

FINANCIAL STATEMENTS AND REPORT OF  
INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS  
HERINGTON MUNICIPAL HOSPITAL  
JUNE 30, 2012 AND 2011

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HERINGTON MUNICIPAL HOSPITAL  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
Years ended June 30, 2012 and 2011

Our discussion and analysis of the financial performance of Herington Municipal Hospital provides a narrative overview of the Hospital's financial activities for the years ended June 30, 2012 and 2011. Please read it in conjunction with the accompanying financial statements.

Financial highlights

The Hospital reported an operating loss of \$167,290 in 2012, an operating gain of \$88,377 in 2011, and an operating loss of \$265,787 in 2010. After consideration of other nonoperating revenues and expenses and other contributions, grants, transfers, and gains, the Hospital's net assets increased by \$679,136 or 140.2 percent in 2012 and increased by \$211,288 or 77.4 percent in 2011.

Using these financial statements

The Hospital's financial statements consist of three statements - a Balance Sheet; a Statement of Revenues, Expenses, and Changes in Net Assets; and a Statement of Cash Flows. These financial statements and related notes provide information about the activities of the Hospital, and resources held by or for the benefit of the Hospital.

One of the most important questions asked about the Hospital's finances is, "Is the Hospital as a whole better or worse off as a result of the year's activities?" The Balance Sheet and the Statement of Revenues, Expenses, and Changes in Net Assets report information about the Hospital'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. Revenues and expenses are taken into account regardless of when cash is received or paid.

These two statements report the Hospital's net assets and changes in them. The Hospital's net assets - the difference between assets and liabilities may be thought of as one way to measure the financial health, or financial position. Over time, increases or decreases in the Hospital's net assets 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 Hospital'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 Hospital.

The final required statement is the Statement of Cash Flows. The statement reports cash receipts, cash payments, and net changes in cash resulting from operating, 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 balance during the reporting period?"

HERINGTON MUNICIPAL HOSPITAL  
MANAGEMENT'S DISCUSSION AND ANALYSIS - CONTINUED  
Years ended June 30, 2012 and 2011

Assets, liabilities, and net assets

Table 1 below summarizes the Hospital's assets, liabilities, and net assets for the latest three fiscal years.

Table 1: Assets, Liabilities, and Net Assets

	<u>2012</u>	<u>2011</u>	<u>2010</u>
<b>Assets</b>			
Current assets	\$ 1,267,064	\$ 1,309,361	\$ 1,180,362
Capital assets, net	831,381	787,159	1,533,929
Other noncurrent assets	<u>136,345</u>	<u>127,624</u>	<u>137,712</u>
Total assets	<u>2,234,790</u>	<u>2,224,144</u>	<u>2,852,003</u>
<b>Liabilities</b>			
Current liabilities	878,059	1,083,014	1,161,261
Noncurrent liabilities	<u>193,186</u>	<u>656,721</u>	<u>1,417,621</u>
Total liabilities	<u>1,071,245</u>	<u>1,739,735</u>	<u>2,578,882</u>
<b>Net assets</b>			
Invested in capital assets, net of related debt	598,141	585,065	476,502
Expendable for capital acquisitions		18,654	18,654
Expendable for operating activities	4,902		
Unrestricted (deficit)	<u>560,502</u>	<u>(119,310)</u>	<u>(222,035)</u>
Total net assets	<u>\$ 1,163,545</u>	<u>\$ 484,409</u>	<u>\$ 273,121</u>

Current assets have remained at consistent levels in 2012 as compared to 2011 after increasing somewhat from 2010. The number of days net revenue in net accounts receivable was 47, 53, and 48 days in 2012, 2011, and 2010, respectively. These balances will fluctuate depending on changes in collection personnel, third-party reimbursement rates, and revenue generated in the two months preceding year-end. Being designated as a critical access hospital, the Hospital is reimbursed for its services to Medicare and traditional Medicaid patients on the basis of the cost of providing services. These services are paid on an interim basis based on various formulas with final settlement made through an annual cost report filed after the Hospital's year-end. In 2011 and 2012, the cost report reflected receivables from Medicare and Medicaid. This balance increased by approximately \$100,000 in 2012 as compared to 2011.

HERINGTON MUNICIPAL HOSPITAL  
MANAGEMENT'S DISCUSSION AND ANALYSIS - CONTINUED  
Years ended June 30, 2012 and 2011

The Hospital's capital acquisitions, including assets purchased through capital leases, were \$179,587, \$126,956, and \$60,535 during 2012, 2011, and 2010. These capital assets were primarily financed through donations received from the Herington Municipal Hospital Foundation and others and capital lease obligations. Other changes in net capital assets result from the normal annual depreciation provisions of \$132,523, \$148,174, and \$234,901 during 2012, 2011, and 2010. The Hospital made principal payments on long-term leases and revenue bonds of \$85,034 in 2012, \$85,506 in 2011, and \$180,103 in 2010. In 2011, the Hospital transferred ownership of the Homestead Village and related debt to the City of Herington, which reduced its noncurrent liabilities and capital equipment by \$855,000 and \$743,358, respectively. The bonds were refinanced in the City of Herington's name, which relieved the Hospital of the debt. In 2012, the City of Herington provided a grant of \$325,000 to the Hospital and forgave \$489,000 in long-term debt which enabled the Hospital to decrease current liabilities and long-term debt, and increased net assets. As of June 30, 2012, the Hospital owes the City a total of \$152,540, of which \$20,000 is classified as long-term.

Other noncurrent assets consist primarily of board-designated funds that are available to fund the continuing operation of the Hospital and funds for the Hospital's self-funded portion of its employees' health insurance deductibles. These funds increased by \$8,721 in 2012 and decreased by \$10,088 in 2011, both as compared with the previous year.

Current liabilities consist of balances accrued or currently due to suppliers, vendors, employees, and government agencies, related to operations and accrued interest on indebtedness and principal on indebtedness that will come due within one year. Accrued interest, accrued salaries and benefits, and accrued compensated absences fluctuate with operation and the timing of payments.

In 2011, accounts payable decreased by \$116,919, and the current amount due to the City of Herington increased by \$131,809. In 2012, accounts payable increased by \$144, and the current amount due to the City of Herington decreased by \$216,109.

HERINGTON MUNICIPAL HOSPITAL  
MANAGEMENT'S DISCUSSION AND ANALYSIS - CONTINUED  
Years ended June 30, 2012 and 2011

Operating results and changes in net assets

In 2012, the Hospital's net assets increased by \$679,136 or 140.2 percent. This change is made up of different components as displayed below in Table 2.

Table 2: Operating Results and Changes in Net Assets

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Operating revenues			
Net patient service revenue	\$ 6,049,600	\$ 6,183,270	\$ 6,006,690
Independent living revenue		22,644	184,778
Other operating revenue	<u>115,794</u>	<u>121,670</u>	<u>84,447</u>
Total operating revenues	<u>6,165,394</u>	<u>6,327,584</u>	<u>6,275,915</u>
Operating expenses			
Salaries and wages	3,033,604	3,061,066	2,999,092
Employee benefits	545,345	550,889	480,905
Supplies and other	2,621,212	2,479,078	2,826,804
Depreciation	<u>132,523</u>	<u>148,174</u>	<u>234,901</u>
Total operating expenses	<u>6,332,684</u>	<u>6,239,207</u>	<u>6,541,702</u>
Operating gain (loss)	(167,290)	88,377	(265,787)
Nonoperating expenses net of revenues	(12,997)	(45,007)	(93,373)
Gain on sale of Homestead Village to City		127,865	
Transfers from City and gain on forgiveness of debt to City	814,000		
Capital grants and contributions	<u>45,423</u>	<u>40,053</u>	<u>79,489</u>
Increase (decrease) in net assets	<u>\$ 679,136</u>	<u>\$ 211,288</u>	<u>\$ (279,671)</u>

The first component of the overall change in the Hospital's net assets is its operating gain or loss - generally the difference between net patient service revenue and other operating revenues and the expenses incurred to generate those revenues. In 2012, the Hospital's operating loss was \$167,290, a decrease of \$255,667 from 2011. In 2011, the Hospital's operating gain was \$88,377, an increase of \$354,164 from its operating loss for 2010. The Hospital's net patient service revenue in 2012 decreased \$133,670 or 2.2 percent. In 2011, net patient service revenue increased \$176,580 or 2.9 percent and, in 2010, increased by 5.1 percent over the previous year. The change in net patient service revenue is affected by changes in charges to patients, payment rates by third-party payors, patient volumes, the type of services provided, bad debts, and the change in utilization by third-party payors. The decrease in 2012 was partially due to an overall decrease in patient days. Acute patient days decreased by 7 percent

HERINGTON MUNICIPAL HOSPITAL  
MANAGEMENT'S DISCUSSION AND ANALYSIS - CONTINUED  
Years ended June 30, 2012 and 2011

in 2012 as compared to 2011, and swing-bed days decreased by 13 percent. The increase in 2011 was partially due to an increase in patient utilization. Acute inpatient days increased by 13 percent and swing-bed days increased by 8 percent in 2011 both as compared to 2010.

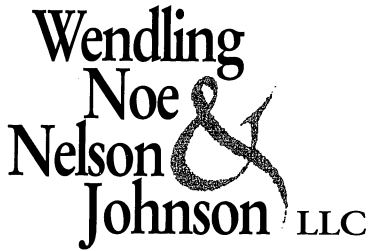
Salaries, wages, and employee benefits totaled \$3,578,949, \$3,611,955, and \$3,479,997 in 2012, 2011, and 2010. These amounts change based on the number of full-time equivalent employees, salary increases, changes to employee benefit cost inflation, and use of contract labor. Supplies and other expenses have also remained relatively consistent from year to year decreasing some in 2011 due to the sale of the independent living apartments and increasing in 2012 due primarily to additional costs associated with ER physician on-call pay and to administrative contract labor for a portion of the year.

Nonoperating revenues (expenses) include interest expense and investment income earned on investments. Interest expense decreased in 2012 and 2011 due primarily to the transfer of the Independent Living Series 1999 revenue bonds to the City.

Other changes in net assets include capital grants and contributions which totaled \$45,423, \$40,053, and \$79,489 in 2012, 2011, and 2010 respectively. In 2012, the Hospital received a grant of \$325,000 from the City, and a forgiveness of debt of \$489,000, which combined, resulted in an increase in net assets of \$814,000. In 2011, the Hospital recognized a gain on the sale of Homestead Village to the City of \$127,865.

Management is focused on stabilizing and growing patient revenues while at the same time controlling expenses necessary in providing those services. This is highly dependent upon recruiting and retaining physician and mid-level providers to our community. We are also closely monitoring our expenses and face many future challenges which include identifying funding for necessary medical technology upgrades, facility maintenance, and electronic health medical record technology. As our Hospital faces these funding challenges, we are also closely monitoring changes in the health care landscape which includes transition of Medicaid to managed care, implementation of insurance coverage mandates by the Affordable Care Act, and reduced payments from Medicare for bad debts and the potential further reduction in payments from not timely installing certified electronic health record technology. We appreciate the support that we have received from our community and employees as we face these challenges and we will continue to focus on strategies to provide essential care to the community we serve.

This financial report is designed to provide a general overview of the Hospital's finances and to discuss the significant changes in our financial statements. If you have any questions about the report or need additional financial information, contact the Administration Office at Herington Municipal Hospital, 100 East Helen, Herington, Kansas 67449.



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REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Trustees  
Herington Municipal Hospital

We have audited the accompanying financial statements of the business-type activity of Herington Municipal Hospital, a component unit of the City of Herington, Kansas, and the discretely presented component unit as of and for the years ended June 30, 2012 and 2011, which collectively comprise the Hospital's financial statements as listed in the table of contents. These financial statements are the responsibility of the Hospital's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the Kansas Municipal Audit Guide. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Hospital's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to previously present fairly, in all material respects, the financial position of the business-type activity and the discretely presented component unit of Herington Municipal Hospital as of June 30, 2012 and 2011, and the results of their operations, changes in net assets, and cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Management's discussion and analysis on pages 1 through 5 is not a required part of the financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

*Wendling Noe Nelson & Johnson LLC*

Topeka, Kansas  
November 5, 2012



FINANCIAL STATEMENTS

HERINGTON MUNICIPAL HOSPITAL

BALANCE SHEETS

June 30,

ASSETS

	2012		2011	
	<u>Hospital</u>	<u>Component unit</u>	<u>Hospital</u>	<u>Component unit</u>
CURRENT ASSETS				
Cash	\$ 43,956	\$ 82,081	\$ 20,599	\$ 50,242
Patient accounts receivable, net	770,184		890,109	
Other receivables			7,533	
Estimated third-party payor settlements	290,000		189,957	
Inventories	123,876		145,505	
Prepaid expenses	39,048		55,658	
Total current assets	<u>1,267,064</u>	<u>82,081</u>	<u>1,309,361</u>	<u>50,242</u>
ASSETS LIMITED AS TO USE				
By Board of Trustees				
For capital assets	120,466		109,249	
For health claims	15,879		18,375	
By donors		10,568		7,992
Total assets limited as to use	<u>136,345</u>	<u>10,568</u>	<u>127,624</u>	<u>7,992</u>
CAPITAL ASSETS, NET	<u>831,381</u>	<u>-</u>	<u>787,159</u>	<u>-</u>
Total assets	<u>\$ 2,234,790</u>	<u>\$ 92,649</u>	<u>\$ 2,224,144</u>	<u>\$ 58,234</u>

The accompanying notes are an integral part of these statements.

# LIABILITIES AND NET ASSETS

	2012		2011	
	<u>Hospital</u>	<u>Component unit</u>	<u>Hospital</u>	<u>Component unit</u>
CURRENT LIABILITIES				
Current portion of long-term debt and capital lease obligations	\$ 78,611	\$ -	\$ 79,110	\$ -
Accounts payable	428,791		428,647	
Accrued salaries, wages, and benefits	136,849		114,443	
Due to City of Herington	132,540		348,649	
Accrued compensated absences	101,268		97,731	
Accrued interest payable			14,434	
Total current liabilities	<u>878,059</u>	<u>-</u>	<u>1,083,014</u>	<u>-</u>
LONG-TERM DEBT AND CAPITAL LEASES, net of current portion				
Capital lease obligations	173,186		147,721	
Due to City of Herington	20,000		509,000	
Total long-term liabilities	<u>193,186</u>	<u>-</u>	<u>656,721</u>	<u>-</u>
Total liabilities	<u>1,071,245</u>	<u>-</u>	<u>1,739,735</u>	<u>-</u>
NET ASSETS				
Invested in capital assets, net of related debt	598,141		585,065	
Expendable for capital acquisitions		10,568	18,654	7,992
Expendable for operating activities	4,902			
Unrestricted (deficit)	<u>560,502</u>	<u>82,081</u>	<u>(119,310)</u>	<u>50,242</u>
Total net assets	<u>1,163,545</u>	<u>92,649</u>	<u>484,409</u>	<u>58,234</u>
Total liabilities and net assets	<u>\$ 2,234,790</u>	<u>\$ 92,649</u>	<u>\$ 2,224,144</u>	<u>\$ 58,234</u>

HERINGTON MUNICIPAL HOSPITAL  
STATEMENTS OF REVENUES, EXPENSES, AND  
CHANGES IN NET ASSETS  
Year ended June 30,

	2012		2011	
	<u>Hospital</u>	<u>Component unit</u>	<u>Hospital</u>	<u>Component unit</u>
Operating revenues				
Net patient service revenue	\$ 6,049,600	\$ -	\$ 6,183,270	\$ -
Independent living			22,644	
Other	<u>115,794</u>	<u>74,460</u>	<u>121,670</u>	<u>47,041</u>
Total operating revenues	<u>6,165,394</u>	<u>74,460</u>	<u>6,327,584</u>	<u>47,041</u>
Operating expenses				
Salaries and wages	3,033,604		3,061,066	
Employee benefits	545,345		550,889	
Supplies and other	2,621,212	40,045	2,479,078	44,863
Depreciation and amortization	<u>132,523</u>		<u>148,174</u>	
Total operating expenses	<u>6,332,684</u>	<u>40,045</u>	<u>6,239,207</u>	<u>44,863</u>
Operating income (loss)	<u>(167,290)</u>	<u>34,415</u>	<u>88,377</u>	<u>2,178</u>
Nonoperating revenues and expenses				
Interest expense	(20,996)		(46,814)	
Contributions	10,485			
Gain (loss) on sale or disposal of equipment	<u>(2,486)</u>		<u>1,807</u>	
Total nonoperating expenses	<u>(12,997)</u>	<u>-</u>	<u>(45,007)</u>	<u>-</u>
Excess of revenues over expenses (expenses over revenues) before capital grants and contributions and transfers	(180,287)	34,415	43,370	2,178
Capital grants and contributions	45,423		40,053	
Grant from City and gain on forgiveness of debt to City	814,000			
Gain on sale of Homestead Village to City			<u>127,865</u>	
Increase in net assets	679,136	34,415	211,288	2,178
Net assets, beginning of year	<u>484,409</u>	<u>58,234</u>	<u>273,121</u>	<u>56,056</u>
Net assets, end of year	<u>\$ 1,163,545</u>	<u>\$ 92,649</u>	<u>\$ 484,409</u>	<u>\$ 58,234</u>

The accompanying notes are an integral part of these statements.

HERINGTON MUNICIPAL HOSPITAL

STATEMENTS OF CASH FLOWS

Year ended June 30,

	2012		2011	
	<u>Hospital</u>	<u>Component unit</u>	<u>Hospital</u>	<u>Component unit</u>
Cash flows from operating activities				
Receipts from and on behalf of patients	\$ 6,069,482	\$ -	\$ 6,108,339	\$ -
Payments to or on behalf of employees	(3,550,510)		(3,577,075)	
Payments for supplies and services	(2,798,938)	(40,045)	(2,527,093)	(45,743)
Other receipts and payments	<u>123,327</u>	<u>74,460</u>	<u>132,498</u>	<u>47,041</u>
Net cash provided (used) by operating activities	<u>(156,639)</u>	<u>34,415</u>	<u>136,669</u>	<u>1,298</u>
Cash flows from noncapital financing activities				
Interest paid	(19,804)		(25,719)	
Noncapital transfers and contributions	<u>335,485</u>			
Net cash provided (used) by noncapital financing activities	<u>315,681</u>	<u>-</u>	<u>(25,719)</u>	<u>-</u>
Cash flows from capital and related financing activities				
Acquisition of capital assets	(69,587)		(47,356)	
Grants and contributions for capital	45,423		40,053	
Principal payments on long-term debt and capital lease obligations	(85,034)		(85,506)	
Interest paid on capital related debt	<u>(15,626)</u>		<u>(17,820)</u>	
Net cash used by capital and related financing activities	<u>(124,824)</u>	<u>-</u>	<u>(110,629)</u>	<u>-</u>
Cash flows from investing activities				
(Increase) decrease in assets limited as to use	(11,217)	(10,568)	10,657	
Proceeds from sale of capital assets	<u>356</u>		<u>1,807</u>	
Net cash provided (used) by investing activities	<u>(10,861)</u>	<u>(10,568)</u>	<u>12,464</u>	<u>-</u>
Increase in cash and cash equivalents	23,357	23,847	12,785	1,298
Cash and cash equivalents at beginning of year	<u>20,599</u>	<u>58,234</u>	<u>7,814</u>	<u>56,936</u>
Cash and cash equivalents at end of year	<u>\$ 43,956</u>	<u>\$ 82,081</u>	<u>\$ 20,599</u>	<u>\$ 58,234</u>

The accompanying notes are an integral part of these statements.

HERINGTON MUNICIPAL HOSPITAL  
STATEMENTS OF CASH FLOWS - CONTINUED  
Year ended June 30,

	2012		2011	
	<u>Hospital</u>	<u>Component unit</u>	<u>Hospital</u>	<u>Component unit</u>
Reconciliation of operating income (loss) to net cash provided by operating activities				
Operating income (loss)	\$ (167,290)	\$ 34,415	\$ 88,377	\$ 2,178
Adjustments to reconcile operating income (loss) to net cash provided by operating activities				
Depreciation	132,523		148,174	
Provision for bad debts	315,298		268,162	
Change in				
Patient accounts receivable	(195,373)		(373,638)	
Inventories	40,735		(25,888)	
Other current assets and assets limited as to use for health claims	7,533		(33,770)	
Accounts payable and accrued expenses	(190,022)		38,707	(880)
Estimated third-party payor settlements	(100,043)		30,545	
Deferred revenue			(4,000)	
Net cash provided (used) by operating activities	<u>\$ (156,639)</u>	<u>\$ 34,415</u>	<u>\$ 136,669</u>	<u>\$ 1,298</u>

Supplemental schedule of noncash investing and financing activities

The Hospital entered into capital lease obligations for equipment totaling \$110,000 in 2012 and \$79,600 in 2011. In 2012, the Hospital received a \$489,000 forgiveness of debt by the City.

The accompanying notes are an integral part of these statements.

HERINGTON MUNICIPAL HOSPITAL  
NOTES TO FINANCIAL STATEMENTS  
June 30, 2012 and 2011

NOTE A - DESCRIPTION OF REPORTING ENTITY AND SUMMARY OF SIGNIFICANT  
ACCOUNTING POLICIES

1. Reporting entity

Herington Municipal Hospital (Hospital), a political subdivision of the State of Kansas, is located in Herington, Kansas, and was organized for the purpose of providing inpatient and outpatient health care services to patients. The Hospital also provided independent living service until August 10, 2010, when it transferred its independent living facility to the City of Herington. The Hospital is governed by a five-member Board of Trustees elected by the voters of the City. The Hospital can sue and be sued, and can buy, sell, or lease real property. Bond issuances must be approved by the City. The Hospital is a discretely presented component unit of the City of Herington, Kansas, for financial statement purposes. The Hospital is licensed as a Critical Access Hospital (CAH) with a bed capacity of 25 beds.

2. Component unit

The financial statements include the financial data of the discretely presented component unit, Herington Municipal Hospital Foundation (Foundation). The component unit is reported separately to emphasize that it is legally separate from the Hospital.

The Foundation is recognized by the Internal Revenue Service as a 501(c)(3) Corporation, incorporated in the State of Kansas on August 7, 2001. The Foundation was originally formed for the purpose of acquiring a long-term care unit. In 2006, the name was changed to Herington Municipal Hospital Foundation. The Foundation was established as a public charitable foundation with the mission of raising funds for the Hospital. The Foundation is administered by a self-perpetuating Board of Directors which is appointed by the Hospital who is the sole member of the Foundation. Separate financial statements of the Foundation are not available.

3. 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.

4. Basis of accounting

The Hospital's financial statements are comprised solely of an enterprise fund that uses proprietary fund accounting. The Hospital utilizes the proprietary fund method of accounting whereby revenue and expenses are recognized on the accrual basis using the economic resources measurement focus. Based on Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, as amended, the Hospital 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.

HERINGTON MUNICIPAL HOSPITAL  
NOTES TO FINANCIAL STATEMENTS - CONTINUED  
June 30, 2012 and 2011

NOTE A - DESCRIPTION OF REPORTING ENTITY AND SUMMARY OF SIGNIFICANT  
ACCOUNTING POLICIES - Continued

5. Cash and cash equivalents

Cash and cash equivalents include all cash and highly liquid debt instruments purchased with a maturity of three months or less, excluding any such amounts included in assets limited as to use.

6. Allowance for uncollectible accounts

The Hospital provides for accounts receivable that could become uncollectible in the future by establishing an allowance to reduce the carrying value of such receivables to their estimated net realizable value. The Hospital estimates this allowance based on the aging of its accounts receivable and its historical collection experience.

7. Inventories

Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method.

8. Assets limited as to use

Assets limited as to use include cash set aside by the Board of Trustees for purchase of capital assets and for payment of partially self-insured health claims, over which the Board retains control and may at its discretion subsequently use for other purposes; and cash restricted as to use by donors.

9. Capital assets

Capital assets (including assets recorded as capital leases) are stated at cost. Depreciation and amortization of capital assets are provided on the straight-line method over the estimated useful lives of the assets. The estimated lives used are substantially in conformity with useful life 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 items or the properties. Gains and losses on disposition of capital assets are included in nonoperating revenues and expenses.

10. Net assets

Net assets of the Hospital are classified in three components. "Net assets 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 expendable net assets" consist of noncapital net assets that must



HERINGTON MUNICIPAL HOSPITAL  
NOTES TO FINANCIAL STATEMENTS - CONTINUED  
June 30, 2012 and 2011

NOTE A - DESCRIPTION OF REPORTING ENTITY AND SUMMARY OF SIGNIFICANT  
ACCOUNTING POLICIES - Continued

be used for a particular purpose, as specified by creditors, grantors, or contributors external to the Hospital. "Unrestricted net assets" are remaining net assets that do not meet the definition of "invested in capital assets net of related debt" or "restricted expendable net assets."

11. Net patient service revenue

Net patient service revenue is reported at established charges with deductions for discounts, charity care, contractual adjustments, and provision for bad debts, 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.

12. 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. The identified amount of charges foregone for services and supplies furnished under the Hospital's charity care policy is disclosed in Note B.

13. Income taxes

The Hospital is exempt from federal income taxes pursuant to Section 115 of the Internal Revenue Code.

14. Subsequent events

The Hospital's management has evaluated all subsequent events through the date of the independent accountants' report, which is the date the financial statements were available to be issued.

15. Reclassifications and restatements

Certain reclassifications have been made to the 2011 financial statements to conform with the 2012 presentation. The reclassifications had no impact on previously reported net assets and the change in net assets.

HERINGTON MUNICIPAL HOSPITAL  
NOTES TO FINANCIAL STATEMENTS - CONTINUED  
June 30, 2012 and 2011

NOTE B - NET PATIENT SERVICE REVENUE

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 balance sheet 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 and is paid for services rendered to Medicare beneficiaries under various cost reimbursement methodologies. The Hospital is paid for cost reimbursable items at a tentative rate 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 June 30, 2010.

Medicaid - Inpatient and outpatient services rendered to traditional Medicaid beneficiaries are paid under a cost reimbursement methodology that is similar to the Medicare program. All other Hospital services rendered to Medicaid beneficiaries are paid at prospective rates determined on a rate per discharge, a per diem, or a fee-for-service basis. The Hospital's Medicaid cost reports have been audited or reviewed by the Kansas Department of Health and Environment through June 30, 2009.

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 case rates and discounts from established charges.

A summary of gross and net patient service revenue follows:

	<u>2012</u>	<u>2011</u>
Gross patient service revenue	\$ 8,456,967	\$ 8,584,268
Contractual adjustments	(1,981,703)	(1,992,629)
Discounts	(64,131)	(97,636)
Charity care	(46,235)	(42,571)
Provision for bad debts	<u>(315,298)</u>	<u>(268,162)</u>
Net patient service revenue	<u>\$ 6,049,600</u>	<u>\$ 6,183,270</u>

Revenue from the Medicare and Medicaid programs accounted for approximately 65 percent and 3 percent, respectively, of the Hospital's net patient service revenue during 2012, and 63 percent and 4 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.

HERINGTON MUNICIPAL HOSPITAL  
NOTES TO FINANCIAL STATEMENTS - CONTINUED  
June 30, 2012 and 2011

NOTE B - NET PATIENT SERVICE REVENUE - Continued

The Hospital maintains records to identify and monitor the level of charity care it provides. The amount of charges forgone for services and supplies furnished under its charity care policy for 2012 and 2011 was \$46,235 and \$42,571, respectively. The Hospital estimates that the cost of providing charity care, based on an overall ratio of cost-to-charges, was \$36,621 and \$30,941, respectively.

NOTE C - 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, U.S. Treasury bills and notes, and the State Treasurer's investment pool. Kansas statutes also require that collateral be pledged and deposited with designated depositories for bank deposits with a fair market value equal to 100 percent of the uninsured amounts, and must be assigned for the benefit of the Hospital.

At June 30, 2012, the carrying amount of the Hospital's bank deposits was \$180,081 and the bank balances were \$259,993. The bank balances are covered by federal depository insurance or pledged securities which are held in the name of the financial institution and pledged on behalf of the Hospital.

The Hospital's bank deposits are included in the financial statements under the following categories:

Cash	\$ 43,736
Assets limited as to use	<u>136,345</u>
Total bank deposits	<u>\$ 180,081</u>

NOTE D - PATIENT ACCOUNTS RECEIVABLE

Patient accounts receivable consist of the following:

	<u>2012</u>	<u>2011</u>
Patient accounts receivable	\$ 1,426,403	\$ 1,568,158
Less		
Allowance for contractual adjustments	(225,598)	(238,690)
Allowance for uncollectible accounts	<u>(430,621)</u>	<u>(439,359)</u>
	<u>\$ 770,184</u>	<u>\$ 890,109</u>

NOTE E - ASSETS LIMITED AS TO USE

Assets limited as to use, held by the Hospital and the Foundation, are carried at fair value and consist of cash.

HERINGTON MUNICIPAL HOSPITAL  
NOTES TO FINANCIAL STATEMENTS - CONTINUED  
June 30, 2012 and 2011

NOTE F - CAPITAL ASSETS

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

	2012			
	<u>Beginning balance</u>	<u>Additions</u>	<u>Retirements</u>	<u>Ending balance</u>
Land	\$ 26,813	\$ -	\$ -	\$ 26,813
Land improvements	49,603			49,603
Buildings	1,587,989	8,750		1,596,739
Fixed equipment	1,087,926	60,103		1,148,029
Movable equipment	<u>2,038,422</u>	<u>110,733</u>	<u>6,495</u>	<u>2,142,660</u>
Totals at historical cost	<u>4,790,753</u>	<u>179,586</u>	<u>6,495</u>	<u>4,963,844</u>
Less accumulated depreciation				
Land improvements	49,067	536		49,603
Buildings	1,237,132	25,598		1,262,730
Fixed equipment	931,827	17,904		949,731
Movable equipment	<u>1,785,568</u>	<u>88,485</u>	<u>3,654</u>	<u>1,870,399</u>
	<u>4,003,594</u>	<u>132,523</u>	<u>3,654</u>	<u>4,132,463</u>
Capital assets, net	<u>\$ 787,159</u>	<u>\$ 47,063</u>	<u>\$ 2,841</u>	<u>\$ 831,381</u>

	2011			
	<u>Beginning balance</u>	<u>Additions</u>	<u>Retirements</u>	<u>Ending balance</u>
Land	\$ 26,813	\$ -	\$ -	\$ 26,813
Land improvements	81,141		31,538	49,603
Buildings	2,311,733	15,051	738,795	1,587,989
Fixed equipment	1,583,724	87,817	583,615	1,087,926
Movable equipment	<u>2,018,408</u>	<u>24,088</u>	<u>4,074</u>	<u>2,038,422</u>
Totals at historical cost	<u>6,021,819</u>	<u>126,956</u>	<u>1,358,022</u>	<u>4,790,753</u>
Less accumulated depreciation				
Land improvements	77,316	3,224	31,473	49,067
Buildings	1,404,352	30,288	197,508	1,237,132
Fixed equipment	1,315,978	16,434	400,585	931,827
Movable equipment	<u>1,690,244</u>	<u>98,228</u>	<u>2,904</u>	<u>1,785,568</u>
	<u>4,487,890</u>	<u>148,174</u>	<u>632,470</u>	<u>4,003,594</u>
Capital assets, net	<u>\$ 1,533,929</u>	<u>\$ (21,218)</u>	<u>\$ 725,552</u>	<u>\$ 787,159</u>

HERINGTON MUNICIPAL HOSPITAL  
NOTES TO FINANCIAL STATEMENTS - CONTINUED  
June 30, 2012 and 2011

NOTE F - CAPITAL ASSETS - Continued

Capital assets include the following property under capital leases at June 30:

	<u>2012</u>	<u>2011</u>
Equipment	\$ 399,050	\$ 568,177
Less accumulated amortization	<u>127,848</u>	<u>346,532</u>
	<u>\$ 271,202</u>	<u>\$ 221,645</u>

NOTE G - LONG-TERM DEBT AND CAPITAL LEASES

Long-term debt and capital lease obligations are summarized as follows:

	<u>2012</u>	<u>2011</u>
Noninterest bearing loan from the City of Herington	\$ 20,000	\$ 509,000
Capital lease obligations	<u>251,797</u>	<u>226,831</u>
	271,797	735,831
Less current portion	<u>78,611</u>	<u>79,110</u>
Noncurrent portion	<u>\$ 193,186</u>	<u>\$ 656,721</u>

The City of Herington loaned the Hospital \$489,000 during the fiscal year ended June 30, 2010, to help pay current obligations of the Hospital. The City loaned an additional \$20,000 to the Hospital during the fiscal year ended June 30, 2011. In 2012, the City forgave the \$489,000 portion of the total outstanding debt. As of June 30, 2012, the Hospital owes the City for the remaining \$20,000, which is classified as long-term.

Long-term debt activity for the years ended June 30, is as follows:

	<u>2012</u>					
	<u>Beginning balance</u>	<u>Additions</u>	<u>Deletions</u>	<u>Ending balance</u>	<u>Amounts due within one year</u>	<u>Long-term portion</u>
Loan from City of Herington	\$ 509,000	\$ -	\$ (489,000)	\$ 20,000	\$ -	\$ 20,000
Capital leases	<u>226,831</u>	<u>110,000</u>	<u>(85,034)</u>	<u>251,797</u>	<u>78,611</u>	<u>173,186</u>
	<u>\$ 735,831</u>	<u>\$ 110,000</u>	<u>\$ (574,034)</u>	<u>\$ 271,797</u>	<u>\$ 78,611</u>	<u>\$ 193,186</u>

HERINGTON MUNICIPAL HOSPITAL  
NOTES TO FINANCIAL STATEMENTS - CONTINUED  
June 30, 2012 and 2011

NOTE G - LONG-TERM DEBT AND CAPITAL LEASES - Continued

	2011					
	<u>Beginning balance</u>	<u>Additions</u>	<u>Deletions</u>	<u>Ending balance</u>	<u>Amounts due within one year</u>	<u>Long-term portion</u>
1999 revenue						
bonds payable	\$ 855,000	\$ -	\$ (855,000)	\$ -	\$ -	\$ -
Loan from City						
of Herington	489,000	20,000		509,000		509,000
Capital leases	<u>232,737</u>	<u>79,600</u>	<u>(85,506)</u>	<u>226,831</u>	<u>79,110</u>	<u>147,721</u>
	<u>\$ 1,576,737</u>	<u>\$ 99,600</u>	<u>\$ (940,506)</u>	<u>\$ 735,831</u>	<u>\$ 79,110</u>	<u>\$ 656,721</u>

The following is a yearly schedule of future minimum lease payments under capital lease obligations at June 30, 2012:

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2013	\$ 78,611	\$ 13,201	\$ 91,812
2014	74,106	7,676	81,782
2015	43,113	3,906	47,019
2016	39,434	1,820	41,254
2017	<u>16,533</u>	<u>340</u>	<u>16,873</u>
Total minimum lease payments	<u>\$ 251,797</u>	<u>\$ 26,943</u>	<u>\$ 278,740</u>

The loan from the City of Herington has no scheduled repayment terms and is based on the Hospital's ability to repay.

Total interest costs are summarized as follows:

	<u>2012</u>	<u>2011</u>
Interest expense	<u>\$ 20,996</u>	<u>\$ 46,814</u>

NOTE H - PENSION PLAN

The Hospital maintains a defined contributory pension plan for all eligible employees. Eligibility is established by all employees 21 years of age or older who have completed 1,000 hours of service for the year. Employer and employee contributions are computed at the rate of 3.5 percent of annual employee compensation, respectively. Past service cost is funded on an installment basis over the estimated duration of employment from the effective date of the plan (July 1, 1982) to the employee's normal retirement date. Contributions to the plan made by employees vest immediately and contributions to the plan made by the Hospital vest based upon the plan's

HERINGTON MUNICIPAL HOSPITAL  
NOTES TO FINANCIAL STATEMENTS - CONTINUED  
June 30, 2012 and 2011

NOTE H - PENSION PLAN - Continued

vesting schedule with all employer contributions fully vested after five years of service. The total cost of the plan for the years ended June 30, 2012 and 2011, was \$68,974 and \$99,569, respectively. The Hospital applied forfeiture credits of \$19,343 towards the 2012 employer's pension contributions. All funds contributed by the Hospital for terminated employees who are not vested are maintained by the pension trustee.

NOTE I - 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 patient accounts receivable from patients and third-party payors is summarized as follows:

	<u>2012</u>	<u>2011</u>
Medicare	31%	32%
Medicaid	4	7
Blue Cross	8	6
Commercial	12	16
Self-pay	<u>45</u>	<u>39</u>
	<u>100%</u>	<u>100%</u>

NOTE J - 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 were renewed for the policy period from June 30, 2012 to June 30, 2013. There are known claims and incidents that have been asserted. These claims have been referred to the Hospital's professional liability insurance carrier and are in various stages of processing. It is the opinion of management that losses, if any, will be covered by insurance subject to normal policy deductible limits. It is also possible that other claims may be asserted arising from past services provided.

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. Settled claims have not exceeded this commercial coverage in any of the past three years.

HERINGTON MUNICIPAL HOSPITAL  
NOTES TO FINANCIAL STATEMENTS - CONTINUED  
June 30, 2012 and 2011

NOTE K - CONTINGENCY

Effective January 1, 2011, the Hospital established a Health Reimbursement Account (HRA) as defined in Internal Revenue Code Section 105 for purposes of providing reimbursement for eligible medical expenses incurred by participants and/or covered dependents. Under the plan, the employee is responsible for the first \$1,500, and the employee, and the Hospital shares equally the next \$3,500 of covered costs. Costs in excess of \$5,000 are insured by a third-party insurer. The Hospital's Board of Trustees has designated cash, which it believes is adequate to fund its costs under the terms of the plan.

NOTE L - RELATED PARTY TRANSACTIONS

During the years ended June 30, 2012 and 2011, the Hospital purchased utilities of \$135,661 and \$149,285, respectively, including late charges, from the City of Herington. During the year ended June 30, 2012, the City granted \$325,000 to the Hospital and forgave \$489,000 in long-term debt owed to the City by the Hospital. As of June 30, 2012, the Hospital owes the City a total of \$152,540, with \$132,540 reflected on the balance sheet as a current liability due to the City of Herington and \$20,000 reflected as long-term debt.

Herington Municipal Hospital Foundation is a component unit of the Hospital (see Note A2). The Foundation periodically transfers funds to the Hospital to support the Hospital's mission. During 2012 and 2011, the Foundation transferred \$37,424 and \$41,395, respectively, to the Hospital for the purchase of equipment and capital improvements to the building.

NOTE M - REALIZATION OF ASSETS

The Hospital had 10 days cash on hand at June 30, 2012, and has operated with low cash liquidity over the past several years. The Hospital's operations also reported a loss of \$167,290 in 2012 after reporting a gain of \$88,377 in 2011. Net assets improved to \$1,163,545 in 2012 due primarily to transfers from the City and forgiveness of debt by the City as discussed in Note L.

Current economic conditions and changes in the regulatory landscape presents health care providers with difficult challenges. These challenges can affect the fair value of assets and provide additional constraints on liquidity primarily in the collection of receivables.

Management has taken actions to improve its balance sheet and to stabilize operations and cash flows. Management has also been exploring opportunities to grow annual community support. Management believes its actions will enable it to generate sufficient cash flows in the upcoming year to sustain operations.