



**Fayette Regional  
Health System**

**FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2008 AND 2007**

# FAYETTE REGIONAL HEALTH SYSTEM

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## REPORT OF INDEPENDENT AUDITORS

Board of Trustees  
Fayette Regional Health System  
Connersville, Indiana

We have audited the accompanying statements of financial position of Fayette Regional Health System (the System) as of September 30, 2008 and 2007, and the related statements of operations, changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the System'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 audits 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 financial statements referred to above present fairly, in all material respects, the financial position of the System as of September 30, 2008 and 2007 and the results of its operations, changes in net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Blue & Co., LLC*

January 22, 2009

# FAYETTE REGIONAL HEALTH SYSTEM

## STATEMENTS OF FINANCIAL POSITION SEPTEMBER 30, 2008 AND 2007

	2008	2007
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 486,500	\$ 864,958
Accounts receivable		
Patient services, net	12,178,827	11,598,206
Other	490,908	694,159
Inventories	1,139,397	1,096,100
Prepaid expenses and other current assets	657,076	508,245
Estimated third-party settlements	-0-	1,919,113
Total current assets	<u>14,952,708</u>	<u>16,680,781</u>
<b>Investments</b>	14,161,550	15,251,483
<b>Property and equipment</b>		
Land	1,410,452	1,344,783
Land improvements	851,912	786,140
Buildings and building equipment	48,422,412	47,639,869
Major movable equipment	25,764,178	25,424,568
Construction in progress	3,834,333	110,658
Total property and equipment	<u>80,283,287</u>	<u>75,306,018</u>
Less accumulated depreciation and amortization	(45,911,424)	(42,604,481)
Net property and equipment	<u>34,371,863</u>	<u>32,701,537</u>
<b>Interest in net assets of Foundation</b>	2,277,745	2,530,516
<b>Property held for sale, net</b>	-0-	426,062
<b>Other assets</b>	732,893	766,236
Total assets	<u>\$ 66,496,759</u>	<u>\$ 68,356,615</u>

See accompanying notes to financial statements.

# FAYETTE REGIONAL HEALTH SYSTEM

## STATEMENTS OF FINANCIAL POSITION SEPTEMBER 30, 2008 AND 2007

### LIABILITIES AND NET ASSETS

	2008	2007
<b>Current liabilities</b>		
Line-of-credit	\$ 2,002,694	\$ -0-
Current maturities of long-term debt	836,947	798,692
Current maturities of capital leases	138,819	129,115
Accounts payable	1,852,373	1,120,074
Accrued salaries, wages, and payroll taxes	2,035,181	2,187,401
Other accrued liabilities	406,707	420,193
Estimated third-party settlements	605,668	-0-
Total current liabilities	7,878,389	4,655,475
<b>Derivative liability</b>	1,343,791	366,746
<b>Long-term debt, less current maturities</b>	22,747,577	23,582,149
<b>Long-term capital leases, less current maturities</b>	125,171	274,760
Total liabilities	32,094,928	28,879,130
<b>Net assets</b>		
Unrestricted	32,124,086	36,946,969
Temporarily restricted - interest in Foundation's net assets	2,277,745	2,530,516
Total net assets	34,401,831	39,477,485
Total liabilities and net assets	\$ 66,496,759	\$ 68,356,615

See accompanying notes to financial statements.

# FAYETTE REGIONAL HEALTH SYSTEM

## STATEMENTS OF OPERATIONS YEARS ENDED SEPTEMBER 30, 2008 AND 2007

	2008	2007
<b>Net revenues</b>		
Net patient service revenue	\$ 59,394,782	\$ 55,316,885
Other revenue, net	1,890,515	2,976,044
Net assets released from restrictions	-0-	2,450
Total revenue	61,285,297	58,295,379
<b>Expenses</b>		
Salaries, wages and fringe benefits	34,886,329	31,566,576
Supplies and drugs	6,520,536	5,904,620
Purchased services	6,956,642	6,289,892
Utilities	1,511,343	1,393,946
Bad debts	5,508,856	4,511,338
Depreciation and amortization	3,726,984	3,630,566
Interest	1,119,527	1,195,103
Other operating expenses	1,920,574	1,950,080
Total expenses	62,150,791	56,442,121
Excess of revenue over (under) expenses	(865,494)	1,853,258
<b>Other changes in unrestricted net assets</b>		
Contributions	34,242	319,050
Net unrealized gain (loss) on investments	(3,014,586)	724,941
Unrealized gain (loss) on derivatives	(977,045)	108,508
<b>Change in unrestricted net assets</b>	\$ (4,822,883)	\$ 3,005,757

See accompanying notes to financial statements.

# FAYETTE REGIONAL HEALTH SYSTEM

## STATEMENTS OF CHANGES IN NET ASSETS YEARS ENDED SEPTEMBER 30, 2008 AND 2007

	<u>2008</u>	<u>2007</u>
<b>Unrestricted net assets</b>		
Excess of revenue over (under) expenses	\$ (865,494)	\$ 1,853,258
Contributions	34,242	319,050
Net unrealized gain (loss) on investments	(3,014,586)	724,941
Unrealized gain (loss) on derivatives	<u>(977,045)</u>	<u>108,508</u>
Change in unrestricted net assets	(4,822,883)	3,005,757
<b>Temporarily restricted net assets</b>		
Net assets released from restrictions	-0-	(2,450)
Change in interest in net assets of Foundation	<u>(252,771)</u>	<u>(174,038)</u>
Change in temporarily restricted net assets	<u>(252,771)</u>	<u>(176,488)</u>
<b>Change in net assets</b>	(5,075,654)	2,829,269
<b>Net assets, beginning of year</b>	<u>39,477,485</u>	<u>36,648,216</u>
<b>Net assets, end of year</b>	<u>\$ 34,401,831</u>	<u>\$ 39,477,485</u>

See accompanying notes to financial statements.

# FAYETTE REGIONAL HEALTH SYSTEM

## STATEMENTS OF CASH FLOWS YEARS ENDED SEPTEMBER 30, 2008 AND 2007

	2008	2007
<b>Operating activities</b>		
Change in net assets	\$(5,075,654)	\$ 2,829,269
Adjustments to reconcile change in net assets to net cash from operating activities		
Change in interest in net assets of the Foundation	252,771	174,038
Unrealized loss (gain) on derivatives	977,045	(108,508)
Depreciation and amortization	3,726,984	3,630,566
Bad debts	5,508,856	4,511,338
Net realized and unrealized loss (gain) on investments	3,091,773	(1,736,635)
Loss on disposal of property and equipment	46,441	7,258
Contributions of property and equipment	(34,242)	(319,050)
Changes in operating assets and liabilities:		
Accounts receivable	(5,886,226)	(5,135,662)
Inventories, prepaid expenses and other current	(192,128)	167,973
Accounts payable and other current liabilities	(1,526)	598,435
Estimated third-party settlements	2,524,781	(2,095,318)
Net cash from operating activities	4,938,875	2,523,704
<b>Investing activities</b>		
Purchases of property and equipment	(4,381,742)	(3,300,404)
Proceeds from sale of property and equipment	5,698	-0-
Change in assets limited as to use, net	-0-	2,450
Other changes in investments, net	(2,001,840)	699,393
Change in other assets, net	(5,941)	(2,970)
Net cash from investing activities	(6,383,825)	(2,601,531)
<b>Financing activities</b>		
Payments on long-term debt	(796,317)	(765,565)
Payments on capital leases	(139,885)	(141,743)
Proceeds (payments) from line of credit	2,002,694	-0-
Net cash from financing activities	1,066,492	(907,308)
Net change in cash and cash equivalents	(378,458)	(985,135)
<b>Cash and cash equivalents, beginning of year</b>	864,958	1,850,093
<b>Cash and cash equivalents, end of year</b>	\$ 486,500	\$ 864,958
<b>Supplemental disclosures of cash flow information</b>		
Cash paid for interest net of amount capitalized	\$ 1,119,527	\$ 1,195,103
<b>Non-cash investing activities</b>		
Property additions included in accounts payable	\$ 568,119	\$ -0-

See accompanying notes to financial statements.

# FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS  
SEPTEMBER 30, 2008 AND 2007

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## 1. SUMMARY OF SIGNIFICANT ACCOUNTING PRINCIPLES

### Organization

Fayette Memorial Hospital Association, Inc. dba Fayette Regional Health System (the System) is located in Connersville, Indiana, and includes a not-for-profit acute care hospital. The System provides inpatient, outpatient, emergency and other ancillary services for residents of east central Indiana.

### Cash and Cash Equivalents

Cash and cash equivalents consist of demand deposits and investments in highly liquid debt instruments with maturities of three months or less from the date of purchase. The System maintains its cash in bank deposit accounts which, at times, may exceed the federally insured limits. The System has not experienced any losses in such accounts. The System believes that it is not exposed to any significant credit risk on cash and cash equivalents.

### Allowance for Patient Services Accounts Receivable

The System evaluates the collectability of its accounts receivable based on certain factors, such as payer type, historical collection trends and aging categories. The allowance that is applied to the receivable balances is based on the historical experience and time limits, if any, for each particular payer source, such as private, insurance, Medicare and Medicaid. Actual results could differ from the estimated allowances.

### Investments

Investments consist primarily of U.S. government securities, corporate bonds and various equity securities. Investments are carried at fair value. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess of revenue over expenses unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the excess of revenues over expenses as the investments are not considered trading securities and the organization demonstrates the ability and intent to hold the securities until they recover.

### Inventories

Inventories are determined by physical count and valued at the lower of cost (first-in, first-out method) or market value.

# FAYETTE REGIONAL HEALTH SYSTEM

## NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

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### Temporarily Restricted Net Assets

Unconditional promises to give cash and other assets to the System are reported at fair value at the date the promise is received and are included in other revenue if the promise to give is unrestricted. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statement of operations as net assets released from restrictions. At September 30, 2008 and 2007, temporarily restricted net assets were restricted for the purpose of purchasing capital assets. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying financial statements.

### Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Useful lives are 3 to 40 years for property and equipment.

Gifts of long-lived assets such as land, buildings or equipment are reported as unrestricted support and are excluded from the excess of revenues over expenses, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the donated 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, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

### Property Held for Sale

Previous to September 30, 2007, the System closed one of its off-site locations and put the property up for sale. Subsequently, the System began utilizing the property again. Therefore, the related amounts have been placed into property and equipment as of September 30, 2008.

# FAYETTE REGIONAL HEALTH SYSTEM

## NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

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### Excess of Revenue Over Expenses

The statements of operations include excess of revenue over expenses. Changes in unrestricted net assets which are excluded from excess of revenue over expenses, consistent with industry practice, include unrealized gains and losses on investments other than trading securities, contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purpose of acquiring such assets) and unrealized gains (losses) on derivatives.

### Other Assets

Deferred financing costs are recorded at cost. Amortization is computed using the effective interest method over the life of the bonds. Amortization expense for 2008 and 2007 is \$39,284. Amortization expense for the next five years is \$39,284 per year.

### Net Patient Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

### Charity Care

The System provides charity care on a case-by-case basis for those patients who meet certain criteria of financial need. This care is provided without charge or at amounts less than established rates. Because the System does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. The System maintains records to identify and monitor the level of charity care it provides. These records include the amount of charges forgone for services and supplies furnished under its charity care policy.

### Pension Plans

The System maintains a defined contribution pension plan (the Plan) covering substantially all employees. The System contributes 2% of each employee's salary and matches 100% of employee deferral contributions up to 3% of the employees' salary, subject to certain eligibility requirements.

The System also maintains a 457(b) deferred compensation plan that provides for non-elective employer deferrals covering a select group of management or highly compensated individuals.

# FAYETTE REGIONAL HEALTH SYSTEM

## NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

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It is the System's policy to fund pension costs as accrued. Pension expense was \$997,976 and \$1,008,624 in 2008 and 2007, respectively.

### Federal and State Income Taxes

The System is a not-for-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code (the Code) and is exempt from federal income taxes on related income pursuant to Section 501(a) of the Code.

### Advertising Costs

The System's policy is to expense advertising costs when the advertising first takes place. Advertising expenses were \$312,643 and \$390,353 in 2008 and 2007, respectively.

### Use of Estimates

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

### Medical Malpractice Claims

The System participates in the Indiana Medical Malpractice Act which limits the maximum recovery to \$1,250,000 per occurrence, the first \$250,000 of which would be the responsibility of the System, with the balance paid by the State of Indiana Patient Compensation Fund. The System carries an occurrence basis insurance policy covering the System's \$250,000 of exposure per claim. Accordingly, the System has not recorded any provision for self-insured medical malpractice claims.

### Risk and Uncertainties

The Systems' investments (Note 3) are exposed to various risks such as interest rate, market and credit. Due to the level of risk associated with these securities and the level of uncertainty related to changes in the value, it is at least reasonably possible that changes in the various risk factors will occur in the near term that could materially affect the amounts reported in the accompanying financial statement.

### Reclassification

Certain 2007 balances were reclassified to agree with the current year presentation.

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## FAYETTE REGIONAL HEALTH SYSTEM

### NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

#### 2. NET PATIENT SERVICES ACCOUNTS RECEIVABLE

Net patient services accounts receivable consists of the following as of September 30, 2008 and 2007:

	2008	2007
Gross patient accounts receivable	\$ 21,672,055	\$ 19,774,897
Allowance for estimated contractual adjustments	(7,867,544)	(7,189,314)
Allowance for uncollectible accounts	(1,625,684)	(987,377)
Net patient services accounts receivable	\$ 12,178,827	\$ 11,598,206

#### 3. INVESTMENTS

The composition of investments at September 30, 2008 and 2007 follows:

	2008	2007
Certificate of deposits	\$ 500,454	\$ -0-
Bond funds	1,033,646	1,103,137
Common stock	9,463,700	11,314,908
Corporate bonds and notes	348,051	190,051
Convertible securities	834,461	887,438
Preferred securities	89,038	171,436
U.S. Government and mortgage backed securities	1,892,200	1,584,513
	\$ 14,161,550	\$ 15,251,483

Investment return for the years ended September 30, 2008 and 2007 is as follows:

	2008	2007
Investment income		
Interest and dividend income	\$ 492,807	\$ 455,330
Realized gain (loss), net	(77,187)	1,011,694
	415,620	1,467,024
Net unrealized gain (loss) on investments	(3,014,586)	724,941
Investment return, net	\$ (2,598,966)	\$ 2,191,965

# FAYETTE REGIONAL HEALTH SYSTEM

## NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

The following schedule summarizes the fair value of securities included in investments that have gross unrealized losses (the amount by which historical cost exceeds the fair value) as of September 30, 2008. The schedule further segregates the securities that have been in a gross unrealized position as of September 30, 2008, for less than twelve months and those for twelve months or more. The gross unrealized losses of less than twelve months are a reflection of the normal fluctuations of the market and are therefore considered temporary.

The gross unrealized losses of twelve months or longer are reflective of current market fluctuations. The majority of the decline is attributable to several securities which industry experts expect recovery in the short-term future. These individual investments have projected recoveries in value in 2009. The decline in value is determined by management to be temporary, and unrealized losses have not been reclassified to realized losses as of September 30, 2008. The System did not have any material unrealized holding losses as of September 30, 2007:

Description of securities	September 30, 2008					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Common stock	\$2,706,999	\$(340,471)	\$ -0-	\$ -0-	\$2,706,999	\$(340,471)
Corporate bonds and notes	335,806	(80,151)	-0-	-0-	335,806	(80,151)
Convertible securities	590,857	(67,043)	-0-	-0-	590,857	(67,043)
Preferred securities	89,038	(38,154)	-0-	-0-	89,038	(38,154)
Mutual funds	494,886	(85,635)	-0-	-0-	494,886	(85,635)
Total temporarily impaired securities	\$4,217,586	\$(611,454)	\$ -0-	\$ -0-	\$4,217,586	\$(611,454)

# FAYETTE REGIONAL HEALTH SYSTEM

## NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

### 4. RELATED PARTIES

The Fayette Memorial Hospital Foundation, Inc., dba Fayette Regional Health System Foundation (the Foundation), which is a financially interrelated organization with Fayette Regional Health System was established to solicit contributions from the general public and to support the System activities. Funds are distributed to the System as determined by the Foundation's Board of Trustees. A summary of the Foundation assets, liabilities, net assets, results of operations and changes in net assets for September 30, 2008 and 2007, follows. The System's interest in the net assets of the Foundation is reported as a non-current asset in the balance sheets.

	2008	2007
Financial position		
Assets, principally cash, investments and property	\$ 2,294,384	\$ 2,563,205
Liabilities	\$ 16,639	\$ 32,689
Net assets	2,277,745	2,530,516
Total liabilities and net assets	\$ 2,294,384	\$ 2,563,205
Statement of activities		
Support, revenue and income	\$ 220,707	\$ 574,872
Expenses		
Contributions to Fayette Regional Health System	45,718	319,050
Other	288,917	302,666
Total expenses	334,635	621,716
Excess revenue over (under) expenses	(113,928)	(46,844)
Net unrealized gains/(loss) on investments	(320,689)	60,994
Unrestricted net assets, beginning of year	2,035,842	2,021,692
Unrestricted net assets, end of year	1,601,225	2,035,842
Temporarily restricted net assets	676,520	494,674
Net assets, end of year	\$ 2,277,745	\$ 2,530,516
Change in temporarily restricted net assets	\$ 181,846	\$ (188,188)
Change in interest in Foundation	\$ (252,771)	\$ (174,038)

The System provided accounting and financial management services to the Foundation of approximately \$180,000 during 2008 and 2007.

# FAYETTE REGIONAL HEALTH SYSTEM

## NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

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The System purchased services related primarily to construction from organizations that employ board members in the amount of \$293,352 and \$166,389, for 2008 and 2007, respectively.

### 5. DERIVATIVE LIABILITY

In September 2002, the System entered into two "cash flow hedge interest rate swap" agreements with a financial institution. The System pays a fixed interest rate and the financial institution pays a variable interest rate (1.7% and 4.3% at September 30, 2008 and 2007, respectively) over the term of the agreements.

The System's objective is to provide protection against market driven increases in variable interest rates. The fair value of each agreement was determined by the financial institution using the present value of the estimated projected cash flows. The System is in a liability position as of September 30, 2008 and 2007 due to the present value of its estimated projected cash flows being greater than the financial institution's present value of estimated projected cash flows.

The first swap was effective on February 28, 2002, was amended on September 1, 2005 and matures on October 1, 2032. It contains an outstanding notional amount of \$13,110,000 with a 3.47% fixed rate of interest and is a derivative liability for the System with a fair value as of September 30, 2008 of \$550,596 and an asset as of September 30, 2007 of \$109,129 .

The second swap was effective on July 3, 2002, was amended on September 1, 2005 and matures on October 1, 2022. It contains an outstanding notional amount of \$10,065,000 with a 4.13% fixed rate of interest and is a derivative liability for the System with a fair value as of September 30, 2008 and 2007 of \$793,195 and \$475,875, respectively.

The total derivative liability recognized on the financial statements as an unrealized loss on derivatives is \$1,343,791 and \$366,746 for 2008 and 2007, respectively. The liability is only payable upon termination of the agreements.

## FAYETTE REGIONAL HEALTH SYSTEM

### NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

#### 6. LONG-TERM DEBT AND LINE-OF-CREDIT

A summary of long-term debt at September 30, 2008 and 2007 follows:

	2008	2007
Indiana Health Facility Financing Authority Hospital Revenue Bonds, Series 1998, Adjustable interest rate every 5 years, 2.87% at September 30, 2008 with monthly principal amounts, due in 2018	\$ 409,524	\$ 445,841
Indiana Health Facility Financing Authority Hospital Revenue Bonds, Series 2002A, variable interest rate, serial bonds, principal maturing in varying annual amounts, due in 2032	13,110,000	13,410,000
Indiana Health Facility Financing Authority Hospital Revenue Bonds, Series 2002B, Variable interest rate, serial bonds, principal maturing in varying annual amounts, due in 2022	10,065,000	10,525,000
	23,584,524	24,380,841
Less current maturities	(836,947)	(798,692)
Long-term debt, less current maturities	\$ 22,747,577	\$ 23,582,149

On February 1, 2002, the System issued \$13,980,000 of revenue bonds, Series 2002A through the Indiana Health Facility Financing Authority for the purchase of a computer system and the construction of an addition to the System facilities.

On July 1, 2002, the System issued \$12,185,000 of revenue bonds, Series 2002B through the Indiana Health Facility Financing Authority to refinance the Series 1992 bonds and a 1997 lease.

The System has entered into an interest rate swap agreement related to the 2002 Series A and B bonds (Note 5).

On May 18, 1999, the System issued \$1,400,000 of Revenue bonds, Series 1998 through the Indiana Health Facility Financing Authority for the purchase of computer equipment and the construction of a new facility.

# FAYETTE REGIONAL HEALTH SYSTEM

## NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

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Principal repayments on long-term debt for the next five years are as follows:

Year ending September 30,	
2009	\$ 836,947
2010	867,084
2011	909,407
2012	945,553
2013	986,733
Thereafter	19,038,800
	<u>\$ 23,584,524</u>

The System has a letter-of-credit for the 2002A Bonds in the amount of \$13,264,192 that is due to expire February 28, 2010. The System has a letter-of-credit for the 2002B Bonds in the amount of \$7,209,784 that is due to expire July 3, 2011. The System has pledged certain assets and is subject to covenants related to the debt instruments. In the event of a liquidity advance, interest will be charged at the bank's prime rate for the first 60 days. Subsequently, interest will be charged at the bank's prime rate plus 50 basis points. Payments on an advance will consist of interest only for the first 60 days and interest and principal for the remaining term not to exceed 60 months. The liquidity advance is due at the later of the stated expiration date of the letter of credit or 12 months after the advance is made.

The debt covenants require the System to maintain a Fixed Charge Ratio of at least 1.15 to 1.0 for each fiscal year of its operations, maintain a ratio of Funded Debt to Tangible Net Assets of not greater than 1.0, maintain a minimum Tangible Net Assets of not less than \$33,500,000, and maintain a Days Cash on Hand of not less than 90 days. At September 30, 2008 the System was in compliance with all debt covenants. At September 30, 2007 the System was in compliance with all covenants except for the Fixed Charge Ratio which a waiver was obtained from the bank.

As of September 30, 2008 and 2007, the System has borrowings of \$2,002,694 and \$-0- borrowings on its \$7,200,000 revolving line of credit, which bears interest at 1.25% above the 30 day LIBOR standard lending rate (2.93% and 5.49% at September 30, 2008 and 2007). The line of credit is secured by the System's investments.

# FAYETTE REGIONAL HEALTH SYSTEM

## NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

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### 7. LEASE OBLIGATIONS

The System leases equipment under non-cancelable operating leases expiring in various years through 2013. Total rental expense amounted to \$1,078,644 and \$881,567 for 2008 and 2007, respectively. Future minimum payments under the operating leases with initial terms in excess of one year are as follows:

Year ending September 30,	
2009	\$ 1,104,922
2010	1,247,121
2011	1,220,818
2012	1,220,818
2013	996,476
	<u>\$ 5,790,155</u>

In October 2004, the System entered into a capital lease arrangement for an MRI upgrade. The lease agreement is non-cancelable for 5 years. The agreement calls for annual payments of \$80,583 over the life of the lease. The effective interest rate on the capital lease is approximately 6.39%. As of September 30, 2008 and 2007, the recorded value on the System's balance sheet is \$344,608 with accumulated amortization of \$241,226 and \$172,304, respectively. Amortization of capital leases is included with depreciation expense for financial statement presentation.

In December 2005, the System entered into a capital lease arrangement for IV equipment. The lease agreement is non-cancelable for 5 years. The agreement calls for annual payments of \$83,160 over the life of the lease. The effective interest rate on the capital lease is approximately 7%. As of September 30, 2008 and 2007, the recorded value on the System's balance sheet is \$349,979 with accumulated amortization of \$131,242 and \$43,747, respectively. Amortization of capital leases is included with depreciation expense for financial statement presentation.

# FAYETTE REGIONAL HEALTH SYSTEM

## NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

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Future payments under all capital lease obligations are as follows:

<u>Year Ending September 30,</u>	
2009	\$ 163,743
2010	96,590
2011	<u>23,879</u>
	284,212
Less interest	<u>(20,222)</u>
	<u>\$ 263,990</u>

### 8. NET PATIENT SERVICE REVENUE

The System has agreements with third-party payors that provide for reimbursement to the System at amounts different from its established rates. Estimated contractual adjustments under third-party reimbursement programs represent the difference between the System's billings at standard rates and amounts reimbursed by third-party payors. They also include any differences between estimated third-party reimbursement settlements for prior years and subsequent final settlements. A summary of the reimbursement arrangements with major third-party payors is as follows:

#### Medicare

Medicare inpatient services are reimbursed based on a predetermined amount for each case based on the diagnosis associated with the patient (Prospective Payment System). These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. The prospectively determined rates are not subject to retroactive adjustment. The System's classification of patients under the Prospective Payment System and the appropriateness of patient admissions are subject to validation reviews by the Medicare peer review organization which is under contract with the System to perform such reviews. Medicare outpatient services are primarily reimbursed on predetermined rates based on the services provided. Medicare cost reports have been settled through 2006.

# FAYETTE REGIONAL HEALTH SYSTEM

## NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

### Medicaid

The System is reimbursed for Medicaid inpatient services under a prospectively determined rate-per-discharge and is not subject to retroactive adjustment. The differences between standard charges and reimbursement from these programs are recorded as contractual adjustments. Reimbursement for Medicaid outpatient services is based on predetermined rates, and is not subject to retroactive cost based settlements.

The System participates in the Disproportionate Share Hospital program. Subject to certain qualification criteria, the System is entitled to participate in the program annually. The System recognized reimbursement from the program within net patient revenue of approximately \$4,300,000 and \$4,800,000 during the years ended September 30, 2008 and 2007, respectively. At September 30, 2008 and 2007, the System has a receivable from the program of approximately \$-0- and \$2,000,000 respectively. This program is a Federal program administered by the state.

### Other Payors

The System also has entered into payment agreements with certain commercial insurance carriers and preferred provider organizations. The basis for payment to the System under these agreements includes prospectively determined rates per discharge, discounts from established charges and prospectively determined daily rates.

A summary of net patient service revenue, contractual adjustments and charity care for the years ended September 30, 2008 and 2007 follows:

	<u>2008</u>	<u>2007</u>
Patient service revenue		
Inpatient		
Routine services	\$ 15,926,400	\$ 14,834,517
Ancillary services	18,266,797	15,539,716
Outpatient		
Ancillary services	62,991,891	57,777,732
Physician services	17,828,839	15,384,273
Charity care	(1,429,795)	(1,776,955)
Patient service revenue	<u>113,584,132</u>	<u>101,759,283</u>
Contractual adjustments	(54,189,350)	(46,442,398)
Net patient service revenue	<u>\$ 59,394,782</u>	<u>\$ 55,316,885</u>

# FAYETTE REGIONAL HEALTH SYSTEM

## NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

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### 9. CONCENTRATIONS OF CREDIT RISK

The System grants credit without collateral to its patients, most of who are local residents and are generally insured under third-party payor agreements. The mix of receivables from patients and third-party payors at September 30, 2008 and 2007, is as follows:

	<u>2008</u>	<u>2007</u>
Medicare	37%	36%
Commercial insurance	14%	15%
Patients	23%	22%
Medicaid	18%	17%
Blue Cross	8%	10%
	<u>100%</u>	<u>100%</u>

### 10. AFFILIATION AGREEMENTS

The System has an affiliation agreement with a health system located in central Indiana to identify areas of collaboration in providing clinical services. No change in control of the System occurred as a result of the agreement. However, neither of the parties is allowed to enter into another affiliation agreement without prior approval of the other party.

During fiscal year 2006, the System entered into a regional affiliation agreement with a health system and cardiology group located in eastern Indiana to provide cardiology services to the System at the Heart Center. The initial term of this agreement is for the period of two years commencing on September 5, 2006 and terminating on September 4, 2008. No change in the control of the System occurred as a result of the agreement.

### 11. FUNCTIONAL EXPENSES

The System is an acute care facility providing long-term care and home health services. The System provides inpatient, outpatient and other ancillary services to residents within its geographical location. Expenses related to providing these services approximate the following:

	<u>2008</u>	<u>2007</u>
Health care services	\$ 55,053,488	\$ 49,095,823
Administrative and general	7,097,303	7,346,298
	<u>\$ 62,150,791</u>	<u>\$ 56,442,121</u>

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# FAYETTE REGIONAL HEALTH SYSTEM

## NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

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### 12. COMMITMENTS AND CONTINGENCIES

#### Self-Funded Health Plan

The System is committed to pay for employees' health care costs. A third-party administrator has been retained to process and present all benefit claims to the System for payment. The System has purchased excess loss insurance from Madison National Life Insurance Company. The System is responsible for the funding of all claims and related administrative costs up to \$100,000 per individual per policy year and up to \$295,090 per month on the group as a whole as of September 30, 2008. Group Health insurance expense for the years ended September 30, 2008 and 2007 totaled \$3,767,064 and \$2,492,938, respectively.

#### Litigation

The System is involved in litigation and regulatory investigations arising in the normal course of business. After consultation with legal counsel, management estimates that these matters will be resolved without adverse effect on the Systems future position or results from operations.