

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Consolidated Financial Statements

December 31, 2003 and 2002

(With Independent Auditor's Report Thereon)

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

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Certification of Chief Executive and Chief Financial Officers

We are responsible for the enclosed financial statements and supporting information of Presbyterian Senior Living Services, Inc. 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 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 Presbyterian Senior Living Services, Inc.'s financial condition. We believe that all of the information contained in this report is accurate and can be trusted by the financial community, Presbyterian Senior Living Services, Inc.'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 results; 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 understanding PHI's mission.

Handwritten signature of Stephen E. Proctor in black ink.

Stephen E. Proctor
Chief Executive Officer
PHI

Handwritten signature of Jeffrey J. Davis in black ink.

Jeffrey J. Davis
Chief Financial Officer
PHI

Independent Auditor's Report

The Board of Directors
Presbyterian Senior Living Services, Inc.:

We have audited the accompanying consolidated statements of financial position of Presbyterian Senior Living Services, Inc. (an affiliate of PHI) as of December 31, 2003 and 2002, and the related consolidated statements of activities, changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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 financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Presbyterian Senior Living Services, Inc. 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

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Consolidated Statements of Financial Position

December 31, 2003 and 2002

Assets	2003	2002
Current assets:		
Cash and cash equivalents	\$ 17,096	23,938
Investments	123,455	—
Accounts receivable, net	316,291	283,792
Current portion, assets whose use is limited	415,315	353,642
Prepaid expenses and other current assets	184,839	178,919
Total current assets	<u>1,056,996</u>	<u>840,291</u>
Assets whose use is limited, net of current portion	1,080,364	880,697
Property and equipment (net of accumulated depreciation of \$11,790,290 and \$10,473,328, respectively)	33,595,596	34,018,186
Other assets:		
Deferred financing costs (net of accumulated amortization of \$69,886 and \$53,657, respectively)	394,784	411,013
Goodwill (net of accumulated amortization of \$495,465 for 2002)	—	1,899,277
Total assets	<u>\$ 36,127,740</u>	<u>38,049,464</u>

See accompanying notes to consolidated financial statements.

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Consolidated Statements of Financial Position

December 31, 2003 and 2002

Liabilities and Net Liabilities	2003	2002
Current liabilities:		
Accounts payable	\$ 674,766	910,993
Swap termination fee payable	1,795,000	—
Accrued expenses	368,977	384,901
Note payable	502,000	395,000
Current portion, annuities payable	12,220	—
Current portion, bonds payable	280,000	265,000
Total current liabilities	3,632,963	1,955,894
Deferred revenue – entrance fees	20,335,645	20,121,211
Resident deposits	162,560	84,960
Due to affiliated entity	955,253	65,099
Fair value of interest rate swaps	517,503	2,866,950
Annuities payable, net of current portion	54,514	—
Bonds payable, net of current portion	19,385,000	19,665,000
Total liabilities	45,043,438	44,759,114
Net (liabilities) assets:		
Unrestricted	(9,315,463)	(7,132,672)
Temporarily restricted	63,970	106,002
Permanently restricted	335,795	317,020
Total net liabilities	(8,915,698)	(6,709,650)
Total liabilities and net liabilities	\$ 36,127,740	38,049,464

See accompanying notes to consolidated financial statements.

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Consolidated Statements of Activities

Year ended December 31, 2003

(with comparative December 31, 2002 totals)

	2003			Total	2002 Total
	Unrestricted	Temporarily Restricted	Permanently Restricted		
Revenues, gains and other support:					
Resident services, including amortization of entrance fees of \$1,050,296 and \$1,002,255, respectively	\$ 9,582,137	—	—	9,582,137	9,570,718
Interest and dividend income, net of expenses	32,934	5,427	—	38,361	28,143
Realized (losses) gains on marketable securities	(43,909)	—	—	(43,909)	240
Contributions	27,630	—	18,775	46,405	46,003
Net assets released from restrictions	47,459	(47,459)	—	—	—
Total revenues, gains and other support	9,646,251	(42,032)	18,775	9,622,994	9,645,104
Expenses:					
Nursing services	2,089,897	—	—	2,089,897	1,906,752
Rehabilitation	157,719	—	—	157,719	145,841
Recreation and special services	235,194	—	—	235,194	208,992
Pharmacy	71,266	—	—	71,266	64,010
Social services	1,677	—	—	1,677	3,799
Physician services	25,613	—	—	25,613	25,000
Food services	1,466,895	—	—	1,466,895	1,453,834
Building operations and maintenance	1,411,936	—	—	1,411,936	1,328,395
Housekeeping	301,187	—	—	301,187	317,244
Laundry and linen	41,625	—	—	41,625	40,665
General and administrative	1,734,549	—	—	1,734,549	1,556,231
Employee benefits	326,056	—	—	326,056	318,045
Interest	1,362,908	—	—	1,362,908	1,429,735
Depreciation	1,316,962	—	—	1,316,962	1,336,187
Amortization	181,383	—	—	181,383	181,383
Change in fair value of interest rate swaps	(2,349,447)	—	—	(2,349,447)	1,271,095
Realized loss on interest rate swap termination	1,795,000	—	—	1,795,000	—
Change in estimated life of goodwill	1,734,123	—	—	1,734,123	—
Total expenses	11,904,543	—	—	11,904,543	11,587,208
Change in net assets (liabilities) before unrealized gain (loss) on marketable securities	(2,258,292)	(42,032)	18,775	(2,281,549)	(1,942,104)
Unrealized gain (loss) on marketable securities	75,501	—	—	75,501	(59,389)
Change in net assets (liabilities)	(2,182,791)	(42,032)	18,775	(2,206,048)	(2,001,493)
Net assets (liabilities), beginning of year	(7,132,672)	106,002	317,020	(6,709,650)	(4,708,157)
Net assets (liabilities), end of year	\$ (9,315,463)	63,970	335,795	(8,915,698)	(6,709,650)

See accompanying notes to consolidated financial statements.

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Consolidated Statements of Activities

Year ended December 31, 2002

	2002			Total
	Unrestricted	Temporarily Restricted	Permanently Restricted	
Revenues, gains and other support:				
Resident services, including amortization of entrance fees of \$1,002,255	\$ 9,570,718	—	—	9,570,718
Interest and dividend income, net of expenses	18,335	9,808	—	28,143
Other income	—	—	—	—
Realized gains on marketable securities	240	—	—	240
Contributions	9,954	—	36,049	46,003
Net assets released from restrictions	(1,050)	1,050	—	—
Total revenues, gains and other support	<u>9,598,197</u>	<u>10,858</u>	<u>36,049</u>	<u>9,645,104</u>
Expenses:				
Nursing services	1,906,752	—	—	1,906,752
Rehabilitation	145,841	—	—	145,841
Recreation and special services	208,992	—	—	208,992
Pharmacy	64,010	—	—	64,010
Social services	3,799	—	—	3,799
Physician services	25,000	—	—	25,000
Food services	1,453,834	—	—	1,453,834
Building operations and maintenance	1,328,395	—	—	1,328,395
Housekeeping	317,244	—	—	317,244
Laundry and linen	40,665	—	—	40,665
General and administrative	1,556,231	—	—	1,556,231
Employee benefits	318,045	—	—	318,045
Interest	1,429,735	—	—	1,429,735
Depreciation	1,336,187	—	—	1,336,187
Amortization	181,383	—	—	181,383
Change in fair value of interest rate swaps	1,271,095	—	—	1,271,095
Total expenses	<u>11,587,208</u>	<u>—</u>	<u>—</u>	<u>11,587,208</u>
Change in net assets (liabilities) before unrealized loss on marketable securities	<u>(1,989,011)</u>	<u>10,858</u>	<u>36,049</u>	<u>(1,942,104)</u>
Unrealized loss on marketable securities	<u>(59,389)</u>	<u>—</u>	<u>—</u>	<u>(59,389)</u>
Change in net assets (liabilities)	<u>(2,048,400)</u>	<u>10,858</u>	<u>36,049</u>	<u>(2,001,493)</u>
Net assets (liabilities), beginning of year	<u>(5,084,272)</u>	<u>95,144</u>	<u>280,971</u>	<u>(4,708,157)</u>
Net assets (liabilities), end of year	<u><u>\$ (7,132,672)</u></u>	<u><u>106,002</u></u>	<u><u>317,020</u></u>	<u><u>(6,709,650)</u></u>

See accompanying notes to consolidated financial statements.

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

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 liabilities	\$ (2,206,048)	(2,001,493)
Adjustments to reconcile change in net liabilities to net cash provided by operating activities:		
Depreciation	1,316,962	1,336,187
Proceeds from entrance fees and deposits	4,780,130	4,605,849
Amortization of entrance fees	(1,050,296)	(1,002,255)
Change in fair value of interest rate swaps	(554,447)	1,271,095
Unrealized (gains) losses on marketable securities	(75,501)	59,389
Realized losses (gains) on marketable securities	43,909	(240)
Realized loss on interest rate swaps	(1,795,000)	—
Contributions restricted for long-term purposes	(18,775)	(36,049)
Amortization	181,383	181,383
Change in estimated life of goodwill	1,734,123	—
Change in assets and liabilities:		
Accounts receivable	(32,499)	(28,904)
Prepaid expenses and other current assets	(5,920)	(97,935)
Accounts payable	(236,227)	253,014
Other current liabilities	(15,924)	(35,735)
Swap termination fee payable	1,795,000	—
Net cash provided by operating activities	<u>3,860,870</u>	<u>4,504,306</u>
Cash flows from investing activities:		
Acquisition of property and equipment	(894,372)	(1,070,235)
Purchases of investments	(2,197,400)	—
Proceeds from sale of investments	2,073,945	—
Change in assets whose use is limited	(229,748)	(191,363)
Net cash used in investing activities	<u>(1,247,575)</u>	<u>(1,261,598)</u>
Cash flows from financing activities:		
Refunds of entrance fees and deposits	(3,437,800)	(3,110,000)
Principal payments and redemptions of bonds	(265,000)	(250,000)
Proceeds from note payable	107,000	72,000
Contributions restricted for long-term purposes	18,775	36,049
Change in annuities payable	66,734	—
Change in due to affiliates	890,154	20,489
Net cash provided by (used in) financing activities	<u>(2,620,137)</u>	<u>(3,231,462)</u>
Net (decrease) increase in cash and cash equivalents	<u>(6,842)</u>	<u>11,246</u>
Cash and cash equivalents, beginning of year	<u>23,938</u>	<u>12,692</u>
Cash and cash equivalents, end of year	\$ <u><u>17,096</u></u>	<u><u>23,938</u></u>

See accompanying notes to consolidated financial statements.

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(1) General Information

Presbyterian Senior Living Services, Inc. (the Corporation) is a not-for-profit corporation, which operates Glen Meadows Retirement Community, a Continuing Care Retirement Community (the Community) located in Glen Arm, Maryland, which provides housing, health care, and other related services to the elderly. The Corporation is also the parent company to a fully controlled affiliate Glen Meadows Retirement Community, Inc. (GMRCI). The Glen Meadows Foundation (the Foundation) was established for the exclusive benefit of the Community and certain assets held by the Corporation are designated for the Foundation. The consolidated financial statements of the Corporation include the financial position and activities of GMRCI and the Foundation. The Corporation and Foundation are governed by independent Boards of Directors, all of whom are elected by the Board of Trustees of PHI, the Corporation's parent organization.

The Community contains 114 independent living cottages, 98 independent living apartments, 29 assisted living units and a 31-bed skilled nursing facility. The facility covers approximately 60 acres of the 483-acre site owned by the Corporation.

The Corporation was formed on July 1, 1999 whereby all operations of Presbyterian Senior Services, Inc. (PSSI) were transferred to Presbyterian Senior Living Services, Inc. and Glen Meadows Retirement Community, Inc. PSSI's corporate existence was discontinued. Under this new structure, the property, plant and certain equipment of PSSI was transferred to Glen Meadows Retirement Community, Inc., and the operations, other assets, and all liabilities of PSSI were transferred to Presbyterian Senior Living Services, Inc. Presbyterian Senior Living Services, Inc. is a fully controlled subsidiary of PHI, a management company located in Camp Hill, Pennsylvania.

(2) Summary of Significant Accounting Policies

(a) Basis of Consolidation

These consolidated financial statements have been prepared to focus on Presbyterian Senior Living Services, Inc. as a whole. All material intercompany transactions have been eliminated.

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(b) *Basis of Accounting*

These consolidated 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.

(c) *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. The Corporation's temporarily restricted net assets consist principally of funds directed for special projects and resident welfare. Permanently restricted net assets have been restricted by donors to be maintained by the Corporation in perpetuity. Permanently restricted net assets are primarily restricted for resident welfare.

(d) *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 consolidated 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 consolidated financial statements.

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.

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(e) 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 the purposes of the statements of financial position and cash flows, except for those included in investments or assets whose use is limited. At times during the years ended December 31, 2003 and 2002, cash balances may have exceeded the federally insured limit of \$100,000.

(f) Consolidated Statements of Cash Flows

Interest paid during the years ended December 31, 2003 and 2002 was \$1,382,247 and \$1,514,527, respectively.

(g) 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	\$ 384,035	424,590
Less: allowance for doubtful accounts	(67,744)	(140,798)
Net accounts receivable	<u>\$ 316,291</u>	<u>283,792</u>

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

(h) Deferred Financing Costs

The Corporation has deferred the costs incurred for obtaining the proceeds of the Corporation's bonds payable. These costs are being amortized over the life of the related bond using the straight-line method, which approximates the effective interest method.

(i) Property and Equipment

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

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(i) Property and Equipment (continued)

Depreciable lives are determined as follows:

Land improvements	15-25 years
Buildings and improvements	10-25 years
Departmental equipment, furniture and fixtures	10-25 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) Assets Whose Use is Limited

Assets whose use is limited are measured at fair value in the statements of financial position and include money deposited with a trustee under a debt agreement, assets restricted by donors for capital improvements, and the Maryland Department of Aging Operating Reserve.

(l) Deferred Revenue – Entrance Fees

Residents entering the Community execute a Residence and Care Agreement, which requires payment of an entrance fee, based on the unit to be occupied. Ten percent of the entrance fee, as approved by the Maryland Department of Aging, is due upon execution of the agreement and the remainder is due upon occupancy. Entrance fees are refundable in full upon termination of the agreement and subsequent reoccupancy of the unit. These entrance fees are amortized into revenue using the straight-line method over the remaining useful life of the facility. In November 2003, the Maryland Department of Aging approved 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 to married couples.

The amount of entrance fees refundable to residents at December 31, 2003 and 2002 under contractual refund provisions was approximately \$28,700,000 and \$27,500,000, respectively.

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(m) 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 consolidated statements of financial position. These deposits are transferred to deferred revenue upon occupancy of the related units.

(n) Goodwill

Goodwill, which represents the excess of purchase price over fair value of net assets acquired from PSSSI, 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.

(o) 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, Maryland Medicaid (Medicaid), and other third-party payors for services rendered. The Corporation derives a significant portion of its revenues from federal and state reimbursement programs. These reimbursements are subject to audit and retroactive adjustment in future periods. The Community is 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. 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.

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(o) Resident Services Revenue and Business Concentration (continued)

Nursing services provided to 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 of changes in Medicaid reimbursement in this state.

Revenues from Medicare and Medicaid represent approximately 11% and 10% of consolidated revenues for 2003 and 2002, respectively. Medicare and Medicaid receivables represent approximately 41% and 44% of consolidated accounts receivable at December 31, 2003 and 2002, respectively.

(p) Use of Estimates

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

(q) Tax Status

The Corporation and its subsidiaries are tax exempt under Section 501(c)(3) of the Internal Revenue Code.

(r) Derivatives and Hedging Activities

The Corporation utilizes interest rate swap agreements to hedge variable interest rates; which are accounted for using 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*.

As discussed in note 8, in 2003, the Corporation 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.

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Notes to Consolidated Financial Statements

December 31, 2003 and 2002

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

The Corporation's remaining interest rate swap is carried at fair value 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. For 2002, an adjustment to the liability was recorded causing a loss of \$1,271,095, representing the increase in the fair value (liability) of the swap. For 2003, an adjustment to the liability was recorded causing a gain of \$554,447, reporting a decrease in the fair value (liability) of the remaining swap.

(s) *Reclassification*

Certain amounts in 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 (losses) gains on investments in compliance with the early adoption of Financial Accounting Standards No. 149, Amendment of Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

(t) *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 net assets (liabilities) before unrealized gain (loss) on marketable securities". 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.

(3) **Investments**

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

	2003	
	Fair Value	Cost
Money market funds	\$ 22,781	22,781
Government bonds and notes	100,674	100,464
Totals	\$ 123,455	123,245

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(4) Related Party Transactions

The Corporation incurs a management fee payable to PHI under a Development, Marketing, and Management Agreement (Management Agreement). Under the Management Agreement, PHI provides a full-time licensed administrator who is responsible for the facility's operation, under the direction of PHI. For the years ended December 31, 2003 and 2002, the Corporation incurred fees under the agreement of \$630,432 and \$581,547, respectively, which are classified as general and administrative expenses on the consolidated statements of activities.

Presbyterian Homes, Inc., a subsidiary of PHI, has guaranteed payment up to \$6,000,000 to the extent collateral is insufficient to satisfy the outstanding debt of the Corporation as described in Note 8.

At December 31, 2003 and 2002 the amounts payable to PHI were \$955,253 and \$65,099, respectively. Under the Management Agreement, this is included in due to or from affiliated entity.

During 2003 and 2002, the Corporation purchased pharmaceuticals of \$71,002 and \$60,937, respectively from Continuing Care Rx, Inc., a wholly owned subsidiary of PHI.

(5) Assets Whose Use is Limited

At December 31 assets whose use is limited consist of the following:

	<u>2003</u>	<u>2002</u>
Operating reserve fund	\$ 927,711	735,914
Designated for renovation and charity care	425,175	363,476
Other reserves required by financing arrangement	142,793	134,949
	1,495,679	1,234,339
Less: current portion assets whose use is limited	(415,315)	(353,642)
Assets whose use is limited, net of net of current portion	<u>\$ 1,080,364</u>	<u>880,697</u>

The Corporation's Board of Directors has designated certain funds toward the purpose of acquiring or renovating property and equipment and for providing charity care. These funds are primarily held in government agency securities and money market funds.

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(5) Assets Whose Use is Limited (continued)

The Corporation is required by the Maryland Department of Aging to maintain and fund an operating reserve based on the Corporation's operating expenses for the most recent fiscal year, excluding depreciation and amortization. The Department of Aging requires the Corporation to build the level of this operating reserve over a period not to exceed ten years beginning in 1997. Annual contributions to the operating reserve equaling at least 10% of the calculated reserve amount are required. For the year ended December 31, 2003, the fund balance was \$927,711, representing cumulative contributions and earnings in satisfaction of the minimum operating reserve amount. Additional contributions of \$179,471 are anticipated to be made during 2004 based on the following computation:

		<u>2003</u>
Total operating expenses:	\$	10,724,867
Less: Depreciation		(1,316,962)
Amortization		<u>(181,383)</u>
Total expenses subject to operating reserve computation	(A)	9,226,522
Operating reserve requirement – 15% of (A)	(B)	1,383,978
Minimum operating reserve as of year 8 – 80% of (B)		1,107,182
Contributions made through year 7		<u>(927,711)</u>
Contributions required for year ended December 31, 2004	\$	<u><u>179,471</u></u>

(6) Commitments and Contingencies

The Corporation is involved in legal proceedings arising from its activities in the health care industry. Although it is not possible to presently determine the 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.

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(7) Property and Equipment

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

	<u>2003</u>		<u>2002</u>	
	<u>Cost</u>	<u>Accumulated depreciation</u>	<u>Cost</u>	<u>Accumulated depreciation</u>
Land	\$ 14,800,000	—	14,800,000	—
Land improvements	2,011,829	815,168	2,004,657	709,463
Buildings and improvements	26,331,416	9,609,108	25,406,329	8,522,122
Departmental equipment, furniture and fixtures	1,813,666	1,201,912	1,780,595	1,077,729
Vehicles	166,673	164,102	164,014	164,014
Construction-in-progress	262,302	—	335,919	—
	<u>\$ 45,385,886</u>	<u>11,790,290</u>	<u>44,491,514</u>	<u>10,473,328</u>
Net book value		<u>\$ 33,595,596</u>		<u>\$ 34,018,186</u>

Land consists of 483 acres, of which 60 acres are utilized for the facility. The remaining land is leased to independent parties and may be available for future expansion.

(8) Bonds payable

Bonds payable as of December 31 consisted of the following:

	<u>2003</u>	<u>2002</u>
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
	19,665,000	19,930,000
Less: current portion bonds payable	<u>(280,000)</u>	<u>(265,000)</u>
	<u>\$ 19,385,000</u>	<u>19,665,000</u>

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(8) Bonds payable (continued)

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

<u>Years ended December 31,</u>	
2004	\$ 280,000
2005	305,000
2006	330,000
2007	350,000
2008	375,000
Thereafter	<u>18,025,000</u>
	<u>\$ 19,665,000</u>

The irrevocable letter of credit, which serves as collateral for the Corporation's bonds payable requires the Corporation to pay an annual fee approximating 1.25% of the principal balance of bonds outstanding. This letter of credit expires August 2004 and is collateralized by property and equipment and gross revenues of the Corporation.

In 2003 the Corporation 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. The Corporation remains in a swap agreement with a financial intermediary which fixes the interest rate to be paid by the Corporation 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%

Pursuant to this agreement 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 Corporation. As discussed in Note 2, swap agreements are reported at fair value.

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Notes to Consolidated Financial Statements

December 31, 2003 and 2002

(9) Note Payable

The Corporation has available a line of credit with a financial institution. Borrowings under this line of credit arrangement vary with the prime rate. As of December 31, 2003, interest on outstanding borrowings was at 4%. Under the line of credit agreement, the Corporation had available maximum borrowings of \$1,250,000. As of December 31, 2003 and 2002, the Corporation's outstanding borrowings under the line of credit agreement were \$502,000 and \$395,000, respectively. The note expires on May 31, 2004.

(10) Leases

The Corporation leases certain equipment under operating leases, which expire at various dates through 2008. The future minimum lease payments under these operating leases are as follows:

2004	\$ 53,998
2005	24,807
2006	10,644
2007	10,644
2008	5,544
	<u>\$ 105,637</u>

Rental expense under operating leases was \$82,730 and \$70,135 for the years ended December 31, 2003 and 2002, respectively.

(11) Annuities

In 2003, the Corporation instituted 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, which creates a liability of the Corporation. Total annuities payable were \$66,734 at December 31, 2003. The Corporation uses published mortality-rate tables adopted by the United States Internal Revenue Service and an assumed discount rate of approximately four percent to determine the present value of the actuarially determined liability. The Corporation has assets included in investments of \$123,000 to satisfy annuities.

PRESBYTERIAN SENIOR LIVING SERVICES, INC.

Notes to Consolidated Financial Statements

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(12) 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 were approximately \$123,118 and \$126,388 for the years ended December 31, 2003 and 2002, respectively, of which the amount of charges foregone for services and supplies were approximately \$3,650 and \$0 for 2003 and 2002, respectively.

(13) Retirement Plan

The Corporation participates in the defined-contribution retirement plan of Presbyterian Homes, Inc., an affiliate. This plan covers 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 \$59,500 and \$61,000, respectively.

(14) 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.

Marketable securities: The fair values of marketable 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 approximates the fair 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 statements of financial position.

(15) Subsequent Events

In January 2004, the Corporation received an advance of \$1,500,000 from PHI, which was used to retire the swap termination fee payable.