

PULASKI MEMORIAL HOSPITAL

BOARD OF TRUSTEES MEETING

JANUARY 27, 2009

CPAs / ADVISORS



PULASKI MEMORIAL HOSPITAL

**BOARD OF TRUSTEES MEETING
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PULASKI MEMORIAL HOSPITAL

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REPORT OF INDEPENDENT AUDITORS

Board of Trustees
Pulaski Memorial Hospital
Winamac, Indiana

We have audited the accompanying balance sheets of Pulaski Memorial Hospital (the Hospital), a component unit of Pulaski County, as of September 30, 2008 and 2007 and the related statements of operations and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Hospital'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 and the Guidelines for Audits of County and City Hospitals by Independent Certified Public Accountants, issued by the Indiana State Board of Accounts. 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 Hospital 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.

The Management Discussion and Analysis, as listed in the table of contents is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Blue & Co., LLC

January 26, 2009

REQUIRED SUPPLEMENTARY INFORMATION

PULASKI MEMORIAL HOSPITAL

MANAGEMENT'S DISCUSSION AND ANALYSIS SEPTEMBER 30, 2008 AND 2007

Our discussion and analysis of Pulaski Memorial Hospital's (the Hospital) financial performance provides an overview of the Hospital's financial activities for the years ended September 30, 2008 and 2007. Please read it in conjunction with the Hospital's financial statements and accompanying notes to the financial statements. Unless otherwise indicated, amounts in millions.

Using This Annual Report

This annual report consists of two parts—*management's discussion and analysis*, and the *basic financial statements*.

- In the "*management discussion and analysis*" section of this report the management of the hospital discuss various components of the annual report and provide an analysis of the current financial statement information.
- The "*basic financial statement*" section of this report includes a series of financial statements which provide information about the activities of the Hospital as a whole. The Balance Sheets reveal the assets and liabilities of the Hospital on September 30, 2008 and 2007 while the Statements of Operations and Changes in Net Assets summarizes the changes in the assets and liabilities for the years then ended. The Statements of Cash Flows summarize the change in cash and cash equivalents as a result of the financial activity during the year. The Notes to the Financial Statements disclose additional information addressed within the body of the financial statements.

Financial Highlights

The Hospital's Total Operating Revenue has experienced a trace increase of approximately \$0.2 million. Net assets have remained consistent at \$9.3 million. Net Patient Service Revenue increased \$.4 million or 2.2%. An updated budgeting process coupled with a concentration on contract re-negotiation has assisted in controlling expense level growth in the last year. FY2008 saw a reduction in Total Operating Expenses of \$0.1 million or .4%. Most of the expenses held the line with last year with slight decreases noted in Salaries and Benefits, Medical Professional Fees, Rent, and Insurance. Significant savings (\$364,392) was noted in the Supplies and Drugs as compared to FY2007.

An injection of approximately \$1.5 million in DSH, UPL, and HCI payments has helped in improving days of cash on hand from 19 in FY2007 to 43 in FY2008. Total Cash and Cash Equivalents showed gains for FY2007 (\$1.0 million) to FY2008 (\$2.4 million).

PULASKI MEMORIAL HOSPITAL

MANAGEMENT'S DISCUSSION AND ANALYSIS SEPTEMBER 30, 2008 AND 2007

Summarized Financial Statement Information

The Hospital's net assets are the difference between its assets and liabilities. The following information documents in summary the net assets and the changes in net assets related to activities of the Hospital for the years as of and for the years ended September 30, 2008 and 2007.

	2008	2007
	Net Assets (millions)	Net Assets (millions)
Current assets	\$ 5.5	\$ 5.0
Non-current cash and investments	0.6	0.5
Capital assets and other assets	6.0	6.2
Total assets	12.1	11.7
Current liabilities	2.0	2.2
Long-term debt and capital leases, net	0.8	0.2
Total liabilities	2.8	2.4
Net assets		
Invested in capital assets, net of related debt	4.7	5.5
Restricted expendable	0.6	0.5
Unrestricted	4.0	3.3
	\$ 9.3	\$ 9.3
	Changes in Net Assets (millions)	Changes in Net Assets (millions)
Revenue		
Net patient service revenue	\$ 19.4	\$ 19.0
Other revenue	0.8	1.0
Total operating revenue	20.2	20.0
Expenses		
Salaries and benefits	11.5	11.7
Medical professional fees	0.7	0.8
Other professional fees	1.7	1.4
Medical supplies and drugs	3.0	3.3
Rent	0.2	0.2
Insurance	0.3	0.3
Depreciation and amortization	1.2	1.2
Other	1.4	1.2
Total operating expenses	20.0	20.1
Operating income (loss)	0.2	(0.1)
Non-operating revenue, net	(0.2)	0.1
Change in assets	\$ 0.0	\$ 0.0

PULASKI MEMORIAL HOSPITAL

MANAGEMENT'S DISCUSSION AND ANALYSIS SEPTEMBER 30, 2008 AND 2007

Capital Assets and Debt Administration

Capital Assets

As of September 30, 2008 and 2007 the Hospital had \$5.9 million invested in capital assets. The following documents the type of assets that make up Capital Assets.

	2008 <u>(millions)</u>	2007 <u>(millions)</u>
Land	\$ 0.2	\$ 0.2
Land improvements	0.3	0.3
Buildings	7.4	7.4
Equipment	10.0	9.6
Construction in process	<u>0.5</u>	<u>0.3</u>
Total	18.4	17.8
Less accumulated depreciation	<u>12.5</u>	<u>11.7</u>
Net capital assets	<u>\$ 5.9</u>	<u>\$ 6.1</u>

*Changes in Capital Assets are reflected in the Notes to the Financial Statements.

Long-term Debt and Capital Leases

As of September 30, 2008 and 2007, the Hospital had approximately \$1.0 million and \$0.4 million in outstanding notes payable and capital leases, respectively. The following documents the long-term debt and capital leases held.

	2008 <u>(millions)</u>	2007 <u>(millions)</u>
Notes Payable	\$ 0.1	\$ 0.1
Capital Leases	<u>0.9</u>	<u>0.3</u>
	<u>\$ 1.0</u>	<u>\$ 0.4</u>

*Changes in Debt are reflected in the Notes to the Financial Statements.

PULASKI MEMORIAL HOSPITAL

MANAGEMENT'S DISCUSSION AND ANALYSIS SEPTEMBER 30, 2008 AND 2007

Economic Factors

The local economy is feeling the effects as evidenced in layoffs in the major manufacturers within the community we serve. Management anticipates ER volumes to increase marginally as the community foregoes family physician visits for budgetary purposes. Self-pay as well as Medicaid volumes are expected to rise creating additional cash flow challenges for the future. Being a Critical Access Hospital (CAH), we are reimbursed the cost of providing inpatient and outpatient services to Medicare patients, which is approximately 50% of the Hospital's revenue.

Contacting Hospital Management

This financial report is designed to provide our citizens, taxpayers, patients, and other interested parties with a general overview of the Hospital's financial condition. If you have any questions about this report, you may contact the Hospital's Chief Executive Officer at Pulaski Memorial Hospital, 616 E. 16th Street, PO Box 279, Winamac, Indiana 46996.

PULASKI MEMORIAL HOSPITAL

BALANCE SHEETS SEPTEMBER 30, 2008 AND 2007

ASSETS	2008	2007
Current assets		
Cash and cash equivalents	\$ 1,739,826	\$ 473,498
Patient accounts receivable, net of estimated uncollectibles of \$1,795,057 and \$1,856,363 in 2008 and 2007, respectively	2,770,972	3,455,218
Estimated third party settlements	111,971	412,289
Supplies and other current assets	866,696	645,048
Total current assets	5,489,465	4,986,053
Noncurrent cash and investments		
Restricted by contributors and grantors	640,080	532,014
Total noncurrent cash and investments	640,080	532,014
Capital assets		
Land and construction in progress	713,688	472,852
Depreciable capital assets, net	5,161,352	5,596,930
Total capital assets	5,875,040	6,069,782
Other assets	144,584	179,584
Total assets	\$ 12,149,169	\$ 11,767,433
LIABILITIES AND NET ASSETS		
Current liabilities		
Line of credit	\$ -0-	\$ 150,000
Current maturities of long-term debt and capital leases	386,894	338,423
Accounts payable and accrued expenses	397,412	762,164
Accrued salaries and related liabilities	1,058,539	872,430
Other current liabilities	133,492	56,052
Total current liabilities	1,976,337	2,179,069
Long-term liabilities		
Long-term debt	-0-	57,094
Capital leases	670,689	22,996
Other long-term liabilities	134,167	169,167
Total long-term liabilities	804,856	249,257
Total liabilities	2,781,193	2,428,326
Net assets		
Unrestricted	4,038,876	3,332,776
Invested in capital assets, net of related debt	4,683,290	5,482,102
Restricted		
Expendable for capital acquisitions	577,536	460,762
Expendable for specific operating activities	68,274	63,467
Total net assets	9,367,976	9,339,107
Total liabilities and net assets	\$ 12,149,169	\$ 11,767,433

See accompanying notes to financial statements.

PULASKI MEMORIAL HOSPITAL

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

	2008	2007
Revenues		
Net patient service revenue	\$ 19,378,966	\$ 18,960,871
Other	769,508	976,400
Total operating revenue	20,148,474	19,937,271
Expenses		
Salaries and benefits	11,536,019	11,711,991
Medical professional fees	715,652	750,695
Other professional fees	1,694,130	1,407,088
Supplies and drugs	2,960,692	3,325,084
Rent	177,666	178,653
Insurance	280,873	295,331
Depreciation and amortization	1,243,393	1,165,384
Other	1,359,251	1,212,721
Total operating expenses	19,967,676	20,046,947
Operating income (loss)	180,798	(109,676)
Nonoperating revenue (expense)		
Investment income	46,935	32,519
Interest expense	(48,036)	(35,548)
Other	(150,828)	114,767
Total nonoperating revenue (expense)	(151,929)	111,738
Change in net assets	28,869	2,062
Net assets, beginning of year	9,339,107	9,337,045
Net assets, end of year	\$ 9,367,976	\$ 9,339,107

See accompanying notes to financial statements.

PULASKI MEMORIAL HOSPITAL

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

	2008	2007
Operating activities		
Cash received from patients and third party payors	\$ 20,363,530	\$ 18,838,318
Cash paid to employees for salaries and benefits	(11,349,910)	(11,793,001)
Cash paid to vendors for goods and services	(7,724,464)	(7,138,473)
Other operating receipts, net	1,015,964	976,400
Net cash from operating activities	2,305,120	883,244
Capital and related financing activities		
Acquisition and construction of capital assets	(401,572)	(359,519)
Interest paid on long-term debt	(48,036)	(35,548)
Proceeds on line of credit	-0-	250,000
Payments on line of credit	(150,000)	(100,000)
Proceeds on long-term debt	125,000	-0-
Principal payments on long-term debt and capital leases	(352,225)	(468,995)
Net cash from capital and related financing activities	(826,833)	(714,062)
Investing activities		
Investment and other nonoperating income	(103,893)	147,286
Net cash from investing activities	(103,893)	147,286
Net change in cash and cash equivalents	1,374,394	316,468
Cash and cash equivalents, beginning of year	1,005,512	689,044
Cash and cash equivalents, end of year	\$ 2,379,906	\$ 1,005,512
Reconciliation of cash and cash equivalents to the balance sheets		
Cash and cash equivalents		
In current assets	\$ 1,739,826	\$ 473,498
In noncurrent cash and investments	640,080	532,014
Total cash and cash equivalents	\$ 2,379,906	\$ 1,005,512

See accompanying notes to financial statements.

PULASKI MEMORIAL HOSPITAL

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

**Reconciliation of operating loss
to net cash from operating activities**

Operating income (loss)	\$ 180,798	\$ (109,676)
Adjustments to reconcile operating income (loss) to net cash from operating activities:		
Depreciation and amortization	1,243,393	1,165,384
Loss on disposal of capital assets	246,456	-0-
Provision for bad debt	1,402,017	992,441
Changes in assets and liabilities		
Patient accounts receivable	(717,771)	(1,208,288)
Estimated third-party settlements	300,318	93,294
Supplies and other current assets	(221,648)	(58,230)
Other assets	7,760	(169,167)
Accounts payable and accrued expenses	(364,752)	116,941
Other current liabilities	77,440	(27,612)
Accrued salaries and related liabilities	186,109	(81,010)
Other long-term liabilities	(35,000)	169,167
Net cash flows from operating activities	\$ 2,305,120	\$ 883,244

Property was acquired under capital leases in the amount of \$1,042,780.

See accompanying notes to financial statements.

PULASKI MEMORIAL HOSPITAL

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

1. SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

Pulaski Memorial Hospital (the Hospital) is a county owned facility and operates under the Indiana County Hospital Law, Indiana Code 16-22. The Hospital provides short-term inpatient and outpatient health care.

The Board of County Commissioners of Pulaski County appoints the Governing Board of the Hospital (Board) and a financial benefit/burden relationship exists between the County and the Hospital. For these reasons, the Hospital is considered a component unit of Pulaski County.

The accompanying financial statements present the activities of the Hospital (primary government). There are no significant component units which require inclusion.

Enterprise Fund Accounting

The Hospital uses enterprise fund accounting. Revenues and expenses are recognized on the accrual basis using the economic resources measurement focus. Based on Governmental Accounting Standards Board (GASB) Statement No. 20, Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting, as amended, the Hospital has elected to apply the provisions of all relevant pronouncements of the Financial Accounting Standards Board (FASB), including those issued after November 30, 1989, that do not conflict with or contradict GASB pronouncements.

Deposits and Investments

Cash and cash equivalents include demand deposits and investments in highly liquid debt instruments with an original maturity date of three months or less. The Hospital maintains its cash in accounts, which at times, may exceed federally insured limits. The Hospital has not experienced any losses in such accounts. The Hospital believes that it is not exposed to any significant credit risk on cash and cash equivalents.

Short-term investments are investments with remaining maturities of up to ninety days.

Nonparticipating certificates of deposit, demand deposits, and similar nonparticipating negotiable instruments that are not reported as cash and cash equivalents are reported as investments at cost.

Investment income includes interest income and is reported as nonoperating revenues in the statement of operations and changes in net assets.

PULASKI MEMORIAL HOSPITAL

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

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 disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Capital Assets

Capital assets, which include land, land improvements, buildings and improvements, and equipment, are reported at historical cost. Contributed or donated assets are reported at estimated fair value at the time received. Capital assets under capital lease obligations are amortized on the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the financial statements.

Capitalization thresholds (the dollar values above which asset acquisitions are added to the capital asset accounts), depreciation methods and estimated useful lives of capital assets reported in the financial statements are as follows:

<u>Description</u>	<u>Capitalization Threshold</u>	<u>Depreciation Method</u>	<u>Estimated Useful Life</u>
Land improvements	\$ 2,000	Straight line	*
Buildings and fixed equipment	\$ 2,000	Straight line	*
Major movable and minor equipment	\$ 2,000	Straight line	*

* Based on the most current edition of the American Hospital Association's (AHA's) Estimated Useful Lives of Depreciable Hospital Assets, for each individual capital asset.

For depreciated assets, the cost of normal maintenance and repairs that do not add to the value of the asset or materially extend assets lives are not capitalized.

Major outlays for capital assets and improvements are capitalized as projects are constructed. Interest incurred during the construction phase of capital assets is included as part of the capitalized value of the assets constructed. No interest was capitalized during either 2008 or 2007.

PULASKI MEMORIAL HOSPITAL

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

Noncurrent Cash and Investments

Internally designated – Funded Depreciation – Amounts transferred from the Operating Fund by the Hospital Board of Trustees through funding depreciation expense. Such amounts are to be used for equipment and building, remodeling, repairing, replacing or making additions to the Hospital buildings as authorized by IC 16-22-3-13.

Restricted by contributors and grantors – Amounts include cash from three funds that are restricted for specific operating purposes either by the donor or funding source. The funds include Sweet Beginnings, Building and Donated, and Cumulative Building Fund.

Compensated Absences

Sick Time – Hospital employees earn sick leave at various rates per pay period. Unused sick leave may be accumulated to a maximum of ninety-six hours. Accumulated sick leave over ninety-six hours is paid to employees through cash payments upon proper notice of termination or upon request of the employee to be included on the last pay of each calendar year.

Paid Time Off – Hospital employees earn paid time off at various rates per pay period based upon their classification and their number of years of service. Paid time off may be accumulated to a maximum of 136 to 216 hours based on their number of years of service. Accumulated paid time off is paid to employees through cash payments upon proper notice of termination.

Paid time off and sick leave are accrued when incurred and reported as a liability.

Estimated Third-Party Settlements

Regulations in effect require annual retroactive settlements for third-party settlements based upon cost reports filed by the Hospital. These retroactive settlements are estimated and recorded in the accompanying financial statements. Changes in these estimates are reflected in the year in which they occur. Net patient service revenues in the accompanying statements of operations and changes in net assets were increased by approximately \$2M during 2008, to reflect changes in the estimated settlements for certain prior years. During 2007 there were no material differences from the estimated settlements from prior years.

PULASKI MEMORIAL HOSPITAL

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

Net Assets

Net assets of the Hospital are classified in three components.

Net assets invested in capital assets net of related debt consist of capital assets net of accumulated depreciation and reduced by the current balances of any outstanding borrowings used to finance the purchase or construction of those assets.

Restricted expendable net assets are net assets that must be used for a particular purpose, as specified by creditors, grantors, or contributors external to the Hospital.

Unrestricted net assets are remaining net assets that do not meet the definition of invested in capital assets net of related debt or restricted.

Patient Accounts Receivable, Revenues and Operating Expenses

Net patient service revenues are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated adjustments under reimbursement agreements. 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.

The Hospital is a provider of services to patients entitled to coverage under Medicare. The Hospital was granted Critical Access Status by Medicare. The Hospital is paid for Medicare services based upon a cost reimbursement methodology. The Hospital is reimbursed for cost reimbursable items at a tentative rate, with final settlement determined after submission of annual cost reports.

Final determination of amounts earned is subject to review by the fiscal intermediary. Medicare reports have been settled through 2006. Management believes adequate provision has been made in the financial statements for any adjustments.

Management estimates an allowance for doubtful accounts receivable based on an evaluation of historical losses, current economic conditions, and other factors unique to the Hospital's patient base.

Revenue from Medicare and Medicaid programs account for approximately 35 percent and 6 percent, respectively, of the Hospital's net patient service revenue for the fiscal year ended 2008, and 39 percent and 3 percent, respectively, of the Hospital's net patient revenue for the fiscal year ended 2007.

PULASKI MEMORIAL HOSPITAL

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

Charity Care

The Hospital provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Amounts deemed to be charity care are not reported as revenues.

Operating Revenues and Expenses

The Hospital's statement of operations and changes in net assets distinguishes between operating and nonoperating revenues and expenses. Operating revenues result from exchange transactions associated with providing health care services, the Hospital's principal activity. Nonoperating revenues include contributions received for purposes other than capital asset acquisition, and other nonoperating activities and are reported as nonoperating revenues. Operating expenses are all expenses incurred to provide health care services, other than financing costs.

Grants and Contributions

From time to time, the Hospital receives grants from Pulaski County and the State of Indiana as well as contributions from individuals and private organizations. Revenues from grants and contributions (including contributions of capital assets) are recognized when all eligibility requirements, including time requirements are met. Grants and contributions may be restricted for either specific operating purposes or for capital purposes. Amounts that are unrestricted or that are restricted to a specific operating purpose are reported as nonoperating revenues. Amounts restricted to capital acquisitions are reported after nonoperating revenues and expenses.

Advertising Costs

The Hospital expenses advertising costs as they are incurred. Advertising expense for the years ended September 30, 2008 and 2007 was \$120,439 and \$99,017, respectively.

Restricted Resources

When the Hospital has both restricted and unrestricted resources available to finance a particular program, it is the Hospital's policy to use restricted resources before unrestricted resources.

PULASKI MEMORIAL HOSPITAL

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

Risk Management

The Hospital is exposed to various risks of loss related to torts; theft of, damage to and the destruction of assets; errors and omissions; job related illness or injuries to employees; medical benefits to employees and dependents (excluding post employment benefits); and natural disasters.

The risk of torts; theft of, damage to, and destruction of assets; errors and omissions; job related illnesses or injuries to employees; and natural disasters are covered by commercial insurance from independent third parties. Settled claims from these risks have not exceeded commercial insurance coverage for the past four years.

Federal of State Income Taxes

The Hospital is a governmental instrumentality organized under Title 16, Article 12, of the Indiana statutes. The Hospital is exempt from federal income tax under Section 115 of the Internal Revenue Code of 1986 as a not-for-profit organization under Section 501(c)(3).

Minimum Revenue Guarantees (New Accounting Pronouncement)

In November 2005, the FASB issued FASB Staff Position No. 45-3, "Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or Its Owners" ("FIN 45-3"). It served as an amendment to FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others" ("FIN 45") by adding minimum revenue guarantees to the list of examples of contracts to which FIN 45 applies.

Under FIN 45, a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. One example cited in FIN 45-3 involves a guarantee provided by a healthcare entity to a non-employed physician in order to recruit such physician to move to the entity's geographical area and establish a private practice, which is the approach the Hospital uses in recruiting physicians to the community. FIN 45 is effective for new minimum revenue guarantees issued or modified on or after January 1, 2006.

The Hospital adopted this amendment to FIN 45 effective January 1, 2006. For periods ending before January 1, 2006, the Hospital did not report the fair value of its obligations under physician revenue guarantee agreements. However, under FIN 45 as amended, the Hospital is required to report the liability for these physician revenue guarantees on its balance sheets at fair value and amortize the related prepaid physician recruitment expense over the period of the physician's contractual commitment to practice in the local community.

PULASKI MEMORIAL HOSPITAL

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

2. CHARITY CARE

Charges excluded from patient service revenue under the Hospital's charity care policy were \$138,655 and \$240,474 for 2008 and 2007, respectively.

3. DEPOSITS AND INVESTMENTS

Deposits with financial institutions in the State of Indiana at year end were entirely insured by the Federal Depository Insurance Corporation or by the Indiana Public Deposit Insurance Fund. This includes any deposit accounts issued or offered by a qualifying financial institution.

The Hospital's investments generally are reported at cost, as discussed in Note 1. As of September 30, 2008 and 2007, the Hospital had the following investments and maturities, all of which were held in the Hospital's name by custodial banks that are agents of the Hospital:

September 30, 2008					
	Carrying Amount	Investment Maturities (in years)			More than 10
		Less than 1	1-5	6-10	
Cash and cash equivalents	<u>\$ 2,379,906</u>	<u>\$ 2,379,906</u>	<u>\$ -0-</u>	<u>\$ -0-</u>	<u>\$ -0-</u>

September 30, 2007					
	Carrying Amount	Investment Maturities (in years)			More than 10
		Less than 1	1-5	6-10	
Cash and cash equivalents	<u>\$ 1,005,512</u>	<u>\$ 1,005,512</u>	<u>\$ -0-</u>	<u>\$ -0-</u>	<u>\$ -0-</u>

Interest rate risk – The Hospital does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from changing interest rates.

Credit risk – Statutes authorize the Hospital to invest in interest bearing deposit accounts, passbook savings accounts, certificates of deposit, money market accounts, mutual funds, pooled fund investments, securities backed by the full faith and credit of the United States Treasury and repurchase agreements. The statutes require that repurchase agreements be fully collateralized by U.S. Government or U.S. Government Agency obligations.

Concentration of credit risk – The Hospital places no limit on the amount it may invest in any one issuer. The Hospital believes that it is not exposed to any significant credit risk on investments.

PULASKI MEMORIAL HOSPITAL

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

Deposits and investments consist of the following as of September 30, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Cash and cash equivalents	<u>\$ 2,379,906</u>	<u>\$ 1,005,512</u>
Included in the following balance sheet		
Cash and cash equivalents	\$ 1,739,826	\$ 473,498
Restricted by contributors and grantors	640,080	532,014
	<u>\$ 2,379,906</u>	<u>\$ 1,005,512</u>

4. ACCOUNTS RECEIVABLE AND PAYABLE

Patient accounts receivable and accounts payable (including accrued expenses) reported as current assets and liabilities by the Hospital at year end consisted of the following amounts at September 30, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Patient accounts receivable		
Receivable from patients and their insurance carriers	\$4,134,179	\$4,684,698
Receivable from Medicare	1,611,199	1,952,834
Receivable from Medicaid	1,131,480	702,690
Total patient accounts receivable	<u>6,876,858</u>	<u>7,340,222</u>
Less allowance for contractual agreements and uncollectible amounts	<u>4,105,886</u>	<u>3,885,004</u>
Patient accounts receivable, net	<u>\$2,770,972</u>	<u>\$3,455,218</u>
Accounts payable and accrued expenses		
Payable to employees (including payroll taxes)	\$ 733,539	\$ 772,430
Payable to suppliers	397,412	762,164
Accrued employee health benefit claims	325,000	100,000
Total accounts payable and accrued expenses	<u>\$1,455,951</u>	<u>\$1,634,594</u>

PULASKI MEMORIAL HOSPITAL

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

5. CAPITAL ASSETS

Capital asset activity for the years ended September 30, 2008 and 2007 is as follows:

	Balance September 30, 2007	Additions	Retirements	Transfers	Balance September 30, 2008
Land	\$ 189,325	\$ -0-	\$ -0-	\$ -0-	\$ 189,325
Land improvements	281,113	-0-	-0-	-0-	281,113
Buildings and fixtures	7,394,995	6,993	-0-	-0-	7,401,988
Fixed equipment	3,565,295	-0-	-0-	-0-	3,565,295
Moveable equipment	6,039,163	993,657	(671,082)	26,384	6,388,122
Construction in process	283,528	267,220	-0-	(26,384)	524,364
Total	17,753,419	1,267,870	(671,082)	-0-	18,350,207
Accumulated depreciation	11,683,637	1,216,153	(424,623)	-0-	12,475,167
Net capital assets	\$ 6,069,782	\$ 51,717	\$ (246,459)	\$ -0-	\$ 5,875,040

	Balance September 30, 2006	Additions	Retirements	Transfers	Balance September 30, 2007
Land	\$ 189,325	\$ -0-	\$ -0-	\$ -0-	\$ 189,325
Land improvements	281,113	-0-	-0-	-0-	281,113
Buildings and fixtures	7,127,898	-0-	-0-	267,097	7,394,995
Fixed equipment	3,471,279	38,409	-0-	55,607	3,565,295
Moveable equipment	5,908,559	62,849	-0-	67,755	6,039,163
Construction in process	415,726	258,261	-0-	(390,459)	283,528
Total	17,393,900	359,519	-0-	-0-	17,753,419
Accumulated depreciation	10,518,253	1,165,384	-0-	-0-	11,683,637
Net capital assets	\$ 6,875,647	\$ (805,865)	\$ -0-	\$ -0-	\$ 6,069,782

PULASKI MEMORIAL HOSPITAL

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

6. PHYSICIAN RELOCATION AGREEMENTS AND OTHER MINIMUM REVENUE GUARANTEES

Consistent with the Hospital's policy on physician relocation and recruitment, the Hospital provides income guarantee agreements to certain physicians who agree to relocate to the community to fill a need in the Hospital's service area and commit to remain in practice there. Annually, under such agreements, the Hospital is required to make payments to the physicians in excess of the amounts they earn in their practice up to the amount of the income guarantee. Such payments are recoverable from the physicians if they do not fulfill their commitment period to the community, which is typically five years. The Hospital also provides minimum revenue collection guarantees to Hospital-based physician groups providing certain services at the Hospital with terms of one year. At September 30, 2008 and 2007, the maximum potential amount of future payments under these guarantees was approximately \$175,000, which is included in the assets and liabilities in the Balance Sheets.

7. LINE OF CREDIT

The Hospital had an \$800,000 line of credit which expired on August 28, 2008. Interest was due monthly at 6.25%. Outstanding borrowings under the line of credit were \$150,000 at September 30, 2007.

8. LONG-TERM DEBT AND CAPITAL LEASES

The Hospital obtained an unsecured note payable during 2008. Payments, including interest at prime plus 2.25% (prime rate was 5.00% at September 30, 2008), of \$10,831 are due monthly through April 2009. The Hospital also has a note payable, secured by computer equipment. Payments, including interest at an annual rate of 4.75%, of \$7,266 are due monthly through May 2009.

The Hospital has also entered into various capital leases at varying rates of imputed interest from 2.8% to 7.5%, collateralized by leased equipment.

PULASKI MEMORIAL HOSPITAL

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

Long-term debt and capital lease activity for the years ended September 30, 2008 and 2007, was as follows:

	Balance September 30, 2007	Additional borrowings	Payments	Balance September 30, 2008	Current portion	Long-term portion
Notes Payable	\$ 139,437	\$ 125,000	\$ (133,320)	\$ 131,117	\$131,117	\$ -0-
Capital Leases	279,076	1,042,784	(395,394)	926,466	255,777	670,689
	<u>\$ 418,513</u>	<u>\$ 1,167,784</u>	<u>\$ (528,714)</u>	<u>\$ 1,057,583</u>	<u>\$ 386,894</u>	<u>\$ 670,689</u>

	Balance September 30, 2006	Additional borrowings	Payments	Balance September 30, 2007	Current portion	Long-term portion
Notes Payable	\$ 270,752	\$ -0-	\$ (131,315)	\$ 139,437	\$ 82,343	\$ 57,094
Capital Leases	616,756	-0-	(337,680)	279,076	256,080	22,996
	<u>\$ 887,508</u>	<u>\$ -0-</u>	<u>\$ (468,995)</u>	<u>\$ 418,513</u>	<u>\$ 338,423</u>	<u>\$ 80,090</u>

Scheduled principal and interest repayments on long-term debt and payments on capital lease obligations are as follows:

Year ending September 30,	Notes payable		Capital lease obligations	
	Principal	Interest	Principal	Interest
2009	\$ 131,117	\$ 2,821	\$ 255,777	\$ 34,138
2010	-0-	-0-	239,641	26,806
2011	-0-	-0-	224,442	18,031
2012	-0-	-0-	167,903	5,980
2013	-0-	-0-	38,703	279
	<u>\$ 131,117</u>	<u>\$ 2,821</u>	<u>\$ 926,466</u>	<u>\$ 85,234</u>

PULASKI MEMORIAL HOSPITAL

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

The following is an analysis of the leased assets included in property and equipment as of September 30:

	<u>2008</u>	<u>2007</u>
Equipment	\$ 1,083,296	\$ 1,022,718
Accumulated depreciation	317,879	691,781
	<u>\$ 765,417</u>	<u>\$ 330,937</u>

9. PATIENT SERVICE REVENUE

Patient service revenue for the years ended September 30, 2008 and 2007 consists of the following:

	<u>2008</u>	<u>2007</u>
Inpatient services	\$ 10,400,782	\$ 9,241,259
Outpatient services	24,297,052	24,950,127
Gross patient service revenue	<u>34,697,834</u>	<u>34,191,386</u>
Contractual allowances	(13,570,939)	(13,753,162)
Charity care	(345,912)	(484,912)
Bad debt	(1,402,017)	(992,441)
Deductions from revenue	<u>(15,318,868)</u>	<u>(15,230,515)</u>
Net patient service revenue	<u>\$ 19,378,966</u>	<u>\$ 18,960,871</u>

10. EMPLOYEE HEALTH PLAN

The Hospital has established a risk financing fund for risks associated with medical benefits to employees and dependents. The risk financing fund is accounted for in the Operating Fund where assets are set aside and a liability is accrued for claim settlements. An excess policy through commercial insurance covers individual claims in excess of \$75,000 per year.

Claim expenditures and liabilities of the fund are reported when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. These losses include an estimate of claims that have been incurred but not reported (IBNR). Claim liabilities are calculated considering the effect of inflation, recent claim settlement trends, including frequency and amounts of payouts, and other economic and social factors.

Health insurance expense for the years ended September 30, 2008 and 2007, was approximately \$2,434,000 and \$2,132,000 respectively.

PULASKI MEMORIAL HOSPITAL

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2008 AND 2007

11. MEDICAL MALPRACTICE

The Indiana Medical Malpractice Act, IC 27-12 (the Act), provides a recovery for an occurrence of malpractice and for any injury or death of a patient due to an act of malpractice in excess of certain thresholds. The Act requires the Hospital to maintain medical malpractice liability insurance on a per occurrence basis and in the annual aggregate.

12. CONCENTRATIONS OF CREDIT RISK

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

	<u>2008</u>	<u>2007</u>
Medicare and Medicaid	41%	37%
Commercial and other payors	23%	28%
Self-pay payors	36%	35%
	<u>100%</u>	<u>100%</u>

13. COMMITMENTS AND CONTINGENCIES

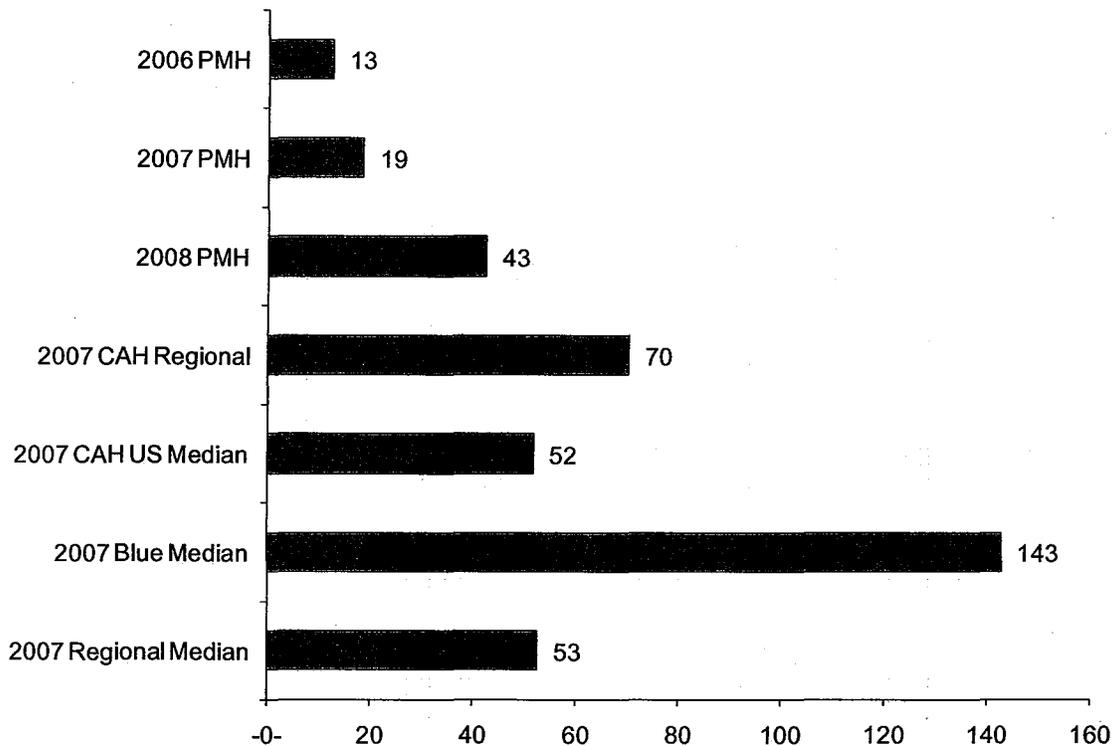
The Hospital is involved in litigation and regulatory investigations arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on the Hospital's future financial position or results from operations.

14. JOINT VENTURE

In January of 2004, the Hospital entered into a joint venture, West Central Health Partners, with three other health care providers in surrounding counties. The initial capital contribution was approximately \$10,000. The venture was formed to provide support for physician recruiting and to potentially establish various purchasing agreements.

Pulaski Memorial Hospital Days Cash on Hand (All Sources)

CPAS / ADVISORS



Desired Position: High

U.S. Trend: Decrease to a five year low

U.S. Forecast: Constant

Formula

Unrestricted Current and Non-current Cash and Investments / [(Total Expenses less Depreciation and Amortization) / 365]

Definition

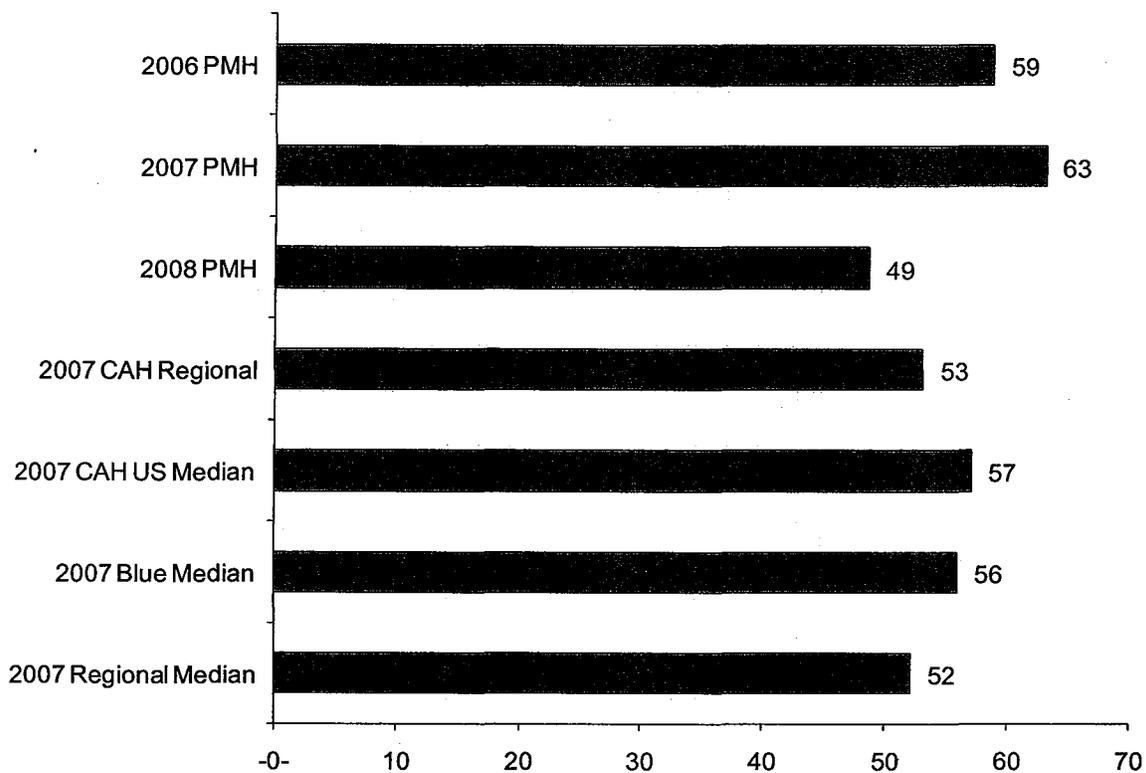
Days cash on hand is a liquidity ratio that measures the number of days of cash operating expenses a hospital has covered by unrestricted cash, cash equivalents and marketable securities.

Performance Implications

High values indicate a greater ability to meet both short-term obligations and long-term capital replacement needs. Lower performing hospitals have lower values. Improvement can come from improved cash flow from operations and controlling purchases of property and equipment.

Pulaski Memorial Hospital

Days in Patient Accounts Receivable, Net



Desired Position: Low
 U.S. Trend: Slight Increase
 U.S. Forecast: Stable

Formula

Net Accounts Receivable / (Net Patient Service Revenues / 365)

Definition

Days in Accounts Receivable is a liquidity ratio which measures the average time that receivables are outstanding and is thus an indicator of the efficiency in collecting receivables.

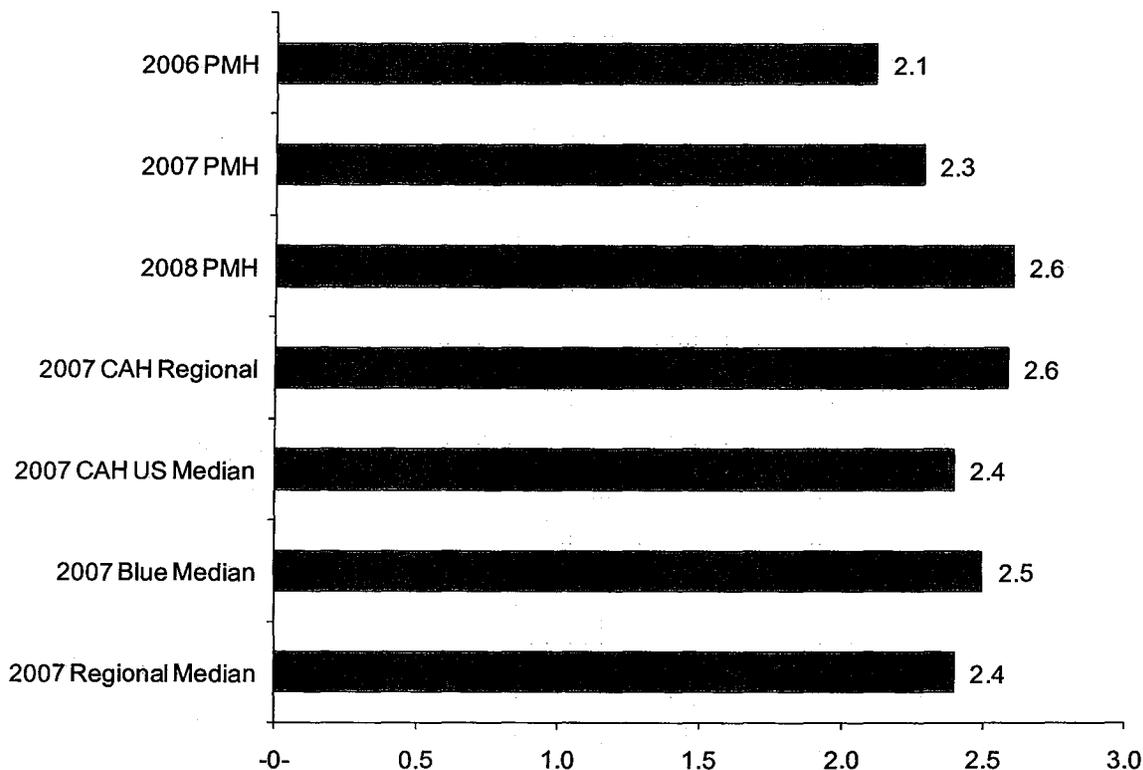
Performance Implications

Payor mix can significantly effect the value of this ratio. Hospitals with high values have an excess investment in a non-earning asset. High-performing hospitals tend to have lower values and thus have higher values of cash and investments.

Pulaski Memorial Hospital

Current Ratio

CPAS ADVISORS



Desired Position: High
U.S. Trend: Stable
U.S. Forecast: Stable

Formula

Current Assets / Current Liabilities

Definition

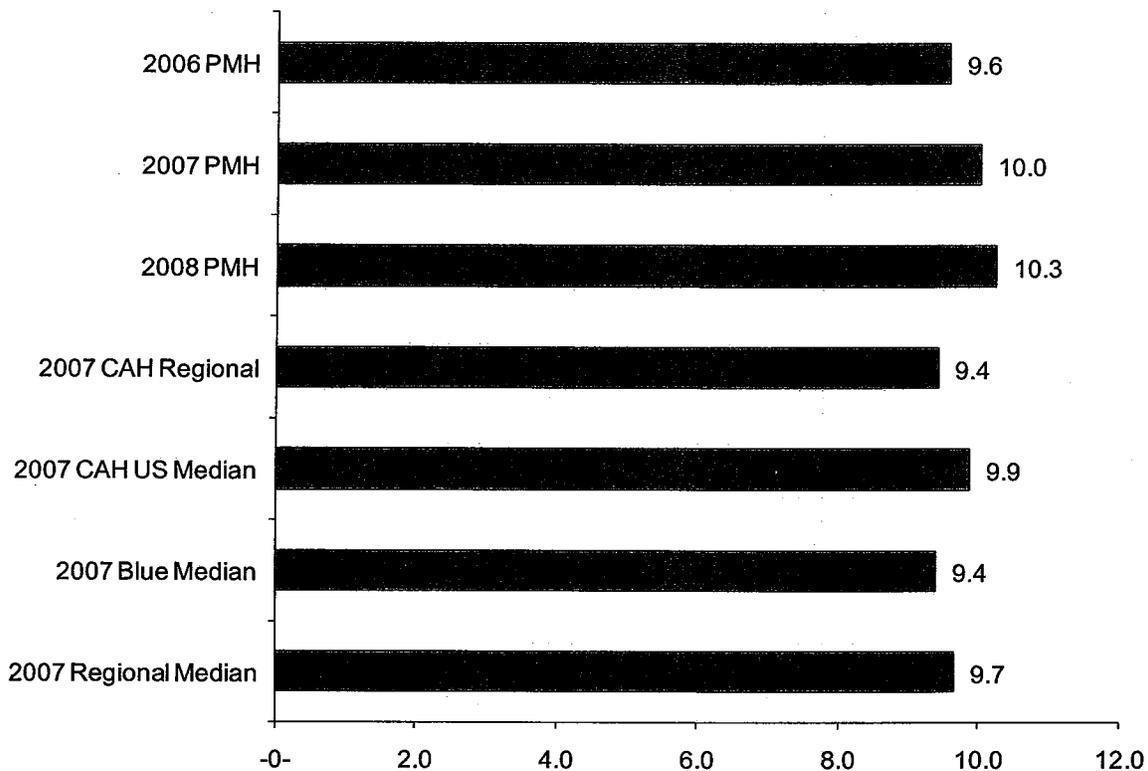
Measures the Hospital's ability to meet short-term financial obligations.

Performance Implications

There is a positive correlation between profitability and the Current Ratio. Hospitals that are more profitable are likely to have higher Current Ratio values. It may be difficult for Hospitals with a consistently low Current Ratio to continue with inadequate total margins.

Pulaski Memorial Hospital Average Age of Plant

CPAS ADVISORS



Desired Position: Low

U.S. Trend: Decrease after five years of increase

U.S. Forecast: Increase

Formula

Accumulated Depreciation / Depreciation Expense

Definition

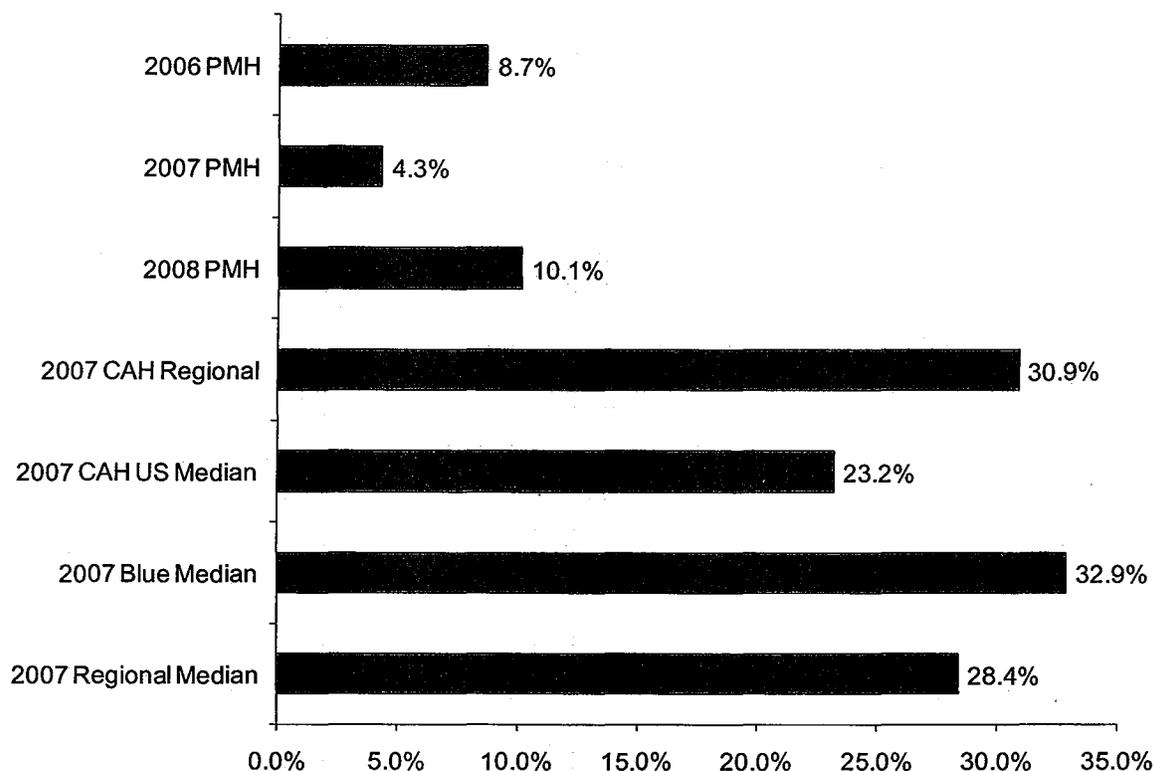
Measures the average age, in years, of a hospital's fixed assets.

Performance Implications

A steadily increasing value indicates resources are not being used to renovate the Hospital. It may also indicate that significant capital expenditures may be required in the near future. Hospitals with older facilities typically have less debt. However, higher performing hospitals have significantly newer plants than lower performing hospitals.

Pulaski Memorial Hospital

Long-Term Debt as a Percentage of Total Capital



Desired Position: Preference
 U.S. Trend: Stable
 U.S. Forecast: Slight decrease

Formula

Long-Term Debt / (Long-Term Debt + Net Assets)

Definition

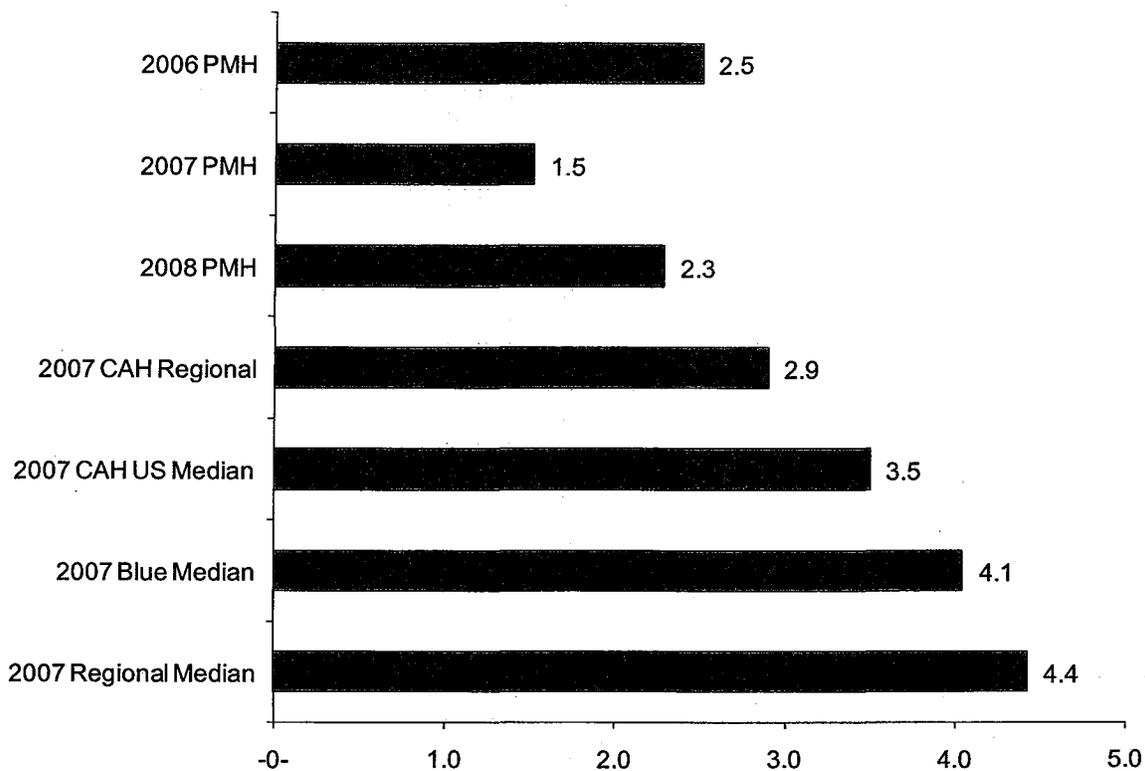
This is a traditional measure of the extent to which a hospital has relied on debt vs. retained earnings and invested or donated capital. It provides a measure of the ability to carry additional debt.

Performance Implications

Higher values may limit future financing opportunities. Operating expense pressures, contribution declines and decreased investment returns have generally constrained growth in net assets, which have not kept pace with increasing debt.

Pulaski Memorial Hospital Debt Service Coverage

CPAs / ADVISORS



Desired Position: High
U.S. Trend: Slight Decrease
U.S. Forecast: Decrease

Formula

(Total Excess of Revenues Over Expenses + Interest, Depreciation and Amortization) / (Principal Payments + Interest Expense)

Definition

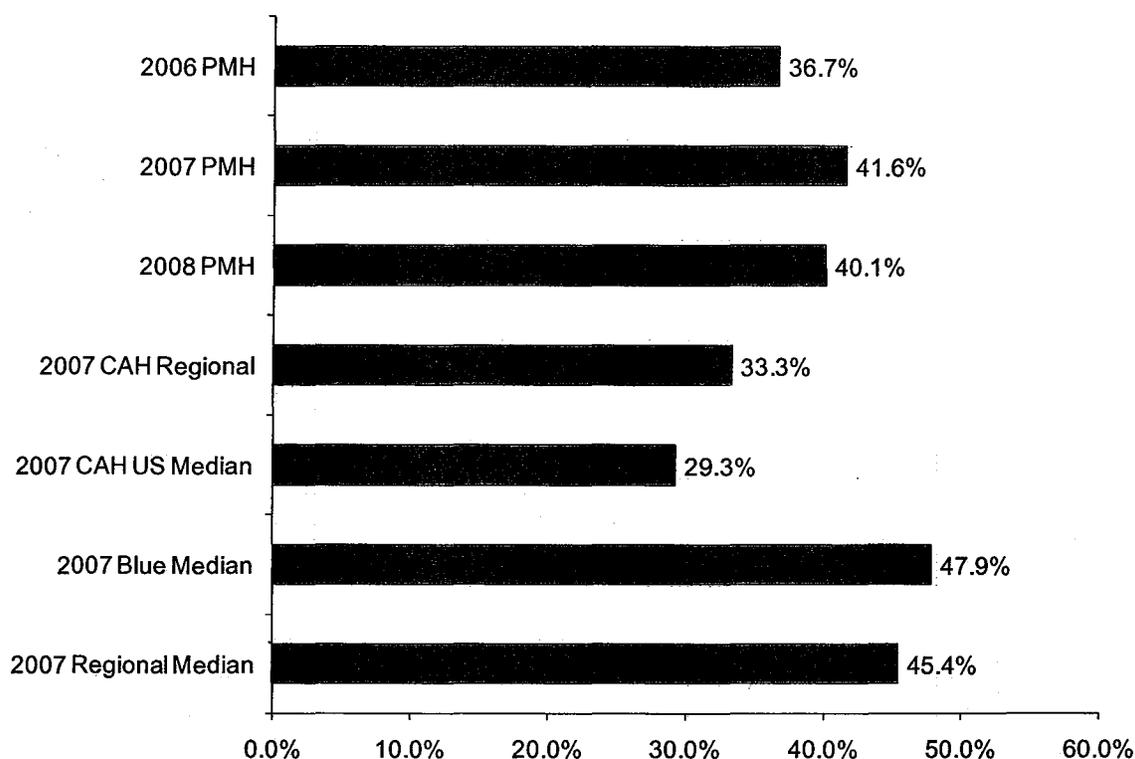
This is a measure of the viability of the Hospital. This ratio reflects the ability to fund annual debt service cash flow from net cash revenues.

Performance Implications

Many debt obligations require Hospitals to maintain a debt service coverage ratio of at least 1.2 times maximum annual debt service. The ratio had tended to decrease in the past several years due to lower profitability.

Pulaski Memorial Hospital

Contractual Allowance Percentage



Desired Position: Low
 U.S. Trend: Five year high
 U.S. Forecast: Increase

Formula

Contractual Allowances / Gross Patient Service Revenue

Definition

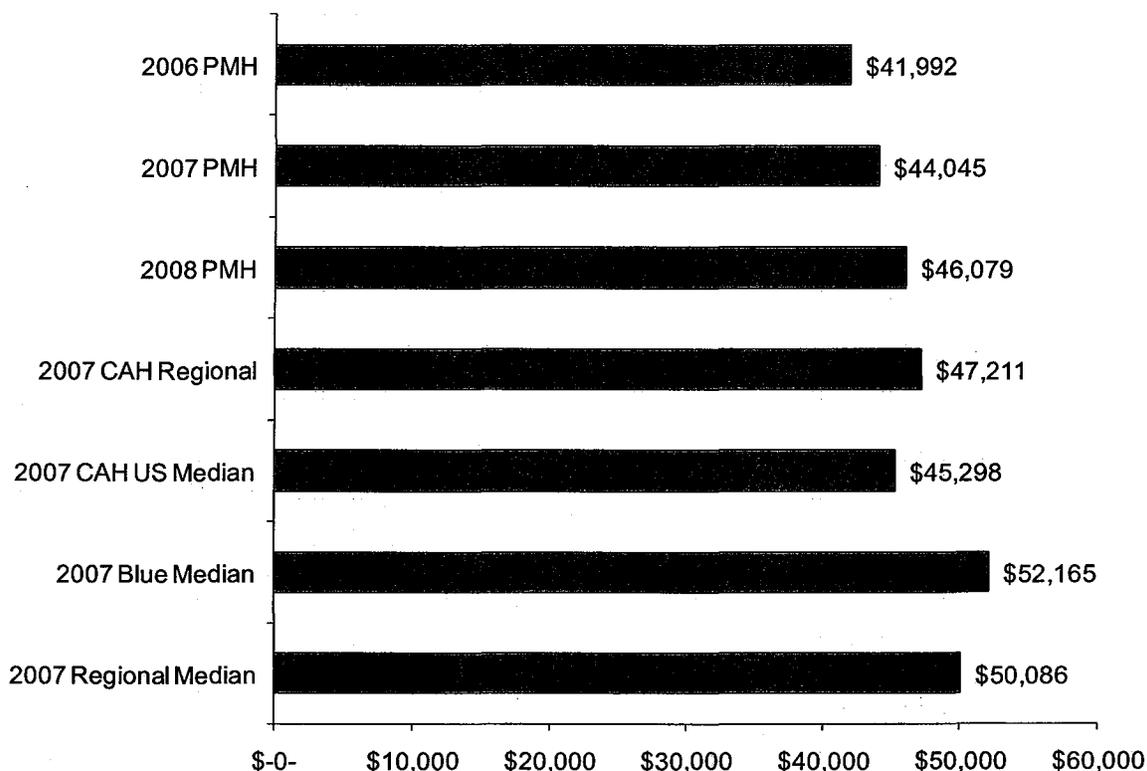
The percentage of gross patient revenue that is discounted to third-party payers.

Performance Implications

High-performance hospitals have similar gross prices on a case mix-adjusted basis compared to low-performance hospitals, however, they have higher net prices. Lower write-offs in high-performance hospitals are either a reflection of a better payer mix, especially private insurance, with lower discounting, or better coding of cases.

Pulaski Memorial Hospital

Salary per Full-Time Employee (FTE)



Desired Position: Preference
 U.S. Trend: Increasing
 U.S. Forecast: Inflationary increase

Formula

Salaries and Wages / Number of Full-Time Employees

Definition

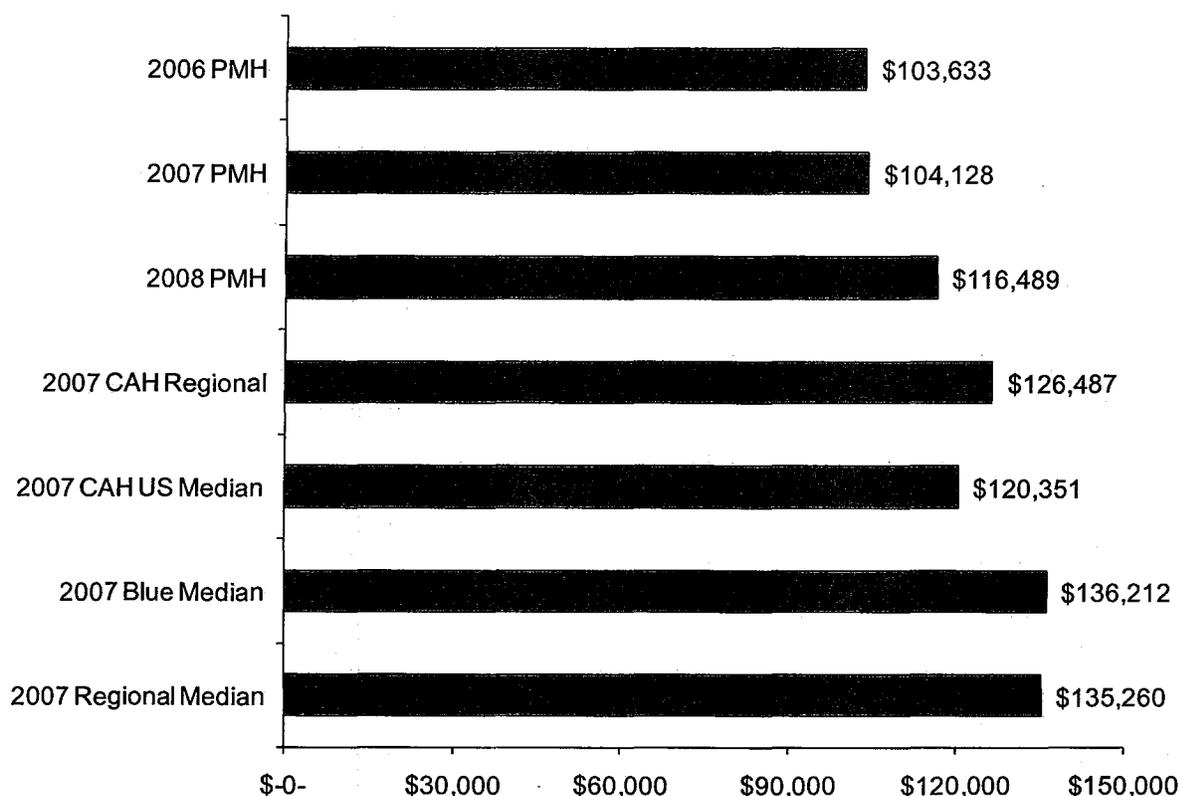
Measures the relative cost of the largest resource item used in the hospital industry.

Performance Implications

High-performance hospitals have higher salary structures when compared to low-performance hospitals. Control over salaries and wages and supply costs is one of the most effective ways to improve profit margins.

Pulaski Memorial Hospital

Revenue per Full-Time Employee (FTE)



Desired Position: High
 U.S. Trend: Increasing Sharply
 U.S. Forecast: Increase

Formula

Total Revenues / Number of Full-Time Employees

Definition

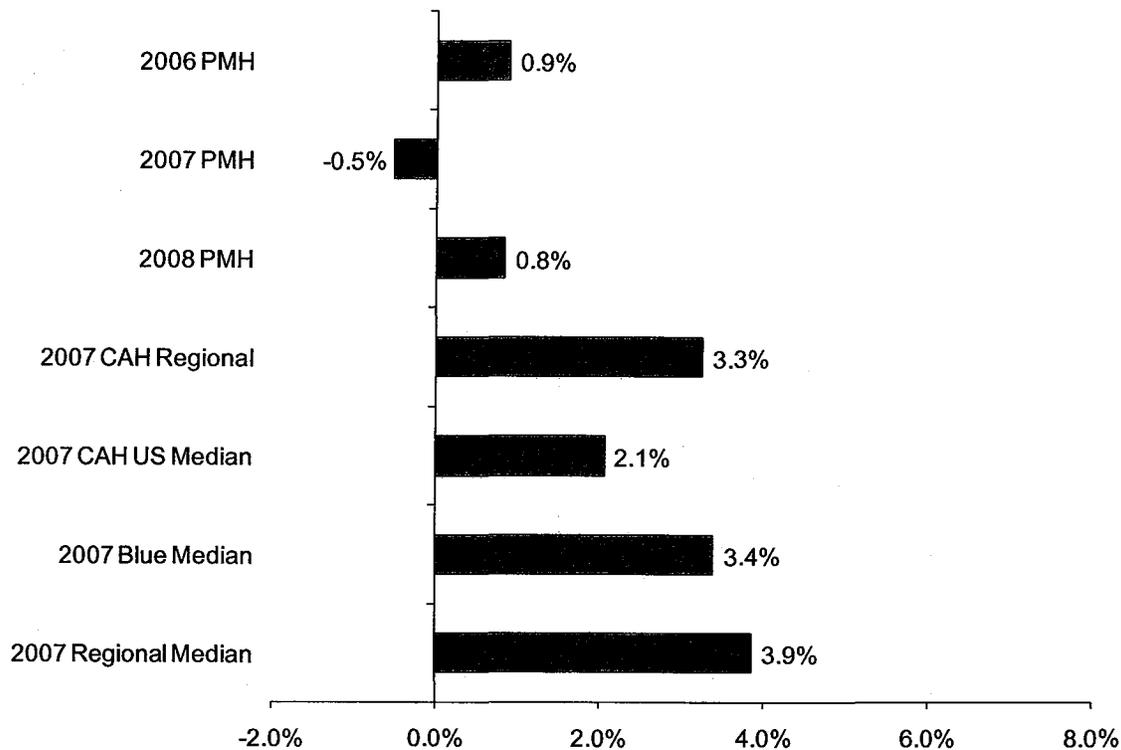
Measures the productivity to compare performance across different industries.

Performance Implications

High performance hospitals have higher values for Total Revenue Per FTE than low-performance hospitals and the gap appears to be widening, due to a \$10,000 jump in 2003. The ultimate measure of productivity is value created per FTE, and high-performance hospitals are doing exceptionally well in this area.

Pulaski Memorial Hospital Operating Margin

CPAS / ADVISORS



Desired Position: High

U.S. Trend: Fluctuating, Slight Decrease

U.S. Forecast: Fluctuating, Slight Increase

Formula

Income From Operations / Total Operating Revenue

Definition

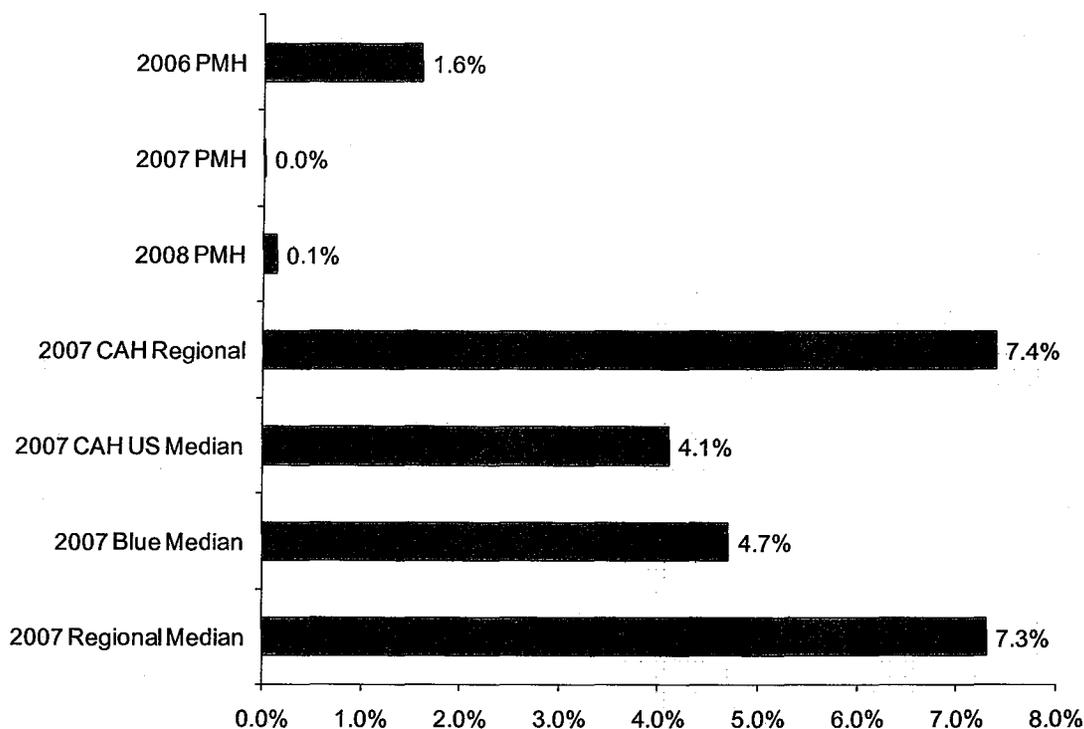
The Operating Margin indicates the amount of return per dollar of operating revenues.

Performance Implications

This ratio represents the hospitals ability to generate a profit from operations. Improving operating profitability has been the factor contributing most to the increase in total margin for the high-performance hospitals and declines in operating profitability have caused the decline in total margin for the low-performance hospitals. High-performing hospitals have substantial cost and price advantages over low-performing hospitals.

Pulaski Memorial Hospital Total Excess Margin

CPAS / ADVISORS



Desired Position: High
U.S. Trend: Regional variations
U.S. Forecast: Constant

Formula

Total Change in Net Assets / Total Operating and Nonoperating Revenues

Definition

The Total Excess Margin Ratio indicates the amount of return per dollar of revenue and support and thus the ability to generate profit from both operating and nonoperating activities.

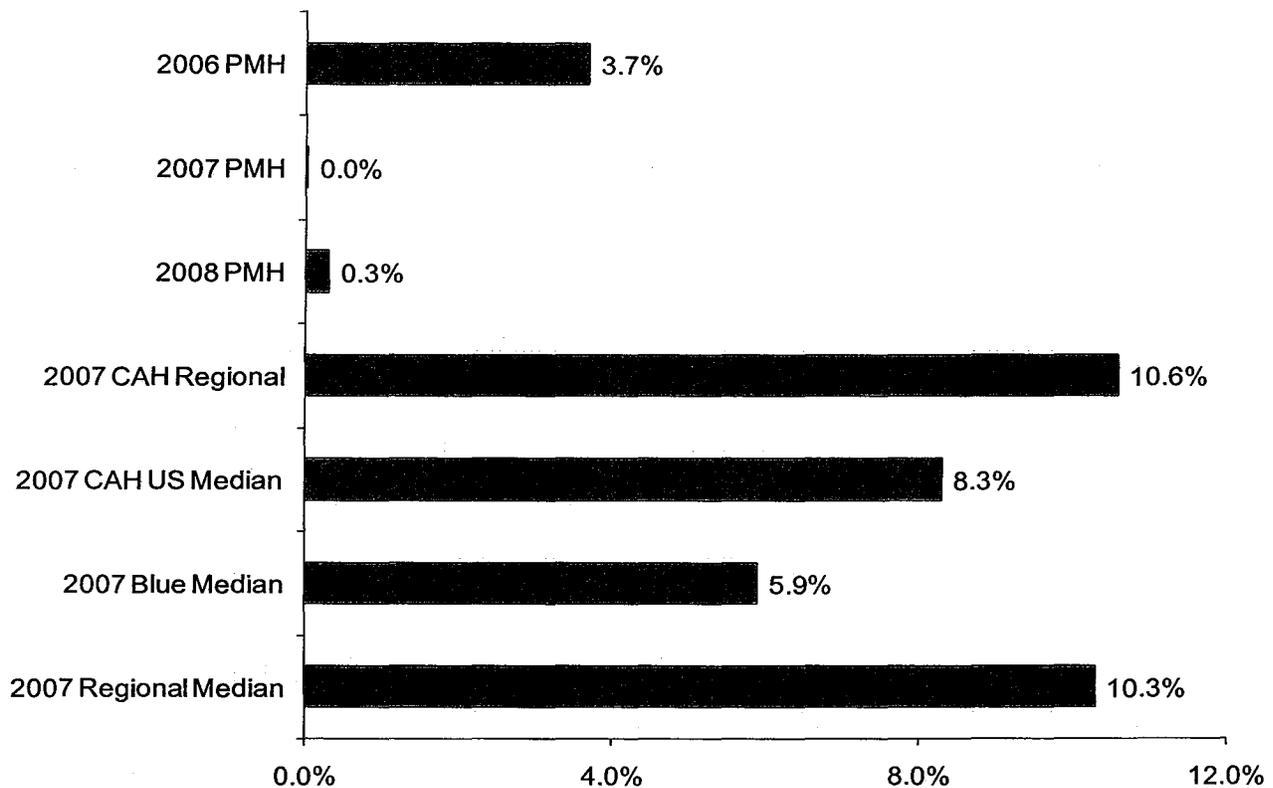
Performance Implications

A value greater than zero for the Total Excess Margin ratio is necessary for the Hospital to positively effect net assets, maintain favorable balance sheets and provide adequate reserves for future needs.

Pulaski Memorial Hospital

Return on Net Assets

CPAS ADVISORS



Desired Position: High
U.S. Trend: Slight Increase
U.S. Forecast: Constant

Formula

Change in Net Assets / Net Assets

Definition

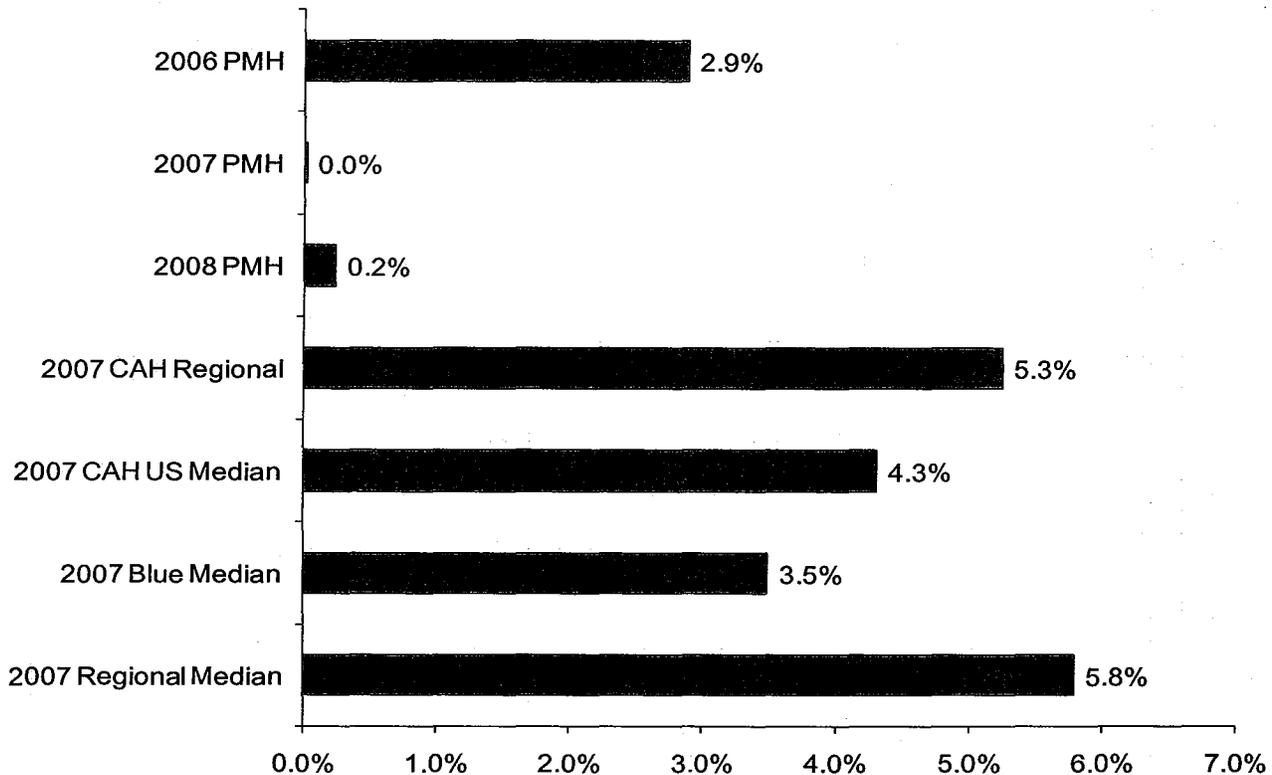
The Return on Net Assets is a profitability ratio which measures the amount of return per dollar of net assets and thus profitability of net assets invested.

Performance Implications

Total margins have a significant impact on this ratio as net assets are a smaller base for return ratios. Capital structure and the level of debt can also have an impact on the ratio performance.

Pulaski Memorial Hospital Return on Total Assets

CPAS / ADVISORS



Desired Position: High
U.S. Trend: Regional variations
U.S. Forecast: Constant

Formula

Change in Net Assets / Total Assets

Definition

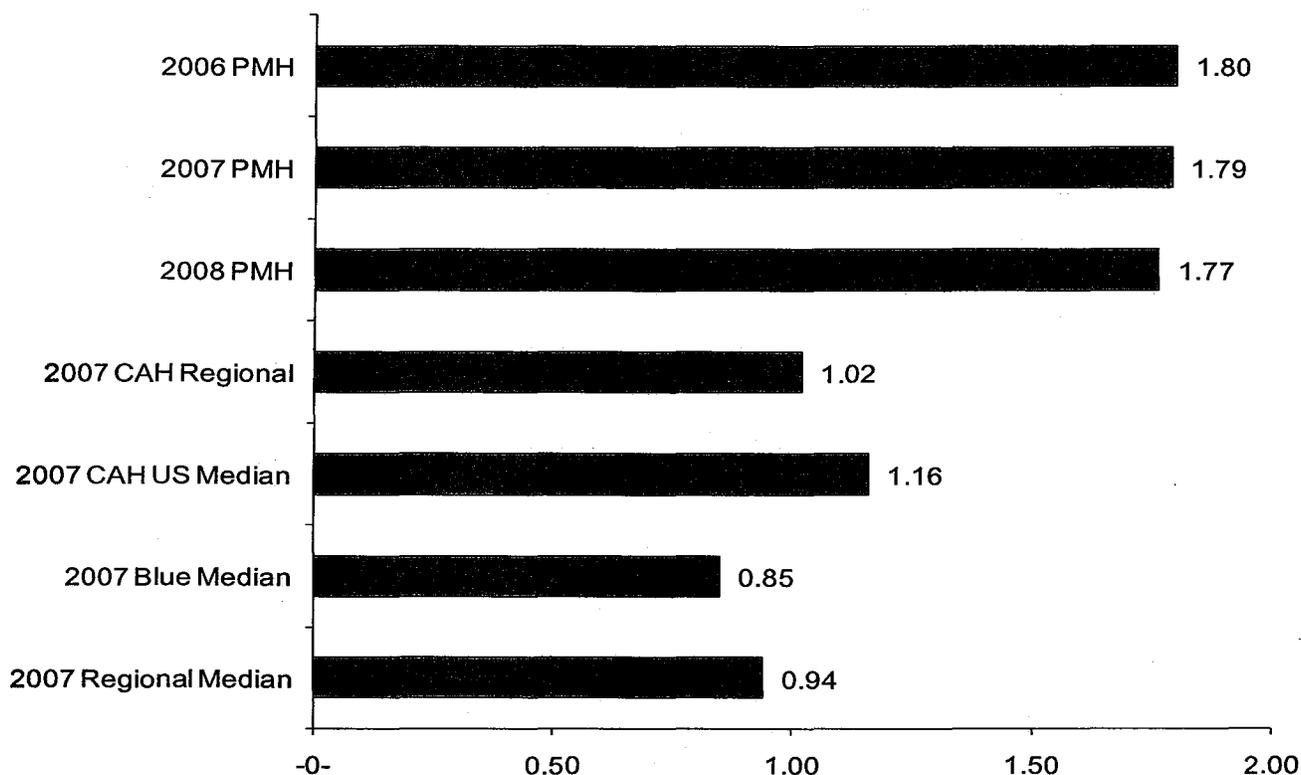
The Return on Total Assets is a profitability ratio which measure the amount of return per dollar of total assets and thus profitability in terms of asset efficiency.

Performance Implications

Hospitals with a newer plant and/or a larger asset base are challenged to maintain commensurate profitability with related charges such as higher depreciation and interest. Maximizing non-operating income and increasing asset efficiency both result in higher values for Return on Total Assets.

Pulaski Memorial Hospital

Total Asset Turnover



Desired Position: High
 U.S. Trend: Constant
 U.S. Forecast: Increase

Formula

Total Revenue / Total Assets

Definition

Total asset turnover provides an index of the number of revenue dollars generated per dollar of asset investment.

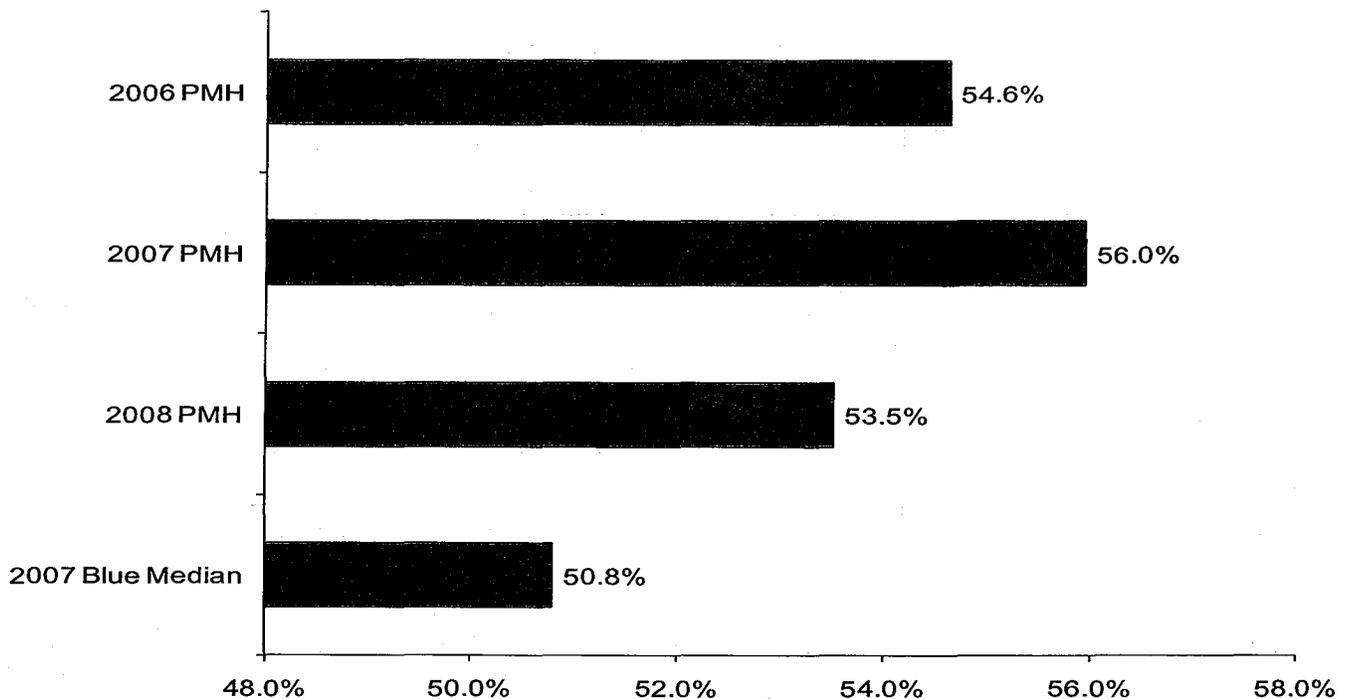
Performance Implications

Low performance hospitals tend to have higher asset turnover ratios due to high performance hospitals larger investment balances and newer plant. However it is important to gain efficiency with a ratio approaching 1 to 1 as services continue to migrate to the outpatient setting.

Pulaski Memorial Hospital

Salaries, Wages & Benefits as Percentage of Operating Revenue

CPAS ADVISORS



Desired Position: Low

Formula

Total Salaries, Wages and Employee Benefits / Operating Revenue

Definition

This ratio provides an indicator of the labor cost in generating operating revenue.

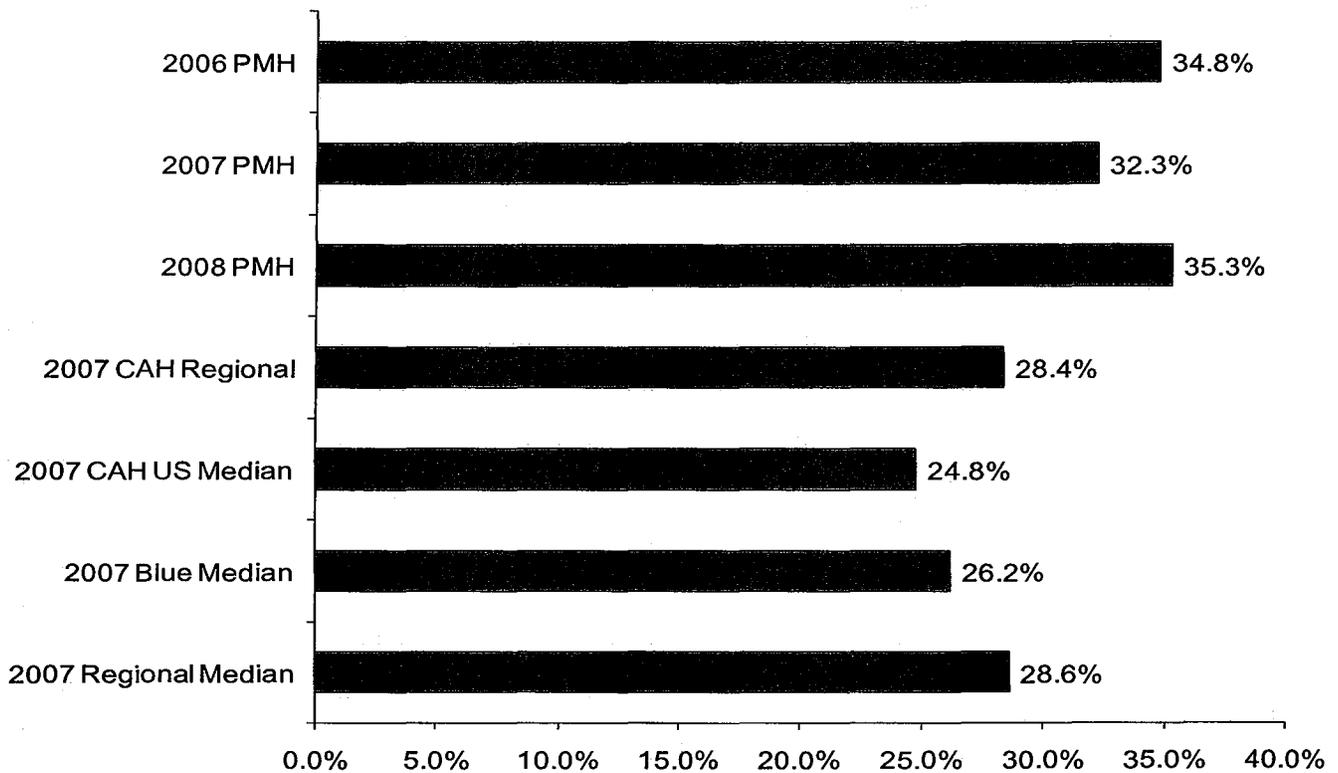
Performance Implications

Lower values are desired. Higher percentages may indicate lower staff productivity and efficiency. Salaries, wages and benefits are the highest annual cost hospitals incur, thus it is essential to monitor those costs as a percentage of the revenue being generated. Close monitoring of staffing and productivity levels will help to keep this percentage low.

Pulaski Memorial Hospital

Employee Benefits as Percentage of Salaries and Wages

CPAS ADVISORS



Desired Position: Preference

U.S. Trend: Increasing

U.S. Forecast: Increase

Formula

Employee Benefits / Salaries & Wages

Definition

The employee benefits ratio provides a measure of the relationship of benefits to salaries and wages.

Performance Implications

Generally, lower values are desired. However, many hospitals consciously maintain higher benefits as a tool to reduce employee turnover costs. Also, benefits can vary widely depending on the hospital's culture and values. Employee health insurance costs, which have experienced double digit increases over the past several years, have been the primary driver of employee benefits expense.



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January 26, 2009

Board of Trustees
Pulaski Memorial Hospital
Winamac, Indiana

Board of Trustees:

We have completed our audits of the financial statements of Pulaski Memorial Hospital (the Hospital) as of and for the year ended September 30, 2008. Our opinion on the financial statements, which was unqualified, is included in the bound copies of the financial statements.

OUR RESPONSIBILITY UNDER AUDITING STANDARDS GENERALLY ACCEPTED IN THE UNITED STATES OF AMERICA

As stated in our engagement letter, our responsibility, as described by professional standards, is to express an opinion about whether the financial statements prepared by management with your oversight are fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles. Our audit of the financial statements does not relieve you or management of their responsibilities.

Our responsibility is to plan and perform the audit to obtain reasonable, but not absolute, assurance that the financial statements are free of material misstatement. As part of our audit, we considered the internal control of the Hospital. Such considerations were solely for the purpose of determining our audit procedures and not to provide any assurance concerning such internal control.

QUALITATIVE ASPECTS OF ACCOUNTING PRACTICES

Management has the responsibility for selection and use of appropriate accounting policies. In accordance with the terms of our engagement letter, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by the Hospital are described in Note 1 to the financial statements. No new accounting policies were adopted and the application of existing policies was not changed during the year. We noted no transactions entered into by the Hospital during the year that were both significant and unusual, and of which, under professional standards, we are required to inform you, or transactions for which there is a lack of authoritative guidance or consensus. There are no significant transactions that have been recognized in the financial statements in a different period than when the transaction occurred.

ACCOUNTING ESTIMATES

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were:

- Contractual and bad debt allowances
- Estimated third-party settlements
- Accrued self funded health claims

You should determine that those charged with governance are informed about the process used by management to formulate particularly sensitive accounting estimates and about the basis for your conclusions regarding the reasonableness of the estimates. Management's estimate is based on evaluation of historical losses, current economic conditions and other factors unique to the Hospital's patient base. We evaluated the key factors and assumptions used by management to develop the estimates in determining that they are reasonable in relation to the financial statements taken as a whole.

The disclosures in the financial statements are neutral, consistent, and clear.

Certain financial statement disclosures are particularly sensitive because of their significance to the financial statement users. The most sensitive disclosures included in the financial statements were:

- Patient accounts receivable, revenues and operating expenses
- Deposits and investments
- Capital assets
- Physician relocation agreements and other minimum revenue guarantees
- Long-term debt and capital leases
- Employee health plan

DIFFICULTIES ENCOUNTERED IN PERFORMING THE AUDIT

We encountered no difficulties in dealing with management in performing and completing our audit.

CORRECTED AND UNCORRECTED MISSTATEMENTS

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. Management has corrected all such misstatements. The following material misstatements detected as a result of audit procedures were corrected by management:

- An adjustment was posted to record prior year audit adjustments resulting in an increase in net assets of \$306,571.
- Health insurance expense accrual was increased by \$225,000 to agree to the amount of claims incurred but not reported as of September 30, 2008 per the administrators lag report.
- An adjustment was posted to adjust inventory to the physical inventory account resulting in a decrease to inventory of \$32,211.
- An adjustment was posted to increase the bad debt allowance to tie to the client provided model of \$207,758.
- An adjustment was posted to decrease the contractual allowance to tie to the client provided model of \$998,940.
- An adjustment was posted to decrease the estimated third party settlements receivable of \$373,142.
- An adjustment was posted to increase the loss on disposal of property of \$196,054.

DISAGREEMENTS WITH MANAGEMENT

For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

MANAGEMENT REPRESENTATIONS

We have requested certain representations from management that are included in the management representation letter dated as of the date of this letter.

OTHER AUDIT FINDINGS OR ISSUES

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the Hospital's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

INTERNAL CONTROL MATTERS

In planning and performing our audit of the financial statements of the Hospital as of and for the year ended September 30, 2008, in accordance with auditing standards generally accepted in the United States of America, we considered the Hospital's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Hospital's internal control. Accordingly, we do not express an opinion on the effectiveness of the Hospital's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies that we consider to be material weaknesses and other deficiencies we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We noted no deficiencies that we considered to be significant deficiencies.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. We believe the following deficiencies constitute material weaknesses (comments made in the prior year are noted with any updates in *italics*):

MATERIAL WEAKNESSES

Prior Year Audit Adjustments (prior year comment)

It was noted in the current year that the prior year adjustments noted in the audit were not posted to the general ledger. This resulted in several beginning balances not agreeing to the prior year audit. A large adjustment was made to adjust the beginning balances to tie to the prior year financials and to roll forward net assets. We recommend that management review all journal entries within the current year audit and post adjustments to the general ledger.

It was noted that certain adjustments were not posted to the general ledger in the current year. Prior year adjustments were not posted due to management not fully and completely understanding the adjustments. The Hospital and Blue & Co. will discuss future recommended adjustments and make definitive adjustment decisions in a timely fashion. We continue to recommend that all audit adjustments be posted to the general ledger.

Patient Accounts Receivable Contractual and Bad Debt Allowance Model (prior year comment)

In working with management through the process, we noted that a contractual and bad debt allowance model to estimate allowances for patient accounts receivable was in place. However, the general ledger was not being adjusted to the model on a monthly basis. As a result, net patient accounts receivable and net patient revenue amounts were not adjusted to net realizable value on a monthly basis. The consistent adjustment of the general ledger to the allowance estimates calculated by the model will help ensure accurate financial reporting on a monthly basis.

The general ledger was not being adjusted to the model on a monthly basis. Both the CFO and controller have discussed and are working on a monthly adjustment procedure. This will result in net patient accounts receivable and net patient revenue amounts being adjusted to net realizable value on a monthly basis. The Hospital wants to move forward in fiscal year 2009 with a model of consistent adjustments of the general ledger to the allowance estimates calculated by the model to help ensure accurate financial reporting. Management hopes to have this process solidified by mid-year 2009.

Accrued Self Funded Health Claims

It was noted during the audit that the estimate for accrued self funded health claims had not been adjusted to supporting detail. It is important to maintain support and review all balance sheet accounts on a regular basis. We recommend that management adjust to the claims lag report on a regular basis, and also a supervisory review be performed.

Establish Detailed Property Records

The preparation of detailed property records aids in the accounting for disposals, substantiate insurance claims for lost or damaged items, provide information for proper filing of income and property tax returns, and provides controls to safeguard the assets. We recommend a written procedure statement that would require the following:

- A detailed property record for each asset
- A property identification number to be assigned and affixed to each asset.
- A capitalization policy under which minor disbursements within a specified dollar amount would be immediately charged to operations.

At a minimum, the detailed property records should include the following information:

- Description, asset number, and location.
- Acquisition cost and date of acquisition.
- Assigned life and method of depreciation.
- Depreciation taken on an annual basis with accumulation thereof.

Properly Account for Property Disposals and Capital Leases

We noted during our audit that a property and equipment disposal was not accounted for correctly. The unpaid portion from the capital lease on the old CT scanner was netted against the net book value of the disposal. The loss should have been the net book value on the disposal. This resulted in an understatement of the loss on equipment and an overstatement of fixed asset cost on the new scanner.

SIGNIFICANT DEFICIENCY

Allowance Posting (*prior year adjustment*)

During the testing of patient A/R balances, we noted several errors in the classifications during the posting of allowances to the general ledger. Several amounts were written off to bad debt instead of to contractual allowances. We recommend that management review these write-offs monthly to determine their classification accuracy.

Patient Financial Services Supervisor and Controller have provided guidance to the staff in this regard. An educational seminar was attended by staff to gain a clear understanding of the classifications.

OTHER COMMENTS

Limit Access to Server

Currently, the server room is located in a separate room within the accounting department. This room is not locked and all accounting personnel have access to the room. This could result in unauthorized entries or adjustments being made. We recommend that management adopt controls over server access such as better physical controls (locked doors to the room containing the server and data files).

Periodically Change Computer Passwords

We understand that computer passwords are not changed on a regular basis. In order to reduce the risk of access to computer files by unauthorized personnel, we recommend that the Hospital institute a policy that requires passwords to be changed on a regular basis. The Hospital may also wish to automatic expiration of passwords to ensure that they are changed periodically.

Document and Enhance Information Technology Disaster Recovery Plan

The Hospital does not have well-defined written disaster recovery procedures. The time to make contingency plans is before disaster strikes, so that all personnel will be aware of their responsibilities in the event of an emergency situation that precludes the use of the existing IT facilities. We recommend that management develop a disaster recovery plan that includes, but is not limited to, the following matters:

- Location of, and access to, off-site storage.
- A listing of all data files that would have to be obtained from the off-site storage location.
- Identification of a backup location (name and telephone number) with similar or compatible equipment for emergency processing. (Management should make arrangements for such backup with another company, a computer vendor, or a service center. The agreement should be in writing.)
- Responsibilities of various personnel in an emergency.
- Priority of critical applications and reporting requirements during the emergency period.

Segregation of Accounting Duties (*prior year comment*)

The Hospital has a small number of people in their offices performing a variety of duties, some of which may be incompatible. For instance, the person who processes payments should not be able to post deposits into the general ledger. Separating these duties will improve internal controls over cash and other assets and reduce the possibility of errors and irregularities. This may be done without hiring more personnel. We recommend that the Hospital make the following analysis:

- Make a list of personnel and the accounting duties they perform.
- Isolate any incompatible accounting functions that are the responsibility of one employee.
- Reassign responsibility for these duties, if practical, or create a supervisory review of these functions.

The Hospital continues to try to segregate as many duties it can. When segregation cannot be made, management puts in place other mitigating procedures such as reviews and approvals to mitigate these risks.

Required Vacations for Employees (prior year comment)

While there is currently a policy in place encouraging employees take vacation time, the Hospital does not require accounting and finance personnel to take vacations. This is a control that would help to reduce exposure to accounting irregularities. Mandatory vacation requires accounting and finance personnel to rotate duties and perform other staff responsibilities. This also promotes cross training amongst the accounting personnel and helps reduce overall exposure in case of employee turnover. We recommend the Hospital consider required vacations for personnel in these areas and duties are rotated when personnel are absent.

The Hospital continuing its cross training efforts as noted in last year's management letter comment.

NOT-FOR-PROFIT HEALTHCARE ISSUES

This section of the letter is not required by professional standards. However, we want to inform you about issues of importance to the not-for-profit healthcare community in order to assist you in continuing to plan proactively for the future of the Organization. The purpose of this section of this letter is to inform you as to the status of certain emerging developments which will affect not-for-profit healthcare organizations.

Medicare Recovery Audit Contractors

The Medicare Modernization Act of 2003 authorized the Recovery Audit Contractors (RAC) demonstration project, initially a three-year demonstration project from March 2005 through March 2008 in California, Florida, and New York. It was expanded in 2007 to include Arizona, Massachusetts, and South Carolina. The Tax Relief and Healthcare Act of 2006, Section 302, mandated CMS to implement a permanent, nationwide RAC program no later than 2010.

The RACs detect improper Medicare payments, correct the improper payments, and implement actions that will prevent future improper payments. The improper payments are to include both overpayments and underpayments to providers. According to the CMS, the RAC demonstration project has identified \$357.2 million in overpayments and \$14.3 million in underpayments. The RACs are paid a contingency fee based on the amount of improper payments identified. This payment methodology has led to criticism that such an incentive could tempt RACs to identify errors where none exist.

Four years of claims, from October 1, 2001, through September 30, 2005, were available for review under the RAC demonstration project. Under the permanent RAC program, the contractors will review claims paid on or after October 1, 2007, and at no time will they look back more than three years.

The RACs have performed two types of reviews: automated reviews and complex medical reviews. The automated reviews were designed to identify the "low hanging fruit" and used data mining techniques to identify multiple units billed, missing modifiers and payments for discounted HCPC/CPT codes. The complex medical reviews improved reviewing the medical record or other documentation. They have led to a denial of payments mainly due to lack of medical necessary and missing records or documentation. The RACs were criticized in this area for failing to have knowledgeable and adequately trained staff performing the reviews and the lack of medical director to interpret the medial records. RACs are now required to have a medical director.

The RAC claim review process for medical records reviews includes the request by the RAC for the medical record or other documentation. Providers have 45 days to comply with the request. If the requested documentation is not submitted within the 45 days, the RAC may identify the claim as an overpayment by default. The RAC has 60 days to review the chart and issue a denial or an "all clear" letter to the provider.

To dispute an RAC adjustment, providers can submit a rebuttal to the RAC or file an appeal following information Medicare appeal rules. The provider must submit a rebuttal to the RAC within 15 days of the denial. The appeals process has various levels and strict deadlines that cannot be missed.

An appeal must be filed soon after the RAC's notice of its decision (initial determination). The initial determination date is presumed to be five days after the date of the denial notice or the date of the take-back. The first level of appeal is to file an appeal or redetermination with the Medicare fiscal intermediary (FI) within 120 days after the initial determination. The second level of appeal is with a qualified independent contractor (QIC).

After receiving the decision of the FI, the provider has 180 days to file an appeal with the QIC. The third level of appeal is with an administrate law judge (ALJ). This appeal must be filed within 60 days of the QIC decision. After the ALJ appeal, the next level of appeal is with the Medicare Appeals Council (MAC). This appeal must be filed within 60 days of the ALJ's decision. If the provider is still dissatisfied with the determination, the provider can file legal proceedings in the U.S. District Court within 60 days of the MAC determination.

Providers can prepare for the RAC program by developing a strategy and creating policies and procedures for addressing all RAC notifications. The strategy should address interdepartmental communication to notify clinical, reimbursement, and financial staff of any and all RAC requests. Providers should keep detailed records of all RAC requests, correspondence with the RAC, and the results of the determination.

In the event of any denials, the provider should consider the value of filing a rebuttal or appeal by evaluating the financial impact, the cost versus the benefit of the appeal and other factors such as availability and accuracy of the medical records and implications of not filing an appeal. Not filing an appeal could force the provider to institute charges in policies and procedures to address the issues raised in the RAC denials and could potentially expose the provider to higher scrutiny and increased medical audits.

Final Regulations Released on Excess Benefit Transactions

The Internal Revenue Service released the final regulations on excess benefit transactions on March 27, 2008. An excess benefit transaction is a transaction in which a not-for-profit organization is deemed to have overcompensated CEO's, board members and other "disqualified" persons. The final regulations under Section 4958 make it clear that tax-exempt organizations involved in excess benefit transactions with disqualified persons should not wait for the IRS to get involved to take corrective action. Also emphasized was the need for exempt organizations to implement preventative safeguards. Safeguards mentioned include implementing a corporate compliance plan as well as making sure that the rebuttable presumption of reasonableness is satisfied whenever possible.

Being aware of the situation and not taking action to correct any excess benefit transactions could lead to excise taxes and/or revocation of an organization's exempt status. Factors identified as those that the IRS considers when deciding whether to assert excise taxes or the revocation of exempt status include:

- the size and scope of the organization's regular and ongoing activities that advance the exempt purposes both before and after the excess benefit transaction took place

the size and scope of the excess benefit transaction compared to the size and scope of the regular and ongoing activities that further the organization's exempt purpose

- whether the organization has been involved in multiple excess benefit transactions with one or more persons
- whether the organization has implemented safeguards to prevent future excess benefit transactions
- whether the organization has corrected the problem or tried to recover money from the disqualified persons who benefited from the transaction

There are several examples actually detailed out in the final regulations. The examples are designed to help exempt organization leaders understand and apply the new regulations to their organizations and their specific situations. It is evident from reading the final regulations regarding excess benefit transactions that the IRS expects an organization's board to not only be aware of the risk involving excess benefit transactions, but to take preventative safeguarding measures to ensure against the risk.

* * * * *

These recommendations are presented for your review and consideration only. Like all other significant business judgments, they must be considered in light of existing procedures and controls present in the Hospital and should be subjected to the usual cost-benefit tests.

Pulaski Memorial Hospital
January 26, 2009
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If there are any questions on matters covered in this letter or any other matters relating to our audit, we would be glad to meet with you at your convenience to discuss your concerns.

Once again, we thank you for the cooperation and hospitality we received during our audit.

Sincerely,

Blue & Co., LLC