



THE HEART HOSPITAL AT DEACONESS GATEWAY, LLC

FINANCIAL STATEMENTS

SEPTEMBER 30, 2012 AND 2011

CPAs / ADVISORS



THE HEART HOSPITAL AT DEACONESS GATEWAY, LLC

BALANCE SHEETS SEPTEMBER 30, 2012 AND 2011

	2012	2011
ASSETS		
Current assets		
Cash	\$ 1,974,496	\$ 5,756,963
Patient accounts receivable less allowance for estimated uncollectible amounts of \$2,277,296 in 2012 and \$3,029,335 in 2011	7,073,324	7,018,809
Inventories	765,570	791,207
Prepaid expenses and other current assets	81,249	45,782
Total current assets	<u>9,894,639</u>	<u>13,612,761</u>
Property and equipment		
Property and equipment	5,969,078	5,274,221
Less accumulated depreciation	<u>2,785,917</u>	<u>2,322,042</u>
Property and equipment, net	3,183,161	2,952,179
Other assets	<u>6,658,815</u>	<u>6,658,815</u>
Total assets	<u>\$ 19,736,615</u>	<u>\$ 23,223,755</u>
LIABILITIES AND MEMBERS' EQUITY		
Current liabilities		
Accounts payable and accrued expenses	\$ 1,605,782	\$ 1,441,093
Related party payable	2,094,187	4,199,789
Line of credit	-0-	1,131
Estimated third party settlements	<u>2,104,686</u>	<u>2,057,851</u>
Total current liabilities	5,804,655	7,699,864
Members' equity	<u>13,931,960</u>	<u>15,523,891</u>
Total liabilities and members' equity	<u>\$ 19,736,615</u>	<u>\$ 23,223,755</u>

See accompanying notes to financial statements.

THE HEART HOSPITAL AT DEACONESS GATEWAY, LLC

STATEMENTS OF OPERATIONS AND CHANGES IN MEMBERS' EQUITY YEARS ENDED SEPTEMBER 30, 2012 AND 2011

	<u>2012</u>	<u>2011</u>
Operating revenue		
Net patient service revenue	\$ 51,771,272	\$ 46,857,723
Less provision for bad debts	<u>1,537,873</u>	<u>1,910,757</u>
Net patient service revenue net of provision for bad debts	50,233,399	44,946,966
Other operating revenue	<u>1,333,384</u>	<u>-0-</u>
Total operating revenue	51,566,783	44,946,966
Operating expenses		
Medical supplies	14,348,884	14,237,200
Other general supplies	137,790	113,582
Contract services	18,463,595	17,516,583
Repairs and maintenance	359,971	415,581
Depreciation	463,740	527,035
Interest	4,412	4,741
Utilities	305,712	299,064
Lease and rentals	2,747,066	2,733,945
Other	<u>1,433,866</u>	<u>799,081</u>
Total operating expenses	<u>38,265,036</u>	<u>36,646,812</u>
Operating income	13,301,747	8,300,154
Nonoperating revenue		
Interest income and other	<u>1,435</u>	<u>1,136</u>
Net income	13,303,182	8,301,290
Members' equity, beginning of year	15,523,891	12,842,397
Distributions to members	<u>(14,895,113)</u>	<u>(5,619,796)</u>
Members' equity, end of year	<u>\$ 13,931,960</u>	<u>\$ 15,523,891</u>

See accompanying notes to financial statements.

THE HEART HOSPITAL AT DEACONESS GATEWAY, LLC

STATEMENTS OF CASH FLOWS YEARS ENDED SEPTEMBER 30, 2012 AND 2011

	<u>2012</u>	<u>2011</u>
Operating activities		
Net income	\$ 13,303,182	\$ 8,301,290
Adjustments to reconcile net income to net cash from operating activities		
Depreciation	463,740	527,035
Provision for bad debts	1,537,873	1,910,757
Changes in operating assets and liabilities		
Patient accounts receivable	(1,592,388)	(1,753,146)
Inventories and other current assets	(9,830)	(16,877)
Accounts payable and accrued expenses	164,689	(484,361)
Related party payable	(2,105,602)	2,274,989
Estimated third party settlements	46,835	573,300
Net cash flows from operating activities	<u>11,808,499</u>	<u>11,332,987</u>
Investing activities		
Purchase of property and equipment	(694,722)	(1,520,940)
Financing activities		
Distributions to members	(14,895,113)	(5,619,796)
Payments on line of credit	(1,131)	(1,519,057)
Net cash flows from financing activities	<u>(14,896,244)</u>	<u>(7,138,853)</u>
Net change in cash	(3,782,467)	2,673,194
Cash, beginning of year	5,756,963	3,083,769
Cash, end of year	<u>\$ 1,974,496</u>	<u>\$ 5,756,963</u>
Other supplemental information		
Cash paid for interest	\$ 4,663	\$ 5,331

See accompanying notes to financial statements.

THE HEART HOSPITAL AT DEACONESS GATEWAY, LLC

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

1. NATURE OF OPERATIONS

Organization

The Heart Hospital at Deaconess Gateway, LLC (Heart Hospital) is a limited liability company, which is classified as a partnership for federal tax purposes. The Heart Hospital was formed prior to September 30, 2008 and significant operational activity commenced on October 4, 2008. The Heart Hospital is owned by Deaconess Hospital (Deaconess) (51%, 208 units at September 30, 2012 and 2011) and the Heart Physicians, LLC (49%, 200 units at September 30, 2012 and 2011). The Heart Hospital leases space and employees from Deaconess. The Heart Hospital also purchases other services and supplies from Deaconess (see Note 4).

The Heart Hospital was formed for the purpose of meeting the demands of the community by owning and operating a cardiovascular hospital that provides a full spectrum of heart care such as; preventative care, medical care, emergent care, diagnostic testing, cardiovascular procedures, cardiovascular surgery and cardiac rehabilitation on an outpatient and inpatient basis. The majority of expenses included in the accompanying statements of operations primarily relate to providing these services.

New Accounting Pronouncements

During 2012, the Heart Hospital adopted Accounting Standards Update (ASU) 2010-23, Healthcare Entities (Topic 954) "Measuring Charity Care for Disclosure" which requires certain healthcare entities to disclose the cost of providing charity care. All periods presented have been reclassified to conform to this presentation. The Heart Hospital's adoption of this standard had no net impact on financial position, results of operations, or cash flows.

Also during 2012, the Heart Hospital changed its accounting policy to early adopt and incorporate the provisions of FASB ASU 2011-7, Health Care Entities (Topic 954), Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities. ASU 2011-7 requires healthcare entities to present all bad debts associated with patient services revenue as a deduction from revenue. Accordingly, this accounting change has been retrospectively applied to prior periods presented as if the policy had always been used.

THE HEART HOSPITAL AT DEACONESS GATEWAY, LLC

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Cash

The Heart Hospital maintains its cash in bank deposit accounts which, at times, may exceed the federally insured limits. The Heart Hospital has not experienced any losses in such accounts. The Heart Hospital believes that it is not exposed to any significant credit risk on cash.

Patient Accounts Receivable and Net Patient Service Revenue

The Heart Hospital reports patient accounts receivable for services rendered at net realizable amounts from third-party payors, patients and others. The Heart Hospital has agreements with third-party payors that provide for payments to the Heart Hospital at amounts different from its established rates. Net patient revenue is reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered.

Patient accounts receivable are reduced by an allowance for uncollectible accounts based on the Heart Hospital's evaluation of its major payor sources of revenue, the aging of the accounts, historical losses, current economic conditions, and other factors unique to its service area and the healthcare industry. Management regularly reviews data about the major payor sources of revenue in evaluating the sufficiency of the allowance for uncollectible accounts. For receivables associated with services provided to patients who have third-party coverage, the Heart Hospital analyzes contractually due amounts and provides an allowance for uncollectible accounts and a provision for bad debts, if necessary. For receivables associated with self-pay payments the Heart Hospital records a significant provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for uncollectible accounts.

During 2012, the Heart Hospital's allowance for uncollectible accounts changed from approximately \$3,000,000 to \$2,300,000. The change was the result of a decrease in self-pay balances as well as improved aging related to these balances. As of September 30, 2012 and 2011, the allowance for uncollectible amounts related primarily to reserves for self-pay balances.

THE HEART HOSPITAL AT DEACONESS GATEWAY, LLC

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Given the current regulatory and reimbursement environment, there can be no assurances that adequate reimbursement levels will continue to be available for the services provided by the Heart Hospital. Significant limits on the scope of services reimbursed and on reimbursement rates and fees could have a material adverse effect on the Heart Hospital's financial position, results of operations and cash flows.

The Heart Hospital is primarily located in Newburgh, Indiana and grants credit without collateral to its patients. Patient accounts receivable and gross patient service revenue from patients and third-party payors were comprised of the following as of and for the years ended September 30:

	Receivable		Revenue	
	2012	2011	2012	2011
Medicare	37%	34%	58%	56%
Medicaid	8%	6%	4%	3%
Managed care and commercial	41%	45%	36%	38%
Self pay	14%	15%	2%	3%
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

Inventories

Inventories consist primarily of cardiovascular supplies and are stated at the lower of cost (first in, first out) or market.

Property and Equipment

Property and equipment are stated at cost and primarily includes equipment. Depreciation is computed on the straight line method. Equipment useful lives range from 2 to 13 years.

Goodwill

As of September 30, 2012 and 2011, the Heart Hospital recorded goodwill of \$6,658,815, related to the acquisition of certain assets and liabilities in conjunction with the provision of certain cardiology, cardiothoracic surgery, and related services from Deaconess. Goodwill is included within other assets on the balance sheets and is evaluated for impairment on an annual basis.

Advertising

The Heart Hospital expenses advertising costs as they are incurred. Advertising expense for the years ended September 30, 2012 and 2011 was \$155,968 and \$88,713, respectively.

THE HEART HOSPITAL AT DEACONESS GATEWAY, LLC

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts presented in the financial statements and accompanying notes. Estimates also affect the reported amounts of revenues and expenses. Although estimates are considered to be fairly stated, actual results could differ.

Charity Care

Traditional charity care covers the health care services provided to persons who meet certain criteria and cannot afford to pay. These charges were excluded from net patient service revenue under the Heart Hospital's charity care policy. Because the Heart Hospital does not pursue collection of amounts determined to qualify as charity care, they are not reported as net patient revenue.

Of the Heart Hospital's total expenses reported (approximately \$38,300,000 and \$36,600,000 during 2012 and 2011, respectively), an estimated \$573,000 and \$709,000 arose from providing services to charity patients during 2012 and 2011, respectively. The estimated costs of providing charity services are based on a calculation which applies a ratio of costs to charges to the gross uncompensated charges associated with providing care to charity patients. The ratio of cost to charges is calculated based on the Heart Hospital's total expenses divided by gross patient service revenue.

Professional Liability Insurance

The Heart Hospital maintains its professional liability insurance coverage on a claims-made basis. The provisions for estimated professional liability claims include estimates of the ultimate costs for both reported and unreported claims. The Heart Hospital does not have any professional or other litigation which is expected to have a material financial impact on its financial position, results of operations or cash flows.

Contractual Arrangements with Third-Party Payors and Net Patient Service Revenue

The Heart Hospital provides care to certain patients under Medicare, Medicaid, Health Maintenance Organization (HMO), Preferred Provider Organization (PPO), and other commercial payors. Covered services are paid at predetermined rates. Reported services are subject to audit by the administering agencies. Changes in the Medicare and Medicaid programs and reduction of funding levels could have an adverse effect on the Heart Hospital.

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NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Provision has been made in the financial statements for contractual adjustments representing the difference between standard charges for services and actual or estimated payment.

During 2012, Hospital Assessment Fee (HAF) Program for the period July 1, 2011 through June 30, 2013 was approved by Centers for Medicare & Medicaid Services retroactive to July 1, 2011. The purpose of the HAF Program is to fund the State share of enhanced Medicaid payments and Medicaid Disproportionate Share (DSH) payments for Indiana hospitals as reflected in the HAF Program expense reported in the statements of operations and changes in members' equity. Previously, the State share was funded by governmental entities through intergovernmental transfers. The Medicaid enhanced payments relate to both fee for service and managed care claims. The Medicaid enhanced payments are designed to follow the patients and result in increased Medicaid rates. During 2012, the Heart Hospital recognized HAF Program expense of approximately \$894,000 which resulted in Medicaid rate increases of approximately \$623,000. HAF Program expense is included in other expenses on the statements of operations and changes in members' equity.

Estimated Third Party Settlements

Estimated third party settlements for Medicare and Medicaid reflect the difference between interim reimbursement and reimbursement as determined by contractual agreements and third party audits.

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is a reasonable possibility that recorded estimated settlements could change by a material amount in the near term.

Electronic Health Records (EHR) Incentive Payments

The Heart Hospital receives EHR incentive payments under the Medicare program. To qualify for the EHR incentive payments, the Heart Hospital must meet "meaningful use" criteria that become more stringent over time. The Heart Hospital periodically submits and attests to its use of certified EHR technology, satisfaction of meaningful use objectives, and various patient data. These submissions generally include performance measures for each annual EHR reporting period (Federal fiscal year ending September 30). The related EHR incentive payments are paid out over a four year transition schedule and are based upon data that is captured in the Heart Hospital's cost reports.

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The payment calculation is based upon an initial amount as adjusted for discharges, Medicare utilization using inpatient days multiplied by a factor of total charges excluding charity care to total charges, and a transitional factor that ranges from 100% in first payment year and thereby decreasing by 25% each payment year until it is completely phased out in the fifth year.

The Heart Hospital recognizes EHR incentive payments as other operating income when there is reasonable assurance that the Heart Hospital will comply with the conditions of the meaningful use objectives and any other specific requirements. In addition, the financial statement effects of the other operating income must be both recognizable and measurable. EHR incentive income is included in other operating revenue in the statements of operations and changes in members' equity. EHR incentive income recognized is based on management's estimate and amounts are subject to change, with such changes impacting operations in the period the changes occur. Receipt of these funds is subject to the fulfillment of certain obligations by the Heart Hospital as prescribed by the programs, subject to future audits and may be subject to repayment upon a determination of noncompliance.

During 2012 and 2011, the Heart Hospital recognized \$1,333,174 and \$-0-, respectively, in income related to EHR incentive payments.

Income Tax Matters

The Heart Hospital at Deaconess Gateway, LLC is treated as a partnership for income tax purposes. As such, it does not pay federal or state income taxes. Items of income and expense flow through to the members who are taxed on these amounts at the member levels. There are no deferred taxes provided for temporary differences between tax and financial reporting.

Accounting principles generally accepted in the United States of America require management to evaluate tax positions taken by the Heart Hospital and recognize a tax liability if the Heart Hospital 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 by the Heart Hospital, and has concluded that as of September 30, 2012 and 2011, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the accompanying financial statements. The Heart Hospital is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress.

The Heart Hospital has filed its federal and state income tax returns for periods through December 31, 2011. 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).

THE HEART HOSPITAL AT DEACONESS GATEWAY, LLC

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Subsequent Events

The Heart Hospital has evaluated events or transactions occurring subsequent to the balance sheet date for recognition and disclosure in the accompanying financial statements through the date the financial statements are available to be issued which is January 23, 2013.

Reclassifications

Certain 2011 balances were reclassified to conform to the current year presentation. There is no effect on net income as a result of these classifications.

3. NET PATIENT REVENUE

Net patient revenue for the years ended September 30, 2012 and 2011 consists of the following:

	<u>2012</u>	<u>2011</u>
Outpatient revenue	\$ 61,662,470	\$ 57,584,889
Inpatient revenue	77,964,030	68,622,200
Gross patient revenue	<u>139,626,500</u>	<u>126,207,089</u>
Contractual allowances	85,762,692	76,908,343
Charity care	2,092,536	2,441,023
Total adjustments	<u>87,855,228</u>	<u>79,349,366</u>
Net patient service revenue	51,771,272	46,857,723
Less provision for bad debts	<u>1,537,873</u>	<u>1,910,757</u>
Net patient service revenue net of provision for bad debts	<u>\$ 50,233,399</u>	<u>\$ 44,946,966</u>

4. RELATED PARTY TRANSACTIONS

Deaconess provides personnel, services, and supplies to the Heart Hospital through a master services agreement. Related expenses amounted to approximately \$20,000,000 and \$19,100,000 for the years ended September 30, 2012 and 2011, respectively.

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NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

The Heart Hospital also leases its space from Deaconess. The lease term is for twenty years and expires on October 31, 2028. Rent expense, along with related maintenance charges, amounted to \$1,633,158 and \$1,571,776 for 2012 and 2011, respectively.

Amounts due to Deaconess for various supplies and services totaled \$2,094,187 and \$4,199,789 as of September 30, 2012 and 2011, respectively.

5. LINE OF CREDIT

The Heart Hospital has a line of credit available with a local financial institution. Amounts outstanding as of September 30, 2012 and 2011 were \$-0- and \$1,131, respectively. At September 30, 2012 the line of credit maximum amount was \$2,000,000 bearing interest at the one month LIBOR rate plus 1.75% but never to be less than 3.00%. The interest rate at September 30, 2012 was 3.00%. The line of credit is secured by accounts receivable, inventory and equipment and matures April 2013.

6. MINIMUM OPERATING LEASE OBLIGATIONS

The Heart Hospital leases a medical office building from Deaconess at fair market value. The Heart Hospital also leases certain equipment from various vendors. Operating lease obligations are as follows:

Year Ending September 30,	
2013	\$ 2,238,229
2014	1,771,909
2015	1,709,269
2016	1,634,092
2017	1,541,347
Thereafter	16,935,644
	<u>\$ 25,830,490</u>