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September 20, 2011

Board of Directors
Howard Regional Health System
3500 S. Lafountain Street
Kokomo, IN 46904

We have reviewed the audit report prepared by Blue & Co., LLC, Independent Public Accountants, for the period January 1, 2010 to December 31, 2010. In our opinion, the audit report was prepared in accordance with the guidelines established by the State Board of Accounts. Per the Independent Public Accountants' opinion, the financial statements included in the report present fairly the financial condition of the Howard Regional Health System, as of December 31, 2010 and the results of its operations for the period then ended, on the basis of accounting described in the report.

The Independent Public Accountants' report is filed with this letter in our office as a matter of public record.

STATE BOARD OF ACCOUNTS



CONSOLIDATED FINANCIAL STATEMENTS

AND

SUPPLEMENTARY INFORMATION

DECEMBER 31, 2010 AND 2009

CPAs / ADVISORS



HOWARD REGIONAL HEALTH SYSTEM

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REPORT OF INDEPENDENT AUDITORS

Board of Trustees
Howard Regional Health System
Kokomo, Indiana

We have audited the accompanying consolidated balance sheets of Howard Regional Health System (the System), as of December 31, 2010 and 2009, and the related consolidated statements of revenues and expenses, changes in net assets and cash flows for the years then ended. These consolidated financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the financial statements of Howard Regional Health System Foundation, Inc. (the Foundation), a blended component unit, whose statements reflect total assets of \$4,044,389 and \$4,077,903 as of December 31, 2010 and 2009, respectively, and change in net assets of \$272,374 and \$290,969, respectively, for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and in our opinion, insofar as it relates to the amounts for the Foundation, is based solely on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States; Guidelines for Examination of Entities Receiving Financial Assistance From Governmental Sources and 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 consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits, and the report of the other auditors, provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of the other auditors, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of the System as of December 31, 2010 and 2009 and the results of its consolidated operations, changes in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.

Board of Trustees
Howard Regional Health System
Kokomo, Indiana

Accounting principles generally accepted in the United States of America require that Management's Discussion and Analysis be presented to supplement the consolidated financial statements. Such information, although not a part of the consolidated financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the consolidated financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the consolidated financial statements, and other knowledge we obtained during our audits of the consolidated financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information listed in the accompanying table of contents is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, changes in net assets and cash flows of the individual entities, and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Blue & Co., LLC

June 30, 2011

REQUIRED SUPPLEMENTARY INFORMATION

HOWARD REGIONAL HEALTH SYSTEM

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED) DECEMBER 31, 2010 AND 2009

This section of Howard Regional Health System's (the System) annual consolidated financial statements presents background information and management's discussion and analysis (MD&A) of the System's consolidated financial performance during the year ended December 31, 2010 with comparable information for 2009 and 2008. This MD&A includes a discussion and analysis of the activities and results of the System, its blended component unit, Howard Regional Health System Foundation, and its majority owned subsidiaries as described in the notes to the consolidated financial statements. This MD&A should be read together with the consolidated financial statements included in this report.

The System has two county-owned facilities and operates under the Indiana County Hospital Law, Indiana Code 16-22. It has a licensed and staffed 150-bed acute regional hospital and a 30-bed regional rehabilitation hospital both located in Kokomo, Indiana serving a nine county region in north central Indiana. The System provides short-term inpatient and outpatient health care among other services.

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

HIGHLIGHTS OF THE YEARS ENDED DECEMBER 31, 2010 AND 2009

Howard Regional Health System continues to offer a full range of inpatient and outpatient services. Even adjusting for a decline in volumes, the System continues to be the third largest employer in Howard County with two hospitals on three campuses plus clinics in Greentown, Grissom, and Frankfort.

Work continues on the System's 2009-2012 strategic plan, which focuses on five major areas:

1. Outstanding quality
2. Superior service
3. Exceptional people
4. Ongoing growth
5. Consistent strength

A System-wide initiative to train and coach System leadership and staff began in partnership with the Studer Group. The Studer Group is nationally renowned firm devoted to teaching prescriptive tools and processes that organizations can use immediately to create and sustain service and operational excellence.

HOWARD REGIONAL HEALTH SYSTEM

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED) DECEMBER 31, 2010 AND 2009

The goal of this training is to connect each person employed by the System to the five areas listed above, thereby increasing quality of the care provided, patient satisfaction, employee satisfaction, and financial viability for the future. We believe these attributes are directly correlated to the needs of healthcare reform.

Physician Recruitment

The employment of physicians and physician groups is a strategic measure many hospitals are taking to help build patient volumes. Over the past decade, one of the System's strategies has been to recruit and secure relationships with primary care physicians. This strategy was behind the formation of Community Family Health Center, North Central Indiana Pediatric Center, Pulmonary Care Center, Community OB/GYN Center and our internal medicine practices.

In order to fulfill our primary mission of providing exceptional quality care, we have made a commitment to further expand and secure a solid base of primary care physicians. As a result, Dr. A. Barhams and Dr. J. Lilla, family practice, joined the system in 2010.

The System also successfully added additional employed specialists during 2010, including Dr. Changjuan Chen, gastroenterology.

Facility Growth

Positioning for the future, we continued our strategic plan for facility growth both within the Main Campus hospital and in outpatient areas. As part of the strategic direction to achieve better efficiencies and improved patient access, the Woman's Center moved to the Imaging Center in 2010.

Indiana Health Information Exchange

Howard Regional Health System continued its relationship with the Indiana Health Information Exchange's (IHIE) DOCS4DOCS® service. Both Howard Regional and St. Joseph Hospital, Kokomo, have implemented IHIE's secure, Web-based service that delivers clinical reports like lab results, reports, and treatment information in real-time, sent instantly to where it needs to be for patient care (outpatient centers and ambulatory practices).

HOWARD REGIONAL HEALTH SYSTEM

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED) DECEMBER 31, 2010 AND 2009

Electronic Medical Record

Kickoff toward a System-wide Electronic Medical Record was initiated in 2009. The *Cerner* person-centric solution framework has been chosen to advance the digitization of individual electronic medical records to meet the needs of our hospital, providers and patients.

Charity Care

The System provided approximately \$9.70 million of charity care to the community in 2010. This compares to \$8.72 million in 2009 or an increase of 11%. Charity care in 2008 was \$8.20 million.

Marketable Securities

We are exposed to market risk related to changes in value of securities. The investment in mutual fund fixed income and equity securities was \$26.3 million as of December 31, 2010 compared to \$26.6 million as of December 31, 2009. These investments are carried at fair value, with changes in unrealized gains and losses being recorded in investment income (loss). During 2010, we had investment income of approximately \$2.8 million compared to investment income of approximately \$4.8 million in 2009.

Interest Rate Swap Agreements

We are exposed to market risk related to changes in interest rates and we entered into interest rate swap agreements to manage our exposure to these fluctuations. Our interest rate swap agreements involve the exchange of fixed and variable rate interest payments between two parties, based on common notional principal amounts and maturity dates. The notional amounts of the swap agreements represent balances used to calculate the exchange of cash flows. Our credit risk related to these agreements is considered low because the swap agreements are with creditworthy financial institutions. The interest payments under these agreements are settled on a net basis. These derivatives have been recognized in the financial statements at their respective fair value. Changes in the fair value of these derivatives are included in the statement of revenues and expenses. During 2010, the System recognized an unrealized loss on the swap agreements of approximately \$1.54 million compared to an unrealized gain of approximately \$5.77 million in 2009.

HOWARD REGIONAL HEALTH SYSTEM

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED) DECEMBER 31, 2010 AND 2009

Accreditations

During 2010, the following accreditations were achieved or renewed:

- Commission on Accreditation of Allied Health Education Programs.
- American College of Surgeons Commission on Cancer, a consortium of professional organizations dedicated to improving survival and quality of life for cancer patients. The System is the only cancer program in Howard County to receive the accreditation.
- American College of Radiology (ACR). The ACR-accreditation demonstrates that the System has voluntarily undergone a comprehensive review process and meets nationally accepted high standards of care.
- The System's West Campus Specialty Hospital Sleep Disorders Center is accredited by the American Academy of Sleep Medicine. The West Campus Sleep Disorders Center diagnoses and treats a variety of sleep disorders in adults and children over the age of four. These include sleep apnea, obstructive sleep apnea, insomnia, narcolepsy, restless leg syndrome and others.
- Inpatient imaging services by the American College of Radiology (ACR) in Ultrasound, as well as Imaging Center for CT and MRI. The System is the only ultrasound accredited facility listed on the ACR website. ACR accreditation in Nuclear Medicine and CT was attained in early 2010.

Other accreditations and certifications include but are not limited to:

- The Intersocietal Commission for the Accreditation of Nuclear Medicine Laboratories
- The Intersocietal Commission for the Accreditation of Echocardiography Laboratories
- The Intersocietal Commission for the Accreditation of Vascular Laboratories
- American Association of Cardiovascular & Pulmonary Rehabilitation
- American College of Radiology accreditation in Mammography
- State of Indiana Family and Social Services Administration, Division of Mental Health
- American Diabetes Association
- Department of Health & Human Services, Health Care Financing Administration

HOWARD REGIONAL HEALTH SYSTEM

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)
DECEMBER 31, 2010 AND 2009

LOOKING AHEAD TO 2011

We continue to make plans to convert to an Electronic Medical Record system (EMR). With an EMR, complete near real-time records can be viewed anytime from anywhere in the secure network, and records can be accessed concurrently by caregivers who have a need to view the information in the provision of care. Faster access from more places means caregivers have the most current information at their fingertips to make quick and evidence-based healthcare decisions.

Quality, patient safety and patient satisfaction will continue to be priorities at the System in the year and years ahead. Working with guidelines provided by state and national healthcare organizations, we are committed to providing exceptional quality, patient-centered care.

Strategic Cost Reduction

In anticipation of the healthcare reform and recognition of financial performance in 2010 that did not meet System objectives, the Board and Senior leadership initiated a Strategic Cost Reduction plan with a target of 10% improvement in overall expenses, or \$13 million. This goal was communicated to all employees seeking their input and ideas, and was initiated in early 2011. Areas of improvement include improved productivity management, supply chain initiatives, revenue cycle opportunities, and other efficiencies.

USING THIS ANNUAL REPORT

The System's consolidated financial statements consist of four statements – a Balance Sheet; a Statement of Revenues and Expenses, a Statement of Changes in Net Assets; and a Statement of Cash Flows. These consolidated financial statements and related notes provide information about the activities and the financial position of the System.

The Consolidated Balance Sheet includes all of the System's assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to System creditors (liabilities).

All of the current year's revenue earned and expenses incurred are accounted for in the Consolidated Statement of Revenues and Expenses. The Consolidated Statements of Changes in Net Assets summarizes the changes in net assets for the year.

Finally, the Consolidated Statement of Cash Flows' purpose is to provide information about the System's cash flows from operating activities, financing activities including capital additions, and investing activities. This statement provides information on the sources and uses of cash and the change in cash balance during the year.

HOWARD REGIONAL HEALTH SYSTEM

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED) DECEMBER 31, 2010 AND 2009

THE BALANCE SHEET AND STATEMENT OF REVENUES AND EXPENSES

One of the most important questions asked about the System's finances is, "Is the System as a whole better or worse off as a result of the year's activities?" The balance sheet and the statement of revenues and expenses report information about the System's resources and its activities in a way that helps answer this question. These statements include all restricted and unrestricted assets and all liabilities using the accrual basis of accounting. All of the current year's revenues and expenses are taken into account regardless of when cash is received or paid.

These two statements report the System's net assets and changes in them. Think of the System's net assets—the difference between assets and liabilities—as one way to measure the System's financial health, or financial position. Over time, increases or decreases in the System's net assets are one indicator of whether its financial health is improving or deteriorating. Consider other nonfinancial factors, however, such as changes in the System's patient base and measures of the quality of service it provides to the community, as well as local economic factors to assess the overall health of the System.

Table 1 – Balance Sheets

	2010	2009	2010-2009 Change	2008	2009-2008 Change
Current assets	\$ 58,459,539	\$ 67,323,624	\$ (8,864,085)	\$ 58,499,435	\$ 8,824,189
Assets whose use is limited	7,826,641	829,183	6,997,458	7,491,193	(6,662,010)
Capital assets, net	90,013,218	84,012,667	6,000,551	89,318,608	(5,305,941)
Other assets	1,684,382	1,767,749	(83,367)	2,387,156	(619,407)
	<u>\$ 157,983,780</u>	<u>\$ 153,933,223</u>	<u>\$ 4,050,557</u>	<u>\$ 157,696,392</u>	<u>\$ (3,763,169)</u>
Current liabilities	\$ 22,076,422	\$ 43,067,072	\$ (20,990,650)	\$ 18,921,710	\$ 24,145,362
Long-term liabilities	66,924,607	33,711,176	33,213,431	70,059,059	(36,347,883)
Total liabilities	89,001,029	76,778,248	12,222,781	88,980,769	(12,202,521)
Net assets	68,982,751	77,154,975	(8,172,224)	68,715,623	8,439,352
	<u>\$ 157,983,780</u>	<u>\$ 153,933,223</u>	<u>\$ 4,050,557</u>	<u>\$ 157,696,392</u>	<u>\$ (3,763,169)</u>

Total assets increased approximately \$4.05 million from December 31, 2009. Current assets and assets whose use is limited changed due to the current versus long term classification of assets whose use limited of approximately \$7 million between years. Capital assets increased mainly due to the addition of an EMR system of approximately \$12 million.

Liabilities increased approximately \$12.2 million from December 31, 2009 mainly related to an increase in accounts payable (\$3.9 million), capital lease obligations (\$7.6 million) and interest rate swap liabilities (\$1.5 million).

HOWARD REGIONAL HEALTH SYSTEM

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED) DECEMBER 31, 2010 AND 2009

The 2009-2008 change in total assets of approximately \$3.8 million is due to fewer capital additions in 2009 compared to depreciation expense. The change between current assets and assets whose use is limited relates to the current versus long term classification of assets whose use limited.

The 2009-2008 change in total liabilities of approximately \$12.2 million was the result of accrued liabilities being paid (\$2.4 million) and interest rate swap liabilities decreasing (\$5.8 million).

The 2010 net assets decreased approximately \$8.2 million from December 31, 2009 mainly due to lower income from operations and decreases in nonoperating revenues and expenses from investment income and the change in the unrealized gain (loss) in the interest rate swaps. The 2009 net assets increased \$8.4 million due to operating income, investment income and gains on interest rate swap liabilities.

Table 2 – Statements of Revenues and Expenses

	2010	2009	2010-2009 Change	2008	2009-2008 Change
Total revenues	\$ 146,219,149	\$ 157,867,028	\$ (11,647,879)	\$ 156,318,178	\$ 1,548,850
Salaries and benefits	75,558,806	79,219,704	(3,660,898)	82,886,775	(3,667,071)
Supplies and drugs	29,238,541	27,570,181	1,668,360	28,924,823	(1,354,642)
Purchased services	8,929,971	10,070,495	(1,140,524)	9,168,827	901,668
Depreciation and amortization	9,687,014	9,909,307	(222,293)	9,744,425	164,882
Other	27,907,752	27,592,248	315,504	27,375,982	216,266
Total operating expenses	151,322,084	154,361,935	(3,039,851)	158,100,832	(3,738,897)
Operating income (loss)	(5,102,935)	3,505,093	(8,608,028)	(1,782,654)	5,287,747
Nonoperating revenues (expenses), net	(2,263,113)	6,771,322	(9,034,435)	(18,767,158)	25,538,480
Consolidated change in net assets	(7,366,048)	10,276,415	(17,642,463)	(20,549,812)	30,826,227
Less amount attributable to non-controlling interest	(632,238)	(1,721,258)	1,089,020	(1,867,104)	145,846
Change in net assets attributable to controlling interest	\$ (7,998,286)	\$ 8,555,157	\$ (16,553,443)	\$ (22,416,916)	\$ 30,972,073

Total revenues decreased approximately \$11.6 million from December 31, 2009 mainly due to net patient service revenue and overall utilization. While gross patient service revenue increased \$6 million over 2009, contractual adjustments, charity care and bad debt expense increased \$16.4 million due to changes in payor mix and changes in overall utilization. Expenses decreased approximately \$3.0 million mainly through salaries and benefits as staffing was monitored based on overall utilization. Together, operating income (loss) decreased \$8.6 million over 2009 to a total loss of \$5.1 million.

Nonoperating revenues and expenses for 2010 were \$2.26 million, a decrease of approximately \$9.03 million from 2009. The unrealized loss on the interest rate swap agreement and interest expense were the main contributing factors.

HOWARD REGIONAL HEALTH SYSTEM

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED) DECEMBER 31, 2010 AND 2009

The 2009-2008 increase in change in net assets of approximately \$30.8 million was due the 2008 unrealized loss on interest rate swaps and investment loss of approximately \$14.7 million compared with 2009 gains of approximately \$10.5 million in these two areas.

STATEMENT OF CASH FLOWS

The final required statement is the statement of cash flows. The statement reports cash receipts, cash payments and net changes in cash resulting from operations, investing and financing activities. It provides answers to such questions as "Where did cash come from?" "What was cash used for?" and "What was the change in the cash balance during the reporting period?"

A summary of cash flows follows:

Cash Flows Data	<u>2010</u>	<u>2009</u>	<u>2010-2009 Change</u>	<u>2008</u>	<u>2009-2008 Change</u>
From operating activities	\$ 11,793,804	\$ 10,461,447	1,332,357	\$ 12,872,769	\$ (2,411,322)
From capital and related financing activities	(13,777,348)	(12,833,304)	(944,044)	(19,171,976)	6,338,672
From investing activities	<u>2,982,581</u>	<u>8,580</u>	<u>2,974,001</u>	<u>3,005,009</u>	<u>(2,996,429)</u>
Change in cash and cash equivalents	<u>\$ 999,037</u>	<u>\$ (2,363,277)</u>	<u>\$ 3,362,314</u>	<u>\$ (3,294,198)</u>	<u>\$ 930,921</u>

Total cash and cash equivalents increased approximately \$1 million in 2010 with cash flows from operating activities generating \$11.8 million in 2010. Capital and related financing activities used cash of \$13.8 million mainly for property additions and payments on long term debt. Investing activities relate mainly to investment income and classification between investments and cash equivalents.

Changes from 2008 to 2009 were mainly in capital and related financing activities (an increase \$6.3 million) as additions to property and equipment changed from \$10.3 million in 2008 to \$5.0 million in 2009.

SOURCES OF REVENUE

The System's revenues depend upon inpatient occupancy levels, the ancillary services and therapy programs ordered by physicians and provided to patients, the volume of outpatient procedures and the negotiated payment rates for such services. The gross charges typically do not reflect what is actually paid. The System has entered into agreements with third party payers, including government programs and managed care health plans, under which payments for healthcare services provided to patients are based upon predetermined rates per diagnoses or discounts from gross charges. The System receives a significant portion of its revenues from government health programs, principally Medicare and Medicaid, which are highly regulated and subject to frequent and substantial changes.

HOWARD REGIONAL HEALTH SYSTEM

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED) DECEMBER 31, 2010 AND 2009

Revenues from Medicare and Medicaid programs increased to 60% of gross revenues in 2010 from 58% in 2009. Legislative changes continue to limit or reduce the levels of payments from these programs. The approximate percentages of gross patient revenues were:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Medicare	48%	47%	46%
Medicaid	12%	11%	9%
Blue Cross/Blue Shield	19%	20%	25%
Commercial	13%	13%	13%
Other	8%	9%	7%
	<u>100%</u>	<u>100%</u>	<u>100%</u>

CAPITAL ASSETS

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Land	\$ 1,002,878	\$ 1,002,878	\$ 1,002,878
Land improvements	6,567,713	6,554,573	6,467,686
Buildings and improvements	96,924,110	95,378,684	93,655,858
Equipment	63,614,006	62,421,888	63,494,462
Construction in progress	12,195,376	3,827,495	4,223,373
	<u>180,304,083</u>	<u>169,185,518</u>	<u>168,844,257</u>
Accumulated depreciation	90,290,865	85,172,851	79,525,649
	<u>\$ 90,013,218</u>	<u>\$ 84,012,667</u>	<u>\$ 89,318,608</u>

Gross additions to property were approximately \$15.76 million before retirements of approximately \$4.64 million. Depreciation expense was approximately \$9.62 million before retirements of approximately \$4.50 million for a net increase in capital assets of approximately \$6.00 million.

LONG TERM DEBT

As of December 31, 2010, the System had \$67.34 million in short term and long term notes and bonds outstanding, an increase from the \$61.68 million as of December 31, 2009. The increase relates to the addition of a capital lease related to the EMR system. More detailed information about the System's long term debt is presented in the notes to the consolidated financial statements.

HOWARD REGIONAL HEALTH SYSTEM

MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)
DECEMBER 31, 2010 AND 2009

ECONOMIC OUTLOOK

Management believes that the healthcare industry operating margins will continue to be under significant pressure because of changes in payer mix and growth in operating expenses in excess of the increase in prospective payments under the Medicare and Medicaid programs. The ongoing challenge facing the System and the entire healthcare market is to continue to provide quality patient care in a competitive environment and to attain reasonable rates for the services it provides while managing its costs. The most significant cost factor affecting the System and the industry in general is the spiraling increase in labor costs due to a nationwide shortage of nurses and other healthcare specialists. The System expects the nursing shortage to continue and has implemented various initiatives to better position itself to attract and retain qualified nursing personnel and improve productivity.

CONTACTING THE SYSTEM'S FINANCIAL MANAGEMENT

This report is designed to provide our patients, suppliers, taxpayers, and creditors with a general overview of the System's finances and to show the System's accountability for the money it receives. If you have questions about this report or need additional financial information, contact the System at 3500 South Lafountain Street, Kokomo, Indiana 46904, (765) 453-0702.

HOWARD REGIONAL HEALTH SYSTEM

CONSOLIDATED BALANCE SHEETS DECEMBER 31, 2010 AND 2009

ASSETS

	<u>2010</u>	<u>2009</u>
Current assets		
Cash and cash equivalents	\$ 9,901,301	\$ 12,250,295
Investments	21,244,299	18,396,185
Patient accounts receivable, net of estimated uncollectibles of \$9,095,405 in 2010 and \$10,069,994 in 2009	18,260,700	19,964,045
Other receivables	2,274,100	2,570,250
Inventory and other current assets	5,894,139	6,258,730
Estimated third party settlements	-0-	200,909
Current portion of assets whose use is limited	<u>885,000</u>	<u>7,683,210</u>
Total current assets	58,459,539	67,323,624
Assets whose use is limited		
Internally designated	7,965,309	7,683,210
Held by trustee	80,021	74,877
Donor restricted	<u>666,311</u>	<u>754,306</u>
Total assets whose use is limited	8,711,641	8,512,393
Less current portion	<u>885,000</u>	<u>7,683,210</u>
Noncurrent portion of assets whose use is limited	7,826,641	829,183
Capital assets, net	90,013,218	84,012,667
Other assets	<u>1,684,382</u>	<u>1,767,749</u>
Total assets	<u>\$ 157,983,780</u>	<u>\$ 153,933,223</u>

See accompanying notes to consolidated financial statements.

HOWARD REGIONAL HEALTH SYSTEM

CONSOLIDATED BALANCE SHEETS DECEMBER 31, 2010 AND 2009

LIABILITIES AND NET ASSETS

	<u>2010</u>	<u>2009</u>
Current liabilities		
Accounts payable and accrued expenses	\$ 7,470,182	\$ 3,541,652
Accrued liabilities	8,396,951	7,836,802
Other current liabilities	724,230	962,423
Estimated third party settlements	771,670	-0-
Current portion of revenue bonds payable	885,000	855,000
Current portion of loans payable	878,802	705,245
Current portion of capital lease obligations	2,949,587	165,950
Current portion of revenue bonds payable due to letter of credit expiration	-0-	29,000,000
Total current liabilities	<u>22,076,422</u>	<u>43,067,072</u>
Long term debt		
Revenue bonds payable	46,335,000	18,220,000
Capital lease obligations	4,838,084	71,627
Loans payable	<u>11,454,401</u>	<u>12,663,025</u>
Total long term debt	<u>62,627,485</u>	<u>30,954,652</u>
Other long term liabilities	<u>4,297,122</u>	<u>2,756,524</u>
Total liabilities	89,001,029	76,778,248
Net assets		
Invested in capital assets, net of related debt	22,672,344	22,331,820
Restricted		
For debt service	80,021	74,877
Expendable for capital improvements	7,965,309	7,683,210
Expendable for other specific purposes	10,885	10,885
Donor restricted	<u>666,311</u>	<u>754,306</u>
Total restricted net assets	<u>8,722,526</u>	<u>8,523,278</u>
Unrestricted	<u>35,287,515</u>	<u>43,825,573</u>
Net assets - controlling interest	66,682,385	74,680,671
Non-controlling interest	<u>2,300,366</u>	<u>2,474,304</u>
Total net assets	<u>68,982,751</u>	<u>77,154,975</u>
Total liabilities and net assets	<u>\$ 157,983,780</u>	<u>\$ 153,933,223</u>

See accompanying notes to consolidated financial statements.

HOWARD REGIONAL HEALTH SYSTEM

CONSOLIDATED STATEMENTS OF REVENUES AND EXPENSES YEARS ENDED DECEMBER 31, 2010 AND 2009

	2010	2009
Revenues		
Net patient service revenue	\$ 133,492,129	\$ 143,713,671
Other	12,727,020	14,153,357
Total revenues	146,219,149	157,867,028
Operating expenses		
Salaries and wages	61,839,363	64,591,140
Employee benefits	13,719,443	14,628,564
Medical professional fees	6,974,507	5,727,377
Medical supplies and drugs	29,238,541	27,570,181
Purchased services	8,929,971	10,070,495
Equipment rentals	7,174,729	8,254,540
Utilities and telephone	2,982,783	3,050,976
Insurance	1,182,381	1,151,725
Depreciation and amortization	9,687,014	9,909,307
Other	9,593,352	9,407,630
Total expenses	151,322,084	154,361,935
Operating income (loss)	(5,102,935)	3,505,093
Nonoperating revenues (expenses)		
Investment income	2,799,689	4,815,268
Interest expense	(3,115,018)	(3,166,142)
Unrealized gain (loss) on interest rate swaps	(1,540,599)	5,765,596
Other nonoperating expenses	(407,185)	(643,400)
Total nonoperating revenues (expenses), net	(2,263,113)	6,771,322
Consolidated change in net assets	(7,366,048)	10,276,415
Less amount attributable to non-controlling interest	(632,238)	(1,721,258)
Change in net assets attributable to controlling interest	\$ (7,998,286)	\$ 8,555,157

See accompanying notes to consolidated financial statements.

HOWARD REGIONAL HEALTH SYSTEM

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

	<u>Controlling Interest</u>	<u>Non-controlling Interest</u>	<u>Total</u>
Net asset balances			
December 31, 2008	\$ 66,125,514	\$ 2,590,109	\$ 68,715,623
Change in net assets	8,555,157	1,721,258	10,276,415
Distributions	<u>-0-</u>	<u>(1,837,063)</u>	<u>(1,837,063)</u>
December 31, 2009	74,680,671	2,474,304	77,154,975
Change in net assets	(7,998,286)	632,238	(7,366,048)
Distributions	<u>-0-</u>	<u>(806,176)</u>	<u>(806,176)</u>
December 31, 2010	<u>\$ 66,682,385</u>	<u>\$ 2,300,366</u>	<u>\$ 68,982,751</u>

See accompanying notes to consolidated financial statements.

HOWARD REGIONAL HEALTH SYSTEM

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

	2010	2009
Operating activities		
Cash received from patients and third party payors	\$ 136,168,053	\$ 144,803,554
Cash paid to vendors for goods and services	(62,102,612)	(66,484,772)
Cash paid for employee wages and benefits	(74,998,657)	(82,010,692)
Other receipts, net	12,727,020	14,153,357
Net cash flows from operating activities	11,793,804	10,461,447
Capital and related financing activities		
Acquisition and construction of capital assets	(5,407,485)	(4,977,541)
Loss on disposal of property and equipment	(136,909)	(441,951)
Distributions to non-controlling interest	(806,176)	(1,837,063)
Interest on long term debt	(3,115,018)	(3,166,142)
Principal paid on long term debt	(4,311,760)	(2,410,607)
Net cash flows from capital and related financing activities	(13,777,348)	(12,833,304)
Investing activities		
Investment income	2,799,689	4,815,268
Investment in affiliated companies, net	83,367	619,407
Other nonoperating revenues and expenses	(407,185)	(643,400)
Other changes in investments and assets whose use is limited	506,710	(4,782,695)
Net cash flows from investing activities	2,982,581	8,580
Net change in cash and cash equivalents	999,037	(2,363,277)
Cash and cash equivalents, beginning of year	12,569,824	14,933,101
Cash and cash equivalents, end of year	\$ 13,568,861	\$ 12,569,824
Reconciliation of cash and cash equivalents		
Included in current assets	\$ 9,901,301	\$ 12,250,295
Included in investments	3,576,654	156,731
Included in assets whose use is limited - internally designated	10,885	87,921
Included in assets whose use is limited - held by trustee	80,021	74,877
Cash and cash equivalents, end of year	\$ 13,568,861	\$ 12,569,824

See accompanying notes to consolidated financial statements.

HOWARD REGIONAL HEALTH SYSTEM

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

	2010	2009
Reconciliation of operating income (loss) to net cash flows from operating activities		
Operating income (loss)	\$ (5,102,935)	\$ 3,505,093
Adjustments to reconcile operating income (loss) to net cash flows from operating activities		
Depreciation and amortization	9,687,014	9,909,307
Bad debts	11,307,259	9,790,137
Changes in operating assets and liabilities		
Patient accounts receivable	(9,603,914)	(8,622,073)
Other receivables	296,150	486,592
Estimated third party settlements	972,579	(78,181)
Inventory and other assets	364,591	(503,110)
Accounts payable and accrued expenses	3,551,104	(926,973)
Accrued liabilities and other liabilities	560,149	(2,436,664)
Other current liabilities	(238,193)	(662,681)
Net cash flows from operating activities	\$ 11,793,804	\$ 10,461,447
Supplemental disclosures of cash flow information		
Cash paid for interest, net of capitalized interest of \$237,000 in 2010 and \$137,000 in 2009	\$ 3,115,018	\$ 3,166,142
Noncash capital and related financing activities		
Capital asset purchases in accounts payable	\$ 377,426	\$ -0-
Capital lease obligations incurred for use of capital assets	\$ 9,971,787	\$ -0-

See accompanying notes to consolidated financial statements.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and Reporting Entity

Howard Regional Health System (the System) is a county-owned facility and operates under the Indiana County Hospital Law, Indiana Code (IC) 16-22. The System provides short-term inpatient and outpatient health care among other services. The Board of County Commissioners of Howard County appoints the Governing Board of the System and a financial benefit/burden relationship exists between the County and the System. For these reasons, the System is considered a component unit of Howard County.

Accounting principles generally accepted in the United States of America require that these consolidated financial statements present the System (primary government) and its significant component units. The component units discussed below are included in the System's reporting entity because of the significance of their operational or financial relationships with the System. Blended component units, although legally separate entities are in substance part of the government's operations and exist solely to provide services for the government; data from these units is consolidated with data of the primary government.

Basis of Consolidation

Howard Regional Health System Foundation, Inc. (the Foundation) is a blended component unit of the System. The Foundation is a separate not-for-profit entity organized to support the operations of the System. Financial statements for the Foundation can be obtained by contacting the Foundation office.

Other component units included in the consolidated financial statements based on the System's control of these entities are:

- Howard Regional Specialty Care, LLC
- Midwest Racquetball, Inc. dba Kokomo Sports Center
- Howard Community Surgery Center, LLC
- The Imaging Center of North Central Indiana, Inc.
- Andrew J. Mandery, MD, LLC

All significant intercompany transactions have been eliminated in the consolidated financial statements.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

Use of Estimates

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

Enterprise Fund Accounting

The System utilizes the enterprise fund method of accounting whereby revenues and expenses are recognized on the accrual basis. Substantially all revenues and expenses are subject to accrual.

Accounting Standards and Upcoming Pronouncements

Pursuant to Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the System 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.

Investments

Certificates of deposit, demand deposits, money market funds and similar negotiable instruments that are not reported as cash and cash equivalents are reported as investments at contract value which approximates fair value.

Mutual funds are reported at fair value based on the fund's market price. Other investments are generally reported at fair value.

Investment income, including changes in the fair value of investments, is reported as nonoperating income in the consolidated statements of revenues and expenses.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

Patient Accounts Receivable and Revenues

The System provides services to patients who reside primarily in the local geographic region. Patient accounts receivable and patient service revenues are recorded when patient services are performed and are reported based on gross charges, net of certain deductions from those charges. The System is a provider of services to patients entitled to coverage under Titles XVIII and XIX of the Health Insurance Act (Medicare and Medicaid). The System is reimbursed for Medicare and Medicaid inpatient services based on a fixed price per discharge for each diagnosis related grouping (DRG). The System is reimbursed for Medicare and Medicaid outpatient services based on a fixed price per clinical unit of service. Differences between the total program billed charges and the payments received are reflected as deductions from revenue. At the System'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. Medicare and Medicaid cost reports through December 31, 2007 have been audited with differences between estimates and settled amounts reflected as deductions from revenue. 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 consolidated financial statements.

The System has entered into agreements with certain commercial carriers. Reimbursement for services under these agreements includes discounts from established charges and other payment methodologies. Patient charges under these programs, on which no interim payments have been received, are included in patient accounts receivable at the estimated net realizable value of such charges.

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

Inventory

Inventory is valued at the lower of cost or market with cost being determined on the first-in, first-out (FIFO) method. Inventory consists of medical supplies and pharmaceuticals.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

Assets Whose Use is Limited

Assets whose use is limited are stated at fair value in the consolidated financial statements. These assets include investments designated by the System's Board of Trustees for internal purposes, investments restricted by donors for a specific purpose and investments held by trustees for debt service and capital expenditures. These investments consist primarily of cash and cash equivalents, certificates of deposit, US government securities and mutual funds.

Investment income, to the extent not capitalized, is reported as nonoperating income in the consolidated statements of revenues and expenses.

Capital Assets and Depreciation

Capital assets such as property and equipment are stated at cost and include expenditures for new additions and other costs added to existing facilities which exceed \$500 and meet certain useful life thresholds. Maintenance, repairs and minor renewals are expensed as incurred. The System provides for depreciation of property and equipment using annual rates, which are sufficient to depreciate the cost of depreciable assets over their estimated useful lives using the straight-line method. The range of useful lives in computing depreciation is as follows:

<u>Description</u>	<u>Range of Useful Lives</u>
Land improvements	15 years
Buildings and fixed equipment	4-50 years
Major moveable equipment	5-15 years

Net Assets

Net assets of the System are classified in various 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 net assets consist of debt service, capital improvement and other designations and held by the Foundation. Unrestricted net assets are remaining net assets that do not meet the definition of invested in capital assets net of related debt. Net assets related to non-controlling interest are reported separately on the consolidated balance sheets.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

Consolidated Statements of Revenues and Expenses

The System's consolidated statements of revenues and expenses distinguish between operating and nonoperating revenues and expenses. Operating revenues result from exchange transactions associated with providing health care services which is the Hospital's principal activity. Contributions and investment income are reported as nonoperating revenues. Operating expenses are all expenses incurred to provide health care services, excluding interest costs.

Consolidated Statements of Cash Flows

For the purposes of the consolidated statements of cash flows, cash and cash equivalents include demand deposits and investments in highly liquid debt instruments with an original maturity date of 90 days or less from the date of purchase.

Cost of Borrowing

Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. Capitalized interest was approximately \$237,000 and \$137,000 for 2010 and 2009, respectively.

Bond Issue Costs

The System provides for the amortization of costs incurred for the issuance of bonds over the life of the debt. Bond issue costs net of accumulated amortization were approximately \$590,000 and \$630,000 as of December 31, 2010 and 2009, respectively.

Federal and State Income Taxes

The System is a governmental instrumentality organized under Title 16, Article 12, of the Indiana statutes. The System 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).

The Foundation, a blended component unit, is a tax-exempt organization under Internal Revenue Code 501(c)(3). As such, the Foundation is generally exempt from income taxes. However, the Foundation is required to file Federal Form 990 – Return of Organization Exempt from Income Tax which is an informational return only.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

The blended component units of Howard Regional Specialty Care, LLC, Howard Community Surgery Center, LLC and Andrew J. Mandery, M.D., LLC are organized as limited liability companies, whereby net taxable income is taxed directly to the members and not these entities. Thus, the financial statements do not include any provision for Federal or State income taxes.

The blended component units of Midwest Racquetball, Inc. dba Kokomo Sports Center and The Imaging Center of North Central Indiana, Inc. are corporations subject to Federal and state income taxes. Income taxes for these entities are provided for the tax effects of transactions reported in the consolidated financial statements and consist of taxed currently due plus deferred taxes. However, the effects of recording a deferred tax provision have been deemed immaterial and have not been recorded in the accompanying consolidated financial statements.

These entities have filed their federal and state income tax returns for periods through December 31, 2009. These income tax returns are generally open to examination by the relevant taxing authorities for a period of three years from the later of the date the return was filed or its due date (including approved extensions).

Compensated Absences

The System's policy on compensated absences (which include vacation, sick leave and holidays) allows full time employees and regular part time employees to accrue days off, to a maximum of 480 hours. Compensated absences are accrued when incurred and reported as a liability on the consolidated balance sheets.

Litigation

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

Risk Management

The System is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; natural disasters; employee health, dental, and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

Advertising Costs

The System's policy is to expense advertising costs when the advertising first takes place. Advertising expenses were approximately \$875,000 and \$799,000 in 2010 and 2009, respectively.

Medical Malpractice Claims

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

Reclassifications

Certain amounts from the 2009 consolidated financial statements have been reclassified to conform to the current year presentation.

Subsequent Events

The System evaluates events or transactions occurring subsequent to consolidated balance sheet date for recognition and disclosure in the accompanying consolidated financial statements through the date the consolidated financial statements are issued which is June 30, 2011.

2. CHANGE IN ACCOUNTING PRINCIPLE

The System adopted the requirements of GASB No. 53, Accounting and Financial Reporting for Derivative Instruments. The System is a party to interest rate swap agreements which are derivative instruments. The new guidance requires governmental entities to evaluate each derivative instrument to determine whether the instrument is an effective hedge. For those instruments deemed to be an effective hedge, governmental entities are required to practice hedge accounting and the instrument continues to be reevaluated at the end of each future reporting period. Under hedge accounting, the fair value of the instrument is recorded on the consolidated balance sheet with the offsetting entry to deferred outflows or deferred inflows, which also reported on the consolidated balance sheet. The adoption of GASB No. 53 did not have a significant impact on these consolidated financial statements.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

For those instruments deemed to be an ineffective hedge, governmental entities are required to practice investment accounting and the instruments are not evaluated in future reporting periods. Once deemed ineffective, the instrument is considered ineffective for the remainder of its term. Under investment accounting, the fair value of the instrument is recorded on the consolidated balance sheet with the offsetting entry posted to investment income.

The System's interest rate swap agreements were determined to be ineffective hedges as of December 31, 2010 and 2009. As a result, the fair value of the instruments have been recorded as other long term liabilities in the consolidated balance sheets with the offsetting entry recorded under nonoperating revenues (expenses) in the consolidated statements of revenues and expenses.

3. NET PATIENT SERVICE REVENUE

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

A summary of the reimbursement arrangements with major third-party payors is as follows:

Medicare

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

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

Medicaid

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

The System is eligible for the Indiana Medicaid Supplemental programs including Medicaid Disproportionate Share Hospital and Municipal Upper Payment Limit programs. The System recognized reimbursement from these programs within net patient revenue of approximately \$3,146,000 and \$3,242,000 during 2010 and 2009, respectively. These programs are Federal programs administered by the state.

Other Payors

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

The following is a summary of net patient service revenue for 2010 and 2009:

	<u>2010</u>	<u>2009</u>
Inpatient routine services	\$ 33,565,998	\$ 37,967,950
Inpatient ancillary services	91,205,584	85,229,370
Outpatient ancillary services	<u>229,588,494</u>	<u>224,946,627</u>
Gross patient service revenue	354,360,076	348,143,947
Contractual allowance	199,862,541	185,916,805
Charity care	9,698,147	8,723,334
Bad debts	<u>11,307,259</u>	<u>9,790,137</u>
Deductions from revenue	<u>220,867,947</u>	<u>204,430,276</u>
Net patient service revenue	<u>\$ 133,492,129</u>	<u>\$ 143,713,671</u>

The System 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 System does not collect amounts deemed to be charity care, they are not reported as revenue.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

4. INVESTMENTS

Investments are recorded at fair value and consist of the following as of December 31:

	2010	2009
Cash and cash equivalents	\$ 3,576,654	\$ 156,731
Mutual funds - equities	8,668,220	9,169,683
Mutual funds - fixed income	8,999,425	9,069,771
	<u>\$ 21,244,299</u>	<u>\$ 18,396,185</u>

5. ASSETS WHOSE USE IS LIMITED

The classification of assets whose use is limited includes:

Internally designated - Amounts transferred by the System's 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 System buildings as authorized by IC 16-22-3-13.

Funds held by trustee - System funds deposited with a trustee and limited as to use in accordance with the requirements of a trust indenture for debt service and capital construction.

Assets whose use is limited that are required for obligations classified as current liabilities are reported in current assets. The composition of assets limited as to use includes the following as of December 31:

	2010	2009
Internally designated		
Cash and cash equivalents	\$ 10,885	\$ 87,921
Mutual funds - equities	3,729,375	3,947,096
Mutual funds - fixed income	4,225,049	3,648,193
	<u>7,965,309</u>	<u>7,683,210</u>
Held by trustee		
Cash and cash equivalents	80,021	74,877
Donor restricted		
Mutual funds - equities	666,311	754,306
Total assets whose use is limited	<u>\$ 8,711,641</u>	<u>\$ 8,512,393</u>

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

6. 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.

Investments are generally carried at fair market value. Net realized gains and losses on security transactions are determined on the specific identification cost basis. Funded depreciation investments consist of cash equivalents and mutual funds.

The System's investments generally are reported at fair value. As of December 31, 2010 and 2009, the System had the following investments and maturities, all of which were held in the System's name by custodial banks that are agents of the System:

	December 31, 2010				
	Carrying Amount	Investment Maturities (in years)			
		Less than 1	1-5	6-10	More than 10
Mutual funds - equities	\$ 13,063,906	\$ 13,063,906	\$ -0-	\$ -0-	\$ -0-
Mutual funds - fixed income	13,224,474	13,224,474	-0-	-0-	-0-
	\$ 26,288,380	\$ 26,288,380	\$ -0-	\$ -0-	\$ -0-

	December 31, 2009				
	Carrying Amount	Investment Maturities (in years)			
		Less than 1	1-5	6-10	More than 10
Mutual funds - equities	\$ 13,871,085	\$ 13,871,085	\$ -0-	\$ -0-	\$ -0-
Mutual funds - fixed income	12,717,964	12,717,964	-0-	-0-	-0-
	\$ 26,589,049	\$ 26,589,049	\$ -0-	\$ -0-	\$ -0-

Interest rate risk – The System 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 System 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.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

Concentration of credit risk – The System maintains its investments, which at times may exceed federally insured limits. The System has not experienced any losses in such accounts. The System believes that it is not exposed to any significant credit risk on investments.

Deposits and investments consist of the following as of December 31:

	<u>2010</u>	<u>2009</u>
Carrying amount		
Deposits	\$ 13,568,861	\$ 12,569,824
Mutual funds - equities	13,063,906	13,871,085
Mutual funds - fixed income	13,224,474	12,717,964
	<u>\$ 39,857,241</u>	<u>\$ 39,158,873</u>
Included in the balance sheet captions		
Cash and cash equivalents	\$ 9,901,301	\$ 12,250,295
Investments	21,244,299	18,396,185
Internally designated	7,965,309	7,683,210
Held by trustee	80,021	74,877
Donor restricted	666,311	754,306
	<u>\$ 39,857,241</u>	<u>\$ 39,158,873</u>

7. FAIR VALUE MEASUREMENTS

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).

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.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

Cash and cash equivalents, accounts payable, other current liabilities, salaries, wages and related liabilities and estimated third-party settlements: The carrying amount reported in the consolidated balance sheets for cash and cash equivalents, accounts payable, other current liabilities, salaries, wages and related liabilities and estimated third-party settlements approximate fair value based on short term maturity.

Long term debt: Fair value of the System's variable rate revenue bonds is based on current traded value. The carrying value of loans payable and capital lease obligations approximates fair value based on incremental borrowing rates of similarly rated entities.

Derivatives: The fair value of the interest rate swaps approximate their carrying value based on interest yield curves and pricing models.

8. CAPITAL ASSETS

A summary of capital assets includes the following as of December 31:

	December 31, 2009	Additions	Retirements	Transfers	December 31, 2010
Land	\$ 1,002,878	\$ -0-	\$ -0-	\$ -0-	\$ 1,002,878
Land improvements	6,554,573	59,859	(53,953)	7,234	6,567,713
Buildings and improvements	95,378,684	509,255	(2,163,041)	3,199,212	96,924,110
Equipment	62,421,888	3,402,241	(2,421,139)	211,016	63,614,006
Construction in progress	3,827,495	11,785,343	-0-	(3,417,462)	12,195,376
Total capital assets	<u>169,185,518</u>	<u>15,756,698</u>	<u>(4,638,133)</u>	<u>-0-</u>	<u>180,304,083</u>
Less accumulated depreciation					
Land improvements	1,994,560	579,146	(50,954)	-0-	2,522,752
Buildings and improvements	40,901,943	3,543,594	(2,157,196)	-0-	42,288,341
Equipment	42,276,348	5,496,498	(2,293,074)	-0-	45,479,772
Total accumulated depreciation	<u>85,172,851</u>	<u>9,619,238</u>	<u>(4,501,224)</u>	<u>-0-</u>	<u>90,290,865</u>
Capital assets, net	<u>\$ 84,012,667</u>	<u>\$ 6,137,460</u>	<u>\$ (136,909)</u>	<u>\$ -0-</u>	<u>\$ 90,013,218</u>
	December 31, 2008	Additions	Retirements	Transfers	December 31, 2009
Land	\$ 1,002,878	\$ -0-	\$ -0-	\$ -0-	\$ 1,002,878
Land improvements	6,467,686	119,571	(32,684)	-0-	6,554,573
Buildings and improvements	93,655,858	552,045	(701,049)	1,871,830	95,378,684
Equipment	63,494,462	1,912,953	(3,855,070)	869,543	62,421,888
Construction in progress	4,223,373	2,392,972	(47,477)	(2,741,373)	3,827,495
Total capital assets	<u>168,844,257</u>	<u>4,977,541</u>	<u>(4,636,280)</u>	<u>-0-</u>	<u>169,185,518</u>
Less accumulated depreciation					
Land improvements	1,446,702	579,849	(31,991)	-0-	1,994,560
Buildings and improvements	37,844,670	3,590,528	(533,255)	-0-	40,901,943
Equipment	40,234,277	5,671,154	(3,629,083)	-0-	42,276,348
Total accumulated depreciation	<u>79,525,649</u>	<u>9,841,531</u>	<u>(4,194,329)</u>	<u>-0-</u>	<u>85,172,851</u>
Capital assets, net	<u>\$ 89,318,608</u>	<u>\$ (4,863,990)</u>	<u>\$ (441,951)</u>	<u>\$ -0-</u>	<u>\$ 84,012,667</u>

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

9. LONG TERM DEBT

The System has the following bond issues outstanding with the Indiana Financing Authority (IFA) and other local financial institutions as of December 31, 2010 and 2009:

- Series 2005A and 2005B IFA Revenue Bonds, original issue \$30,000,000, Series 2005A and \$20,000,000, Series 2005B, both due through January 2035, variable interest rate of approximately 0.35% for Series 2005A and 0.33% for Series 2005B as of December 31, 2010.
- Loans payable with local financial institutions, due through 2025 at fixed and variable interest rates ranging from 1.73% to 5.15% as of December 31, 2010, secured by certain System assets.
- Capital lease obligations with imputed interest rates ranging from 3.50% to 6.43% executed for property and equipment are due in monthly or quarterly installments of varying amounts from \$3,194 to \$751,211 including interest, due through 2015. The total cost of the property and equipment under capital leases approximated \$15,572,000 and \$5,600,000 as of December 31, 2010 and 2009, respectively, and is listed as security for the obligations. The associated accumulated depreciation approximated \$5,600,000 and \$5,500,000 as of December 31, 2010 and 2009, respectively.

The System has two available letters of credit totaling approximately \$48,000,000 with financial institutions for the Series 2005A and 2005B Bonds. The letters of credit are intended to provide credit enhancement and liquidity support for the System's tax-exempt bonds. The letters of credit are collateralized by the Hospital's gross revenues as well as designated assets. The Series 2005A letter of credit, in the amount of approximately \$29,000,000, expires August 2012 while the Series 2005B letter of credit, in the amount of approximately \$19,000,000, expires February 2012.

There were no balances outstanding as of December 31, 2010 and 2009. The debt agreements require the System to maintain certain financial ratios and restrictive covenants. As of December 31, 2010, the System was not in compliance with certain financial ratios and covenants. The System obtained waivers for the covenant violations as of December 31, 2010.

In the event of liquidity drawing, the System will reimburse the banks in installments through the due dates unless the bonds are remarketed, redeemed or purchased at which time the liquidity advance is due.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

The liquidity drawing due date for the Series 2005A letter of credit is 367 days after the liquidity drawing in 24 equal monthly installments. The liquidity drawing due date for the Series 2005B letter of credit is 367 days after the liquidity drawing. Reimbursements of other than liquidity drawings are due on the date such drawings are honored.

Accounting guidance requires long term debt backed by a letter of credit to be reported as current if the letter of credit does not provide a long term financing option for liquidity drawings. As of December 31, 2009, the Series 2005A letter of credit expired in August 2010 and was not renewed until subsequent to the issuance of the December 31, 2009 financial statement audit. Therefore, the Series 2005A Bonds were classified as current as of December 31, 2009.

A summary of long term debt for 2010 and 2009 follows:

	December 31, 2009		December 31, 2010		Current Portion
	Borrowings	Payments	Borrowings	Payments	
2005 IFA Revenue Bonds	\$ 48,075,000	\$ -0-	\$ 47,220,000	\$ (855,000)	\$ 885,000
Loans payable	13,368,270	-0-	12,333,203	(1,035,067)	878,802
Capital lease obligations	237,577	9,971,787	7,787,671	(2,421,693)	2,949,587
Total long term debt	<u>\$ 61,680,847</u>	<u>\$ 9,971,787</u>	<u>\$ 67,340,874</u>	<u>\$ (4,311,760)</u>	<u>\$ 4,713,389</u>
	December 31, 2008		December 31, 2009		Current Portion
	Borrowings	Payments	Borrowings	Payments	
2005 IFA Revenue Bonds	\$ 48,895,000	\$ -0-	\$ 48,075,000	\$ (820,000)	\$ 855,000
Loans payable	14,504,934	-0-	13,368,270	(1,136,664)	705,245
Capital lease obligations	691,520	-0-	237,577	(453,943)	165,950
Total long term debt	<u>\$ 64,091,454</u>	<u>\$ -0-</u>	<u>\$ 61,680,847</u>	<u>\$ (2,410,607)</u>	<u>1,726,195</u>
Current portion of revenue bonds payable due to letter of credit expiration					<u>29,000,000</u>
Total current portion					<u>\$ 30,726,195</u>

The System has interest rate swap agreements related to the Series 2005A and 2005B Bonds. The interest rate swap agreements do not affect the obligation of the System under the indenture to repay principal and interest on the Series 2005A and 2005B Bonds. However, during the term of the swap agreements, the System effectively pays a fixed rate on a portion of the debt. A portion of the debt service requirements to maturity for the Series 2005A and 2005B Bonds are based on that fixed rate. The System will be exposed to variable rates if the counterparty to the swaps defaults or the swap agreements are terminated.

A termination of the swap agreements may also result in the System making or receiving a termination payment. As of December 31, 2010, the variable rates on the Series 2005A and 2005B Bonds were lower than the swap agreements fixed rates. Thus, the amounts reported in the interest rate swap, net column of the above table is positive for the difference between the variable rate and swap fixed rate.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

See the footnote on Derivative Instruments – Interest Rate Swaps for additional information.

Scheduled maturities for the years subsequent to December 31, 2010 are as follows:

Years Ending December 31,	Principal	Interest	Interest Rate Swap, Net	Total
2011	\$ 4,713,389	\$ 710,182	\$ 1,543,658	\$ 6,967,229
2012	4,848,524	485,510	1,513,958	6,847,992
2013	3,344,433	444,791	1,483,185	5,272,409
2014	2,305,785	393,707	1,451,175	4,150,667
2015	1,846,182	406,372	1,417,928	3,670,482
2016-2020	9,589,320	1,858,802	6,550,995	17,999,117
2021-2025	10,688,241	824,983	5,525,850	17,039,074
2026-2030	13,675,000	291,994	3,854,318	17,821,312
2031-2035	16,330,000	334,065	1,156,403	17,820,468
	<u>\$ 67,340,874</u>	<u>\$ 5,750,406</u>	<u>\$ 24,497,470</u>	<u>\$ 97,588,750</u>

The System has lines of credit with local financial institutions. The lines bear interest at rates ranging from a fixed rate of 5% to a variable rate of prime less .25%. Outstanding draws are due on demand and are collateralized by System assets. There were no borrowings outstanding on the lines of credit as of December 31, 2010 and 2009.

10. DERIVATIVE INSTRUMENTS – INTEREST RATE SWAPS

Contracts

The System has two interest rate swap agreements in effect as of December 31, 2010 for the IFA Hospital Revenue Bonds, Series 2005A and 2005B.

Objectives and Strategies for Using Derivatives

As a means to manage the risk associated with interest rate risk on its variable rate debt, the System entered into interest rate swaps agreements in connection with its IFA Hospital Revenue Bonds, Series 2005A and 2005B. The intention of the swap agreements was to effectively change the System's variable interest rate on the Series 2005A and 2005B Bonds to fixed rate of 3.55%.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

Terms, Fair Values and Credit Risk

The swap agreements relate to the Series 2005A and 2005B Bonds with original notional amounts of \$30,000,000 and \$10,000,000, respectively. The counter party is the same for each swap agreement. The terms and fair values of the outstanding swaps as of December 31, 2010 are as follows:

<u>Original Notional Amount</u>	<u>Current Notional Amount</u>	<u>Effective Date</u>	<u>Fixed Rate</u>	<u>Variable Rate</u>	<u>Fair Value</u>	<u>Termination Date</u>
\$30,000,000	\$28,330,000	10/3/2005	3.550%	0.183%	\$(3,222,571)	1/1/2035
\$10,000,000	\$9,445,000	10/3/2005	3.550%	0.183%	(1,074,551)	1/1/2035
					<u>\$(4,297,122)</u>	

As of December 31, 2010, the negative fair values of the agreements may be countered by reductions in total interest payments under the swap agreements should the variable rates on the 2005A and 2005B Series bonds increase. The variable rate on the swaps is 70% of the USD-LIBOR BBA and resets monthly.

The counter party is rated A2 by Moody's Investor Service, A by Standard & Poor's and A by Fitch Ratings.

Basis Risk

The swaps variable rates are pegged to USD-LIBOR-BBA index. The Series 2005A and 2005B Bonds variable rates are determined through remarketing. Therefore basis risk relating to the swaps could be significant.

Termination Risk

The System or the counter party may terminate the swaps if the other party fails to perform under the terms of the contracts. If at the time of termination, the swaps have a negative fair value, the System could be liable to the counter party for a payment equal to the swaps' fair values. As of December 31, 2010, the System was not in compliance with certain terms of the swap contracts. The System obtained a waiver from the counter party as of December 31, 2010.

Swap Payments and Associated Debt

Using rates as of December 31, 2010, debt service requirements of the variable rate debt and net swap payments of the Series 2005A and 2005B Bonds, assuming current interest rates remain the same for the term of the bonds are disclosed in the Long Term Debt note. As rates vary, variable-rate bond interest payments and net swap payments will vary.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

The System has determined the swaps to be ineffective hedges. Accordingly, the fair value of the swaps have been recorded and subsequent changes in fair value will be recorded in the consolidated balance sheets with the offsetting entry recorded under nonoperating revenues (expenses) in the consolidated statements of revenues and expenses.

Following is an analysis of the recording of the interest rate swap agreements:

	<u>2010</u>	<u>2009</u>
Nonoperating revenues (expenses)		
Unrealized gain (loss) on interest rate swaps	<u>\$ (1,540,599)</u>	<u>\$ 5,765,596</u>
Other long term liabilities		
Interest rate swaps	<u>\$ 4,297,122</u>	<u>\$ 2,756,524</u>

See the Fair Value Measurements and Long Term Debt footnotes for additional information.

11. PENSION PLAN

The System has a defined contribution pension plan as authorized by IC 16-22-3-11 covering eligible employees who are at least 21 years of age and work 1,000 hours in a plan year. The plan provides retirement, disability and death benefits to plan members and beneficiaries. The plan was established by written agreement between the System's Board of Trustees and the plan administrator. The plan administrator issues a publicly available financial report that includes financial statements and required supplementary information of the plan. Contact the System's human resource department for information on the plan.

Total pension expense for 2010 and 2009 was approximately \$2,623,000 and \$2,634,000, respectively. The current employer contribution rate is 6% of annual covered payroll.

12. COMMITMENTS AND CONTINGENCIES

Operating Leases

Leases that do not meet the criteria for capitalization are classified as operating leases with related rentals charged to operations as incurred. Leases expire through 2012. Total rental expense in 2010 and 2009 for all operating leases was approximately \$3,885,200 and \$4,725,000, respectively.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

Minimum payments under non-cancellable operating lease agreements for the years subsequent to December 31, 2010 are as follows:

Years Ending December 31,	
2011	\$ 577,304
2012	<u>252,036</u>
	<u>\$ 829,340</u>

13. CONCENTRATIONS

Howard Regional Health System is located in Kokomo, Indiana. The System grants credit without collateral to its patients, most of who are local residents and are insured under third-party payor agreements. The mix of receivables and revenue from patients and third-party payors as of and for the years ended December 31, 2010 and 2009 was as follows:

	Receivables		Revenues	
	2010	2009	2010	2009
Medicare	31%	29%	48%	47%
Medicaid	10%	10%	12%	11%
Blue Cross	12%	13%	19%	20%
Other third party payors	14%	16%	13%	13%
Self-pay	<u>33%</u>	<u>32%</u>	<u>8%</u>	<u>9%</u>
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

The blended component units of the System maintain cash in accounts, which at times may exceed federally insured limits. The blended component units have not experienced any losses in such accounts. The blended component units believe that it is not exposed to any significant credit risk on cash and cash equivalents.

14. SELF FUNDED HEALTH INSURANCE

The System is self funded for medical and related health benefits provided to employees and their families. A stop/loss policy through commercial insurance covers individual claims in excess of \$150,000 per year with an overall aggregate of \$1,000,000.

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

Claim expenditures and liabilities 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. Self funded health insurance and related expenses were \$5,869,588 and \$6,768,466 in 2010 and 2009, respectively. A progression of unpaid claims for 2010 and 2009 follows:

	<u>2010</u>	<u>2009</u>
Unpaid claims, beginning of year	\$ 1,069,223	\$ 1,055,318
Incurred claims and changes in estimates	5,869,588	6,768,466
Claim payments	<u>(5,665,258)</u>	<u>(6,754,561)</u>
Unpaid claims, end of year	<u>\$ 1,273,553</u>	<u>\$ 1,069,223</u>

15. INVESTMENTS IN AFFILIATED COMPANIES

North Central Indiana Linen Service, Inc.

The System owns 33% of North Central Indiana Linen Service. The investment is accounted for under the equity method. Summarized financial information as of December 31 follows:

	<u>2010</u>	<u>2009</u>
Assets	\$ 1,185,513	\$ 1,192,049
Liabilities	\$ 166,625	\$ 207,722
Equity	\$ 1,018,888	\$ 984,327
Revenue	\$ 1,286,585	\$ 1,394,421
Expenses	\$ 1,252,024	\$ 1,385,397
Net income	\$ 34,561	\$ 9,024

HOWARD REGIONAL HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2010 AND 2009

16. STATE AND LOCAL AWARDS

During 2010 and 2009, the System recorded the following state and local awards:

<u>Grantor</u>	<u>Grant Identification</u>	<u>2010</u>	<u>2009</u>
Indiana Division of Mental Health and Addiction & Affiliated Service Providers of Indiana Managed care provider agreement	A55-9-34-09-HO-2710	\$ 1,960,803	\$ 2,174,261
Indiana State Department of Health Community Health Centers	A70-7-7957	164,923	137,742
Tipton County	Not applicable	91,217	87,877
Clinton County	Not applicable	157,172	151,418
Howard County	Not applicable	605,845	583,666
Total state and local awards		<u>\$ 2,979,960</u>	<u>\$ 3,134,964</u>

State and local awards are reported in the consolidated statements of revenues and expenses under other revenue.

17. MANAGEMENT'S PLANS

The System experienced an operating loss during the year ended December 31, 2010 due mainly to decreased utilization, reduced reimbursement and changes in payor mix. Additionally, the System was not in compliance with certain financial ratios and covenants related to debt agreements. Management is considering several alternatives for mitigating these conditions during the next year. These include implementation of programs to increase inpatient days, outpatient procedures, overall utilization and revenue enhancement strategies, development of medical staff, reduction and control of certain expenditures and potential alignment with other health care providers. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets, or the amounts and classification of liabilities that might be necessary in the event the System cannot continue in existence.

18. SUBSEQUENT EVENT

Subsequent to December 31, 2010, the Board of Trustees of the System approved a letter of intent to integrate with Indiana University Health.

SUPPLEMENTARY INFORMATION

HOWARD REGIONAL HEALTH SYSTEM

CONSOLIDATING BALANCE SHEETS DECEMBER 31, 2010

	Howard Regional Health System	HRHS Foundation	Howard Regional Specialty Care	Kokomo Sports Center	Howard Community Surgery Center	Imaging Center of North Central Indiana	Andrew J. Mandery, MD, LLC	Eliminations	Total
ASSETS									
Current assets									
Cash and cash equivalents	\$ 6,767,997	\$ 430,151	\$ 1,194,452	\$ 66,067	\$ 1,348,645	\$ -0-	\$ 93,989	\$ -0-	\$ 9,901,301
Investments	18,976,396	2,267,903	-0-	-0-	-0-	-0-	-0-	-0-	21,244,299
Patient accounts receivable, net	16,376,344	-0-	1,241,502	-0-	-0-	299,278	343,576	-0-	18,260,700
Other receivables	5,433,178	51,620	676	13,633	780,823	-0-	-0-	(4,005,830)	2,274,100
Inventory and other current assets	5,126,711	-0-	323,050	11,012	397,410	35,956	-0-	-0-	5,894,139
Current portion of assets whose use is limited	885,000	-0-	-0-	-0-	-0-	-0-	-0-	-0-	885,000
Total current assets	<u>53,565,626</u>	<u>2,749,674</u>	<u>2,759,680</u>	<u>90,712</u>	<u>2,526,878</u>	<u>335,234</u>	<u>437,565</u>	<u>(4,005,830)</u>	<u>58,459,539</u>
Assets whose use is limited									
Internally designated	7,965,309	-0-	-0-	-0-	-0-	-0-	-0-	-0-	7,965,309
Held by trustee	-0-	80,021	-0-	-0-	-0-	-0-	-0-	-0-	80,021
Donor restricted	-0-	666,311	-0-	-0-	-0-	-0-	-0-	-0-	666,311
Total assets whose use is limited	<u>7,965,309</u>	<u>746,332</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>8,711,641</u>
Less current portion	<u>885,000</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>885,000</u>
Noncurrent portion	<u>7,080,309</u>	<u>746,332</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>7,826,641</u>
Capital assets, net	83,680,288	85	785,223	656,627	422,332	4,468,663	-0-	-0-	90,013,218
Other assets	<u>3,647,376</u>	<u>548,298</u>	<u>662,594</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>(3,173,886)</u>	<u>1,684,382</u>
Total assets	<u>\$ 147,973,599</u>	<u>\$ 4,044,389</u>	<u>\$ 4,207,497</u>	<u>\$ 747,339</u>	<u>\$ 2,949,210</u>	<u>\$ 4,803,897</u>	<u>\$ 437,565</u>	<u>\$ (7,179,716)</u>	<u>\$ 157,983,780</u>

See report of independent auditors on pages 1 and 2.

HOWARD REGIONAL HEALTH SYSTEM

CONSOLIDATING BALANCE SHEETS DECEMBER 31, 2010

	Howard Regional Health System	HRHS Foundation	Howard Regional Specialty Care	Kokomo Sports Center	Howard Community Surgery Center	Imaging Center of North Central Indiana	Andrew J. Mandery, MD, LLC	Eliminations	Total
LIABILITIES AND NET ASSETS									
Current liabilities									
Accounts payable and accrued expenses	\$ 6,928,577	\$ -0-	\$ 370,212	\$ 1,574,195	\$ 569,781	\$ 1,423,865	\$ 452,421	\$ (3,848,869)	\$ 7,470,182
Accrued liabilities	7,867,997	-0-	469,948	-0-	-0-	59,006	-0-	-0-	8,396,951
Other current liabilities	523,994	70,045	127,695	120,564	-0-	-0-	-0-	(118,068)	724,230
Estimated third party settlements	771,670	-0-	-0-	-0-	-0-	-0-	-0-	-0-	771,670
Current portion of revenue bonds payable	885,000	-0-	-0-	-0-	-0-	-0-	-0-	-0-	885,000
Current portion of loans payable	572,554	-0-	-0-	-0-	-0-	306,248	-0-	-0-	878,802
Current portion of capital lease payable	2,805,115	-0-	-0-	-0-	-0-	407,615	-0-	(263,143)	2,949,587
Total current liabilities	20,354,907	70,045	967,855	1,694,759	569,781	2,196,734	452,421	(4,230,080)	22,076,422
Long term debt									
Loans payable	9,989,824	499,124	-0-	37,000	-0-	965,453	-0-	(37,000)	11,454,401
Capital lease payable	3,814,860	-0-	-0-	-0-	-0-	1,235,727	-0-	(212,503)	4,838,084
Revenue bonds payable	46,335,000	-0-	-0-	-0-	-0-	-0-	-0-	-0-	46,335,000
Total long term debt	60,139,684	499,124	-0-	37,000	-0-	2,201,180	-0-	(249,503)	62,627,485
Other long term liabilities									
	4,297,122	-0-	-0-	-0-	-0-	-0-	-0-	-0-	4,297,122
Total liabilities	84,791,713	569,169	967,855	1,731,759	569,781	4,397,914	452,421	(4,479,583)	89,001,029
Net assets									
Invested in capital assets, net of related debt	19,277,935	49,259	785,223	619,627	422,332	1,553,620	-0-	(35,652)	22,672,344
Restricted									
For debt service	-0-	80,021	-0-	-0-	-0-	-0-	-0-	-0-	80,021
Expendable for capital improvements	7,965,309	-0-	-0-	-0-	-0-	-0-	-0-	-0-	7,965,309
Expendable for other specific purposes	10,885	-0-	-0-	-0-	-0-	-0-	-0-	-0-	10,885
Donor restricted	-0-	666,311	-0-	-0-	-0-	-0-	-0-	-0-	666,311
Total restricted net assets	7,976,194	746,332	-0-	-0-	-0-	-0-	-0-	-0-	8,722,526
Unrestricted	35,927,757	2,679,629	2,454,419	(1,604,047)	1,957,097	(1,147,637)	(14,856)	(4,964,847)	35,287,515
Net assets - controlling interest	63,181,886	3,475,220	3,239,642	(984,420)	2,379,429	405,983	(14,856)	(5,000,499)	66,682,385
Non-controlling interest	-0-	-0-	-0-	-0-	-0-	-0-	-0-	2,300,366	2,300,366
Total net assets	63,181,886	3,475,220	3,239,642	(984,420)	2,379,429	405,983	(14,856)	(2,700,133)	68,982,751
Total liabilities and net assets	\$ 147,973,599	\$ 4,044,389	\$ 4,207,497	\$ 747,339	\$ 2,949,210	\$ 4,803,897	\$ 437,565	\$ (7,179,716)	\$ 157,983,780

See report of independent auditors on pages 1 and 2.

HOWARD REGIONAL HEALTH SYSTEM

CONSOLIDATING STATEMENTS OF REVENUES AND EXPENSES YEAR ENDED DECEMBER 31, 2010

	Howard Regional Health System	HRHS Foundation	Howard Regional Specialty Care	Kokomo Sports Center	Howard Community Surgery Center	Imaging Center of North Central Indiana	Andrew J. Mandery, MD, LLC	Eliminations	Total
Revenues									
Net patient service revenue	\$ 110,298,251	\$ -0-	\$ 13,963,522	\$ -0-	\$ 6,540,261	\$ 2,029,654	\$ 660,441	\$ -0-	\$ 133,492,129
Other	12,631,284	41,159	836,602	526,565	-0-	(14,070)	-0-	(1,294,520)	12,727,020
Total revenues	122,929,535	41,159	14,800,124	526,565	6,540,261	2,015,584	660,441	(1,294,520)	146,219,149
Operating expenses									
Salaries and wages	51,428,722	-0-	7,094,750	-0-	2,619,251	696,640	-0-	-0-	61,839,363
Employee benefits	11,882,508	-0-	1,782,290	-0-	-0-	54,645	-0-	-0-	13,719,443
Medical professional fees	5,995,925	-0-	720,473	19,946	-0-	232,032	6,131	-0-	6,974,507
Medical supplies and drugs	26,051,145	-0-	906,811	56,885	1,991,621	205,450	26,629	-0-	29,238,541
Purchased services	6,748,815	-0-	732,132	503,310	247,514	289,963	599,733	(191,496)	8,929,971
Equipment rentals	5,789,737	-0-	1,160,622	16,353	940,659	324,868	14,947	(1,072,457)	7,174,729
Utilities and telephone	2,392,719	-0-	341,856	58,998	64,825	116,805	7,580	-0-	2,982,783
Insurance	1,020,618	-0-	68,611	11,262	36,745	45,145	-0-	-0-	1,182,381
Depreciation and amortization	8,609,883	-0-	244,513	90,444	213,998	528,176	-0-	-0-	9,687,014
Other	8,784,394	-0-	224,458	68,913	389,868	105,042	20,677	-0-	9,593,352
Total expenses	128,704,466	-0-	13,276,516	826,111	6,504,481	2,598,766	675,697	(1,263,953)	151,322,084
Operating income (loss)	(5,774,931)	41,159	1,523,608	(299,546)	35,780	(583,182)	(15,256)	(30,567)	(5,102,935)
Nonoperating revenues (expenses)									
Investment income	2,457,283	340,976	-0-	-0-	1,430	-0-	-0-	-0-	2,799,689
Interest expense	(3,084,440)	-0-	-0-	(3)	-0-	(61,142)	-0-	30,567	(3,115,018)
Unrealized loss on interest rate swaps	(1,540,599)	-0-	-0-	-0-	-0-	-0-	-0-	-0-	(1,540,599)
Other nonoperating revenues (expenses)	(153,120)	(109,761)	13,559	-0-	-0-	(10,723)	400	(147,540)	(407,185)
Nonoperating revenues (expenses), net	(2,320,876)	231,215	13,559	(3)	1,430	(71,865)	400	(116,973)	(2,263,113)
Consolidated change in net assets	(8,095,807)	272,374	1,537,167	(299,549)	37,210	(655,047)	(14,856)	(147,540)	(7,366,048)
Less amount attributable to non-controlling interest	-0-	-0-	-0-	-0-	-0-	-0-	-0-	(632,238)	(632,238)
Change in net assets attributable to controlling interest	<u>\$ (8,095,807)</u>	<u>\$ 272,374</u>	<u>\$ 1,537,167</u>	<u>\$ (299,549)</u>	<u>\$ 37,210</u>	<u>\$ (655,047)</u>	<u>\$ (14,856)</u>	<u>\$ (779,778)</u>	<u>\$ (7,998,286)</u>

See report of independent auditors on pages 1 and 2.

HOWARD REGIONAL HEALTH SYSTEM

CONSOLIDATING BALANCE SHEETS DECEMBER 31, 2009

	Howard Regional Health System	HRHS Foundation	Howard Regional Specialty Care	Kokomo Sports Center	Howard Community Surgery Center	Imaging Center of North Central Indiana	Eliminations	Total
ASSETS								
Current assets								
Cash and cash equivalents	\$ 8,352,860	\$ 771,828	\$ 1,181,917	\$ 67,662	\$ 1,638,313	\$ 237,715	\$ -0-	\$ 12,250,295
Investments	16,811,397	1,584,788	-0-	-0-	-0-	-0-	-0-	18,396,185
Patient accounts receivable, net	18,717,611	-0-	1,069,121	-0-	-0-	177,313	-0-	19,964,045
Other receivables	3,823,725	61,851	3,597	14,060	1,243,254	0	(2,576,237)	2,570,250
Inventory and other current assets	5,474,017	-0-	291,816	11,012	449,280	32,605	-0-	6,258,730
Estimated third party settlements	200,909	-0-	-0-	-0-	-0-	-0-	-0-	200,909
Current portion of assets whose use is limited	7,683,210	-0-	-0-	-0-	-0-	-0-	-0-	7,683,210
Total current assets	61,063,729	2,418,467	2,546,451	92,734	3,330,847	447,633	(2,576,237)	67,323,624
Assets whose use is limited								
Internally designated	7,683,210	-0-	-0-	-0-	-0-	-0-	-0-	7,683,210
Held by trustee	-0-	74,877	-0-	-0-	-0-	-0-	-0-	74,877
Donor restricted	-0-	754,306	-0-	-0-	-0-	-0-	-0-	754,306
Total assets whose use is limited	7,683,210	829,183	-0-	-0-	-0-	-0-	-0-	8,512,393
Less current portion	7,683,210	-0-	-0-	-0-	-0-	-0-	-0-	7,683,210
Noncurrent portion	-0-	829,183	-0-	-0-	-0-	-0-	-0-	829,183
Capital assets, net	79,005,685	187	599,566	684,969	527,845	3,194,415	-0-	84,012,667
Other assets	4,823,511	830,066	730,370	-0-	-0-	-0-	(4,616,198)	1,767,749
Total assets	<u>\$ 144,892,925</u>	<u>\$ 4,077,903</u>	<u>\$ 3,876,387</u>	<u>\$ 777,703</u>	<u>\$ 3,858,692</u>	<u>\$ 3,642,048</u>	<u>\$ (7,192,435)</u>	<u>\$ 153,933,223</u>

See report of independent auditors on pages 1 and 2.

HOWARD REGIONAL HEALTH SYSTEM

CONSOLIDATING BALANCE SHEETS DECEMBER 31, 2009

	Howard Regional Health System	HRHS Foundation	Howard Regional Specialty Care	Kokomo Sports Center	Howard Community Surgery Center	Imaging Center of North Central Indiana	Eliminations	Total
LIABILITIES AND NET ASSETS								
Current liabilities								
Accounts payable and accrued expenses	\$ 2,877,304	\$ -0-	\$ 428,141	\$ 1,306,203	\$ 643,514	\$ 724,416	\$ (2,437,926)	\$ 3,541,652
Accrued liabilities and other	7,385,608	-0-	403,941	-0-	-0-	47,253	-0-	7,836,802
Other current liabilities	724,300	101,523	118,540	119,371	-0-	0	(101,311)	962,423
Current portion of revenue bonds payable	855,000	-0-	-0-	-0-	-0-	-0-	-0-	855,000
Current portion of loans payable	441,834	-0-	-0-	-0-	-0-	300,996	(37,585)	705,245
Current portion of capital lease payable	263,143	-0-	-0-	-0-	-0-	165,950	(263,143)	165,950
Current portion of revenue bonds payable due to letter of credit expiration	29,000,000	-0-	-0-	-0-	-0-	-0-	-0-	29,000,000
Total current liabilities	41,547,189	101,523	950,622	1,425,574	643,514	1,238,615	(2,839,965)	43,067,072
Long term debt								
Loans payable	10,584,290	773,533	-0-	37,000	-0-	1,270,778	(2,576)	12,663,025
Capital lease payable	507,229	-0-	-0-	-0-	-0-	71,627	(507,229)	71,627
Revenue bonds payable	18,220,000	-0-	-0-	-0-	-0-	-0-	-0-	18,220,000
Total long term debt	29,311,519	773,533	-0-	37,000	-0-	1,342,405	(509,805)	30,954,652
Other long term liabilities								
Total liabilities	2,756,524	-0-	-0-	-0-	-0-	-0-	-0-	2,756,524
Total liabilities	73,615,232	875,056	950,622	1,462,574	643,514	2,581,020	(3,349,770)	76,778,248
Net assets								
Invested in capital assets, net of related debt	19,134,189	56,720	599,566	647,969	527,845	1,385,064	(19,533)	22,331,820
Restricted								
For debt service	-0-	74,877	-0-	-0-	-0-	-0-	-0-	74,877
Expendable for capital improvements	7,683,210	-0-	-0-	-0-	-0-	-0-	-0-	7,683,210
Expendable for other specific purposes	10,885	-0-	-0-	-0-	-0-	-0-	-0-	10,885
Donor restricted	-0-	754,306	-0-	-0-	-0-	-0-	-0-	754,306
Total restricted net assets	7,694,095	829,183	-0-	-0-	-0-	-0-	-0-	8,523,278
Unrestricted	44,449,409	2,316,944	2,326,199	(1,332,840)	2,687,333	(324,036)	(6,297,436)	43,825,573
Net assets - controlling interest	71,277,693	3,202,847	2,925,765	(684,871)	3,215,178	1,061,028	(6,316,969)	74,680,671
Non-controlling interest	-0-	-0-	-0-	-0-	-0-	-0-	2,474,304	2,474,304
Total net assets	71,277,693	3,202,847	2,925,765	(684,871)	3,215,178	1,061,028	(3,842,665)	77,154,975
Total liabilities and net assets	\$ 144,892,925	\$ 4,077,903	\$ 3,876,387	\$ 777,703	\$ 3,858,692	\$ 3,642,048	\$ (7,192,435)	\$ 153,933,223

See report of independent auditors on pages 1 and 2.

HOWARD REGIONAL HEALTH SYSTEM

CONSOLIDATING STATEMENTS OF REVENUES AND EXPENSES YEAR ENDED DECEMBER 31, 2009

	Howard Regional Health System	HRHS Foundation	Howard Regional Specialty Care	Kokomo Sports Center	Howard Community Surgery Center	Imaging Center of North Central Indiana	Eliminations	Total
Revenues								
Net patient service revenue	\$ 117,293,528	\$ -0-	\$ 13,451,256	\$ -0-	\$ 10,211,110	\$ 2,757,777	\$ -0-	\$ 143,713,671
Other	14,080,938	50,172	894,901	453,612	-0-	17,885	(1,344,151)	14,153,357
Total revenues	131,374,466	50,172	14,346,157	453,612	10,211,110	2,775,662	(1,344,151)	157,867,028
Operating expenses								
Salaries and wages	53,612,778	-0-	7,323,380	-0-	2,978,090	676,892	-0-	64,591,140
Employee benefits	12,756,588	-0-	1,839,476	-0-	-0-	32,500	-0-	14,628,564
Medical professional fees	4,708,257	-0-	686,653	21,720	-0-	310,747	-0-	5,727,377
Medical supplies and drugs	24,135,446	-0-	832,536	34,676	2,409,567	157,956	-0-	27,570,181
Purchased services	8,430,954	-0-	757,514	458,183	426,753	231,319	(234,228)	10,070,495
Equipment rentals	6,395,439	-0-	1,100,913	17,757	1,036,019	764,357	(1,059,945)	8,254,540
Utilities and telephone	2,454,050	-0-	364,154	44,804	61,616	126,352	-0-	3,050,976
Insurance	987,836	-0-	69,923	10,773	37,503	45,690	-0-	1,151,725
Depreciation and amortization	8,886,429	-0-	215,833	87,405	207,063	512,577	-0-	9,909,307
Other	8,835,153	-0-	146,522	73,531	247,203	105,221	-0-	9,407,630
Total expenses	131,202,930	-0-	13,336,904	748,849	7,403,814	2,963,611	(1,294,173)	154,361,935
Operating income (loss)	171,536	50,172	1,009,253	(295,237)	2,807,296	(187,949)	(49,978)	3,505,093
Nonoperating revenues (expenses)								
Investment income	4,261,056	547,373	-0-	-0-	6,831	8	-0-	4,815,268
Interest expense	(3,161,009)	-0-	-0-	(109)	-0-	(55,002)	49,978	(3,166,142)
Unrealized gain on interest rate swaps	5,765,596	-0-	-0-	-0-	-0-	-0-	-0-	5,765,596
Other nonoperating revenues (expenses)	1,310,387	(306,576)	9,546	-0-	-0-	233,978	(1,890,735)	(643,400)
Nonoperating revenues (expenses), net	8,176,030	240,797	9,546	(109)	6,831	178,984	(1,840,757)	6,771,322
Consolidated change in net assets	8,347,566	290,969	1,018,799	(295,346)	2,814,127	(8,965)	(1,890,735)	10,276,415
Less amount attributable to non-controlling interest	-0-	-0-	-0-	-0-	-0-	-0-	(1,721,258)	(1,721,258)
Change in net assets attributable to controlling interest	\$ 8,347,566	\$ 290,969	\$ 1,018,799	\$ (295,346)	\$ 2,814,127	\$ (8,965)	\$ (3,611,993)	\$ 8,555,157

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