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STATE OF INDIANA

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STATE BOARD OF ACCOUNTS
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January 23, 2013

Board of Directors
Morgan Hospital and Medical Center
2209 John R. Wooden Drive
Martinsville, IN 46151

We have reviewed the audit report prepared by Blue & Company, LLC, Independent Public Accountants, for the period January 1, 2011 to June 30, 2011. 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 Morgan Hospital and Medical Center, as of June 30, 2011 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

MORGAN HOSPITAL AND MEDICAL CENTER AND AFFILIATED ORGANIZATIONS

CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2011

MORGAN HOSPITAL AND MEDICAL CENTER AND AFFILIATED ORGANIZATIONS

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JUNE 30, 2011

CPAs / ADVISORS

blue

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REPORT OF INDEPENDENT AUDITORS

Board of Trustees
Morgan Hospital and Medical Center
Martinsville, Indiana

We have audited the accompanying consolidated balance sheet of Morgan Hospital and Medical Center and Affiliated Organizations (the "Medical Center"), component units of Morgan County, as of June 30, 2011, and the related consolidated statements of operations and changes in net assets and cash flows for the six months then ended. These consolidated financial statements are the responsibility of the Medical Center's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the auditing standards generally accepted in the United States of America and the Guidelines for Audits of County and City Hospitals by Independent Certified Public Accountants, issued by the Indiana State Board of Accounts. Those standards require that we plan and perform the audit 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 audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Medical Center as of June 30, 2011, and the results of its operations, its changes in net assets and its cash flows for the six months then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 21 to the consolidated financial statements, on July 1, 2011, the Medical Center became an affiliate of IU Health by transferring substantially all assets and liabilities into a new Indiana nonprofit corporation controlled by IU Health.

Management has omitted the Management's Discussion and Analysis that accounting principles generally accepted in the United States of America require to be presented to supplement the basic consolidated financial statements. Such missing information, although not a part of the basic 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 basic consolidated financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic consolidated financial statements is not affected by this missing information.

Blue & Co., LLC

October 31, 2011

MORGAN HOSPITAL AND MEDICAL CENTER
AND AFFILIATED ORGANIZATIONS

CONSOLIDATED BALANCE SHEET
JUNE 30, 2011

ASSETS

Current assets	
Cash and cash equivalents	$ 4,779,590
Patient accounts receivable, net of estimated uncollectibles of $8,156,805	4,188,202
Inventories	925,812
Prepaid expenses and other current assets	853,473
Estimated third party payor settlements	1,850,000
Other assets, current portion	13,636
Total current assets	12,610,713
Assets whose use is limited	5,439,204
Capital assets	
Land	1,913,186
Land improvements	555,386
Buildings	22,615,925
Fixed equipment	5,642,496
Movable equipment	35,238,133
	65,965,126
Less accumulated depreciation	47,277,079
	18,688,047
Construction in progress	157,390
Capital assets, net	18,845,437
Other assets, net of current portion	28,364
Total assets	$ 36,923,718

See accompanying notes to consolidated financial statements.

MORGAN HOSPITAL AND MEDICAL CENTER
AND AFFILIATED ORGANIZATIONS

CONSOLIDATED BALANCE SHEET
JUNE 30, 2011

LIABILITIES AND NET ASSETS

Current liabilities	
Accounts payable	$ 1,855,525
Accrued payroll and payroll withholdings	595,224
Accrued expenses	1,415,060
Current portion of obligations under capital leases	700,142
Total current liabilities	4,565,951
Long-term liabilities	
Obligations under capital leases, net of current portion	767,767
Other	1,028,500
Total long-term liabilities	1,796,267
Total liabilities	6,362,218
Net assets	
Invested in capital assets net of related debt	17,377,528
Unrestricted	13,183,972
Total net assets	30,561,500
Total liabilities and net assets	$ 36,923,718

See accompanying notes to consolidated financial statements.

MORGAN HOSPITAL AND MEDICAL CENTER
AND AFFILIATED ORGANIZATIONS

CONSOLIDATED STATEMENT OF OPERATIONS AND CHANGES IN NET ASSETS
SIX MONTHS ENDED JUNE 30, 2011

Operating revenues	
Net patient service revenue	$ 23,369,387
Other revenue	347,596
Total operating revenues	23,716,983
Operating expenses	
Salaries and wages	10,590,484
Employee benefits and payroll taxes	2,203,386
Professional medical fees	911,723
Medical supplies	1,348,363
Other supplies	359,671
Drugs	1,672,634
Purchased services	3,002,778
Utilities	562,000
Insurance	342,904
Depreciation and amortization	1,119,753
Rent	393,249
Other operating expenses	447,940
Total operating expenses	22,954,885
Income from operations	762,098
Nonoperating revenues (expenses)	(775,562)
Excess revenues (expenses) / Change in net assets	(13,464)
Net assets, beginning of period	30,574,964
Net assets, end of period	$ 30,561,500

See accompanying notes to consolidated financial statements.

MORGAN HOSPITAL AND MEDICAL CENTER
AND AFFILIATED ORGANIZATIONS

CONSOLIDATED STATEMENT OF CASH FLOWS
SIX MONTHS ENDED JUNE 30, 2011

Operating activities	
Cash received for patient services	$ 23,579,128
Cash paid to/for employees	(13,017,206)
Cash paid to vendors and suppliers	(9,595,785)
Other receipts, net	347,596
Net cash flows from operating activities	1,313,733
Noncapital financing activities	
Noncapital contributions	3,011
Capital and related financing activities	
Principal payments on obligations under capital leases	(415,875)
Principal payments on long-term debt	(14,123,296)
Interest paid	(440,909)
Payoff on interest rate swaps	(1,679,000)
Loss on extinguishment of debt	643,231
Purchases of capital assets	(583,744)
Proceeds from sale of capital assets	41
Loss on disposal of capital assets	2,612
Net cash flows from capital and related financing activities	(16,596,940)
Investing activities	
Investment income	390,647
Change in certificates of deposit	2,501,026
Change in assets whose use is limited	8,152,539
Other nonoperating revenues (expenses)	(728,311)
Change in interest rate swaps	79,282
Change in other long-term liabilities	60,500
Change in other assets	7,905
Net cash flows from investing activities	10,463,588
Net change in cash and cash equivalents	(4,816,608)
Cash and cash equivalents, beginning of year	11,619,157
Cash and cash equivalents, end of year	$ 6,802,549
Reconciliation of cash and cash equivalents to the balance sheets	
Cash and cash equivalents in current assets	$ 4,779,590
Cash and cash equivalents in assets whose use is limited	2,022,959
Total cash and cash equivalents	$ 6,802,549

See accompanying notes to consolidated financial statements.

MORGAN HOSPITAL AND MEDICAL CENTER
AND AFFILIATED ORGANIZATIONS

CONSOLIDATED STATEMENT OF CASH FLOWS
SIX MONTHS ENDED JUNE 30, 2011

Reconciliation of income from operations to net cash flows from operating activities	
Income from operations	$ 762,098
Adjustments to reconcile income from operations to net cash flows from operating activities	
Depreciation	1,111,202
Amortization	8,551
Provision for bad debts	4,330,372
Changes in operating assets and liabilities	
Patient accounts receivable	(2,120,631)
Inventories	163,033
Prepaid expenses and other current assets	(388,177)
Accounts payable	(152,471)
Accrued payroll and payroll withholdings	(223,336)
Accrued expenses	(176,908)
Estimated third party payor settlements	(2,000,000)
Net cash flows from operating activities	$ 1,313,733
Supplemental disclosures of noncash capital and related financing activities	
Capital assets acquired included in accounts payable	$ 129,000
Capital assets acquired under capital leases	$ 295,853

See accompanying notes to consolidated financial statements.

1. NATURE OF OPERATIONS

Morgan Hospital and Medical Center (the "Hospital") is a not-for-profit, acute care hospital located in Martinsville, Indiana. The Hospital is county owned and operates under the Indiana County Hospital Law, Indiana Code 16-22 for the purpose of providing healthcare services to the residents of Morgan County and the surrounding area. The Hospital's primary sources of support are from patient revenues and investment income. Patient revenues include funds received from Medicare, state agencies, insurance companies, and the patients themselves.

Morgan Health Services, Inc. ("MHS") is a not-for-profit corporation located in Martinsville, Indiana. MHS was organized to manage the practices of physicians that are affiliated with the Hospital. MHS's primary source of support is from patient revenues.

Morgan Physician Specialists, LLC ("MPS") consists of surgical and specialty physician practices located in Martinsville, Indiana. MPS was organized for the purpose of acquiring and holding multi-specialty physician practices to serve the residents of Morgan County and the surrounding area. MPS's primary source of support is from patient revenues.

Morgan County Memorial Hospital Foundation, Inc. (the "Foundation") is a not-for-profit organization located in Martinsville, Indiana. The Foundation operates for the benefit of the Hospital, and is a blended component unit of the Hospital. The Foundation's primary source of support is from contributions received.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies followed by the Hospital, MHS, MPS, and the Foundation (collectively the "Medical Center") in the preparation of the consolidated financial statements are summarized below:

Reporting Entity and Consolidation Policy

The accompanying consolidated financial statements include the accounts of the Hospital, MHS, MPS, and the Foundation. The Board of County Commissioners of Morgan County appoints the governing Board of Trustees of the Hospital, and a financial benefit/burden relationship exists between the Hospital and the Morgan County government. For these reasons, the Hospital is considered a component unit of Morgan County. Similarly, due to their organized purposes, the Foundation, MHS, and MPS are considered blended component units of the Hospital. Intercompany transactions and balances have been eliminated in consolidation. The separate financial statements of MHS, MPS, and the Foundation may be obtained through contacting the Hospital as follows:

Morgan Hospital and Medical Center
2209 John R. Wooden Drive
Martinsville, IN 46151

Management's Estimates

Management uses estimates and assumptions in preparing the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, if any, and the reported revenues and expenses. Actual results could vary from the estimates that were used.

Proprietary Fund Accounting

The Medical Center utilizes the proprietary fund method of accounting whereby revenues and expenses are recognized on the accrual basis of accounting using the economic resources measurement focus. Substantially all revenues and expenses are subject to accrual.

Accounting Standards

Pursuant to Governmental Accounting Standards Board (GASB) standards, the Medical Center 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.

Risk Management

The Medical Center 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; and employee health, dental, and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage in any of the three preceding years. The Medical Center is insured for medical malpractice claims and judgments.

Cash and Cash Equivalents

Cash and cash equivalents as reported on the consolidated balance sheets include petty cash and other cash on hand amounts, checking accounts, and savings accounts that are readily available for use, excluding amounts included in assets whose use is limited.

Cash and cash equivalents as reported on the consolidated statements of cash flows include investments in highly liquid assets with maturity dates of 90 days or less when purchased.

Patient Accounts Receivable and Net Patient Service Revenue

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

Allowance for Patient Uncollectible Accounts

The Medical Center estimates an allowance for uncollectible patient accounts receivable based on an evaluation of the aging of the accounts, historical losses, current economic conditions, and other factors unique to their service area and the healthcare industry.

Inventories

Inventories consist of medical supplies, pharmaceuticals, and office supplies and are valued at the lower of cost or market, with cost being determined on the first-in, first-out (FIFO) method.

Assets Whose Use is Limited

Assets whose use is limited include assets set aside by the Hospital's Board of Trustees for future capital improvements, over which the Board retains control and may at its discretion subsequently use for other purposes; assets that have been restricted by donors for specific purposes; and insurance benefit plan assets related to an executive deferred compensation agreement.

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair market value in the consolidated balance sheets. Investment income or loss, including realized gains and losses on investments, net change in the market value of assets whose use is limited, interest, and dividends, is included in nonoperating revenues (expenses) when earned.

Capital Assets

The Medical Center's capital assets are reported at historical cost and include expenditures for additions and repairs which substantially increase the useful lives of capital assets. Maintenance, repairs, and minor improvements are expensed as incurred. Contributed capital assets are reported at their estimated fair value at the time of their donation. All capital assets other than land and construction in progress are depreciated using the straight-line method of depreciation over their estimated useful lives based upon the American Hospital Association Guide for Estimated Useful Lives for Fixed Assets.

Costs of Borrowing

Except for capital assets acquired through gifts, contributions, or capital grants, interest cost on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

Other Assets

Other assets consist of notes receivable.

Net Assets

Net assets of the Medical Center are classified in four components. *Net assets invested in capital assets net of related debt* consist of capital assets net of accumulated depreciation and reduced by the current balances of any outstanding borrowings used to finance the purchase or construction of those assets. *Restricted expendable net assets* are noncapital net assets that must be used for a particular purpose, as specified by creditors, grantors, or contributors external to the Medical Center, including amounts deposited with trustees as required by revenue bond indentures. *Restricted nonexpendable net assets* equal the principal portion of permanent endowments, if any. *Unrestricted net assets* are remaining net assets that do not meet the definition of *invested in capital assets net of related debt* or *restricted*.

Consolidated Statement of Operations and Changes in Net Assets

For purposes of display, transactions deemed by management to be ongoing, major, or central to the provision of healthcare services are reported as revenues and expenses. Peripheral and incidental transactions are reported as nonoperating revenues (expenses). Nonoperating revenues (expenses) which are excluded from income from operations include interest expense, investment income, contributions, fair value change of interest rate swaps, loss on sale of capital assets, loss on extinguishment of debt, and net change in the market value of assets whose use is limited.

Performance Indicator

The Consolidated Statement of Operations and Changes in Net Assets includes *excess revenues (expenses)*. Consistent with industry practice, changes in unrestricted net assets which are excluded from *excess revenues (expenses)* include, if any, permanent transfers of assets to and from affiliates for other than goods and services and contributions of long-lived assets.

Charity Care

The Medical Center provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Amounts determined to qualify as charity care are reported as reductions in net patient service revenue.

Advertising and Public Relations Costs

Advertising and public relations costs are charged to operations when incurred. Advertising and public relations costs charged to operations were $116,251 for the period ended June 30, 2011.

Income Taxes

The Hospital, Foundation and MHS are not-for-profit corporations as described in Section 501(c)(3) of the Internal Revenue Code and are exempt from income taxes on related income pursuant to Section 501(a) of the Code. MPS is organized as a single-member Limited Liability Company (LLC). The Hospital is the sole member of MPS. As such, MPS is not required to file a separate State or Federal tax return.

Accounting principles generally accepted in the United States of America require management to evaluate tax positions taken and recognize a tax liability if the Medical Center has taken an uncertain position that more likely than not would not be sustained upon examination by various federal and state taxing authorities. Management has analyzed the tax positions taken, and has concluded that as of June 30, 2011, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the accompanying consolidated financial statements. The Medical Center is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress.

Grants and Contributions

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

Subsequent Events

The Medical Center has evaluated events or transactions occurring subsequent to the 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 October 31, 2011.

3. BANK DEPOSITS AND INVESTMENTS

Deposits and investments are comprised of the following at June 30, 2011:

Carrying amount	
Cash and cash equivalents	$ 6,802,549
Certificates of deposit	185,170
Mutual funds	2,202,575
Cash surrender value of life insurance	1,028,500
Total	$ 10,218,794
Included in the consolidated balance sheet captions:	
Cash and cash equivalents	$ 4,779,590
Assets whose use is limited	5,439,204
Total	$ 10,218,794

Custodial Credit Risk – Deposits

Custodial credit risk is the risk that, in the event of a bank failure, the Medical Center's deposits may not be returned to it. The Medical Center does not have a deposit policy for custodial credit risk. Deposits with financial institutions are insured by the Federal Depository Insurance Corporation ("FDIC") up to the FDIC limits. This includes any deposit accounts issued or offered by a qualifying institution.

Investments are carried at fair market value or cost which approximates fair value. Net realized gains and losses on security transactions are determined on the specific identification cost basis. As of June 30, 2011, the Medical Center had the following investments and maturities, all of which were held in the Medical Center's name by custodial banks or investment companies that are agents of the Medical Center:

		Investment Maturities (in years)			
	Carrying Amount	Less than 1	1 - 5	6 - 10	More than 10
Certificates of deposit	$ 185,170	$ 185,170	$ -0-	$ -0-	$ -0-

Interest Rate Risk

Interest rate risk is the risk that changes in market interest rates will adversely affect the fair value of an investment. Generally, the longer the maturity of an investment, the greater the sensitivity of its fair value to changes in market interest rates.

The Medical Center 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 – Investments

Credit risk is the risk that, in the event of a failure of a financial institution, the Medical Center would not be able to recover deposits, the value of its investments, or collateral securities that are in the possession of an outside party.

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

Concentration of Credit Risk

The Medical Center places no limit on the amount it may invest in any one issuer. The Medical Center maintains its deposits and investments, which at times may exceed federally insured limits. The Medical Center believes that it is not exposed to any significant credit risk on investments.

4. PATIENT ACCOUNTS RECEIVABLE

Patient accounts receivable reported as current assets at June 30, 2011 consist of the following:

Receivable from Medicare	$ 6,641,402
Receivable from Medicaid	2,894,391
Receivable from Blue Cross	2,206,385
Receivable from other insurance carriers	2,873,662
Receivable from patients	8,088,618
Total patient accounts receivable	22,704,458
Less allowance for contractuals	10,359,451
Less allowance for uncollectible amounts	8,156,805
Patient accounts receivable, net	$ 4,188,202

5. ASSETS WHOSE USE IS LIMITED

Assets whose use is limited are reported at market value or cost which approximates fair value and include the following at June 30, 2011:

Total Investment Summary by Class

	Amount	%
Cash and cash equivalents	$ 2,022,959	37.2 %
Cash surrender value of life insurance	1,028,500	18.9
Certificates of deposit	185,170	3.4
Mutual funds	2,202,575	40.5
Total assets whose use is limited	$ 5,439,204	100.0 %

Total Investment Summary by Fund

	Amount	%
Board-Designated Funds	$ 2,788,301	51.3 %
Building Fund	1,622,403	29.8
Insurance Benefit Plan	1,028,500	18.9
Total	$ 5,439,204	100.0 %

<u>Board-Designated Funds</u>

The Medical Center's Board of Trustees approved the funding of depreciation expense to meet the capital equipment replacement needs of the facility. Depreciation is funded totally with expenditures for capital equipment reducing the funded depreciation balance. Board-designated funds also include amounts intended for specific purposes, as established by the Medical Center’s Board. All income earned by the Board-designated accounts is left to accumulate as additions to the funds. Board-designated funds remain under the control of the Board which may at its discretion later use the funds for other purposes. Therefore, all Board-designated funds are included in unrestricted net assets.

<u>Building Fund</u>

The Medical Center’s Board of Trustees established a building fund with the Foundation to reserve amounts for the construction or purchase of medical facilities or other long term capital projects. All income earned by the Building Fund account is left to accumulate as an addition to the fund.

Insurance Benefit Plan Assets

The insurance benefit plan assets are equal to the amount of premiums paid for an executive insurance benefit program.

Fair Value Measurements and Disclosures

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.

Assets and liabilities measured at fair value on a recurring basis as of June 30, 2011 are as follows:

	Level 1	Level 2	Level 3	Total
Assets whose use is limited				
Mutual funds				
Growth funds	$ 1,014,507	$ -0-	$ -0-	$ 1,014,507
Growth and value funds	482,273	-0-	-0-	482,273
Growth and income funds	221,660	-0-	-0-	221,660
Current income funds	79,652	-0-	-0-	79,652
Fixed income funds	404,483	-0-	-0-	404,483
Total mutual funds	$ 2,202,575	$ -0-	$ -0-	$ 2,202,575

6. CAPITAL ASSETS

Capital asset activity for the period ended June 30, 2011, was as follows:

	Beginning Balance	Additions	Retirements / Transfers	Ending Balance
Land	$ 1,913,186	$ -0-	$ -0-	$ 1,913,186
Land improvements	555,386	-0-	-0-	555,386
Buildings	22,615,925	-0-	-0-	22,615,925
Fixed equipment	5,642,496	-0-	-0-	5,642,496
Movable equipment	33,781,498	851,207	605,428	35,238,133
Construction in progress	662,222	157,390	(662,222)	157,390
Total historical cost	65,170,713	1,008,597	(56,794)	66,122,516
Less accumulated depreciation for				
Land improvements	(417,759)	(9,622)	-0-	(427,381)
Buildings	(13,094,361)	(233,634)	-0-	(13,327,995)
Fixed equipment	(4,650,936)	(68,331)	-0-	(4,719,267)
Movable equipment	(28,056,962)	(799,615)	54,141	(28,802,436)
Total accumulated depreciation	(46,220,018)	(1,111,202)	54,141	(47,277,079)
Capital assets, net	$ 18,950,695	$ (102,605)	$ (2,653)	$ 18,845,437

7. COMPENSATED ABSENCES

The Hospital and MHS provide paid time off (PTO) policies to employees for vacation, personal days, and holidays. Upon employment, full and part-time employees accrue PTO from the date of hire. After completion of 30 days of service, full and part-time employees qualify for PTO with pay for the total amount accrued. The maximum number of hours that employees may carry over to the following year as of December 31st, is 208 for the Hospital and 40 for MHS.

The rate at which employees earn PTO depends upon credited length of service, and is as follows:

Length of Service	Hospital Hours Earned Per Year	MHS Hours Earned Per Year (Date of Hire Pre-2004)	MHS Hours Earned Per Year (Date of Hire 2004 and After)
0 - 5 years	195	195	150
6 - 14 years	232.5	232.5	150
15 or more years	270	270	150

PTO days are accrued when incurred and reported as accrued expenses in the consolidated financial statements. The PTO accrual at June 30, 2011 was $744,748.

8. EMPLOYEE HEALTH BENEFIT PLAN

The Medical Center operates a self-funded health plan covering substantially all eligible employees. The Medical Center has an annual stop loss limit on the plan of $135,000 per individual. The Medical Center does not carry aggregate stop loss limits. 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. Claim liabilities are calculated considering the effects of inflation, recent claim settlement trends including frequency and amounts of pay out, and other economic and social factors.

The change in the balance of claims liabilities during the period ended June 30, 2011 was as follows:

Accrued liability, beginning of year	$ 580,216
Incurred claims and changes in estimates	804,927
Claim payments	918,643
Accrued liability, end of year	$ 466,500

The accrued liability for the health benefit plan is included in Accrued Expenses on the Consolidated Balance Sheets.

9. PENSION PLAN

The Medical Center sponsors separate defined contribution pension plans that cover all eligible employees who work over 1,000 hours a year. To be eligible for enrollment, employees must have completed one year of employment and be 21 years of age. The Hospital and MHS contribute for each eligible participant an amount equal to 2 percent of compensation that does not exceed 150 percent of the social security contribution. In addition, the Hospital and MHS match up to an additional 2 percent of each participant's contribution to the plan at a matching rate of 50 percent. MPS sponsors various defined contribution pension plans that cover all eligible employees (physicians) according to the terms of each physician's individual employment agreement. The Medical Center incurred expenses related to these plans of $379,297 for the period ended June 30, 2011.

10. OBLIGATIONS UNDER CAPITAL LEASES

The Medical Center is the lessee of equipment under capital leases expiring in various years through 2016. The assets and liabilities under the capital leases are originally recorded at the lower of the present value of the minimum lease payments or the fair value of the asset. Amortization of assets held under the capital lease is included in depreciation expenses and was $364,893 for the period ended June 30, 2011. The capital lease obligations carry imputed interest rates between 3.3 and 7.1 percent, and are collateralized by the leased equipment.

Following is a summary of equipment held under capital leases:

Equipment	$ 3,802,679
Less: accumulated amortization	1,748,022
	$ 2,054,657

Capital lease activity for the period ended June 30, 2011 was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance	Current Portion
Obligations under capital leases	$ 1,587,931	$ 295,853	$ 415,875	$ 1,467,909	$ 700,142

Debt service requirements on obligations under capital leases at June 30, 2011, are as follows:

Year Ending June 30,	Principal	Interest
2012	$ 700,142	$ 50,836
2013	412,149	23,748
2014	256,031	8,800
2015	72,807	2,521
2016	26,780	822
Total	$ 1,467,909	$ 86,727

11. LONG-TERM DEBT

On December 17, 2002, Morgan County, Indiana issued $14,030,000 of Adjustable Rate Demand Economic Development Revenue Bonds, Series 2002A and 2002B (the “2002 Bonds”) on behalf of the Medical Center.

On June 17, 2010, Morgan County, Indiana issued $14,000,000 of Adjustable Rate Demand Economic Development Revenue Bonds, Series 2010 (the “2010 Bonds”) on behalf of the Medical Center. The proceeds of the 2010 Bonds were used to refund the 2002 Bonds, to establish an approximate $1,500,000 project fund for future projects, and to pay for the bond issuance costs relating to the 2010 Bonds.

On June 30, 2011, the Hospital paid off all of its long term debt agreements and its two interest rate swap agreements. A $643,231 loss on extinguishment of debt was recorded due to the write-off of the prior bond refunding loss, unamortized bond discounts, and unamortized bond issue costs. The loss on extinguishment of debt is reported within Nonoperating revenues (expenses) on the Consolidated Statement of Operations and Changes in Net Assets.

Long-term debt activity for the period ended June 30, 2011 was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance	Current Portion
Note payable to bank	$ 116,662	$ -0-	$ (116,662)	$ -0-	$ -0-
Note payable to bank	199,783	-0-	(199,783)	-0-	-0-
Revenue bonds, series 2010	13,806,851	-0-	(13,806,851)	-0-	-0-
Bond discounts	6,896	-0-	(6,896)	-0-	-0-
Bond refunding losses	(336,738)	-0-	336,738	-0-	-0-
Total long-term debt	$ 13,793,454	$ -0-	$ (13,793,454)	$ -0-	$ -0-

Interest Rate Swap Agreements

Contracts

The Medical Center had two interest rate swap agreements (the “Swaps”) with a highly rated counterparty. The Swaps were originally entered into as a means of fixing the interest costs associated with the 2002 Bonds. Effective in June 2010, the Swaps were utilized as a means of fixing a portion of the interest costs on the 2010 Bonds.

Objectives

As a means to lower its borrowing costs and increase its savings, when compared against fixed-rate refunding bonds at the time of issuance, the Medical Center entered into interest rate swaps in connection with its 2002 Bonds. The intention of the Swap agreement was to effectively change the Medical Center's variable interest rate on the bonds to a synthetic fixed rate of 3.82% and 3.99% for interest rate management purposes. Beginning in June 2010, the Medical Center began utilizing the Swaps for the same purpose on the 2010 Bonds. The Medical Center was exposed to credit loss in the event of nonperformance by the other parties to the interest rate swap agreements. However, the Medical Center did not anticipate nonperformance by the counterparties.

Terms, Fair Values, and Credit Risk

The terms, fair values, and credit ratings of the outstanding Swaps as of June 30, 2011 are as follows:

Swaps	Notional Amount	Effective Date	Fixed Rate Paid	Variable Rate Received (1)	Fair Values*	Termination Date	Counterparty Credit Rating (2)
Swap "B"	$ 5,000,000	5/5/2005	3.82%	Bond Market Association Municipal Swap Index	$ -0-	6/30/2011	A
Swap "C"	6,685,000	7/16/2007	3.99%	67% of LIBOR	-0-	6/30/2011	A
	$ 11,685,000				$ -0-		

(1) LIBOR - London Interbank Offered Rate
(2) Counter party's guarantor
* As noted above, these swaps were paid off on June 30, 2011.

The notional amounts of the Swaps were inconsistent with the principal amount of the associated debt and did not decline with the principal amortization of the bonds. Therefore, the Swaps did not qualify as hedging derivatives. The Swaps were marked-to-market on the consolidated balance sheet at fair value.

Basis Risk

The Medical Center was exposed to basis risk on its Swaps because the variable-rate payments received by the Medical Center were based on a rate or index other than the interest rates the Medical Center paid on the 2010 Bonds.

12. INSURANCE BENEFIT PLAN

The Medical Center funds an executive insurance benefit plan for the Medical Center CEO. The plan accumulates cash value over time. The Medical Center records an asset and liability amount for the amount of premiums paid into the plan. The asset relating to the executive insurance benefit plan is reported in assets whose use is limited. The liability is reported as other long-term liabilities on the consolidated balance sheets.

13. NET PATIENT SERVICE REVENUE

The Medical Center has agreements with third-party payors that provide for payments at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

- ***Medicare***. The Medical Center is a provider of services to patients entitled to coverage under Title XVIII (Medicare) of the Health Insurance Act. The Medical Center is reimbursed for Medicare inpatient services based on a fixed price per discharge for each diagnosis related grouping ("DRG") and Medicare 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 Medical Center's year end, a cost report is filed with the Medicare program computing reimbursement amounts related to Medicare patients. The difference between computed reimbursement and interim reimbursement is reflected as a receivable from, or payable to the third-party program. The Medical Center's classification of patients under the Medicare program and the appropriateness of their admissions are subject to an independent review by a peer review organization under contract with the Medical Center. As of June 30, 2011, the Medical Center's submitted Medicare cost reports have been final settled with the Fiscal Intermediary through December 31, 2006.

- ***Medicaid***. The Medical Center is a provider of services to patients entitled to coverage under Title XIX (Medicaid) of the Health Insurance Act. The Medical Center is reimbursed for Medicaid inpatient services based on a fixed price per discharge for each diagnosis related grouping ("DRG") 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. There is no cost settlement for either of the inpatient or outpatient. For the period ended June 30, 2011, the Medical Center received and recorded in net patient service revenue $1,592,812 relating to net Medicaid Disproportionate Share Hospital ("DSH") payments and/or Indiana Medicaid Municipal Hospital Upper Payment Limit ("UPL") adjustments.

- ***Other***. The Medical Center has also entered into preferred provider agreements with certain commercial insurance carriers. The basis for payment to the Medical Center under these agreements is a discount from established charges.

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Final determination of compliance with such laws and regulations is subject to future government review and interpretation. Violations may result in significant regulatory action including fines, penalties, and exclusions from the Medicare and Medicaid programs. The Medical Center believes that it is in compliance with all applicable laws and regulations.

For the period ended June 30, 2011, net patient service revenue was as follows:

Gross patient service revenue	
Inpatient routine services	$ 7,008,136
Inpatient ancillary services	13,495,959
Outpatient ancillary services	59,886,552
Total gross patient service revenue	80,390,647
Deductions from revenue	
Contractual allowances	52,020,139
Charity care	670,749
Bad debts	4,330,372
Total deductions from revenue	57,021,260
Total net patient service revenue	$ 23,369,387

GASB requires bad debts to be reported as a deduction from gross patient service revenue while FASB requires bad debts to be reported as an operating expense.

14. NONOPERATING REVENUES (EXPENSES)

For the period ended June 30, 2011 nonoperating revenues (expenses) were as follows:

Investment income	$ 390,647
Investment loss - fair value change of interest rate swaps	(79,282)
Interest expense	(415,778)
Loss on extinguishment of debt	(643,231)
Other	(27,918)
Total nonoperating revenues (expenses)	$ (775,562)

GASB requires interest expense to be reported as a nonoperating expense while FASB requires interest expense to be reported as an operating expense.

15. PROFESSIONAL LIABILITY INSURANCE

The Indiana Medical Malpractice Act, IC 34-18, provides a maximum recovery of $250,000 for an occurrence of malpractice and $1,250,000 for an injury or death of a patient due to an act of malpractice. The Act requires physicians to maintain medical malpractice liability insurance in the minimum amount of $250,000 per occurrence and $750,000 in the annual aggregate and hospitals to maintain medical malpractice liability insurance in the minimum amount of $250,000 per occurrence and $5,000,000 in the annual aggregate for hospitals with 100 or fewer occupied beds and $7,500,000 for hospitals with more than 100 occupied beds. The Act also requires the Medical Center to pay a surcharge to the State Patient's Compensation Fund. This fund may be used to pay medical malpractice claims in excess of the annual aggregate amount noted above, under certain terms and conditions.

The Medical Center is insured against professional liability claims on a claims-made basis. Liabilities for incurred but not reported losses at June 30, 2011 are not determinable; however, in management's opinion, such liabilities, if any, will not have a material effect on the Medical Center's financial position and its malpractice and general liability insurance is adequate to cover losses, if any. Should the claims-made policies not be renewed or replaced with appropriate insurance coverage, claims based upon occurrences during these terms, but reported subsequently, will be uninsured. The Medical Center intends to continue carrying such insurance. Professional liability insurance coverage for the Hospital is $250,000 per occurrence and $7,500,000 in the aggregate. Professional liability insurance coverage for MHS and MPS is $250,000 per occurrence and $750,000 in the aggregate. In addition, the Medical Center has umbrella coverage of $5,000,000 per occurrence and in the aggregate. Professional liability insurance expense for the period ended June 30, 2011 was $259,511.

16. CONCENTRATIONS OF CREDIT RISK

The Medical Center grants credit without collateral to its patients, most of whom are local residents and insured under third-party payor agreements. The mix of gross revenue and receivables from patients and third-party payors at June 30, 2011 was as follows:

	Revenues	Receivables
Medicare	43 %	29 %
Medicaid	20	13
Blue Cross	15	10
Other third-party payors	15	13
Patients	7	35
	100 %	100 %

17. CONTINGENCIES

There are a variety of legal proceedings and claims by others against the Medical Center in a variety of matters arising out of the conduct of the Medical Center's business. The ultimate resolution of such claims would not, in the opinion of management, have a material adverse effect on the consolidated financial statements.

18. COMMITMENTS

As of June 30, 2011, the Hospital has construction in progress commitments as follows, which include equipment acquired under a capital lease agreement that was received before June 30, 2011 but not placed into service until after June 30, 2011:

Project	Expected Date of Completion	Estimated Total Cost of Project	Costs Incurred as of June 30, 2011
ARRA Software	Aug-11	$ 129,000	$ 129,000
Encor Software	Aug-11	5,000	5,000
Real Estate Development	Various	25,000	22,300
Furnishings for HR	Jul-11	1,090	1,090
		$ 160,090	$ 157,390

19. TRANSFERS

For the period ended June 30, 2011, MHS received transfers from the Hospital totaling $1,013,234. MPS received transfers from the Hospital in the amount of $1,005,136 for the period ended June 30, 2011. These transfers have been eliminated in consolidation.

20. FAIR VALUE OF FINANCIAL INSTRUMENTS

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

<u>Cash and Cash Equivalents</u>

The carrying amount reported in the consolidated balance sheet for cash and cash equivalents approximates its fair value based on short maturities of those items.

<u>Assets Whose Use is Limited</u>

These assets are reported in the consolidated balance sheet at fair value or cost that approximates fair value. The fair value amounts are based on quoted market prices, if available, or are estimated using quoted market prices for similar securities.

Accounts Payable, Accrued Payroll and Payroll Withholdings, and Accrued Expenses

The carrying amounts reported in the consolidated balance sheet for accounts payable, accrued payroll and payroll withholdings, and accrued expenses approximate their fair value based upon short maturities of those items.

Estimated Third-Party Payor Settlements

The carrying amount reported in the consolidated balance sheet for estimated third-party payor settlements approximates its fair value because they are expected to be settled in the near future.

Obligations Under Capital Leases and Deferred Compensation Liabilities

The carrying amount and fair value reported in the consolidated balance sheet for capital leases were $1,467,909 and $1,466,635, respectively. The carrying amount reported in the consolidated balance sheet for deferred compensation liabilities approximates its fair value based on the insurance policy terms.

21. SUBSEQUENT EVENT - AFFILIATION AGREEMENT

Effective July 1, 2011, the Medical Center has entered into an agreement with Clarian Health Partners, an Indiana nonprofit corporation, a/k/a Indiana University Health ("IU Health"). The agreement allows for the Medical Center to become an affiliate of IU Health by transferring substantially all assets and liabilities into a new Indiana nonprofit corporation named Indiana University Health Morgan Hospital, Inc. ("IUH Morgan"). The Board of Commissioners of Morgan County, Indiana ("Commissioners"), effectively ceded Morgan County government's control and ownership of the Medical Center's assets and liabilities for no payment. IUH Morgan is operated and controlled by IU Health.