparation of 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 at the date of the financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(y) ***Derivatives and Hedging Activities***

In accordance with Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities* as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, the Corporation recorded a liability of \$705,573, and \$3,280,199, representing the fair value (liability) of the swap as of December 31, 2003 and 2002, respectively. For 2003, an adjustment to the liability was recorded causing a gain of \$2,574,626, representing the decrease in the fair value (liability) of the swaps.

All of the Corporations' interest rate swaps are carried at fair value (liability) as determined by a third party. Changes in fair value are reported in the consolidated statement of activities as a component of the change in net assets. The Corporation believes that the interest rate swaps are an effective economic hedge of its exposure to variable interest rates.

The terms of the various interest rate swaps are described in note 7.

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Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(y) *Derivatives and Hedging Activities (continued)*

In 2003, Presbyterian Senior Living Services, Inc. terminated two of the interest rate swaps. These swaps totaled approximately \$10,000,000, expired in 2010, and carried interest rates of 6.94% and 6.61%. Termination fees for these swaps were \$1,795,000.

(z) *Reclassification*

Certain amounts in the 2002 financial statements have been reclassified to conform with the 2003 financial presentation, including reclassifying the 2002 loss on debt extinguishment into changes in net assets (liabilities) before unrealized gains (losses) on investments, loss on discontinued operations and taxes in compliance with Financial Accounting Standards No. 145, *Rescission of FAS Statements No. 4, 44 and 64, Amendment of FASB No. 13, and Technical Corrections*.

In addition, the 2002 financial statements have been reclassified to conform to the 2003 financial statement presentation, including reclassifying the changes in fair value of interest rate swaps into changes in net assets (liabilities) before unrealized gains (losses) on investments, loss on discontinued operations and taxes in compliance with the early adoption of Financial Accounting Standards No. 149, *Amendment of Statement No. 133, Accounting for Derivative Instruments and Hedging Activities*.

(aa) *Performance Indicator*

The Corporation measures the performance of its operations using the statement of activities, which includes a performance indicator of operations labeled as “changes in unrestricted net assets (liabilities) before unrealized gains (losses) on investments, loss on discontinued operations, and taxes.” Changes in unrestricted net assets which are excluded from this measure are: unrealized gains and losses on investments, and other significant adjustments which do not directly indicate operational performance.

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Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(3) Investments

The cost and market value of investments at December 31 are as follows:

	2003		2002	
	Market	Cost	Market	Cost
Certificates of deposit	\$ 157,670	157,670	3,253,922	3,253,922
Money market funds	1,979,330	1,979,330	2,137,605	2,137,605
Marketable equity securities	8,924,146	6,432,835	3,909,538	3,023,639
U.S. Government securities	12,515,480	12,531,434	7,263,080	7,158,438
Corporate bonds and notes	7,010,502	6,812,479	9,342,134	9,136,514
Other	163,764	163,764	—	—
Totals	\$ 30,750,892	<u>28,077,512</u>	25,906,279	<u>24,710,118</u>
Less permanently restricted investments (note 4)	<u>(1,457,194)</u>		<u>(1,215,360)</u>	
Total investments	\$ <u>29,293,698</u>		\$ <u>24,690,919</u>	

(4) Assets Whose Use is Limited

At December 31 assets whose use is limited which are carried at market value consisted of the following:

	2003	2002
Permanently restricted investments	\$ 1,457,194	1,215,360
Debt service reserve funds	7,104,990	5,434,061
Operating reserve fund	927,711	735,914
Bond funds	761,898	877,899
Assets designated to renovation and charity care	425,175	363,476
Other reserves required under financing arrangements	<u>463,093</u>	<u>453,858</u>
	11,140,061	9,080,568
Less current portion	<u>(1,177,213)</u>	<u>(1,231,541)</u>
	\$ <u>9,962,848</u>	<u>7,849,027</u>

The Corporation's assets whose use is limited are primarily comprised of deposits held with trustees that Presbyterian Homes, Inc., PHSC and PSLSI are required to maintain to satisfy certain covenants included in their bond indentures.

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Notes to Consolidated Financial Statements
December 31, 2003 and 2002

(4) Assets Whose Use is Limited (continued)

As described in note 7, in January 2003 Presbyterian Homes, Inc. issued Cumberland County Municipal Authority Revenue Bonds, Series 2003 A and B, part of the proceeds of which provided for the establishment of a construction fund to fund capital expenditures. The construction funds, of \$9,927,751 at December 31, 2003, which are also classified as assets whose use is limited, are held by a trustee and distributed when specific requirements of the bond indentures have been met.

Amounts included in assets whose use is limited have been invested in government agency securities, fixed rate investment contracts with financial institutions, certificates of deposit and money market funds. The cost of these funds approximate their fair values.

(5) Related Party Transactions

Prelude Systems, Inc. (Prelude), is a joint venture between the Corporation and Diakon Lutheran Social Ministries. Prelude is a technical services organization with a wide range of programs designed to support the information systems needs of both PHI and Diakon as well as other healthcare and community service organizations. PHI's investment in Prelude is included in investments in marketable equity securities as of December 31, 2003 and 2002. During 2003 and 2002, respectively, PHI paid Prelude approximately \$1,004,000 and \$1,010,000 for information services provided by Prelude.

(6) Property and Equipment

A summary of property and equipment and accumulated depreciation at December 31 is as follows:

	<u>2003</u>	<u>2002</u>
Land	\$ 20,951,669	20,951,669
Land improvements	9,421,622	9,256,768
Buildings and improvements	180,454,323	180,471,049
Building equipment	117,078	118,953
Departmental equipment, furniture and fixtures	20,080,194	19,991,662
Furniture	2,792,943	2,964,803
Vehicles	1,600,952	1,497,649
Construction-in-progress	<u>2,967,458</u>	<u>869,998</u>
	238,386,239	236,122,551
Accumulated depreciation	<u>(92,057,494)</u>	<u>(85,102,124)</u>
	<u>\$ 146,328,745</u>	<u>151,020,427</u>

As the Corporation undertakes expansion projects, costs are included in construction-in-progress. As projects are completed, the costs are transferred to buildings and building improvements. Ongoing improvement and expansion is anticipated in the normal course of operations.

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Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(6) Property and Equipment (continued)

Construction-in-progress consists of construction costs incurred for various renovation and expansion projects at the Corporation's existing facilities.

As of December 31, 2003 and 2002, commitments for future construction totaled approximately \$2,000,000 and \$1,500,000, respectively.

In December 2003, PHI sold Presbyterian Health Center, an 84 bed skilled nursing facility, for approximately \$4 million, and a recognized gain of \$445,937.

For the years ended December 31, 2003 and 2002, Presbyterian Health Center's losses consisted of:

	<u>2003</u>	<u>2002</u>
Depreciation	\$ 156,157	266,245
Interest	72,161	323,824
Amortization	2,360	5,665
Other expenditures, net of gain	<u>1,742,685</u>	<u>397,469</u>
Total loss on discontinued operations	<u>\$ 1,973,363</u>	<u>993,203</u>

In December 2002, Presbyterian Homes, Inc. sold Hutchinson House; an 80 bed assisted living facility for approximately \$3.1 million, and recognized a gain of \$172,635.

For the year ended December 31, 2002 Hutchinson House's losses consisted of:

Depreciation	\$ 298,314
Interest	199,856
Other expenditures, net of gain	<u>67,425</u>
Total loss on discontinued operations	<u>\$ 565,595</u>

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Notes to Consolidated Financial Statements
December 31, 2003 and 2002

(7) Long-term Debt

Long-term debt as of December 31 consisted of the following:

	<u>2003</u>	<u>2002</u>
Cumberland County Municipal Authority Bonds Series 1993A principal due in 2018, variable interest rate, 1.25% at December 31, 2003, secured by irrevocable letter of credit with annual fee of 1.25%, which expires December 15, 2005	\$ 6,000,000	6,000,000
Cumberland County Municipal Authority Revenue Bonds Series 1996, principal due in varying annual amounts from 2002 to 2026, interest rate set at 6.0%, net of unamortized discount, collateralized by property and equipment and gross revenues of Presbyterian Homes, Inc.	31,585,000	42,685,000
Cumberland County Municipal Authority Revenue Bonds Series 2003A, tax exempt debenture bonds, principal due in varying annual amounts from 2003 to 2026, interest rates ranging from 1.4% to 5%, insured by municipal bond insurance and property and equipment and gross revenues of Presbyterian Homes, Inc.	19,335,000	-
Cumberland County Municipal Authority Revenue Bonds Series 2003B, taxable variable rate debenture bonds, principal maturities in varying amounts from 2003 to 2032, interest adjusted weekly, 1.24% at December 31, 2003, collateralized by letter of credit with an annual fee of 1.25% which expires on December 15, 2005	8,935,000	-
Kent County Delaware Economic Development Revenue Bonds Series 1996, principal and interest payable monthly on a 20 year amortization period, final principal payment due 2016, interest at 5.56% through 2003 and remarketed thereafter, collateralized by property and equipment and gross revenues of Presbyterian Homes, Inc.	-	5,040,515
Kent County Delaware Economic Development Revenue Bond Series 1998, and 1999, maximum available principal of \$6,000,000, interest only through 2000, principal and interest payable in equal monthly installments from 2002 to 2020 at 4.9% with remarketing as of 2005, collateralized by property and equipment and gross revenues of Presbyterian Homes, Inc.	-	5,321,278
Kent County Delaware Economic Development Revenue Bond Series 2003, principal and interest payable monthly on a 15-year amortization period, final principal payment due October 31, 2018, variable interest of 1.60% at December 31, 2003, collateralized by property and equipment and gross revenues of Presbyterian Homes, Inc.	9,957,067	-

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Notes to Consolidated Financial Statements
December 31, 2003 and 2002

(7) Long-term Debt (continued)

	<u>2003</u>	<u>2002</u>
Northampton County Industrial Development Authority Series 1998 First Mortgage Revenue Refunding Bonds, principal due in varying annual amounts through 2023, interest rates ranging from 4.75% to 5.625%, net of unamortized discount	14,045,000	14,725,000
Northampton County Industrial Development Authority Series 2002 First Mortgage Revenue Refunding Bonds, principal due in varying annual amounts through 2030, interest adjusted weekly, 1.24% at December 31, 2003 collateralized by a letter of credit	27,200,000	27,500,000
Fannie Mae mortgage payable executed on March 29, 1973, amortization of principal from May 1, 1973 through September 2013, interest rate of 7% effective rate of .0% in 2003 due to FHA subsidy	925,640	988,113
HUD Flexible Subsidy Loans payable, principal balance due upon sale of the project building or upon full payment of the HUD mortgage, simple interest of 1% payable at time of principal payments	1,672,491	1,672,491
Mortgage payable for building loan provided by HUD, monthly installments of principal and interest, interest rate of 3%	1,186,357	1,246,976
Maryland Health and Higher Educational Facilities Authority Revenue Bonds Series 1999A, tax exempt variable rate debenture bonds, principal maturities in varying amounts from 2012 to 2029, interest adjusted weekly 1.18% at December 31, 2003, collateralized by letter of credit	3,340,000	3,340,000
Maryland Health and Higher Educational Facilities Authority Revenue Bonds Series 1999B, taxable variable rate debenture bonds, principal maturities in varying amounts from 2001 to 2029, interest adjusted weekly 1.25% at December 31, 2003, collateralized by letter of credit	16,325,000	16,590,000
Term Loan with Waypoint Bank, bearing interest at a fixed rate of 4.49%, interest payments due monthly, principal payments due July 2005 and 2006 in the amounts of \$500,000 and \$1,000,000 respectively	1,500,000	-
Term Loan with a Bank Group The loan requires principle payments to be repaid over five years starting in 2001. Loan carries an interest rate of prime plus 1.00% (4.75% at December 31, 2002).	-	594,881

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Notes to Consolidated Financial Statements
December 31, 2003 and 2002

(7) Long-term Debt (continued)

	<u>2003</u>	<u>2002</u>
Central and Western Chester County Industrial Development Authority Mortgage Revenue Bond Series 1996 payable to Fulton Bank in monthly installments of principal and interest, interest at 5.60% through June 2003 and at 75% of prime through August 2012.	\$ -	3,104,340
Other notes and mortgages, primarily paying interest only as of December 31, 2003; interest rates ranging from 0% to 8.25% as of December 31, 2003	<u>479,396</u>	<u>535,015</u>
	142,485,951	129,343,609
Less: Current portion	(2,870,846)	(3,270,073)
Unamortized discount	<u>(959,009)</u>	<u>(779,308)</u>
	\$ <u><u>138,656,096</u></u>	<u><u>125,294,228</u></u>

All of the obligations above are collateralized by either property, plant and equipment and gross revenues of the Corporation's consolidated affiliates, or by a letter of credit.

On June 12, 2002, the Corporation issued the \$27,500,000 Northampton County Industrial Development Authority First Mortgage Revenue Refunding Bonds Series 2002. Proceeds from the bonds were used to refund the Series 1996 bonds, and a portion of the Series 1998 bonds. The remaining proceeds from the bonds were used to finance the cost of constructing, furnishing and equipping future capital projects.

As a result of the refunding, the Corporation wrote off \$160,630 of unamortized bond discounts and \$1,196,661 in unamortized bond issuance costs totaling \$1,357,591.

Under the terms of the remaining 1998 revenue bond indentures and the 2002 revenue bond indentures, the Corporation is required to maintain certain deposits with a trustee. These deposits are included in assets whose use is limited. The indenture also places limits on the incurrence of additional borrowings and requires the Corporation to satisfy certain measures of financial performance as long as the bonds are outstanding. These covenants have been met as of December 31, 2003. The bonds and the letter of credit are secured by a first mortgage lien on the Kirkland Village Project and a security interest in the gross revenues of the Corporation.

On November 6, 2003, the Corporation issued the \$10,000,000 Kent County Economic Development Revenue Refunding Bonds Series 2003. Proceeds from the bonds were used to refund the Series 1996, Series 1998 and the Series 1999 bonds.

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Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(7) Long-term Debt (continued)

In January 2003, the Corporation issued Cumberland County Municipal Authority Series A and B bonds totaling \$29,420,000. The bonds were used to refund \$11.1 million of the Cumberland County Series 1996 bonds, provide approximately \$15 million for future capital improvements, increase debt service reserves by \$1.7 million, and to pay for issuance and bond insurance costs.

As a result of the sale of Presbyterian Health Center, the Corporation wrote off \$76,944 in unamortized bond issuance costs.

Under the terms of Presbyterian Homes, Inc.'s, PHSC's, and PSLSI's bond indentures, the Corporations are required to maintain certain deposits with a trustee. These deposits are included in assets whose use is limited. The indentures also place limits on additional borrowings and require the Corporations to satisfy certain measures of financial performance as long as the bonds are outstanding. These covenants have been met at December 31, 2003.

Current Maturities of Long-term Debt

Maturities for the five years subsequent to December 31, 2003 and thereafter are as follows:

<u>Years ended</u> <u>December 31,</u>	<u>Aggregate</u> <u>maturities</u>
2004	\$ 2,870,846
2005	3,633,632
2006	4,361,909
2007	3,498,189
2008	3,656,589
Thereafter	<u>124,464,786</u>
	<u>\$ 142,485,951</u>

In 2003, Presbyterian Senior Living Services, Inc. terminated two of the swap agreements that had been entered into since September 13, 2000. These two swap agreements had notional amounts of approximately \$10,000,000 which were to expire in 2010, and carried interest rates of 6.94% and 6.61%. Termination fees for these swaps were \$1,795,000. Presbyterian Senior Living Services, Inc. remains in a swap agreement with a financial intermediary which fixes the interest rate to be paid by Presbyterian Senior Living Services, Inc. on a portion of the taxable bonds as follows:

<u>Notional Amount</u>	<u>Expiration Date</u>	<u>Interest Rate</u>
\$6,000,000	September 15, 2005	6.88%

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Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(7) Long-term Debt (continued)

In June 2002, Presbyterian Housing and Services Corporation entered into a swap agreement with a financial intermediary which fixes the interest rate to be paid by Presbyterian Housing and Services Corporation on a portion of the 2002 bonds as follows:

<u>Notional Amount</u>	<u>Expiration Date</u>	<u>Interest Rate</u>
\$9,200,000	May 1, 2004	2.79%

In October 2003, Presbyterian Housing and Services Corporation extended the above swap with a new intermediary at an interest rate of 2.41% from May 2, 2004 until May 1, 2006. Also in June 2002, Presbyterian Housing and Services Corporation entered into an additional swap agreement on a notational amount of \$18,000,000, at 2.54%, which expired on December 15, 2003.

In September 2003, Presbyterian Homes, Inc. entered into a swap agreement with a financial intermediary, which fixes the interest rate to be paid by Presbyterian Homes, Inc. on a portion of the Kent County 2003 bonds as follows:

<u>Notional Amount</u>	<u>Expiration Date</u>	<u>Interest Rate</u>
\$10,000,000	November 28, 2008	3.39%

Pursuant to all these agreements the intermediary assumes the risk of varying interest rates, with the difference between the weekly variable rates and the fixed rates above being either paid by, or reimbursed to, the Corporations. As discussed in Note 2, swap agreements are reported at fair value.

(8) Notes Payable

The Corporation has available various lines of credit with financial institutions. Interest rates on these lines of credit are variable based on the prime rate of the various financial institutions or the LIBOR rate. As of December 31, 2003 and 2002, under the line of credit agreements, the Corporation had available a maximum of \$12,000,000 and \$15,550,000 from the financial institutions. As of December 31, 2003 and 2002, the Corporation had amounts totaling \$5,228,136 and \$6,979,585 outstanding under these agreements at interest rates ranging from 2.8% to 4.0%.

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Notes to Consolidated Financial Statements
December 31, 2003 and 2002

(9) Leases

The Corporation, through CCRx is obligated under various capital leases for medical carts, infusion pumps and other equipment that expire at various dates during the next three years. At December 31, 2003 and 2002, the gross amount of the equipment and related accumulated amortization recorded under capital leases was as follows:

	<u>2003</u>	<u>2002</u>
Medical and office equipment	\$ 748,365	629,989
Accumulated amortization	<u>(406,442)</u>	<u>(269,741)</u>
	<u>\$ 341,923</u>	<u>360,248</u>

A schedule of future minimum lease payments under capital leases together with the present value of the net minimum lease payments as of December 31, 2003 follows:

2004	\$ 96,371
2005	61,931
2006	<u>17,410</u>
	175,712
Amounts representing interest	<u>(21,525)</u>
	<u>\$ 154,187</u>

The Corporation leases several offices, certain equipment and automobiles under operating leases, which expire at various dates through 2009. The future minimum lease payments under these operating leases are as follows:

2004	\$ 1,124,371
2005	811,281
2006	333,245
2007	87,904
2008	15,229
Thereafter	<u>752</u>
	<u>\$ 2,372,782</u>

Rental expense under operating leases was \$1,546,756 and \$1,295,662 for the years ended December 31, 2003 and 2002, respectively.

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Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(10) Annuities

The Corporation has a gift annuity program. In return for their gifts, donors are paid a fixed annuity amount during the lifetime of the donor and/or the donor's beneficiary. Total annuities payable were \$938,042 and \$715,455 at December 31, 2003 and 2002, respectively. The Corporation uses published mortality rate tables adopted by the Internal Revenue Service and an assumed discount rate of approximately 4% to 6% to determine the present value of the actuarially determined liability. The Corporation has assets included in investments of \$5,958,097 and \$4,418,639 as of December 31, 2003 and 2002, respectively to satisfy annuities.

(11) Workers' Compensation Insurance

The Corporation has a self-insured Workers' Compensation program as allowed by the Commonwealth of Pennsylvania and the State of Delaware Bureau of Workers' Compensation. This program provides for self payment of work related injuries and illnesses as opposed to utilizing an insurance carrier. The Corporation has contracted with major insurance carriers for excess insurance coverage, loss control services and administration. The Corporation maintains a letter of credit for \$2 million in connection with this self-insurance program. At December 31, 2003 and 2002, the Corporation has recorded an accrued expense of approximately \$1.4 million for workers' compensation claims which includes known case reserves and an estimate of the Corporation's liability for incurred but not reported claims.

(12) Deferred Compensation

During 2003, the Corporation implemented an incentive compensation plan for certain management employees of Continuing Care Rx. Under the plan, participating employees earn incentive compensation based on the achievement of certain performance measurements as approved by the Corporation's Board of Directors. Incentives earned by participants vest over a five-year period and are payable in equal annual installments over that time period. As of December 31, 2003, the balance of deferred incentive compensation earned totaled \$129,801 and is included in other liabilities.

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Notes to Consolidated Financial Statements
December 31, 2003 and 2002

(13) Temporarily Restricted Net Assets

Temporarily restricted net assets as of December 31 are available for the following purposes:

	<u>2003</u>	<u>2002</u>
Purchase of buildings and equipment	\$ 4,091	4,091
Educational	3,565	3,395
Charity care and/or equipment, including pledges receivable	3,141,502	1,753,758
Assets held in charitable trust for charity care	503,246	301,195
Various resident activities	<u>141,519</u>	<u>145,562</u>
	<u>\$ 3,793,923</u>	<u>2,208,001</u>

(14) Permanently Restricted Net Assets

Permanently restricted net assets are allocated to the following purposes at December 31:

	<u>2003</u>	<u>2002</u>
Charity care/equipment	\$ 2,663,533	2,353,129
Educational	9,542	9,337
Perpetual trusts, income restricted for charity care	<u>5,956,725</u>	<u>5,604,947</u>
	<u>\$ 8,629,800</u>	<u>7,967,413</u>

(15) Charity Care

The Corporation provides care to residents who meet certain criteria under its charity care policy at amounts less than its established rates. Because the Corporation does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. In addition, the Corporation considers contractual allowances charity care. The total amount of charity care provided under these policies was approximately \$6.1 and \$5.4 million for the years ended December 31, 2003 and 2002, respectively, of which the amount of charges foregone for services and supplies was approximately \$1,009,000 and \$963,000, respectively.

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Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(16) Retirement Plan

The Corporation has a defined-contribution retirement plan covering all employees that have completed one year of service and have reached the age of 21. Vesting occurs after five years of service. Contributions to the plan are at the discretion of the Board of Trustees of PHI. For the years ended December 31, 2003 and 2002, retirement plan expense totaled approximately \$701,300 and \$613,600, respectively.

(17) Commitments and Contingencies

The Corporation is involved in several legal proceedings arising from its activities in the health care industry. Although it is not possible to presently determine the final outcome of these matters, management believes the aggregate liability, if any, resulting from such proceedings will not have a material adverse effect on the Corporation's assets, liabilities, net assets, operations or cash flows.

(18) Financial Instruments

(a) *Fair Values of Financial Instruments*

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

Cash and cash equivalents: The carrying amount approximates fair value because of the short-term nature of those investments.

Investments: The fair values of U.S. Government securities, notes, commercial bonds and equity securities are estimated based on quoted market prices for those or similar investments.

Long-term debt: The carrying amount included in long-term debt in the statement of financial position for bonds payable and mortgages payable approximate fair market value.

The Corporation has a number of other financial instruments, none of which are held for investment purposes. The Corporation estimates that the fair value of all financial instruments at December 31, 2003 and 2002 does not differ materially from the aggregate carrying values of its financial instruments recorded in the accompanying statement of financial position.

(b) *Financial Instruments with Off-Balance-Sheet Risk*

Financial instruments with off-balance-sheet risk to the Corporation, consist of certain financial guarantees of its affiliates and letters of credit obtained from various financial institutions. The Corporation's exposure to credit loss in the event of nonperformance by the other party to the financial instrument is represented by the contractual amount of those obligations as disclosed in the notes.