

FINANCIAL STATEMENTS AND REPORT OF
INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS
MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1
OF DICKINSON COUNTY, KANSAS
DECEMBER 31, 2012 AND 2011

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MEMORIAL HEALTH SYSTEM

MANAGEMENT'S DISCUSSION AND ANALYSIS

Years ended December 31, 2012 and 2011

Our discussion and analysis of the financial performance of Memorial Health System provides a narrative overview of the Health System's financial activities for the years ended December 31, 2012 and 2011. Abilene Housing Inc. is not considered in the calculations made in the following paragraphs because it is legally separate from the hospital. Please read this analysis in conjunction with the accompanying basic financial statements.

Abilene Housing Inc. (Frontier Estates)

Abilene Housing Inc. was added to Memorial Health System's family of services on June 1, 2004. Financial data of Abilene Housing Inc. are presented in "Note D" of these financial statements. The 2012 financial statements of Abilene Housing Inc. were audited by an accounting firm different from the Health System's auditors, therefore, the Health System's auditors, Wendling, Noe, Nelson, and Johnson LLC, do not express an opinion on the audit of Abilene Housing Inc. Reese & Novelly, P.A, performed the 2012 and 2011 audit of Abilene Housing Inc.

Financial highlights

The Health System's net position increased during each of the past two years with a \$911,793 or 5.5% increase in 2011 and a \$797,725 or 4.6% increase in 2012.

The Health System's total operating revenue increased during each of the past two years with a \$2,654,601 or 13.4% increase in operating revenue for 2011 and a \$1,628,623 or 7.2% increase in operating revenue for 2012. The larger increase in total operating revenue in 2011 was primarily as a result of purchasing a physician's clinic effective November 1, 2010 and operating it for a full year in 2011. The larger increase in total operating revenue in 2012 was primarily as a result of purchasing a second physician's clinic effective January 1, 2012 and operating it for a full year in 2012.

The hospital became designated as a Critical Access Hospital (CAH) effective December 16, 2005. This classification change increased the 2006 and subsequent years total operating revenue due to contractual adjustments being reduced for Medicare related patients. During 2009, Memorial Health System secured the consulting services of Stroudwater Associates who calculated the CAH annual impact on the income statement to be an increase in net patient services revenue of approximately \$950,000. Management believes that the financial impact of being a CAH facility has increased in 2011 and 2012.

Memorial Health System
Management's Discussion and Analysis – Continued
Years Ended December 31, 2012 and 2011

Using these financial statements

The Health System's financial statements consist of three statements – (1) Statements of Net Position; (2) Statements of Revenues, Expenses, and Changes in Net Position, and (3) Statements of Cash Flows. These financial statements and related notes provide information about the activities of the Health System, including resources held by or for the benefit of the Health System, and resources restricted for specific purposes by contributors, grantors, and indenture agreements.

One of the most important questions asked about the Health System's finances is, "Is the Health System as a whole better or worse off as a result of the year's activities?" The Statements of Net Position and the Statements of Revenues, Expenses, and Changes in Net Position report information about the Health 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. For purposes of these two statements, revenues and expenses are taken into account regardless of when cash is received or paid.

These two statements report the Health System's net position and changes in it. The Health System's net position – the difference between assets and liabilities – may be thought of as one way to measure its financial health, or financial position. Over time, increases or decreases in the Health System's net position are one indicator of whether its financial health is improving or deteriorating. Consideration must also be given to other nonfinancial indicators, such as changes in the Health 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 Health System.

The final required statement is the Statements of Cash Flows. This 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 cash balances during the reporting period?"

Memorial Health System
Management's Discussion and Analysis – Continued
Years Ended December 31, 2012 and 2011

Assets, liabilities, and net assets

The Health System's statements of net position as of the end of each of the last three years are summarized as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Assets			
Current assets	\$6,877,211	\$6,001,313	\$4,156,195
Assets limited as to use	12,242,068	14,008,398	0
Capital assets, net	20,615,933	7,932,196	7,413,922
Other assets	388,742	233,296	19,364
Other investments	<u>5,657,370</u>	<u>5,432,657</u>	<u>6,078,296</u>
Total assets	<u>\$45,781,324</u>	<u>\$33,607,860</u>	<u>\$17,667,777</u>
Liabilities			
Long-term obligations	\$23,050,000	\$13,760,000	\$ 0
Capital asset acquisitions payable	0	22,955	0
Agency funds	13,871	14,706	19,414
Current liabilities	<u>4,524,436</u>	<u>2,414,907</u>	<u>1,164,864</u>
Total liabilities	<u>\$27,588,307</u>	<u>\$16,212,568</u>	<u>\$ 1,184,278</u>
Net position	<u>\$18,193,017</u>	<u>\$17,395,292</u>	<u>\$16,483,499</u>

Cash and invested cash in the current asset category decreased by \$54,182 in 2011 and increased by \$311,852 during 2012. Although the cash balance is small for an organization with over \$45,000,000 in assets, significant additional cash is available in other investments and is held in money market accounts, certificates of deposit, and marketable securities and is readily available for day-to-day operating cash flow needs.

Assets whose use is limited by board and other investments decreased by \$645,639 in 2011 and increased by \$240,539 in 2012. The increase of other investments in 2012 was a result of profitable operations in 2012 as well as non-operating revenues in 2012. A significant portion of the decrease in 2011 (\$509,792) was due to reserve requirements deposited for the bond issue indenture agreements entered into during 2011.

In aggregate, the Health System's unrestricted cash, restricted cash, and investments total \$5,674,592 and \$6,211,157 as of December 31, 2011 and 2012, respectively. This represents 98 and 99 days, respectively, of average cash expenses during each of the years then ended.

The Health System's net patient accounts receivable were 42.4% of current assets as of December 31, 2012, 59.5% of current assets as of December 31, 2011, and 68.3% of current

Memorial Health System
Management's Discussion and Analysis – Continued
Years Ended December 31, 2012 and 2011

assets as of December 31, 2010. The average number of days in accounts receivable of net patient revenue was 47 days, 60 days, and 55 days as of December 31, 2012, 2011, and 2010, respectively.

At the end of 2011, the Health System had \$7,932,196 invested in capital assets, net of accumulated depreciation. Net capital assets increased in 2011 by \$518,274. This increase included payments for design and development work in preparation for the construction project which began in November of 2011. At the end of 2012, the Health System had \$20,615,933 invested in capital assets, net of accumulated depreciation. Net capital assets increased in 2012 by \$12,683,737. The total cost of the construction project including monies spent on design and development is projected to be over \$24,000,000 over a two to three year period. As of the writing of this analysis, the Health System has taken possession of Phase I of the construction project and is moving into Phase I during the month of May, 2013.

Bonds were issued in 2011 in the amount of \$13,760,000 with an additional \$10,000,000 issued in 2012. These bonds are for the construction of more than 46,000 square feet of new clinical inpatient and outpatient area plus renovation of existing space.

The Health System's net position increased during each of the past two years (\$911,793 or 5.5% during 2011 and \$797,725 or 4.6% during 2012), primarily due to profitable operations after including non-operating revenues and contributions to capital. The percentage of total assets financed with net position, or equity, was 39.7%, 51.8%, and 93.3% as of December 31, 2012, 2011, and 2010 respectively. The change to 51.8% of total assets financed with net position, or equity was a result of issuing \$13,760,000 of bonds in 2011 for a hospital construction project. The change to 39.7% of total assets financed with net position, or equity was a result of issuing \$10,000,000 of bonds in 2012 for the remainder of the hospital construction project.

Memorial Health System
Management's Discussion and Analysis – Continued
Years Ended December 31, 2012 and 2011

Operating results and changes in net position

The Health System's operating results and changes in net position for each of the last three years are summarized as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Operating revenues	\$24,122,643	\$22,494,020	\$19,839,419
Operating expenses	<u>23,860,010</u>	<u>22,393,050</u>	<u>19,334,949</u>
Operating income	262,633	100,970	504,470
Interest expense	(\$143,338)	\$ 0	(\$ 1,932)
Nonoperating revenues	606,765	792,316	545,773
Gain (Loss) on disposal of capital assets	52,200	(8,308)	0
Capital grants and contributions	<u>19,465</u>	<u>26,815</u>	<u>15,885</u>
Increase in net position	<u>\$797,725</u>	<u>\$911,793</u>	<u>\$1,064,196</u>

The first, and most significant, component of the overall change in the Health System's net position is its operating income – generally, the difference between net patient service revenue and the expenses incurred to perform these services. The hospital became designated a Critical Access Hospital (CAH) effective December 16, 2005. This classification change increased the total operating revenue due to contractual adjustments being reduced for Medicare related patients. The financial impact of being designated a CAH was a positive annual amount of approximately \$950,000 as calculated by Stroudwater Associates, a consultant hired by the Health System. Management believes that the impact of being a CAH facility has increased in 2011 and 2012. Included in operating expenses in 2011 is \$247,683 of provision for impairment of property and equipment as a result of the construction project that was committed to in 2011. The impaired amount was a non-cash amount recording the lost value of capital assets that were not fully depreciated that will be destroyed in the construction project. There was no remaining debt on the impaired values written off. This was a one time reduction in capital assets relating to the construction project.

Net patient service revenue is analyzed as follows:

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Inpatient services	\$14,096,924	\$13,357,650	\$13,140,332
Outpatient services	<u>23,567,946</u>	<u>20,674,845</u>	<u>17,381,806</u>
Gross patient service revenue	<u>\$37,664,870</u>	<u>\$34,032,495</u>	<u>\$30,522,138</u>
Contractual adjustments	\$13,698,300	\$11,652,290	\$10,914,652
Provision for bad debts	1,011,106	622,109	546,569
Charity Care	<u>271,745</u>	<u>196,020</u>	<u>187,982</u>
Net patient service revenue	<u>\$22,683,719</u>	<u>\$21,562,076</u>	<u>\$18,872,935</u>

Memorial Health System
Management's Discussion and Analysis – Continued
Years Ended December 31, 2012 and 2011

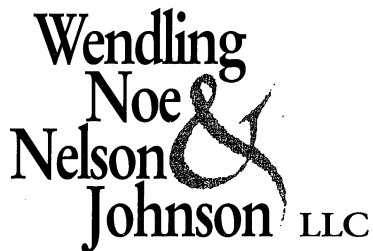
Beginning in 2008 and forward thru 2012, the Health System experienced outpatient charges being more than 50% of total patient charges. For 2010, the outpatient charges represented 56.9% of total patient service charges, 60.8% for 2011, and 62.6% for 2012. In recent past years, the Health System grew its inpatient services due primarily to the purchase of a long term care facility on February 1, 2003 and the resulting growth of long term care services. However, beginning with 2008, the trend toward outpatient services was more pronounced and increased at a higher rate than in the past for the Health System. This is consistent with what is happening in the health care industry. The purchase of a physicians' clinic effective November 1, 2010 increased the outpatient care percentage as the clinic was operated for the full 2011 year. The purchase of the second physicians' clinic effective January 1, 2012 further increased the outpatient care percentage of total services.

Effective January 1, 2010, the hospital increased its most prevalent acute care room rate by 8.0%. Effective January 1, 2011, the hospital increased its most prevalent acute care room rate by 6.2%. Effective March 1, 2012, the hospital increased its most prevalent acute care room rate by 5.8%.

The Health System has agreements with various third-party payors that provide for payments to the Health System at amounts different from its established charge rates. These differences are referred to as contractual adjustments. Contractual adjustments continue to be a significant portion of the reduction in gross patient services revenue and have represented 36.4% of charges for 2012, 34.2% of charges for 2011, and 35.8% of charges for 2010.

The Health System provides care free of charge or at amounts less than its established rates to patients who meet certain criteria under its charity care policy. Charity care write-offs have amounted to \$187,982 for 2010, \$196,020 for 2011, and \$271,745 for 2012. There is a growing trend in the health care industry to identify and report the value of charity care provided to patients. The provision for bad debts represented 2.68%, 1.83%, and 1.79% of gross patient service revenue during 2012, 2011, and 2010 respectively.

Employee salaries and wages increased by \$996,897 or 8.4% during 2012 and \$1,559,624 or 15.2% during 2011. The health system implemented pay raises commensurate with market conditions for 2012 and 2011. Supplies and other expenses increased during 2012 by \$714,784 or 7.6% and during 2011 by \$1,361,753 or 17.0%. The larger than usual increase in wages and supplies and other was primarily due to the purchase of a physicians' clinic effective November 1, 2010 with a full year of expenses for 2011 and the purchase of a second physicians' clinic effective January 1, 2012 and the related employment of physicians and clinic staff in both clinic purchases.



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REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

The Board of Directors
Memorial Hospital of Hospital District #1
of Dickinson County, Kansas

We have audited the accompanying financial statements of the business-type activity of Memorial Hospital of Hospital District #1 of Dickinson County, Kansas, as of and for the years ended December 31, 2012 and 2011, and the related notes to the financial statements, which collectively comprise the Hospital's financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the Kansas Municipal Audit Guide. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the business-type activity of Memorial Hospital of Hospital District #1 of Dickinson County, Kansas, as of December 31, 2012 and 2011, and the changes in financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 1 through 6 be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the 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 financial statements, and other knowledge we obtained during our audits of the 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.

Wendling Roe Nelson & Johnson LLC

Topeka, Kansas
April 29, 2013

FINANCIAL STATEMENTS

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

STATEMENTS OF NET POSITION

December 31,

ASSETS

	<u>2012</u>	<u>2011</u>
CURRENT ASSETS		
Cash and invested cash	\$ 553,787	\$ 241,935
Patient accounts receivable, net of allowance for doubtful accounts of \$659,720 in 2012 and \$595,069 in 2011	2,917,726	3,567,796
Accounts receivable - other	653,036	417,413
Interest receivable	29,253	31,848
Estimated third-party payor settlements	412,305	571,985
Assets whose use is limited by indenture agreement - required for current liabilities	1,447,568	509,792
Inventories	317,638	323,329
Prepaid expenses	296,898	337,215
Ad valorem taxes receivable	249,000	
Total current assets	<u>6,877,211</u>	<u>6,001,313</u>
ASSETS WHOSE USE IS LIMITED		
By Board of Directors	15,826	
By indenture agreement	13,654,532	14,518,190
By contributors	19,278	
	<u>13,689,636</u>	<u>14,518,190</u>
Less amounts required for current liabilities	<u>1,447,568</u>	<u>509,792</u>
Noncurrent assets whose use is limited	<u>12,242,068</u>	<u>14,008,398</u>
OTHER INVESTMENTS	<u>5,657,370</u>	<u>5,432,657</u>
CAPITAL ASSETS - NET	<u>20,615,933</u>	<u>7,932,196</u>
OTHER ASSETS		
Agency funds	13,871	14,706
Prepaid expenses	9,589	12,852
Deferred financing costs	365,282	205,738
	<u>388,742</u>	<u>233,296</u>
TOTAL ASSETS	<u>\$ 45,781,324</u>	<u>\$ 33,607,860</u>

The accompanying notes are an integral part of these statements.

LIABILITIES AND NET POSITION

	<u>2012</u>	<u>2011</u>
CURRENT LIABILITIES		
Current maturities of long-term debt	\$ 710,000	\$ -
Accounts payable	655,527	539,020
Estimated third-party payor settlements	298,928	293,985
Accrued salaries, wages, and related withholding taxes payable	581,734	457,230
Accrued vacation pay	552,279	474,096
Capital asset acquisitions payable	1,363,871	598,694
Accrued interest payable	79,632	38,796
Deferred revenue	282,465	13,086
Total current liabilities	<u>4,524,436</u>	<u>2,414,907</u>
LONG-TERM DEBT, excuding current maturities	<u>23,050,000</u>	<u>13,760,000</u>
CAPITAL ASSET ACQUISITIONS PAYABLE, excluding current portion	<u>-</u>	<u>22,955</u>
AGENCY FUNDS	<u>13,871</u>	<u>14,706</u>
Total liabilities	<u>27,588,307</u>	<u>16,212,568</u>
NET POSITION		
Invested in capital assets - net of related debt	9,045,595	7,808,504
Restricted		
For capital asset acquisitions and operating activities	19,278	46,787
Unrestricted		
Board designated endowment	15,826	
Undesignated	9,112,318	9,540,001
Total net position	<u>18,193,017</u>	<u>17,395,292</u>
TOTAL LIABILITIES AND NET POSITION	<u>\$ 45,781,324</u>	<u>\$ 33,607,860</u>

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION
Year ended December 31,

	<u>2012</u>	<u>2011</u>
Operating revenues		
Net patient service revenue	\$ 22,683,719	\$ 21,562,076
Other	<u>1,438,924</u>	<u>931,944</u>
Total operating revenues	<u>24,122,643</u>	<u>22,494,020</u>
Operating expenses		
Salaries and wages	12,821,301	11,824,404
Employee benefits	3,199,251	2,735,464
Supplies and other	6,871,675	6,620,678
Depreciation and amortization	967,783	964,821
Provision for impairment of property and equipment	<u> </u>	<u>247,683</u>
Total operating expenses	<u>23,860,010</u>	<u>22,393,050</u>
Operating income	<u>262,633</u>	<u>100,970</u>
Nonoperating revenues (expenses)		
Ad valorem taxes	277,728	269,523
Contributions	128,162	182,274
Investment income	193,694	101,889
Interest expense	(143,338)	
Insurance recovery, net of impairment of property and equipment		223,722
Gain (loss) on disposal of assets	52,200	(8,308)
Other	<u>7,181</u>	<u>14,908</u>
Nonoperating revenues (expenses), net	<u>515,627</u>	<u>784,008</u>
Excess of revenues over expenses before capital contributions	778,260	884,978
Capital contributions	<u>19,465</u>	<u>26,815</u>
Increase in net position	797,725	911,793
Net position at beginning of year	<u>17,395,292</u>	<u>16,483,499</u>
Net position at end of year	<u>\$ 18,193,017</u>	<u>\$ 17,395,292</u>

The accompanying notes are an integral part of these statements.

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

STATEMENTS OF CASH FLOWS

Year ended December 31,

	<u>2012</u>	<u>2011</u>
Cash flows from operating activities		
Receipts from and on behalf of patients	\$23,599,303	\$20,858,081
Payments to or on behalf of employees	(15,817,865)	(14,426,061)
Payments to suppliers	(6,705,897)	(6,501,518)
Other receipts and payments	<u>1,223,680</u>	<u>916,629</u>
Net cash provided by operating activities	<u>2,299,221</u>	<u>847,131</u>
Cash flows from noncapital financing activities		
Ad valorem taxes	277,728	269,523
Noncapital contributions	128,162	173,636
Other nonoperating receipts	<u>7,181</u>	
Net cash provided by noncapital financing activities	<u>413,071</u>	<u>443,159</u>
Cash flows from capital and related financing activities		
Purchase of capital assets	(12,075,875)	(1,191,192)
Contributions for purchase of capital assets	19,465	26,815
Proceeds from sale of assets	58,949	10,475
Insurance recoveries		25,624
Issuance of long-term debt	10,000,000	13,760,000
Payment of deferred financing costs	(192,911)	(208,091)
Interest paid	<u>(909,307)</u>	
Net cash (used) provided by capital and related financing activities	<u>(3,099,679)</u>	<u>12,423,631</u>
Cash flows from investing activities		
Decrease (increase) in assets whose use is limited	828,554	(14,518,190)
(Increase) decrease in investments	(142,234)	618,747
Increase in other assets		(50)
Purchase of physician practice	(100,891)	
Investment income	<u>113,810</u>	<u>131,390</u>
Net cash provided (used) by investing activities	<u>699,239</u>	<u>(13,768,103)</u>

The accompanying notes are an integral part of these statements.

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS
STATEMENTS OF CASH FLOWS - CONTINUED
Year ended December 31,

	<u>2012</u>	<u>2011</u>
Net change in cash and cash equivalents	\$ 311,852	\$ (54,182)
Cash and cash equivalents at beginning of year	<u>241,935</u>	<u>296,117</u>
Cash and cash equivalents at end of year	<u>\$ 553,787</u>	<u>\$ 241,935</u>
Reconciliation of operating income to net cash provided by operating activities		
Operating income	\$ 262,633	\$ 100,970
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation and amortization	967,783	964,821
Provision for impairment of property and equipment		247,683
Increase (decrease) in deferred revenue	20,379	(1,356)
Provision for bad debts	1,011,106	622,109
Changes in		
Patient and other accounts receivable	(495,768)	(1,364,063)
Estimated third-party payor settlements	164,623	24,000
Inventories and prepaid expenses	49,271	(75,595)
Accounts payable and accrued expenses	<u>319,194</u>	<u>328,562</u>
Net cash provided by operating activities	<u>\$ 2,299,221</u>	<u>\$ 847,131</u>

The accompanying notes are an integral part of these statements.

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

NOTES TO FINANCIAL STATEMENTS

December 31, 2012 and 2011

NOTE A - SUMMARY OF ACCOUNTING POLICIES

A summary of the significant accounting policies consistently applied in the preparation of the accompanying financial statements follows.

1. Financial reporting entity

Memorial Hospital of Hospital District #1 of Dickinson County, Kansas (Hospital), is a municipal corporation operating an acute-care hospital located in Abilene, Kansas, with a licensed bed capacity of 25 acute care beds and 10 psychiatric beds and a long-term care facility with a licensed bed capacity of 77 beds. The Hospital also operates two physician clinics located in Abilene, Kansas. The Hospital is governed by an elected five-member Board of Directors.

2. Component unit

Abilene Housing, Inc. (AHI), was formed and organized as a Kansas not-for-profit corporation. AHI provides housing for elderly and handicapped persons in a 60-unit apartment project located in Abilene, Kansas, and provides services specifically designed to meet the physical, social, and psychological needs of those individuals. Effective June 1, 2004, membership of AHI's Board consists of one member of the Board of Directors of the Hospital, the Chief Executive Officer of the Hospital, and the Chief Financial Officer, Chief Operating Officer, or Chief Nursing Officer of the Hospital. Before June 1, 2004, AHI's Board membership was independent of the Hospital Board and officers.

The Hospital is financially accountable for AHI since the Hospital appoints a majority of AHI's Board and the Hospital employs an individual responsible for AHI's day to day operations. The Hospital does not have access to AHI's resources and is not legally obligated for AHI's long-term debt.

Condensed financial statements of AHI are presented in Note D. Separate financial statements are not available for public distribution.

3. Basis of accounting

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

4. Use of estimates

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

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2012 and 2011

NOTE A - SUMMARY OF ACCOUNTING POLICIES - Continued

5. Patient accounts receivable

The Hospital reports patient accounts receivable for services rendered at net realizable amounts from third-party payors, patients, and others. The Hospital provides an allowance for uncollectible accounts based upon a review of outstanding receivables, historical collection information, and existing economic conditions.

6. Inventories

Inventories are stated at cost as determined on the first-in, first-out method.

7. Investments in debt and equity securities

Investments in debt and equity securities are carried at fair value. Interest, dividends, and gains and losses, both realized and unrealized, on investments in debt and equity securities are included in nonoperating investment income.

8. Capital assets

Capital assets are stated at cost. Depreciation and amortization of capital assets is provided on the straight-line method over the estimated useful lives of the assets. The estimated lives used are generally in accordance with the guidelines established by the American Hospital Association.

The costs of maintenance and repairs are charged to operating expenses as incurred. The costs of significant additions, renewals, and betterments to depreciable properties are capitalized and depreciated over the remaining or extended estimated useful lives of the item or the properties. Gains and losses on disposition of capital assets are included in nonoperating revenues and expenses.

9. Costs of borrowing

Interest costs, including amortization of deferred financing costs, incurred on borrowed funds during the period of construction of capital assets are capitalized as a component of the cost of acquiring those assets. Costs incurred in connection with the issuance of long-term debt are amortized using the interest method over the term of the related debt.

10. Net position

Net position is classified in three components. "Net position invested in capital assets net of related debt" consist of capital assets net of accumulated depreciation and reduced by the balances of any outstanding borrowings used to finance the purchase or construction of those assets. "Restricted net position" is the noncapital net position that must be used for a particular purpose, as specified by creditors, grantors, or contributors external to the Hospital. "Unrestricted net position" is the remaining net position that does not meet the definition of "invested in capital assets net of related debt" or "restricted."

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2012 and 2011

NOTE A - SUMMARY OF ACCOUNTING POLICIES - Continued

11. Operating revenues and expenses

The statement of revenues, expenses, and changes in financial position distinguishes 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. Nonexchange revenues, including taxes, grants, and contributions received for purposes other than capital asset acquisition, are reported as nonoperating revenues. Operating expenses are all expenses incurred to provide health care services, other than financing costs.

12. Net patient service revenue

Net patient service revenue is reported at established charges with deductions for discounts, charity care, the provision for bad debts, and contractual adjustments, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

13. Charity care

The Hospital provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because the Hospital does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue.

14. Ad valorem taxes

The Hospital receives financial support from ad valorem taxes. Ad valorem taxes are assessed in November of each year and are available for use by the Hospital in the following year.

15. Income taxes

The Hospital is exempt from federal income taxes pursuant to Sections 115 and 501(a) of the Internal Revenue Code.

16. Cash equivalents

All cash and invested cash, excluding assets whose use is limited and investments, are considered to be cash equivalents.

17. Reclassifications

Certain reclassifications have been made to the 2011 financial statements to conform to the 2012 presentation. These reclassifications did not affect previously reported net position or the change in net position.

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2012 and 2011

NOTE B - REIMBURSEMENT PROGRAMS

The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established charge rates. The amounts reported on the statements of net position as estimated third-party payor settlements consist of the estimated differences between the contractual amounts for providing covered services and the interim payments received for those services. A summary of the payment arrangements with major third-party payors follows:

Medicare - The Hospital is a critical access hospital for purposes of the Medicare program. Inpatient and outpatient acute care services, skilled nursing swing-bed services, and rural health clinic (RHC) services rendered to Medicare beneficiaries are paid under cost reimbursement methodologies. Geriatric psychology services and skilled nursing services, provided at the Hospital's long-term care facility, rendered to Medicare beneficiaries are paid based on prospectively determined per diem rates. Physician services, other than RHC services, rendered to Medicare beneficiaries are paid based on a prospectively determined fee schedule.

The Hospital is paid for cost reimbursable items at tentative rates with final settlement determined after submission of annual cost reports by the Hospital and audits or reviews thereof by the Medicare administrative contractor. The Hospital's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review by a peer review organization. The Hospital's Medicare cost reports have been audited or reviewed by the Medicare administrative contractor through December 31, 2010.

Medicaid - Acute care services rendered to Medicaid beneficiaries, other than those covered under managed care plans, and RHC services rendered to Medicaid beneficiaries, including those covered under managed care plans, are paid under cost reimbursement methodologies. The Hospital is paid for cost reimbursable items at tentative rates with final settlement determined after submission of annual cost reports by the Hospital and reviews thereof by the state Medicaid agency. The Hospital's Medicaid cost reports have been reviewed by the state Medicaid agency through December 31, 2009.

Nursing facility services are paid at prospectively determined per diem rates set annually on the basis of cost information supplied by nursing facilities for the preceding calendar year.

Blue Cross and Blue Shield - All services rendered to patients who are insured by Blue Cross-Blue Shield are paid on the basis of prospectively determined rates per discharge or discounts from established charges.

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

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2012 and 2011

NOTE B - REIMBURSEMENT PROGRAMS - Continued

A summary of gross and net patient service revenue follows:

	<u>2012</u>	<u>2011</u>
Gross patient service revenue	\$ 37,664,870	\$ 34,032,495
Adjustments to patient service revenue		
Third-party contractual adjustments, discounts, and allowances	(13,698,300)	(11,652,290)
Provision for bad debts	(1,011,106)	(622,109)
Charity care	<u>(271,745)</u>	<u>(196,020)</u>
Net patient service revenue	<u>\$ 22,683,719</u>	<u>\$ 21,562,076</u>

Revenue from the Medicare and Medicaid programs accounted for approximately 46 percent and 12 percent, respectively, of the Hospital's net patient service revenue during 2012, and 45 percent and 14 percent, respectively, of the Hospital's net patient service revenue during 2011. 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.

NOTE C - ELECTRONIC HEALTH RECORD INCENTIVE PAYMENTS

The American Recovery and Reinvestment Act of 2009 (ARRA) provides for incentive payments under the Medicare and Medicaid programs for certain hospitals and physician practices that demonstrate meaningful use of certified electronic health record (EHR) technology. These provisions of ARRA are intended to promote the adoption and meaningful use of interoperable health information technology and qualified EHR technology.

The Hospital recognizes revenue for EHR incentive payments when the hospital facility and physician practices have attested that they have demonstrated meaningful use of certified EHR technology for the applicable period and complied with the reporting conditions to receive the payments. The demonstration of meaningful use is based upon meeting a series of objectives and varies between hospital facilities and physician practices and between the Medicare and Medicaid programs. Additionally, meeting the objectives in order to demonstrate meaningful use becomes progressively more stringent as its implementation is phased in through stages as outlined by Centers for Medicare & Medicaid Services. During the year ended December 31, 2012, the Hospital recognized \$490,879 of revenue for EHR incentive payments. This amount is included in other operating revenues.

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2012 and 2011

NOTE D - COMPONENT UNIT FINANCIAL DATA

Financial data of AHI are presented as of and for the years ended September 30, 2012 and 2011. The following is a summary of the assets, liabilities, net position, revenues and expenses, and changes in net position of AHI:

	<u>2012</u>	<u>2011</u>
Cash and cash equivalents	\$ 149,288	\$ 137,342
Other current assets	<u>47,177</u>	<u>46,341</u>
Total current assets	196,465	183,683
Investments	105,724	84,593
Capital assets - net	733,957	761,310
Other assets	<u>20,335</u>	<u>26,352</u>
Total assets	<u>\$ 1,056,481</u>	<u>\$ 1,055,938</u>
Accounts payable	\$ 19,760	\$ 14,853
Current portion of mortgage payable	80,813	75,929
Other current liabilities	<u>5,103</u>	<u>8,096</u>
Total current liabilities	105,676	98,878
Mortgage payable, excluding current portion	525,439	606,006
Other liabilities	<u>19,371</u>	<u>19,184</u>
Total liabilities	650,486	724,068
Net position	<u>405,995</u>	<u>331,870</u>
Total liabilities and net position	<u>\$ 1,056,481</u>	<u>\$ 1,055,938</u>
Revenues	\$ 477,180	\$ 459,997
Management fee paid to Hospital	63,587	59,568
Depreciation and amortization	66,664	64,990
Other expenses	<u>272,804</u>	<u>325,016</u>
Total expenses	<u>403,055</u>	<u>449,574</u>
Increase in net position	<u>\$ 74,125</u>	<u>\$ 10,423</u>

NOTE E - ASSETS WHOSE USE IS LIMITED BY BOARD OF DIRECTORS

Assets whose use is limited by Board of Directors consist of cash designated to provide income to support future fund-raising activities. The funds may be used for other purposes by action of the Board of Directors.

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2012 and 2011

NOTE F - ASSETS WHOSE USE IS LIMITED BY INDENTURE AGREEMENT

Assets whose use is limited by indenture agreement consist of money market mutual funds that are held by a trustee under bond indenture agreements. Amounts that are required for obligations classified as current liabilities are reported in current assets.

NOTE G - ASSETS WHOSE USE IS LIMITED BY CONTRIBUTORS

Assets whose use is limited by contributors consist of cash received from contributors that is restricted for the acquisition of capital assets and for funding specific operating activities.

NOTE H - INVESTMENTS

Investments are summarized as follows:

	<u>2012</u>	<u>2011</u>
Invested cash consisting of bank certificates of deposit, bank savings accounts, and money market mutual fund	\$3,574,317	\$3,370,314
Common stock at fair value	17,998	19,908
Equity in undistributed earnings of Mobile Clinical Services, Inc.	116,284	101,377
Corporate bonds at fair value	1,941,874	1,934,924
Abilene Community Foundation Endowment fund	<u>6,897</u>	<u>6,134</u>
	<u>\$5,657,370</u>	<u>\$5,432,657</u>

The Hospital received contributions from an outside trust consisting of common stock and corporate bonds. The outside trustee stipulated that the Hospital board administer the resources created by the contributions separate from public monies held by the Hospital and that the assets be invested with the goal of maximizing the benefit to the Hospital by retaining the securities in their existing form through their maturities and placing the assets in similar high-grade securities in the future. Restrictions on the use of the contributions have been met and the investments are now unrestricted as to their use by the Hospital.

In 2005, the Hospital acquired a 20 percent ownership interest in Mobile Clinical Services, Inc., (MCSI). The Hospital's equity in undistributed net earnings of MCSI since acquisition is \$116,284. Nuclear medicine and ultrasound services are provided to the Hospital through arrangements with MCSI. Total fees charged to operating expense for these services were approximately \$81,000 in 2012 and \$98,000 in 2011. Amounts payable to MCSI for these services were insignificant at December 31, 2012 and 2011.

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2012 and 2011

NOTE I - CAPITAL ASSETS

Capital asset additions, retirements, and balances are as follows:

	2012			
	<u>Beginning balance</u>	<u>Additions/ transfers</u>	<u>Retirements</u>	<u>Ending balance</u>
Land	\$ 790,483	\$ 80,750	\$ -	\$ 871,233
Land improvements	700,648	8,260		708,908
Buildings	11,270,897	703,756		11,974,653
Major movable equipment	<u>6,548,819</u>	<u>911,409</u>	<u>439,629</u>	<u>7,020,599</u>
Totals at historical cost	<u>19,310,847</u>	<u>1,704,175</u>	<u>439,629</u>	<u>20,575,393</u>
Less accumulated depreciation				
Land improvements	262,143	33,562		295,705
Buildings	7,610,608	447,630	(4,825)	8,063,063
Major movable equipment	<u>4,784,372</u>	<u>486,591</u>	<u>437,705</u>	<u>4,833,258</u>
Total accumulated depreciation	<u>12,657,123</u>	<u>967,783</u>	<u>432,880</u>	<u>13,192,026</u>
Less reserve for impaired assets	<u>247,683</u>	<u>-</u>	<u>-</u>	<u>247,683</u>
Construction in progress and planning costs	<u>1,526,155</u>	<u>11,954,094</u>	<u>-</u>	<u>13,480,249</u>
Capital assets, net	<u>\$ 7,932,196</u>	<u>\$12,690,486</u>	<u>\$ 6,749</u>	<u>\$20,615,933</u>

	2011			
	<u>Beginning balance</u>	<u>Additions/ transfers</u>	<u>Retirements</u>	<u>Ending balance</u>
Land	\$ 790,483	\$ -	\$ -	\$ 790,483
Land improvements	742,932	41,712	83,996	700,648
Buildings	11,555,314	153,132	437,549	11,270,897
Major movable equipment	<u>6,245,965</u>	<u>576,464</u>	<u>273,610</u>	<u>6,548,819</u>
Totals at historical cost	<u>19,334,694</u>	<u>771,308</u>	<u>795,155</u>	<u>19,310,847</u>
Less accumulated depreciation				
Land improvements	306,854	30,406	75,117	262,143
Buildings	7,417,642	520,642	327,676	7,610,608
Major movable equipment	<u>4,639,749</u>	<u>413,773</u>	<u>269,150</u>	<u>4,784,372</u>
Total accumulated depreciation	<u>12,364,245</u>	<u>964,821</u>	<u>671,943</u>	<u>12,657,123</u>
Less reserve for impaired assets	<u>-</u>	<u>247,683</u>	<u>-</u>	<u>247,683</u>
Construction in progress and planning costs	<u>443,473</u>	<u>1,082,682</u>	<u>-</u>	<u>1,526,155</u>
Capital assets, net	<u>\$ 7,413,922</u>	<u>\$ 641,486</u>	<u>\$ 123,212</u>	<u>\$ 7,932,196</u>

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2012 and 2011

NOTE I - CAPITAL ASSETS - Continued

Construction in progress and planning costs consist primarily of design, planning, and construction costs for additions to the Hospital's facilities. The total contract commitment for design and construction costs of the facility additions project was \$14,470,961. As of December 31, 2012, the outstanding contract commitment is \$3,138,627. At December 31, 2012, the Hospital has open purchase orders for diagnostic imaging equipment for the new addition in the approximate amount of \$1,500,000.

Most of the Hospital's operations will be moved to the newly constructed addition upon its completion and a renovation of the existing hospital building will commence. In 2011, management determined that the carrying value of the facility and related equipment then in use had been impaired. A provision for impairment of property and equipment loss was recognized in the amount of \$247,683, which represents the estimated reduction in service utility of assets that will be demolished or abandoned when the renovation project begins. The provision for impairment of property and equipment loss is included in operating expenses.

NOTE J - DEFERRED FINANCING COSTS

Deferred financing costs are summarized as follows:

	<u>2012</u>	<u>2011</u>
Hospital District No. 1, Dickinson County, Kansas Lease Agreement Certificates of Participation, Series 2011	\$ 89,718	\$ 88,954
Abilene, Kansas Public Building Commission Revenue Bonds, Series 2011	131,599	116,466
Abilene, Kansas Public Building Commission Revenue Bonds, Series 2012	179,685	2,671
Less accumulated amortization	<u>(35,720)</u>	<u>(2,353)</u>
	<u>\$365,282</u>	<u>\$205,738</u>

NOTE K - DEFERRED REVENUE

Deferred revenue consists of ad valorem taxes levied but not available for expenditure in the current period and payments received in advance of the performance of services.

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2012 and 2011

NOTE L - LONG-TERM DEBT

Long-term debt consists of the following:

	<u>2012</u>	<u>2011</u>
1.50% - 4.40% Hospital District No. 1, Dickinson County, Kansas Lease Agreement Certificates of Participation, Series 2011; issued on December 1, 2011, in the original amount of \$6,000,000; due serially through December 1, 2021, with principal payments beginning on December 1, 2013	\$ 6,000,000	\$ 6,000,000
1.00% - 4.30% Abilene, Kansas Public Building Commission Revenue Bonds, Series 2011; issued on December 1, 2011, in the original amount of \$7,760,000; due serially through December 1, 2028, with principal payments beginning on December 1, 2013	7,760,000	7,760,000
4.45% - 5.03% Abilene, Kansas Public Building Commission Revenue Bonds, Series 2012; issued on January 5, 2012, in the original amount of \$10,000,000; due serially through December 1, 2035, with principal payments beginning on December 1, 2028	10,000,000	
	23,760,000	13,760,000
Less current maturities	710,000	
	<u>\$23,050,000</u>	<u>\$13,760,000</u>

The following is a summary of changes in long-term debt:

Outstanding at January 1, 2011	\$ -
Issuance of long-term debt	<u>13,760,000</u>
Outstanding at December 31, 2011	13,760,000
Issuance of long-term debt	<u>10,000,000</u>
Outstanding at December 31, 2012	<u>\$23,760,000</u>

On December 1, 2011, the Abilene, Kansas Public Building Commission issued \$7,760,000 in Revenue Bonds, Series 2011 (the 2011 PBC bonds) and on January 5, 2012, issued \$10,000,000 in Revenue Bonds, Series 2012 (the 2012 PBC bonds), for the benefit of the Hospital pursuant to a Trust Indenture dated December 1, 2011. On December 1, 2011, the Hospital issued its Lease Agreement Certificates of Participation, Series 2011 (the Certificates),

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2012 and 2011

NOTE L - LONG-TERM DEBT - Continued

pursuant to a Trust Indenture dated December 1, 2011. The Certificates represent proportionate interests of the owners thereof in basic rent payments to be made by the Hospital. The proceeds of the 2011 PBC bonds, the 2012 PBC bonds, and the Certificates (collectively the project debt) will be used, together with other available funds of the Hospital, to (1) pay for renovations and additions to the Hospital's facilities, (2) purchase certain medical equipment, (3) fund a debt service reserve fund for the project debt, (4) pay interest costs during the period of construction, and (5) pay for certain costs related to issuance of the project debt.

The indenture agreement for the project debt requires the Hospital to transfer to a trustee, on a monthly basis, specified amounts which, when combined with interest earned on the respective funds held by the trustee, will provide sufficient funds to pay the project debt principal and interest on the appropriate due dates. These required transfers begin on January 1, 2013. The obligations of the Hospital under the indenture agreement are secured by a pledge of its unrestricted revenues, subject to the right of the Hospital to dispose of or encumber property as defined and permitted in the indenture agreement. The indenture agreement also includes certain restrictive covenants relating to the disposition of property, adequacy of insurance coverage, incurrence of additional indebtedness, the level of days cash on hand, and the level of fees and rates charged. The covenant in the indenture agreement regarding the level of fees and rates charged requires that fees and rates for services be set at levels sufficient for the Hospital to produce income available for debt service in each fiscal year equal to 125 percent of the debt service requirements during that fiscal year for outstanding debt. This covenant and the level of days cash on hand covenant are not in effect until the year ending December 31, 2014.

Scheduled annual debt service requirements on long-term debt are as follows:

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2013	\$ 710,000	\$ 955,589	\$ 1,665,589
2014	720,000	945,464	1,665,464
2015	730,000	932,664	1,662,664
2016	750,000	916,506	1,666,506
2017	770,000	896,451	1,666,451
2018 - 2022	4,245,000	4,071,576	8,316,576
2023 - 2027	5,090,000	3,229,209	8,319,209
2028 - 2032	6,240,000	2,063,699	8,303,699
2033 - 2035	<u>4,505,000</u>	<u>460,039</u>	<u>4,965,039</u>
	<u>\$23,760,000</u>	<u>\$14,471,197</u>	<u>\$38,231,197</u>

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2012 and 2011

NOTE L - LONG-TERM DEBT - Continued

Total interest costs are summarized as follows:

	<u>2012</u>	<u>2011</u>
Total interest incurred	\$ 950,143	\$ 38,796
Amortization of deferred financing costs	<u>33,367</u>	<u>2,353</u>
	983,510	41,149
Less capitalized interest costs	<u>840,172</u>	<u>41,149</u>
Interest expense	<u>\$ 143,338</u>	<u>\$ -</u>

NOTE M - LEASES

The Hospital leases property and equipment under operating lease arrangements. Total lease expense under all operating leases was approximately \$34,000 for 2012 and \$41,000 for 2011.

NOTE N - RISK MANAGEMENT

The Hospital is insured for professional liability under a comprehensive hospital liability policy provided by an independent insurance carrier with limits of \$200,000 per occurrence up to an annual aggregate of \$600,000 for all claims made during the policy year. The Hospital is further covered by the Kansas Health Care Stabilization Fund for claims in excess of its comprehensive hospital liability policy up to \$300,000 pursuant to any one judgment or settlement against the Hospital for any one party, subject to an aggregate limitation for all judgments or settlements arising from all claims made in the policy year in the amount of \$900,000. All coverage is on a claims-made basis. The above policies have been renewed through January 1, 2014. The Hospital intends to renew this coverage on that date and is aware of no reason why such coverage would be denied at that time.

In addition to the risk disclosed elsewhere in these financial statements and notes thereto, the Hospital is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Hospital purchases commercial insurance for these risks.

NOTE O - DEPOSITS WITH FINANCIAL INSTITUTIONS

Kansas statutes authorize the Hospital, with certain restrictions, to deposit or invest in open accounts, time deposits, certificates of deposit, repurchase agreements, the State Treasurer's municipal investment pool, and U.S. Treasury bills and notes. Also, statutes generally require that financial institutions pledge securities with a market value equal to total deposits, except for monies acquired through the receipt of grants, donations, bequests, and gifts, in excess of F.D.I.C. coverage at any given time and the securities pledged be deposited with a Kansas state or national bank or trust company, the Federal Reserve Bank, the Federal Home Loan Bank, or the Kansas State Treasurer.

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2012 and 2011

NOTE O - DEPOSITS WITH FINANCIAL INSTITUTIONS - Continued

The carrying amount of the Hospital's deposits with financial institutions was \$3,727,765 and the bank balances were \$3,877,657 at December 31, 2012. The bank balances are categorized as follows at December 31, 2012:

Amount insured by the F.D.I.C., or collateralized with securities held by the Hospital or by its agent in the Hospital's name	\$ 886,066
Uncollateralized (amount collateralized with securities held in safekeeping by an authorized depository other than the pledging financial institution's trust department, but not in the Hospital's name)	<u>2,991,591</u>
	<u>\$ 3,877,657</u>

NOTE P - CONCENTRATION OF CREDIT RISK

The Hospital grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at December 31, 2012 and 2011, is as follows:

	<u>2012</u>	<u>2011</u>
Medicare	40%	37%
Medicaid	7	7
Blue Cross	10	10
Other third-party payors	14	15
Patients	<u>29</u>	<u>31</u>
	<u>100%</u>	<u>100%</u>

NOTE Q - BUDGETARY COMPARISON

Kansas statutes require that a fixed annual operating budget be legally adopted for the Hospital. All legal annual operating budgets are prepared using the modified accrual basis of accounting, modified further by the encumbrance method of accounting. Revenues are recognized when cash is received. Expenditures include disbursements, accounts payable, and encumbrances. Encumbrances are commitments by the Hospital for future payments and are supported by a document evidencing the commitment, such as a purchase order or contract. All unencumbered appropriations lapse at year-end. Actual expenditures for the year ended December 31, 2012, on the modified accrual basis of accounting and encumbrances were \$36,837,472 as compared to the legally adopted budgeted expenditures of \$52,183,824. Actual expenditures for the year ended December 31, 2011, on the modified accrual basis of accounting and encumbrances were \$23,315,870 as compared to the legally adopted budgeted expenditures of \$48,649,166.

MEMORIAL HOSPITAL OF HOSPITAL DISTRICT #1 OF DICKINSON COUNTY, KANSAS

NOTES TO FINANCIAL STATEMENTS - CONTINUED

December 31, 2012 and 2011

NOTE R - DEFINED BENEFIT PENSION PLAN

The Hospital contributes to the Kansas Public Employees Retirement System (KPERS), a cost-sharing multiple-employer defined benefit pension plan as provided by K.S.A. 74-4901, et seq. KPERS provides retirement benefits, life insurance, disability income benefits, and death benefits. Kansas law establishes and amends benefit provisions. KPERS issues a publicly available financial report that includes financial statements and required supplementary information. That report may be obtained by writing to KPERS, 611 S. Kansas Avenue, Suite 100, Topeka, Kansas 66603-3869 or by calling 1-888-275-5737.

K.S.A. 74-4919 establishes the KPERS member-employee contribution rate at 4.00 percent of covered salary for employees hired prior to July 1, 2009, and 6.00 percent of covered salary for employees hired on or after July 1, 2009. The employer collects and remits member-employee contributions according to the provisions of Section 414(h) of the Internal Revenue Code. State law provides that the employer contribution rate be determined annually based on the results of an annual actuarial valuation. KPERS is funded on an actuarial reserve basis. State law sets a limitation on annual increases in the contribution rates for KPERS employers. The employer rate established by statute for calendar years 2012 and 2011, is 8.34 percent and 7.74 percent, respectively. The Hospital employer contributions to KPERS for the years ended December 31, 2012 and 2011, were \$956,670 and \$834,698, respectively, equal to the statutory required contributions for each year.

NOTE S - INSURANCE RECOVERIES

On June 1, 2011, the Hospital's facilities, vehicles, and certain equipment sustained damage from a hail storm. An impairment loss was recognized for the reduction in service utility from the physical damage to property and equipment. Insurance proceeds recovered or recoverable at December 31, 2011, exceeded the impairment loss. The net gain from impairment of property and equipment is included in nonoperating revenues and expenses and is summarized as follows:

Insurance proceeds recovered or recoverable	\$ 328,151
Impairment loss from physical damage	<u>104,429</u>
Insurance recovery, net of impairment of property and equipment	<u>\$ 223,722</u>