



**FINANCE COMMITTEE MEETING**

**MARCH 18, 2011**

*CPAs / ADVISORS*



# **MARGARET MARY COMMUNITY HOSPITAL, INC.**

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**FINANCIAL STATEMENTS**

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**BOARD OF DIRECTOR LETTER**



**MARGARET MARY  
COMMUNITY HOSPITAL**

**FINANCIAL STATEMENTS**

**DECEMBER 31, 2010 AND 2009**

**MARGARET MARY COMMUNITY HOSPITAL, INC.**

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## REPORT OF INDEPENDENT AUDITORS

Board of Directors  
Margaret Mary Community Hospital, Inc.  
Batesville, Indiana

We have audited the accompanying balance sheets of Margaret Mary Community Hospital, Inc. (Hospital) as of December 31, 2010 and 2009, 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 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. 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 December 31, 2010 and 2009, 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*

March 18, 2011

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## BALANCE SHEETS DECEMBER 31, 2010 AND 2009

	2010	2009
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 2,892,223	\$ 2,921,465
Investments	19,370	18,936
Patient accounts receivable, net of uncollectible allowance of \$4,047,935 in 2010 and \$3,664,148 in 2009	7,270,089	6,538,580
Other receivables	354,827	173,459
Inventories	865,276	725,911
Prepaid expenses	468,904	380,632
Current portion of assets whose use is limited	1,107,879	868,296
Total current assets	<u>12,978,568</u>	<u>11,627,279</u>
<b>Assets whose use is limited</b>		
Board designated for capital improvements	36,014,724	28,086,755
Board designated for retirement plan	535,727	573,003
Held by trustee for capital improvements	8,042,324	55,833
	<u>44,592,775</u>	<u>28,715,591</u>
Less current portion	1,107,879	868,296
Assets whose use is limited - noncurrent	<u>43,484,896</u>	<u>27,847,295</u>
<b>Property and equipment, net</b>	49,956,584	51,456,590
<b>Bond issue costs, net</b>	490,514	498,536
Total assets	<u>\$ 106,910,562</u>	<u>\$ 91,429,700</u>
<b>LIABILITIES AND NET ASSETS</b>		
<b>Current liabilities</b>		
Accounts payable	\$ 1,484,609	\$ 1,580,147
Accrued wages and related liabilities	3,315,568	3,025,884
Estimated third-party settlements	1,521,961	1,625,611
Current portion of long-term debt	1,107,879	868,296
Total current liabilities	<u>7,430,017</u>	<u>7,099,938</u>
<b>Derivative liability</b>	1,849,503	1,223,854
<b>Long-term debt, less current portion</b>	33,817,356	26,882,379
Total liabilities	<u>43,096,876</u>	<u>35,206,171</u>
<b>Net assets</b>		
Unrestricted	63,665,762	56,194,096
Temporarily restricted	147,924	29,433
Total net assets	<u>63,813,686</u>	<u>56,223,529</u>
Total liabilities and net assets	<u>\$ 106,910,562</u>	<u>\$ 91,429,700</u>

See accompanying notes to financial statements.

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## STATEMENTS OF OPERATIONS YEARS ENDED DECEMBER 31, 2010 AND 2009

	2010	2009
<b>Unrestricted revenue, gains and other support</b>		
Patient service revenue	\$ 62,638,938	\$ 59,258,887
Other revenue	748,406	304,787
Net assets released from restrictions	35,690	105,586
Total revenue, gains and other support	63,423,034	59,669,260
<b>Expenses</b>		
Salaries and wages	22,897,053	20,917,641
Employee benefits	7,405,714	7,527,701
Physician fees	2,552,542	2,426,144
Medical and surgical supplies	6,637,393	6,709,735
Other supplies	346,582	368,422
Purchased services	4,735,204	4,470,605
Equipment rentals	123,331	77,275
Food	299,083	290,732
Utilities	894,086	907,906
Bad debts	5,257,832	4,865,959
Insurance	523,057	499,681
Depreciation and amortization	4,821,243	4,596,222
Interest	1,571,105	1,477,898
Other	1,258,981	1,193,696
Total expenses	59,323,206	56,329,617
Operating income	4,099,828	3,339,643
<b>Nonoperating gain (loss)</b>		
Investment loss	(404,442)	(22,782)
Unrealized gain (loss) on derivative	(625,649)	2,038,485
Total nonoperating gain (loss)	(1,030,091)	2,015,703
Excess revenue and gain over expenses and loss	3,069,737	5,355,346
<b>Other changes in unrestricted net assets</b>		
Unrealized gain on investments	4,401,929	4,072,331
Change in unrestricted net assets	\$ 7,471,666	\$ 9,427,677

See accompanying notes to financial statements.

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## STATEMENTS OF CHANGES IN NET ASSETS YEARS ENDED DECEMBER 31, 2010 AND 2009

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	<u>2010</u>	<u>2009</u>
<b>Unrestricted net assets</b>		
Change in unrestricted net assets	\$ 7,471,666	\$ 9,427,677
<b>Temporarily restricted net assets</b>		
Contributions	154,181	79,491
Net assets released from restrictions	<u>(35,690)</u>	<u>(105,586)</u>
Change in temporarily restricted net assets	<u>118,491</u>	<u>(26,095)</u>
Change in net assets	7,590,157	9,401,582
<b>Net assets</b>		
Beginning of year	<u>56,223,529</u>	<u>46,821,947</u>
End of year	<u><u>\$ 63,813,686</u></u>	<u><u>\$ 56,223,529</u></u>

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See accompanying notes to financial statements.

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## STATEMENTS OF CASH FLOWS YEARS ENDED DECEMBER 31, 2010 AND 2009

	2010	2009
<b>Operating activities</b>		
Change in net assets	\$ 7,590,157	\$ 9,401,582
Adjustments to reconcile change in net assets to net cash flows from operating activities		
Depreciation and amortization	4,821,243	4,596,222
Bad debts	5,257,832	4,865,959
Realized and unrealized gain on investments, net	(2,875,233)	(3,266,999)
Unrealized (gain) loss on derivative	625,649	(2,038,485)
Change in operating assets and liabilities		
Patient accounts receivable	(5,989,341)	(4,371,798)
Other receivables	(181,368)	(56,137)
Inventories	(139,365)	(23,245)
Prepaid expenses	(88,272)	56,772
Accounts payable	(95,538)	(1,535,634)
Accrued wages and related liabilities	289,684	409,439
Estimated third-party settlements	(103,650)	767,545
Net cash flows from operating activities	9,111,798	8,805,221
<b>Investing activities</b>		
Proceeds from sale of investments	25,667,613	6,745,679
Purchases of investments	(38,669,564)	(4,064,436)
Additions to property and equipment	(3,210,526)	(9,181,847)
Other changes in investing activities	(434)	(994)
Net cash flows from investing activities	(16,212,911)	(6,501,598)
<b>Financing activities</b>		
Payments for bond issuance costs	(102,689)	(196,298)
Proceeds from long-term debt	16,625,235	-0-
Principal payments on long-term debt	(9,450,675)	(838,759)
Net cash flows from financing activities	7,071,871	(1,035,057)
Net change in cash and cash equivalents	(29,242)	1,268,566
<b>Cash and cash equivalents</b>		
Beginning of year	2,921,465	1,652,899
End of year	\$ 2,892,223	\$ 2,921,465
<b>Noncash investing, capital and related financing activities</b>		
Property and equipment included in liabilities	\$ -0-	\$ 214,093
<b>Supplemental disclosure of cash flows information</b>		
Cash paid for interest net of amounts capitalized of \$-0- in 2010 and \$412,529 in 2009	\$ 1,571,105	\$ 1,477,898

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

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### 1. SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies followed by Margaret Mary Community Hospital, Inc. (Hospital) in the preparation of its financial statements are summarized below:

#### Organization

The Hospital, located in Batesville, Indiana, is a not-for-profit acute care hospital providing inpatient, outpatient, and other ancillary services to the residents of Ripley and surrounding counties. Admitting physicians are primarily practitioners in the local area.

#### Use of Estimates

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

#### 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. Because the Hospital does not pursue collection of amounts deemed to be charity care, they are not reported as revenue.

#### Patient Accounts Receivable and Revenues

Patient service revenue and the related accounts receivable are recorded at the time services to patients are performed. The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. 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.

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

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The Hospital is a provider of services to patients entitled to coverage under Titles XVIII and XIX of the Health Insurance Act (Medicare and Medicaid). In 2006, the Hospital was granted Critical Access Status by Medicare and is paid for Medicare services based upon a cost reimbursement methodology. The Hospital is reimbursed for cost reimbursable items at an interim rate, with final settlement determined after submission of annual cost reports. Differences between the total program billed charges and the payments received are reflected as deductions from revenue. At the Hospital's year-end, a cost report is filed with the Medicare program computing reimbursement amounts related to Medicare patients.

The difference between computed reimbursement and interim reimbursement is reflected as a receivable from or payable to the third-party program. The year-end cost reports filed with the Medicare and Medicaid programs through December 31, 2008 have been audited by these programs and any resulting differences are reflected in the financial statements. During 2010 and 2009, the Hospital recognized increase in net assets of approximately \$161,000 and \$500,000, respectively due to the differences between original estimates and subsequent revisions for the final settlement of cost reports. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. Although these audits may result in some changes in these amounts, they are not expected to have a material effect on the accompanying financial statements.

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

A summary of patient service revenue for 2010 and 2009 follows:

	<u>2010</u>	<u>2009</u>
Gross patient service revenue		
Inpatient routine	\$ 5,337,420	\$ 5,635,602
Inpatient ancillary	16,363,735	16,794,190
Outpatient services	<u>86,169,698</u>	<u>78,479,740</u>
Total gross patient service revenue	107,870,853	100,909,532
Less provisions for		
Contractual adjustments under third-party reimbursement programs	43,821,524	40,480,461
Charity care	<u>1,410,391</u>	<u>1,170,184</u>
Total provisions	<u>45,231,915</u>	<u>41,650,645</u>
Patient service revenue	<u>\$ 62,638,938</u>	<u>\$ 59,258,887</u>

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# MARGARET MARY COMMUNITY HOSPITAL, INC.

## NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

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### Investments

Investments consist of fixed income mutual funds recorded at fair market value.

### Inventories

Inventories, consisting of mainly medical supplies and pharmaceuticals, are valued at the lower of cost or market with cost being determined on an average cost method.

### Property and Equipment and Provision for Depreciation

Property and equipment are recorded at historical cost except for donations, which are recorded at fair market value at the date of the donation.

Property and equipment include expenditures for additions and repairs that substantially increase the useful lives of existing property and equipment. Maintenance, repairs and minor renewals are expensed as incurred.

The property and equipment of the Hospital are being depreciated over their estimated useful lives using the straight-line method. The ranges of useful lives used in computing depreciation are as follows:

<u>Description</u>	<u>Range of Useful Lives</u>
Land improvements	12-24 years
Buildings and improvements	10-40 years
Equipment	3-20 years

Gifts of long-lived assets such as land, buildings, or equipment are reported as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor restrictions 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. During 2010 and 2009, there were no gifts of long-lived assets with restrictions.

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

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### Assets Whose Use is Limited

Assets whose use is limited by internal board designation includes cash and cash equivalents, accrued interest receivable, and marketable securities. Marketable securities include investments in fixed income mutual funds, equity mutual funds and common stock. Such securities are stated at fair market value. Donated securities are recorded at fair market value at the date of the donation.

Assets held by trustee include cash, certificates of deposit and investments for debt service payments and/or capital improvements in compliance with the Indiana Health Facility Financing Authority bond issues described in the long-term debt note.

### Bond Issue Costs

Unamortized bond issue costs as of December 31, 2010 and 2009 were \$490,514 and \$498,536. Bond issue costs are amortized over the life of the bonds. Accumulated amortization as of December 31, 2010 and 2009 was approximately \$199,900 and \$89,100, respectively. Amortization expense for the years ending December 31, 2011 through 2015 is approximately \$57,000.

### Temporarily Restricted Net Assets

Temporarily restricted net assets are those whose use by the Hospital has been limited by external sources for a specific time period or purpose. When a restriction expires, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statements of operations and changes in net assets as net assets released from restrictions. Restrictions that are met within the year of receipt are reflected with unrestricted net assets. As of December 31, 2010 and 2009, temporarily restricted net assets were \$147,924 and \$29,433, respectively. These assets are restricted for scholarships and other Hospital programs.

### Performance Indicator

The statements of operations include a performance indicator, excess revenue and gain over expenses and loss. Changes in unrestricted net assets that are excluded from performance indicator include unrealized gain and loss on investments other than trading securities and contributions of long-lived assets.

### Federal and State Income Taxes

The Hospital is organized as a not-for-profit corporation under Section 501(c) (3) of the United States Internal Revenue Code. As such, the Hospital is generally exempt from income taxes. However, the Hospital is required to file Federal Form 990 – Return of Organization from Income Tax, which is an informational return only.

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

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### Costs of Borrowing

Except for capital assets acquired through gifts, contributions or capital grants, interest cost on borrowed funds, as well as interest earned on those funds, during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. Capitalized interest cost was approximately \$-0- and \$413,000 in 2010 and 2009, respectively, and capitalized interest income was approximately \$-0- and \$64,000 in 2010 and 2009, respectively.

### Advertising Costs

The Hospital's policy is to expense advertising costs when the advertising first takes place. Advertising expenses were approximately \$186,000 and \$172,000 in 2010 and 2009, respectively.

### Statements of Cash Flows

For the purposes of reporting cash flows, cash and cash equivalents include all cash held in checking and money market accounts available for operating purposes with original maturities of 90 days or less.

### Reclassification

Certain amounts in the prior year financial statements have been reclassified for comparative purposes to conform to the current year presentation.

### Subsequent Events

The Hospital has evaluated events or transactions occurring subsequent to the balance sheet date for recognition and disclosure in the accompanying financial statements through the date the financial statements are issued which is March 18, 2011.

## 2. INVESTMENTS

Investments are recorded at fair market value and consist of the following as of December 31, 2010 and 2009:

	2010	2009
Mutual funds - fixed income	\$ 19,370	\$ 18,936

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# MARGARET MARY COMMUNITY HOSPITAL, INC.

## NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

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### 3. ASSETS WHOSE USE IS LIMITED

Assets whose use is limited include board designated funds as of December 31:

	2010	2009
Cash and cash equivalents	\$ 10,323,352	\$ 2,653,263
Accrued interest receivable	-0-	55,784
Marketable securities	34,269,423	26,006,544
	\$ 44,592,775	\$ 28,715,591

The following is a summary of market value and cost for board designated marketable securities as of December 31:

	2010		2009	
	Market	Cost	Market	Cost
	Value		Value	
Mutual funds - fixed income	\$ 8,220,281	\$ 8,290,340	\$ 12,888,233	\$ 12,498,234
Mutual funds - equities	25,492,923	23,796,886	12,779,380	15,779,831
Common stock	556,219	447,858	338,931	396,069
	\$ 34,269,423	\$ 32,535,084	\$ 26,006,544	\$ 28,674,134

The following is a reconciliation of investment return for 2010 and 2009:

	2010	2009
Interest and dividends	\$ 1,122,254	\$ 782,550
Realized loss on investments	(1,526,696)	(805,332)
Investment loss	\$ (404,442)	\$ (22,782)
Unrealized gain on investments	\$ 4,401,929	\$ 4,072,331

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

The following schedules summarize the fair value of securities included in assets whose use is limited that have gross unrealized losses (the amount by which historical cost exceeds the fair value) as of December 31, 2010 and 2009. The schedules further segregate the securities that have been in a gross unrealized position as of December 31, 2010 and 2009, 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 securities which industry experts expect recovery in the short-term future.

The decline in value is determined by management to be temporary, and unrealized losses have not been reclassified to realized losses as of December 31, 2010 and 2009:

Description of securities	December 31, 2010					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mutual funds - equities	\$ 6,232,795	\$ 151,614	\$ -0-	\$ -0-	\$ 6,232,795	\$ 151,614
Mutual funds - bonds	2,533,999	36,721	\$ -0-	\$ -0-	2,533,999	36,721
Total	<u>\$ 8,766,794</u>	<u>\$ 188,335</u>	<u>\$ -0-</u>	<u>\$ -0-</u>	<u>\$ 8,766,794</u>	<u>\$ 188,335</u>

Description of securities	December 31, 2009					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mutual funds - equities	\$ -0-	\$ -0-	\$ 12,779,390	\$ 3,006,822	\$ 12,779,390	\$ 3,006,822
Common Stocks	-0-	-0-	338,931	57,138	338,931	57,138
Total	<u>\$ -0-</u>	<u>\$ -0-</u>	<u>\$ 13,118,321</u>	<u>\$ 3,063,960</u>	<u>\$ 13,118,321</u>	<u>\$ 3,063,960</u>

#### 4. FAIR VALUE OF FINANCIAL INSTRUMENTS

Major classes of assets and liabilities that are measured at fair value are categorized according to a fair value hierarchy that prioritizes the inputs to value techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3).

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

Level 1 inputs are readily determinable using unadjusted quoted prices for identical assets or liabilities in active markets. Level 2 inputs are derived from quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets (other than those included in Level 1) which are observable for the asset or liability, either directly or indirectly. Level 3 inputs are derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable. If the inputs used fall within different levels of the hierarchy, the categorization is based upon the lowest level input that is significant to the fair value measurement.

Assets and liabilities measured at fair value on a recurring basis as of December 31, 2010 and 2009 are as follows:

	December 31, 2010			
	Total	Level 1	Level 2	Level 3
Assets				
Investments				
Mutual funds - fixed income	\$ 19,370	\$ 19,370	\$ -0-	\$ -0-
Assets whose use is limited				
Mutual funds - fixed income	\$ 8,220,281	\$ 8,220,281	\$ -0-	\$ -0-
Mutual funds - equities	25,492,923	25,492,923	-0-	-0-
Common stock	556,219	556,219	-0-	-0-
	34,269,423	\$ 34,269,423	\$ -0-	\$ -0-
Cash and equivalents	10,323,352			
Total assets whose use is limited	\$ 44,592,775			
Liabilities				
Derivative	\$ 1,849,503	\$ -0-	\$ 1,849,503	\$ -0-
	December 31, 2009			
	Total	Level 1	Level 2	Level 3
Assets				
Investments				
Mutual funds - fixed income	\$ 18,936	\$ 18,936	\$ -0-	\$ -0-
Assets whose use is limited				
Mutual funds - fixed income	\$ 12,888,233	\$ 12,888,233	\$ -0-	\$ -0-
Mutual funds - equities	12,779,380	12,779,380	-0-	-0-
Common stock	338,931	338,931	-0-	-0-
	26,006,544	\$ 26,006,544	\$ -0-	\$ -0-
Cash and equivalents	2,709,047			
Total assets whose use is limited	\$ 28,715,591			
Liabilities				
Derivative	\$ 1,223,854	\$ -0-	\$ 1,223,854	\$ -0-

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

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The following methods and assumptions were used by the Hospital in estimating the fair value of its financial instruments:

Cash and cash equivalents, accounts payable, accrued expenses and estimated third party settlements: The carrying amount reported in the balance sheets for cash and cash equivalents, accounts payable, accrued expenses and estimated third-party settlements approximate fair value based on short-term maturity.

Long-term debt: Fair value of the Hospital's revenue bonds approximates its carrying value based on incremental borrowing rates.

Derivative liability: Fair value of the Hospital's derivative liability approximates its carrying value based on discounted cash flows and market yields.

### 5. PROPERTY AND EQUIPMENT

Property and equipment consist of the following as of December 31:

	2010	2009
Land	\$ 2,371,158	\$ 2,371,158
Land improvements	372,269	372,269
Buildings and improvements	61,461,851	60,331,609
Fixed equipment	6,136,642	5,861,186
Movable and minor equipment	29,099,763	27,024,891
	<u>99,441,683</u>	<u>95,961,113</u>
Less accumulated depreciation	50,076,122	45,365,590
	<u>49,365,561</u>	<u>50,595,523</u>
Construction in progress	591,023	861,067
	<u>\$ 49,956,584</u>	<u>\$ 51,456,590</u>

### 6. DERIVATIVE FINANCIAL INSTRUMENTS – INTEREST RATE SWAPS

#### Objectives and Strategies for Using Derivatives

The Hospital makes limited use of derivative financial instruments for the purpose of managing interest rate risk. In particular, forward interest rate swaps (which are designated as cash flow hedges) are used to manage the risk associated with interest rates on variable-rate borrowings and to lower its overall borrowing costs.

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

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At December 31, 2010, the Hospital had outstanding one interest rate swap agreement with a financial institution, having a total principal amount of \$18,300,000. The agreement effectively changes the Hospital's interest rate exposure on its Variable Rate Demand Revenue Bonds Series 2004A-1 due 2029 to a fixed 3.48%. The interest rate swap agreements mature at the time the related notes mature. The Hospital is exposed to credit loss in the event of nonperformance by the other parties to the interest rate swap agreements. However, the Hospital does not anticipate nonperformance by the counterparties.

The derivative is not designated as a hedging instrument, and is marked-to-market on the balance sheet at fair value. The related gains and losses are included in excess revenue and gains over expenses and losses, the performance indicator, for the reporting period. Cash flows from interest rate swap contracts are classified as an operating activity on the statement of cash flows.

The asset derivatives are reported in the balance sheets as other assets and liability derivatives are reported as derivative liabilities. As of December 31, 2010 and 2009, the fair values of derivatives recorded in the balance sheets are as follows:

	<u>2010</u>	<u>2009</u>
Derivative liability	\$ 1,849,503	\$ 1,223,854

During 2010 and 2009, the amount of gain or loss recognized in the statement of operations and reported as a component of nonoperating gain (loss) is as follows:

	<u>2010</u>	<u>2009</u>
Unrealized gain (loss) on derivative	\$ (625,649)	\$ 2,038,485

Additional information regarding fair value measurements of the interest rate swap agreements is disclosed in Note 4.

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

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### 7. LONG-TERM DEBT

The following is the summary of long-term debt as of December 31:

	<u>2010</u>	<u>2009</u>
Indiana Finance Authority Health Facility Variable Rate Demand Revenue Bonds dated March 1, 2004, due 2029; Series 2004A-1	\$ 18,300,000	\$ 18,970,000
Indiana Finance Authority Health Facility Revenue Bonds Series 2010; dated December 1, 2010, due 2035	16,625,235	-0-
Indiana Finance Authority Health Facility Revenue Bonds Series 2008; dated October 1, 2008, due 2038	-0-	8,780,675
	<u>34,925,235</u>	<u>27,750,675</u>
Less current portion	1,107,879	868,296
	<u>\$ 33,817,356</u>	<u>\$ 26,882,379</u>

In 2004, the Hospital borrowed from the Indiana Finance Authority (the Authority) \$22,000,000 for the addition and improvement of the Hospital facilities. The Authority, created under Indiana Code 5-1-16, provides funds to eligible health facilities for financing capital expenditures.

On September 29, 2009, the Hospital, the Authority and Branch Banking and Trust Company, Inc. (BB&T) entered into a Bond Purchase Agreement (Agreement) whereby BB&T purchased from the Authority all of the Series 2004A Bonds in a private placement. The Agreement provides that BB&T will hold the Series 2004A Bonds during the Initial Long Mode Period which runs through October 2014. During this Initial Long Mode Period, the Series 2004A Bonds bear interest at a variable rate of 68% of one month LIBOR plus 1.30% with a floor of 2.35% (rate as of December 31, 2010 - 2.35%). At the end of the Initial Long Mode Period, the Series 2004A Bonds may be converted to another interest rate mode and remarketed to another bondholder or holders or renewed for another Long Mode Period with BB&T. The Series 2004A Bonds could be converted to another interest rate mode to accommodate market conditions at that time. If the Series 2004A Bonds cannot be remarketed at the end of the Initial Long Mode Period, the Hospital would be subject to payment of the remaining principal of approximately \$16,145,000 at the end of the Initial Long Mode Period. The Series 2004A Bonds are secured ultimately by the gross revenues of the Hospital.

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

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In December 2010, the Hospital borrowed \$16,625,235 from the Authority the Health Facility Revenue Bonds, Series 2010 to pay in full the Series 2008 Bonds and to provide for future capital projects. The Series 2010 Bonds could bear interest at fixed rates as determined by daily, weekly, flexible, semiannual or long modes. The Series 2010 Bonds are secured by an interest in the gross revenues of the Hospital.

On December 16, 2010, the Hospital, the Authority and Key Government Finance, Inc. (Key) entered into an Agreement whereby Key purchased from the Authority all of the Series 2010 Bonds in a private placement. The Agreement provided that Key would hold the Series 2010 Bonds during the Initial Long Mode Period which runs through November 2020. During the Initial Long Mode Period, the Series 2010 Bonds would bear interest at the fixed rate long mode (4.64%) for 120 months with principal and interest payments determined using a 25-year amortization schedule. At the end of the Initial Long Mode Period, the Series 2010 Bonds could be converted to another interest rate mode and remarketed to another bondholder or holders or renewed for another Long Mode Period with Key. The Series 2010 Bonds could be converted to another interest rate mode to accommodate market conditions at that time. If the Series 2010 Bonds could not be remarketed at the end of the Initial Long Mode Period, the Hospital would be subject to payment of the remaining principal of approximately \$11,487,000 at the end of the Initial Long Mode Period.

The Series 2008 Bonds were defeased with a portion of the proceeds from the Series 2010 Bonds. The defeasance resulted in a loss of approximately \$42,000 for 2010, which is recorded in other expenses on the statement of operations.

Annual maturities of long-term debt for the years succeeding December 31, 2010 are as follows:

Year Ending December 31,	
2011	\$ 1,107,879
2012	1,147,585
2013	1,198,232
2014	16,619,864
2015	497,529
Thereafter	<u>14,354,146</u>
	<u>\$ 34,925,235</u>

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

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### 8. RETIREMENT PLANS

The Hospital has a defined contribution pension plan, which covers all eligible employees. Allocations of plan contributions are made based upon the earnings of qualified employees. Contribution percentages are at the discretion of the Hospital.

In 2003, the Hospital adopted a 457(b) deferred compensation plan that provides for non-elective employer deferrals covering a select group of management or highly compensated individuals.

Total pension expense under all retirement plans was approximately \$571,000 and \$559,000 for 2010 and 2009, respectively.

### 9. CONCENTRATIONS OF CREDIT RISK

The Hospital is located in Batesville, Indiana. The Hospital grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. Accounts receivable and revenues from self-pay and third party payors were as follows:

	Receivables		Revenues	
	2010	2009	2010	2009
Medicare	28%	25%	44%	44%
Medicaid	4%	5%	8%	8%
Blue Cross	14%	15%	25%	26%
Other third-party payors	16%	15%	18%	17%
Self pay	38%	40%	5%	5%
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

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.

# MARGARET MARY COMMUNITY HOSPITAL, INC.

## NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

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### 10. COMMITMENTS AND CONTINGENCIES

#### Self-Funded Health Plan

The Hospital 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 Hospital for payment. Under a stop loss agreement, the Hospital is responsible for the funding of all claims and related administrative costs up to \$150,000 per individual per policy year. There is no aggregate limit for the Plan under the stop loss agreement. Group health insurance expense for the years ended December 31, 2010 and 2009 totaled \$4,591,000 and \$4,881,000, respectively.

#### Litigation

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 adverse effect on the Hospital's future position or results from operations.

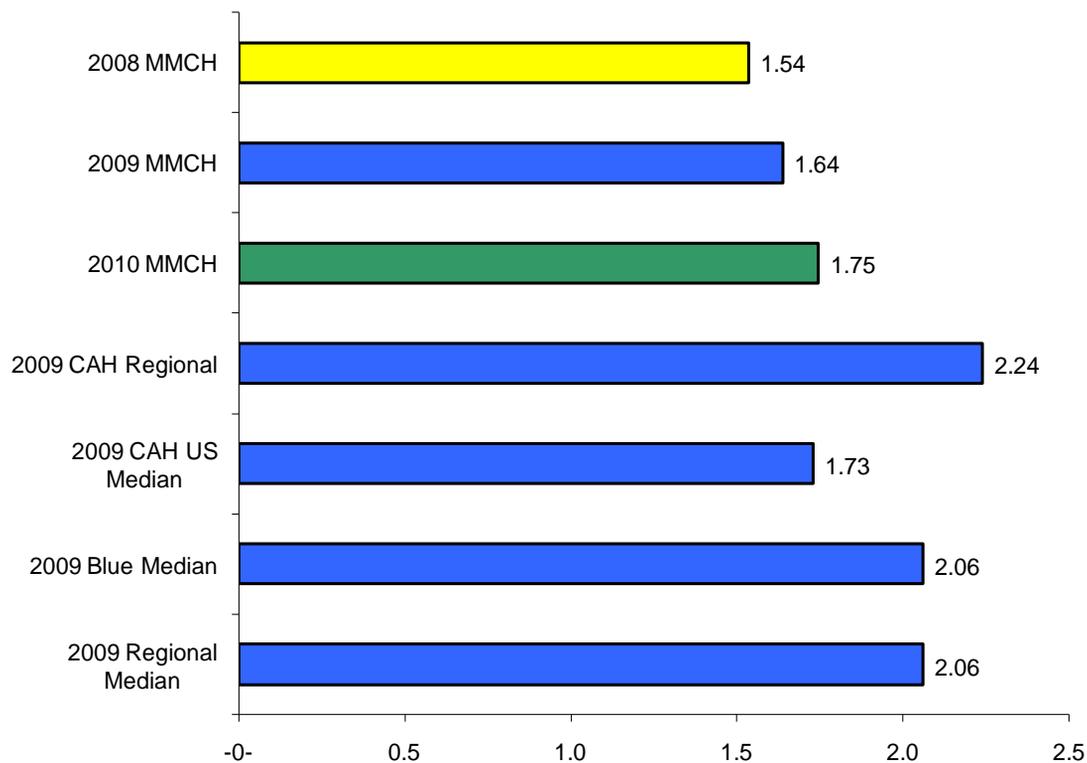
### 11. FUNCTIONAL EXPENSES

The Hospital is an acute care hospital also providing long-term care and home health services. The Hospital has provided inpatient, outpatient and other ancillary services to the residents within its geographical region. Expenses related to providing these services for 2010 and 2009 approximate the following:

	<u>2010</u>	<u>2009</u>
Health care services	\$ 51,981,619	\$ 49,358,504
General and administrative	7,341,587	6,971,113
	<u>\$ 59,323,206</u>	<u>\$ 56,329,617</u>

# Margaret Mary Community Hospital

## Current Ratio



Desired Position: High  
 US Trend: Stable  
 US Forecast: Stable

### Formula

Current Assets / Current Liabilities

### Definition

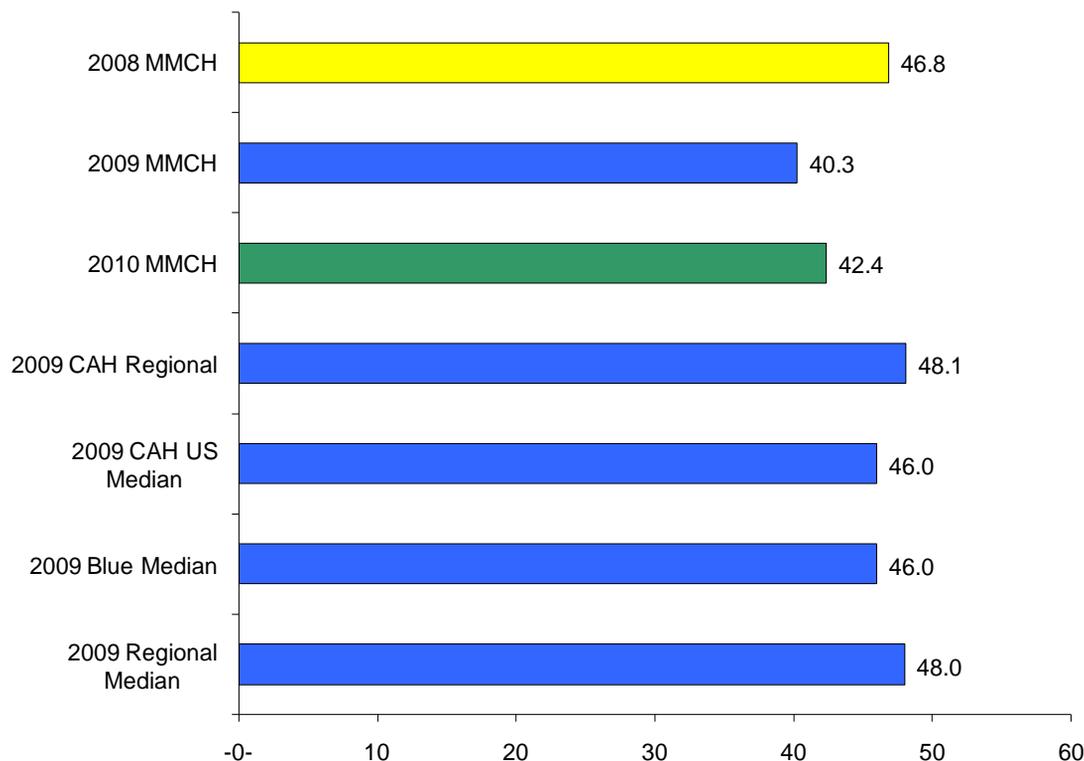
Measures the Hospital's ability to meet short-term financial obligations.

### 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.

# Margaret Mary Community Hospital

## Days in Patient Accounts Receivable, Net



Desired Position: Low  
 US Trend: Decreasing  
 US Forecast: Stable

### Formula

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

### Definition

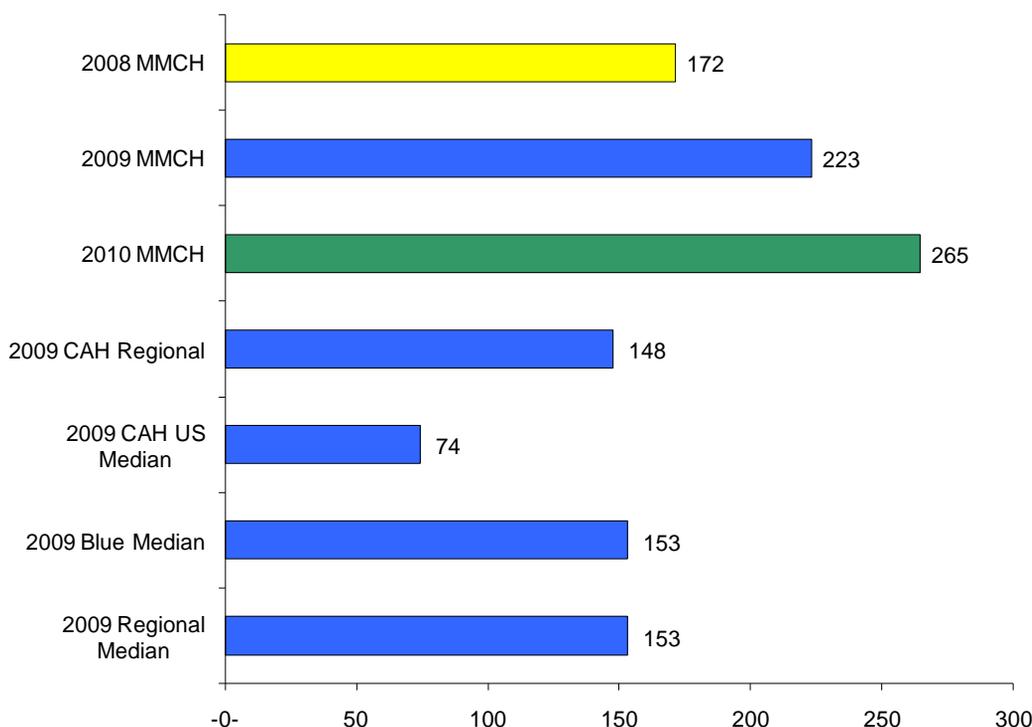
Days in Accounts Receivable is a liquidity ratio which measures the average time that receivables are outstanding and is thus an indicator of the efficiency in collecting receivables.

### Performance Implications

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

# Margaret Mary Community Hospital

## Days Cash on Hand (All Sources)



Desired Position: High

US Trend: Decreasing: Decreasing

US Forecast: Stable

### Formula

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

### Definition

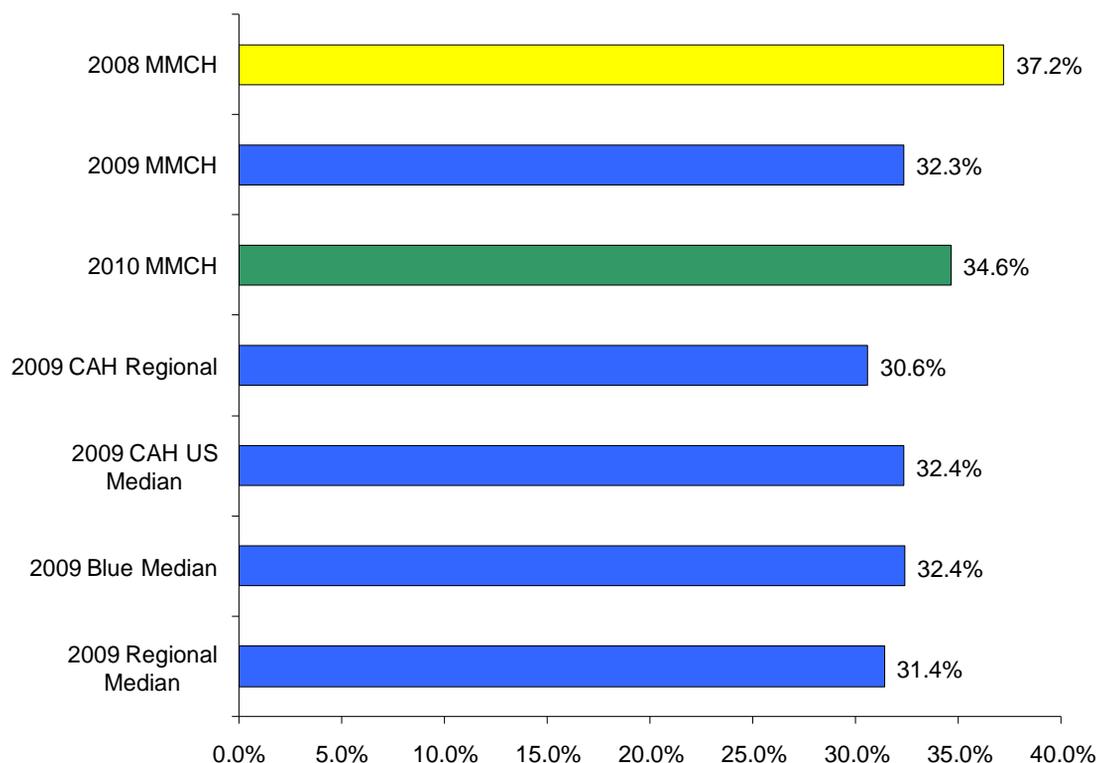
Days cash on hand is a liquidity ratio that measures the number of days of cash operating expenses a hospital has covered by unrestricted cash, cash equivalents and marketable securities.

### 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.

# Margaret Mary Community Hospital

## Long-Term Debt as a Percentage of Total Capital



Desired Position: Preference

US Trend: Stable

US Forecast: Slight decrease

### Formula

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

### Definition

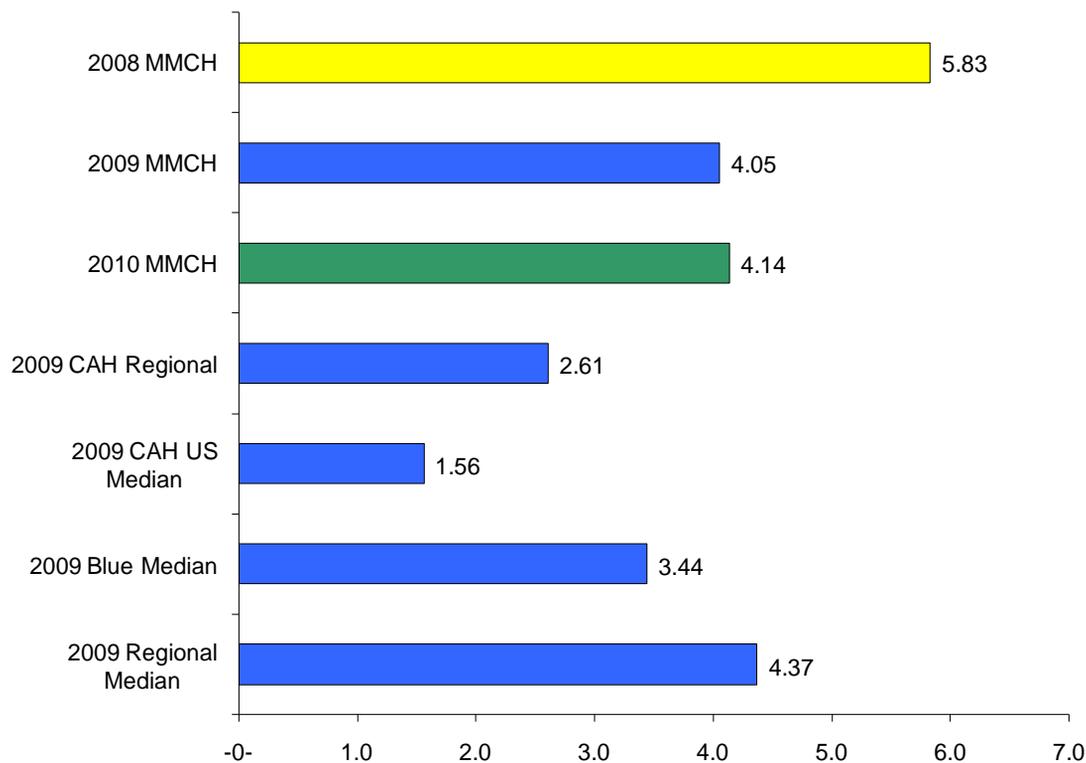
This is a traditional measure of the extent to which a hospital has relied on debt vs. retained earnings and invested or donated capital. It provides a measure of the ability to carry additional debt.

### 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.

# Margaret Mary Community Hospital

## Debt Service Coverage



Desired Position: High  
 US Trend: Slight Decrease  
 US Forecast: Decrease

### Formula

$$\frac{\text{Total Excess of Revenues Over Expenses} + \text{Interest, Depreciation and Amortization}}{\text{Principal Payments} + \text{Interest Expense}}$$

### Definition

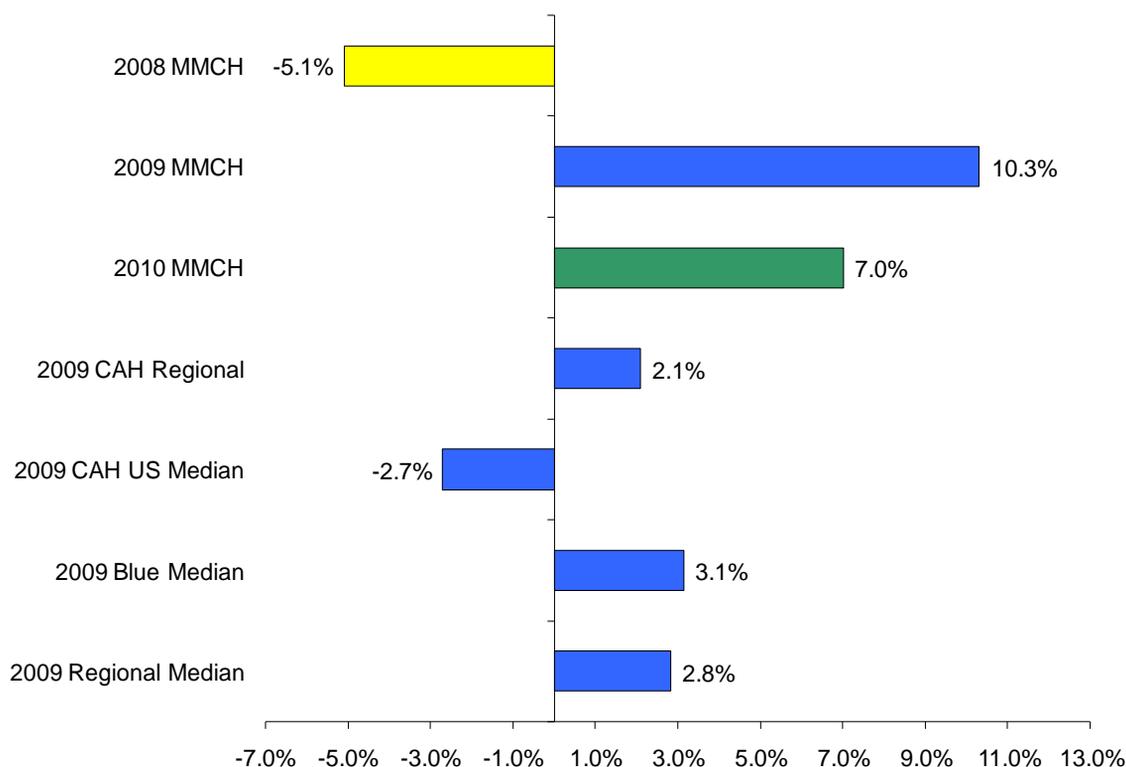
This is a measure of the viability of a hospital. This ratio reflects the ability to fund annual debt service cash flow from net cash revenues.

### 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.

# Margaret Mary Community Hospital

## Return on Total Assets



Desired Position: High  
 Hospital Trend: Decreasing  
 US Trend: Decreasing

### Formula

Change in Net Assets / Total Assets

### Definition

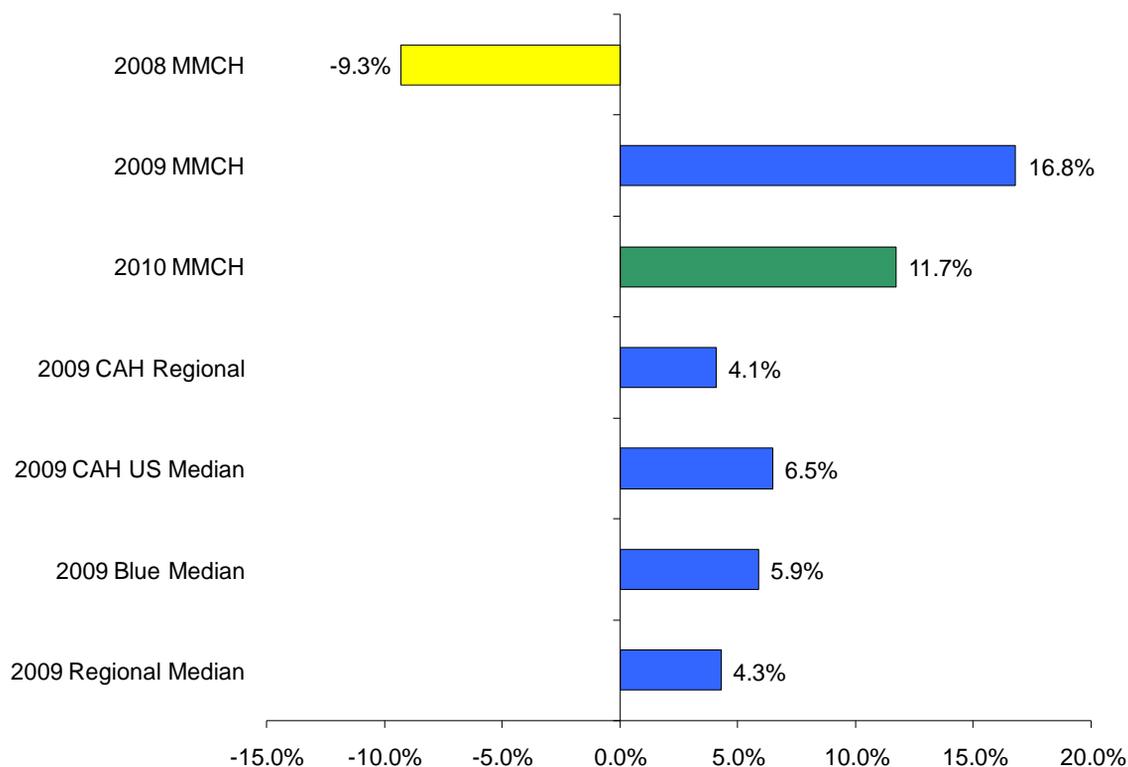
The Return on Total Assets is a profitability ratio which measures the amount of return per dollar of Total Assets and thus profitability in terms of asset efficiency.

### 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.

# Margaret Mary Community Hospital

## Return on Net Assets



Desired Position: High  
 Hospital Trend: Decreasing  
 US Trend: Slight Decreasing

### Formula

Change in Net Assets / Net Assets

### Definition

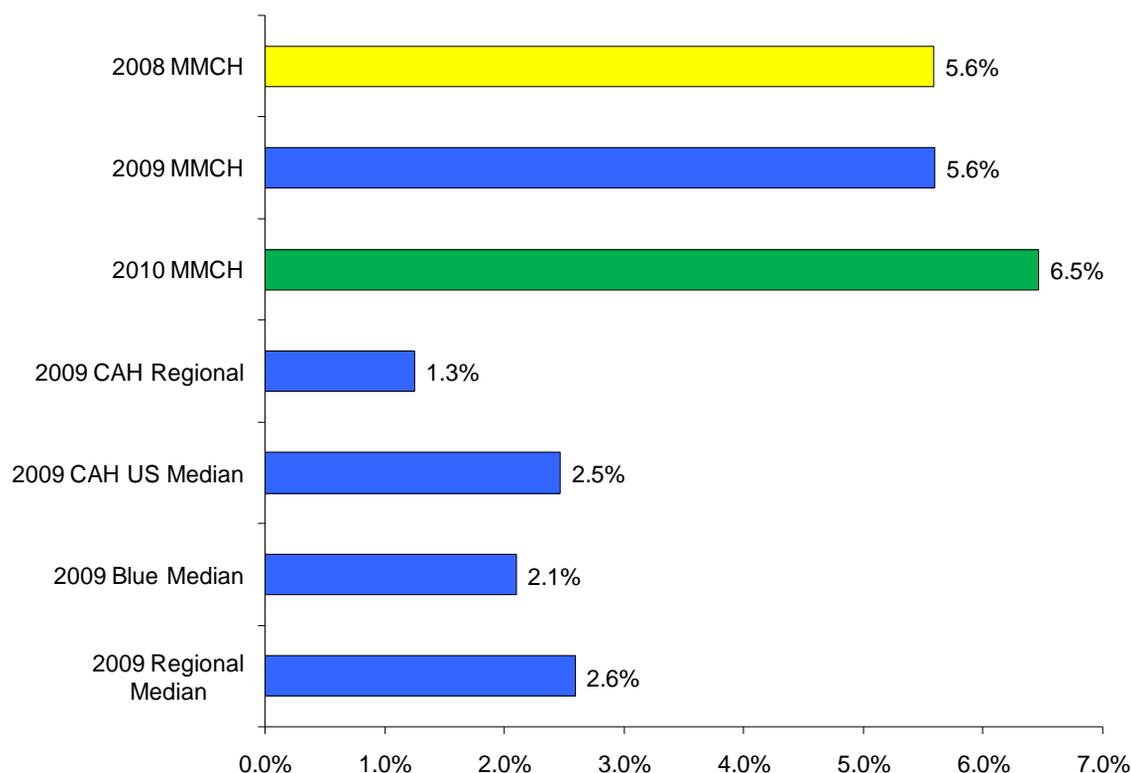
The Return on Net Assets is a profitability ratio which measures the amount of return per dollar of net assets and thus profitability of net assets invested.

### 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.

# Margaret Mary Community Hospital

## Operating Margin



Desired Position: High  
 US Trend: Decreasing – Decreasing  
 US Forecast: Stable

### Formula

$\text{Income From Operations} / \text{Total Operating Revenue}$ .

### Definition

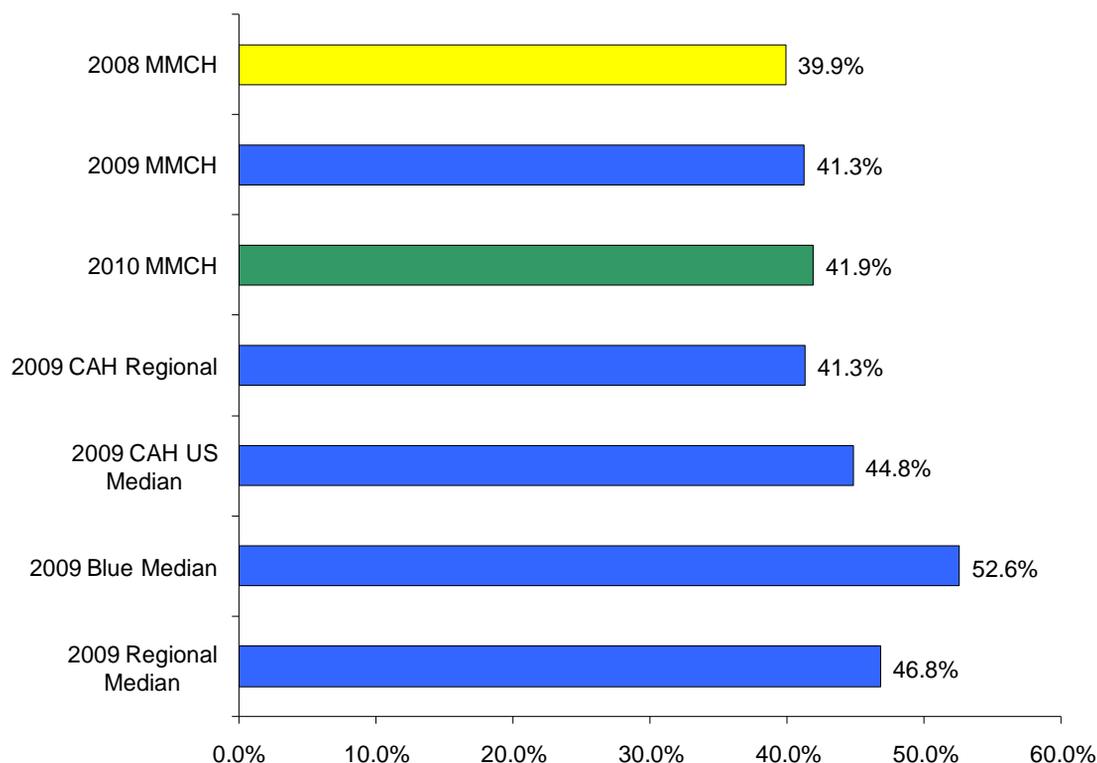
The Operating Margin indicates the amount of return per dollar of operating revenues.

### Performance Implications

This ratio represents the hospital's 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.

# Margaret Mary Community Hospital

## Contractual Allowance Percentage



Desired Position: Preference

US Trend: Increasing significantly

US Forecast: Increase

### Formula

Contractual Allowances / Gross Patient Service Revenue

### Definition

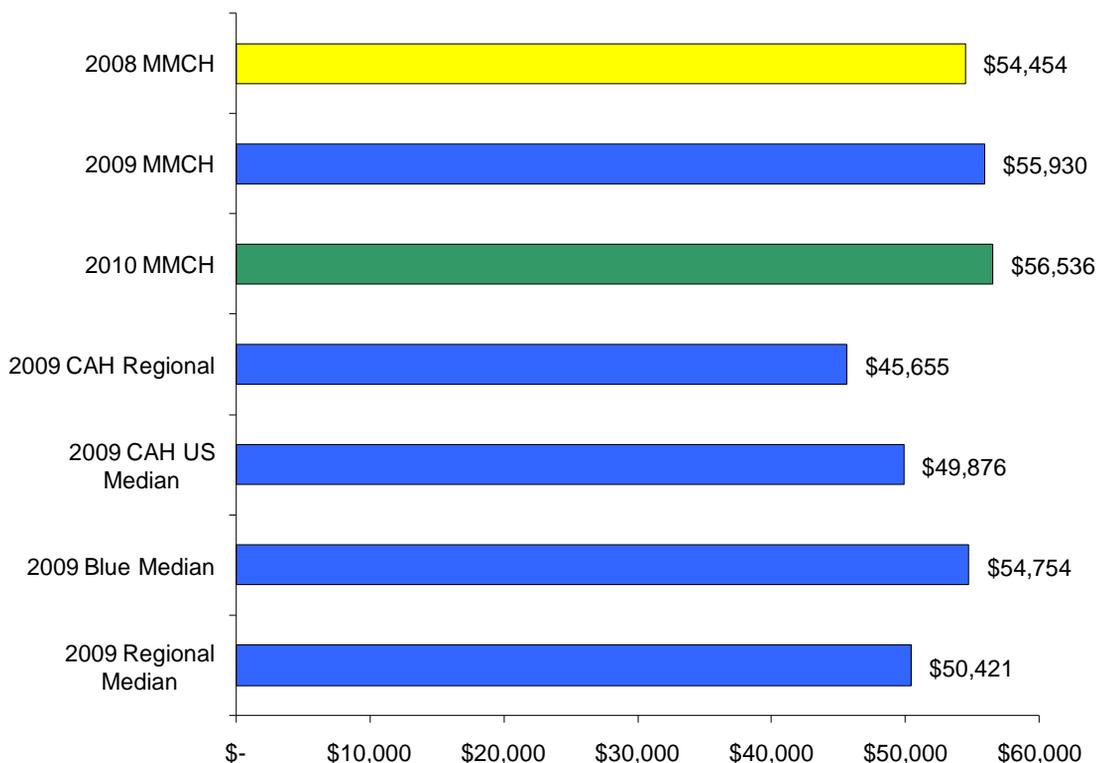
The percentage of gross patient revenue that is discounted to third-party payers.

### 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.

# Margaret Mary Community Hospital

## Salary per Full-Time Employee (FTE)



Desired Position: Preference  
 US Trend: Increasing  
 US Forecast: Inflationary increase

### Formula

Salaries and Wages / Number of Full-Time Employees

### Definition

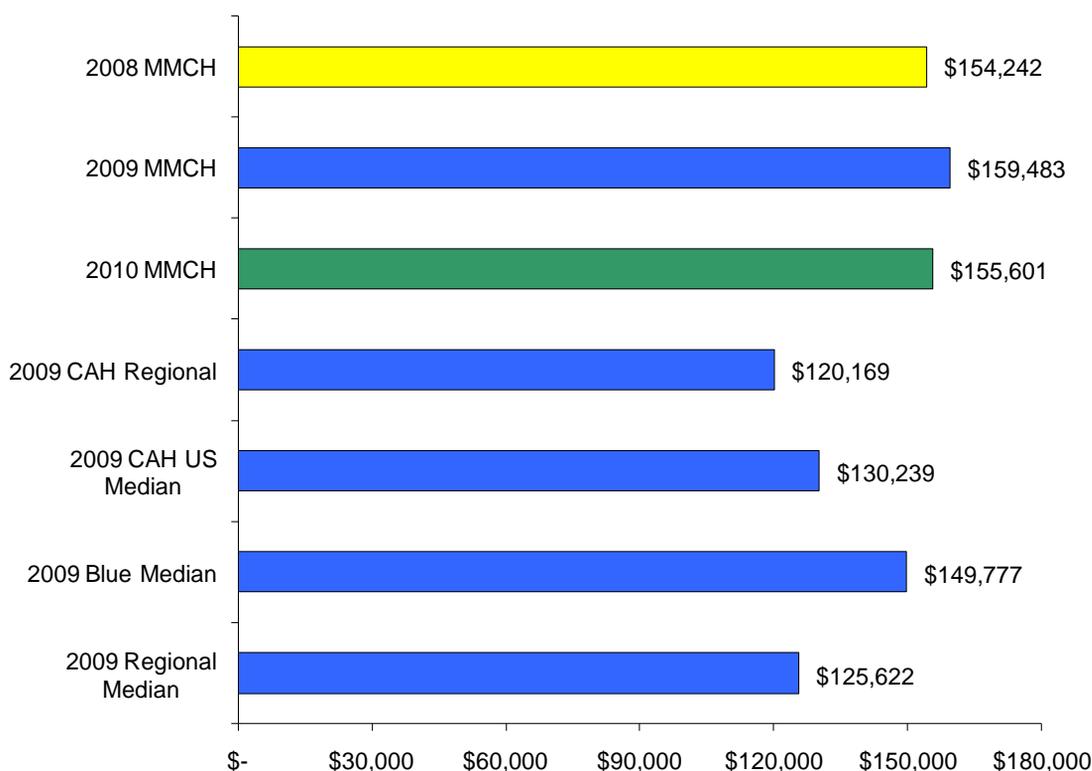
Measures the relative cost of the largest resource item used in the hospital industry.

### 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.

# Margaret Mary Community Hospital

## Revenue per Full-Time Employee (FTE)



Desired Position: Increasing  
 US Trend: Increasing  
 US Forecast: Increasing

### Formula

Total Revenues / Number of Full-Time Employees

### Definition

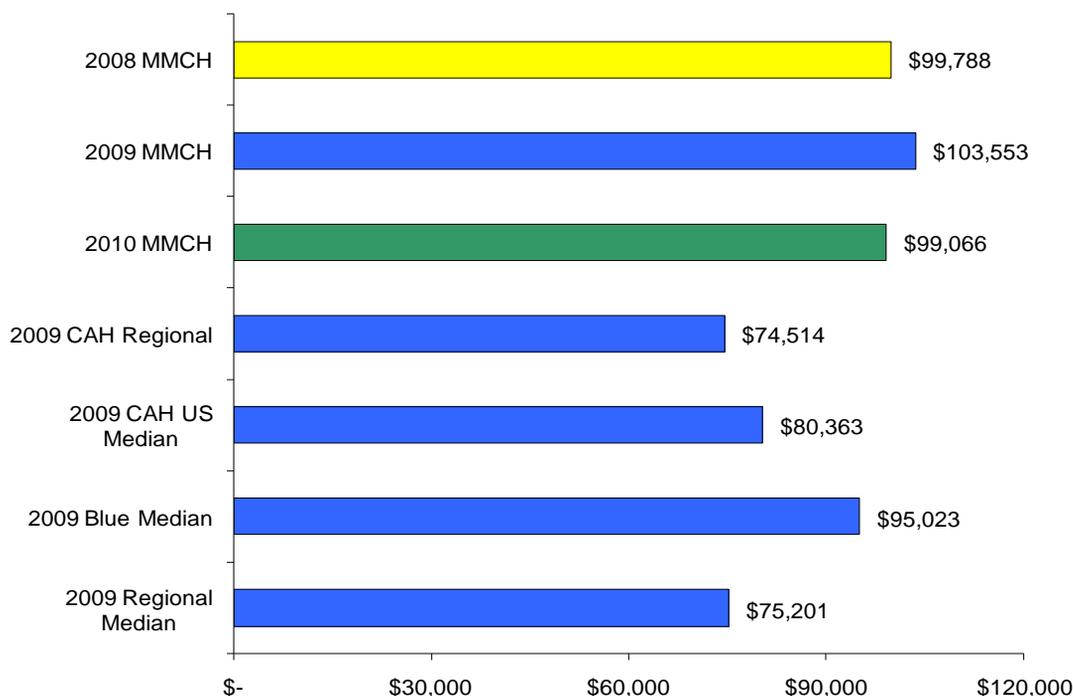
Measures the productivity to compare performance across different industries.

### Performance Implications

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

# Margaret Mary Community Hospital

## Margin per Full-Time Employee (FTE)



Desired Position: Increasing  
 US Trend: Stable  
 US Forecast: Stable

### Formula

Total Revenues Net of Salaries & Wages / Number of Full-Time Employees

### Definition

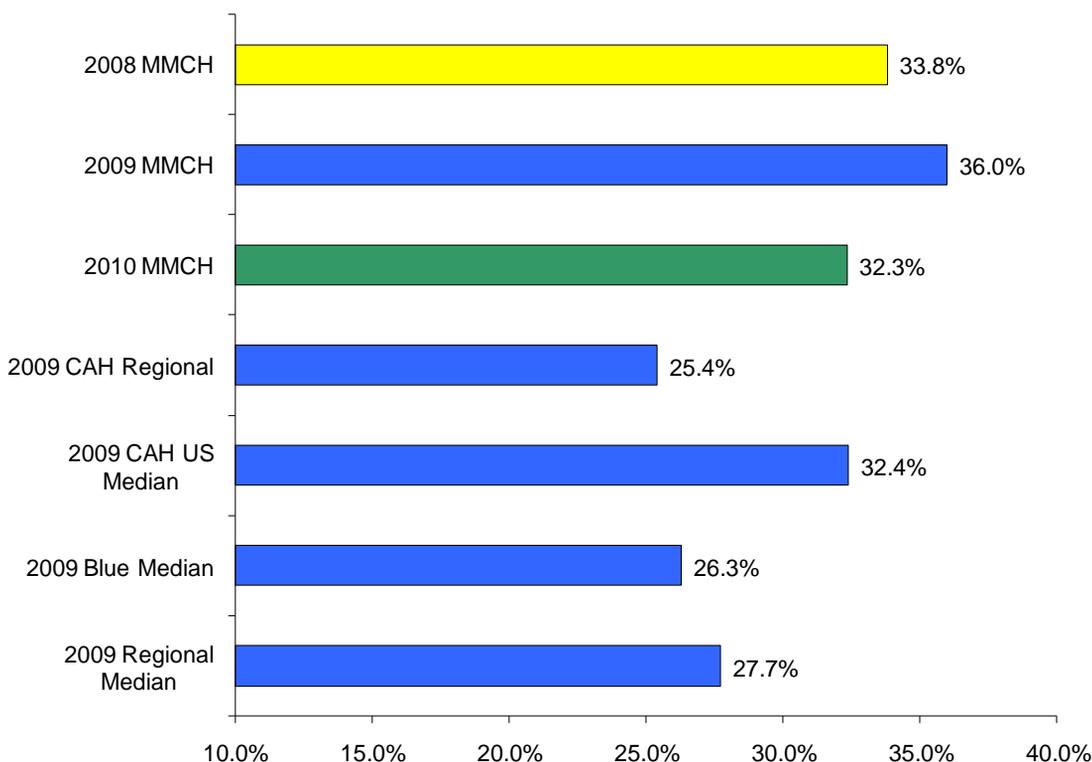
Measures the productivity margin to compare performance across different industries.

### Performance Implications

High performance hospitals have higher values for Margin Per FTE than low-performance hospitals. The ultimate measure of productivity is value created per FTE, and high-performance hospitals are doing exceptionally well in this area.

# Margaret Mary Community Hospital

## Employee Benefits as a Percentage of Salaries and Wages



Desired Position: Preference

US Trend: Increasing

US Forecast: Increase

### Formula

Employee Benefits Expense / Salaries and Wages Expense

### Definition

Defines the percentage relationship between fringe benefits and salaries and wages expense. These benefits include basic payroll tax items, life, death, and dental insurance as well as pension costs.

### Performance Implications

Decreasing values are favorable. Values for Benefits as a % of Salaries and Wages are slightly higher in rural hospitals than in urban hospitals.



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March 18, 2011

Board of Directors  
Margaret Mary Community Hospital, Inc.  
Batesville, Indiana

We have audited the financial statements of Margaret Mary Community Hospital, Inc (the Hospital) for the year ended December 31, 2010 and have issued our report thereon dated as of the date of this letter. Professional standards require that we provide you with the following information related to our audit.

#### **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 your 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. The significant accounting policies used by the Hospital are described in the notes to the financial statements. No new accounting policies were adopted and the application of existing policies was not chanced during the year. We noted no transactions entered into by the Hospital during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

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.

We evaluated the key factors and assumptions used to develop the estimates in determining that they are reasonable in relation to the financial statements taken as a whole.

#### **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. There were no known or likely misstatements identified during the audit. Management did present post-closing adjustments, which increased net assets by approximately \$173,000 mainly related to estimated third party settlements and employee benefit accruals.

#### **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.

#### **MANAGEMENT CONSULTATIONS WITH OTHER INDEPENDENT ACCOUNTANTS**

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the Hospital's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

## **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 December 31, 2010, 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 was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore there can be no assurance that all such deficiencies have been identified.

A deficiency in internal control 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 and correct misstatements on a timely basis. A material weakness is a deficiency or combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

## **CURRENT YEAR RECOMMENDATIONS**

During the course of an audit, we frequently become aware of matters which are opportunities to strengthen internal controls or improve operating efficiency or effectiveness. The following current year comments are not considered to be significant deficiencies or material weaknesses as defined by U.S. generally accepted auditing standards.

### Charity Care Policy

While testing charity care, it was noted that one individual received charity care without submitting all of the required documentation identified by the charity care policy. We recommend the policy be amended to allow senior management the discretion to approve charity care in instances where the facts and circumstances support charity care, but it is not possible to obtain the requested supporting documentation.

### Loan Covenants

The 2010 Series Bond Purchase Agreement identifies various compliance covenants for the Hospital. In addition to financial ratios for debt service, capitalization and days cash on hand, other covenants require the Hospital to submit quarterly financial and utilization information within stipulated time frames.

We recommend the Hospital submit the compliance covenants with supporting calculations as required and obtain formal approval from the bank. This will ensure both parties concur with the submitted information.

### Continued Assessment of Accounts Receivable Balances

During 2010, gross accounts receivable increased approximately \$1,300,000 to \$14,210,000 from 2009. Of the total balance as of December 31, 2010, self-pay represents over \$5,300,000 or 37.5%. With the significant changes in under insured and self insured over the years, the trend of higher self-pay balances will increase.

We recommend the Hospital continue to monitor the accounts receivable balances, especially self-pay, including aging to ensure the appropriate trends are considered in net realizable value assessment. Additionally, self-pay can be further separated in to self-pay after insurance and straight self-pay. Collection history indicates better collections on self-pay after insurance.

<b>PRIOR YEAR RECOMMENDATION WITH CURRENT YEAR STATUS</b>
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We would like to briefly follow-up on certain recommendations that were included in our board letter to you dated March 4, 2010. Current year status updates are included in italics.

### Review of Revenue and Billing Changes

During 2009, changes were made to the charge structure for oncology IV pump services which inadvertently increased the charge from approximately \$130 per unit to approximately \$5,000 per unit. As such, gross revenue for 2009 was overstated by approximately \$1,100,000. The Hospital, through other compensating control and review procedures, identified the billing error and made the appropriate corrections for 2009 in early 2010.

***Current year status – recommendation addressed*** - *The Hospital implemented additional control procedures which include restricted access to the charge system for modifications, approval of changes and periodic review of all changes on a regular basis. Additionally, monthly review of department revenue variations to budget assisted in identifying potential input errors.*

### Segregation of Accounting Duties

The Hospital has a limited number of people available to perform a variety of accounting functions and duties, some of which may be incompatible. For instance, the person who initiates journal entries also approves and posts journal entries into the general ledger. Separating these duties or implementing additional compensating controls will improve overall internal controls and reduce the potential for errors and irregularities. This may be done without hiring more personnel. We recommend that the Hospital consider the following:

- Identify accounting personnel and the duties performed.
- Identify 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.

***Current year status – recommendation addressed*** - A review of accounting personnel duties was performed and improvements in segregation of duties were made along with additional review and sign off procedures that were implemented. Key personnel were also required to take at least one week of vacation while their duties were covered by another employee.

### Vendor List Modification and Review

The Hospital should conduct periodic reviews of vendor payment lists by responsible officials. Additionally, various personnel in the accounting department can edit and modify vendor lists without prior approval or oversight. We recommend access to vendor creation and modification be limited to specific authorized personnel. A monthly report identifying additions and modifications can be generated for review by a responsible official to ensure the changes are appropriate.

***Current year status – recommendation addressed*** - In July 2010, the Finance department conducted a review of all vendors within the Meditech accounts payable system. As a result of that review, 2,830 vendors were deemed inactive and blocked from further use. This was a 45% reduction in the number of active vendors in the MMCH vendor file. The Finance Department will conduct this review annually and delete vendors that have been inactive for 3 consecutive years.

*Additionally the following procedures were added:*

- Procedures were added to restrict accounts payable clerk and materials management employees from modifying bank account information for vendors.

- *The accounting manager reviews and signs off on the vendor "Change Report" each month. This report is generated by I.S., and lists all changes made to vendor accounts.*
- *The accounts payable clerk reviews vendor accounts each month and for those accounts with no activity for more than three years, they are made inactive.*

#### Documentation of Bank Reconciliation Reviews

During 2009, a key employee in the Hospital's accounting function was on an extended leave of absence. During this period, the key functions performed by this employee were properly allocated amongst the remaining personnel. One of the key functions is the review of bank reconciliations with appropriate documentation of the review.

While the review of bank reconciliations did occur, there was no formal documentation of the review by the appropriate personnel. We recommend that all reconciliations should be initialed by the preparer and the individual reviewing them. This will assist in proper recording of transactions and attribute responsibility to the appropriate individuals.

***Current year status – recommendation addressed*** – *The accounting manager now reviews and signs off on all bank reconciliations performed by the payroll clerk and CFO.*

#### Improve Back-Up Data Procedures

During the audit we noted a lack of an operations document related to the back-up procedures performed at the Hospital. Without proper documentation, management is not assured that its policies and procedures are being carried out. We believe it is critical to document the existing policy because it is an effective tool for training new personnel, providing instructions, and assisting in system revision and development as well as program maintenance. The back-ups performed also should be tested on a regular basis to determine that they are usable.

***Current year status – recommendation addressed*** - *During 2010 the Hospital reviewed its data backup procedures. This review resulted in improvements to the backup system and an update to the policies and procedure on the backup process.*

### **CURRENT ISSUES AFFECTING HEALTHCARE AND NOT-FOR-PROFIT ORGANIZATIONS**

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

### **New Requirements for Hospitals exempt under IRC Section 501(c)(3)**

During March 2010, the Federal Government enacted the Patient Protection and Affordable Care Act, which created several new requirements for Hospital Organizations exempt under Internal Revenue Code section 501(c)(3). Under this act, a facility required by the State to be licensed, registered, or similarly recognized as a hospital must meet this new criteria. The new code section of the Internal Revenue Code has been added under section 501(r) and will need to be met in order to keep the Hospital Organization's exempt status under section 501(c)(3). For hospital systems, each hospital must meet each of the requirements or the entire system is in jeopardy of losing its tax-exempt status.

In addition any other organization that the Secretary determines has the provision of hospital care as its principal function or purpose constituting the basis for its exemption under section 501(c)(3) must meet the criteria; however, the Secretary has not announced which organizations will be required. Failure to meet the community health needs assessment (effective March 2012) will entail a \$50,000 excise tax on the hospital organization. The following requirements would also effect governmental hospitals in Indiana that are not required to file a Form 990, if the organization is also exempt under 501(c)(3)

Requirements that must be met for fiscal years ending after March 23, 2010 include:

- Have a written Financial Assistance Policy which includes:
  - eligibility criteria for financial assistance
  - basis for calculating amounts charged to patients
  - method for applying for financial assistance
  - actions in the event of non-payment (for hospitals without billing and collection policies)
  - measures to widely publicize the policy throughout the community it serves
- Have a written Emergency Medical Care policy which includes:
  - a provision of care for emergency medical conditions without discrimination to individuals regardless of their eligibility under the hospital's financial assistance policy.
- Limit charges for emergency or other medically necessary care provided to individuals, eligible for assistance under the financial assistance policy, equivalent or less than the amount generally billed to individuals who have insurance covering such care. In addition, gross charges will not be allowed to be used for such charges.

- Eliminate any "extraordinary collection actions" before making "reasonable effort" to determine if an individual is eligible for assistance under the financial assistance policy. Extraordinary collections include: lawsuits, liens on residences, arrests, body attachments, or other similar collection processes. Reasonable efforts include notification by the hospital of its financial assistance policy upon admission and in written and oral communication with the patient regarding the patient's bill, including invoices and telephone calls, before collection action or reporting to credit agencies is initiated.
- Submit a copy of Audited Financial statements with the Form 990 submissions.

Requirements that must be met for fiscal years ending after March 23, 2012 include:

- Conduct a community health needs assessment every three years
- Adopt an implementation strategy to meet the health needs identified in the assessment
- Acquire feedback from representatives of the community being served
- Make the assessment widely available to the public
- Submit with the Form 990 filing a description of how the needs identified are being addressed or why any of the needs identified are not being addressed.

### **Proposed Changes to Lease Accounting**

The Financial Accounting Standard Board (FASB) recently issued an exposure draft to introduce some proposed changes to the accounting rules on leases. The exposure draft introduced a new "right of use" approach that when finalized will impact the financial accounting for all leases. Another key difference from existing standards is that the new rules are "principles" based whereas the existing standards were "rules" based.

Historically, leases were classified as either an operating lease or a capital lease dependent upon established criteria or "rules". For those leases classified as operating, an asset and liability was not recorded under the existing rules. Expense under operating leases has generally been recognized when the lease payments occur. The proposed rules would require the lessee to initially recognize assets and liabilities arising from those leases.

Although capital leases would be less affected, the proposed rules would result in significant changes in the measurement of assets and liabilities because of the way the exposure draft would account for lease options and contingent rentals. In addition, the pattern of expense recognition would change significantly.

Organizations should be aware of the potential effects of these proposed changes to ensure financial planning opportunities are identified and potential negative consequences are proactively addressed. Some of the more significant effects of the expected lease accounting change are as follows:

- Increased debt on the balance sheet
- More expense recognition in the early years and less expense recognition in the later years with total expense recognized on the income statement being equal to that recognized for operating leases
- Impact on financial ratios (debt service coverage, days cash on hand, cushion ratio, long-term debt to capitalization, current ratio, return on assets, etc.)
- Impact on debt covenants – changes to the financial ratios could impact financial debt covenants
- Increase in Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) – interest expense and depreciation will be added back for purposes of calculating EBITDA, while rent expense recognized under operating leases historically was not
- Bonus payments – employee bonuses calculated using EBITDA could increase based on the proposed accounting changes

The proposed rules are currently in deliberation and will likely be finalized in the near future. Currently, the FASB anticipates the release of the final rules in the second calendar quarter of 2011.

### **Proposed Changes to Accounting Standards for Private Companies**

In December 2009, the American Institute of Certified Public Accountants, the Financial Accounting Foundation (parent of the Financial Accounting Standards Board) and the National Association of State Boards of Accountancy established a “Blue-Ribbon” Panel (the Panel) to address how accounting standards can best meet the needs of the users of private company financial statements in the United States. The report and recommendations of the Panel were issued in January 2011, and contained recommendations that could significantly change accounting standards for private companies. Some of these recommendations and comments include:

- The Panel has concluded that there are urgent and growing systemic issues that need to be addressed in the current system of U.S. accounting standards setting.
- The Panel believes that the system should focus on making exceptions and modifications to accounting principles generally accepted in the United States of America (GAAP) for private companies that better respond to the needs of the private company sector rather than move toward a separate, self-contained GAAP for private companies or a wholesale reorganization of GAAP.
- The Panel recommends establishment of a separate private company standards board, under the auspices of the Financial Accounting Foundation.

- While there are no specific recommendations as to which current GAAP requirements would be changed or eliminated for private companies, the report suggests a lack of relevance of a number of accounting standards, including variable interest entities, uncertain tax positions, fair value measurement and goodwill impairment. The report further states that the least relevant standards for private companies are often the most complex, and costly to implement.

The Board of Trustees of the Financial Accounting Foundation, as part of its strategic initiative to review private company issues, will now consider the Panel's recommendations as it deliberates improvements to the standard-setting process. As of the date of this letter, no timeline has been published on the website ([www.accountingfoundation.org](http://www.accountingfoundation.org)) of the Financial Accounting Foundation for such deliberations. We are hopeful that action will be taken during 2011 to simplify the accounting standards that you are required to follow.

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This communication is intended solely for the information and use of management, the Board of Directors and its relevant committees (including as applicable the Audit and Finance Committee), and others within the Hospital and is not intended to be and should not be used by anyone other than these specified parties.

We appreciate this opportunity to be of service and extend our thanks to everyone for their cooperation and assistance. We would be pleased to discuss any of the above matters with you at your convenience.

Sincerely,

*Blue & Co., LLC*