

Portage Health and Subsidiaries

**Consolidated Financial Report
with Additional Information
June 30, 2010**

Portage Health and Subsidiaries

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Independent Auditor's Report

To the Board of Directors
Portage Health and Subsidiaries

We have audited the accompanying consolidated balance sheet of Portage Health and Subsidiaries (the "Organization") as of June 30, 2010 and 2009 and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the financial statements of wholly owned subsidiaries, Copper Country Apothecaries, Inc., Portage Health Resources, Inc., and Portage Health Home Services, Inc., whose statements reflect total assets of \$3,316,511 and \$2,830,830, and total revenue of \$10,928,765 and \$10,441,830 as of and for the years ended June 30, 2010 and 2009, respectively. Those statements were audited by other auditors whose reports have been furnished to us and our opinion, insofar as it relates to the amounts included for Copper Country Apothecaries, Inc., Portage Health Resources, Inc., and Portage Health Home Services, Inc., is based solely on the reports of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 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 and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the reports of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Portage Health and Subsidiaries at June 30, 2010 and 2009 and the results of their operations and cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Plante & Moran, PLLC

November 10, 2010

Portage Health and Subsidiaries

Consolidated Balance Sheet

	<u>June 30, 2010</u>	<u>June 30, 2009</u> (as restated)
Assets		
Current Assets		
Cash and cash equivalents	\$ 16,966,393	\$ 13,434,031
Accounts receivable (Note 2)	7,972,748	6,713,155
Estimated third-party payor settlements (Note 3)	1,025,696	606,173
Prepaid expenses and other	<u>2,170,473</u>	<u>2,047,531</u>
Total current assets	28,135,310	22,800,890
Assets Limited as to Use (Note 5)	14,469,152	13,096,971
Property and Equipment - Net (Note 6)	42,382,483	44,042,306
Other Assets		
Investments in joint ventures (Note 12)	668,562	711,497
Bond issue costs	<u>359,075</u>	<u>380,301</u>
Total assets	<u>\$ 86,014,582</u>	<u>\$ 81,031,965</u>
Liabilities and Net Assets		
Current Liabilities		
Current portion of long-term debt (Note 7)	\$ 1,365,000	\$ 1,320,000
Accounts payable	2,605,699	2,074,852
Estimated third-party payor settlements (Note 3)	1,010,984	879,078
Accrued liabilities and other	<u>3,279,639</u>	<u>3,143,415</u>
Total current liabilities	8,261,322	7,417,345
Long-term Debt - Net of current portion (Note 7)	22,869,900	24,235,000
Fair Value of Interest Rate Swap Agreement (Note 7)	<u>2,598,082</u>	<u>1,778,553</u>
Total liabilities	33,729,304	33,430,898
Net Assets - Unrestricted	<u>52,285,278</u>	<u>47,601,067</u>
Total liabilities and net assets	<u>\$ 86,014,582</u>	<u>\$ 81,031,965</u>

Portage Health and Subsidiaries

Consolidated Statement of Operations

	Year Ended	
	June 30, 2010	June 30, 2009 (as restated)
Unrestricted Revenue, Gains, and Other Support		
Net patient service revenue	\$ 73,458,320	\$ 70,128,124
Apothecary retail pharmacy revenue	8,985,275	8,484,350
Other	1,980,500	1,835,247
Total unrestricted revenue, gains, and other support	84,424,095	80,447,721
Expenses		
Salaries and wages	33,713,027	32,415,343
Employee benefits and payroll taxes	10,365,047	9,246,889
Operating supplies and expenses	17,986,507	17,333,616
Professional services and consultant fees	472,102	541,443
Purchased services	7,240,356	6,578,003
Insurance	770,858	929,043
Utilities	1,339,057	1,245,705
Depreciation	4,556,969	4,406,763
Provision for bad debts	1,257,529	1,143,937
Interest expense	1,055,379	1,248,133
Other	3,648,039	3,279,622
Total expenses (Note 11)	82,404,870	78,368,497
Operating Income	2,019,225	2,079,224
Other Income (Expenses)		
Interest income (Note 5)	711,688	784,998
Equity in losses of unconsolidated investees (Note 12)	(239,598)	(188,721)
Realized gain (loss) on sale of investments (Note 5)	2,539,942	(320,823)
Other (expense) income	(30,020)	66,081
Change in unrealized investment gain (loss) (Note 5)	452,664	(545,212)
Change in fair value of interest swap agreements (Note 7)	(819,529)	(1,267,968)
Rent income	180,948	172,656
Other expense	(131,109)	(81,606)
Total other income (expenses)	2,664,986	(1,380,595)
Excess of Revenue Over Expenses	\$ 4,684,211	\$ 698,629

Portage Health and Subsidiaries

Consolidated Statement of Changes in Net Assets

	Year Ended June 30	
	2010	2009
		(as restated)
Net Assets - Beginning of year	\$ 47,601,067	\$ 46,902,438
Excess of Revenue Over Expenses	<u>4,684,211</u>	698,629
Net Assets - End of year	<u>\$ 52,285,278</u>	\$ 47,601,067

Portage Health and Subsidiaries

Consolidated Statement of Cash Flows

	Year Ended	
	June 30, 2010	June 30, 2009 (as restated)
Cash Flows from Operating Activities		
Cash received from patients and third-party payors	\$ 73,168,639	\$ 74,528,853
Cash paid to suppliers and employees	(77,505,922)	(73,193,473)
Interest and dividends received	711,688	784,998
Interest paid	(1,034,153)	(1,226,907)
Other receipts from operations	10,790,536	10,503,696
Net cash provided by operating activities (Note 10)	6,130,788	11,397,167
Cash Flows from Investing Activities		
Purchase of property and equipment	(2,898,751)	(3,203,262)
Purchase of investments	(2,320,893)	(4,744,093)
Proceeds from sales and maturities of investments	3,941,318	1,275,000
Net cash used in investing activities	(1,278,326)	(6,672,355)
Cash Flows from Financing Activities - Principal payments on debt obligations	(1,320,100)	(1,275,000)
Net Increase in Cash and Cash Equivalents	3,532,362	3,449,812
Cash and Cash Equivalents - Beginning of year	13,434,031	9,984,219
Cash and Cash Equivalents - End of year	<u>\$ 16,966,393</u>	<u>\$ 13,434,031</u>

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note I - Nature of Business and Significant Accounting Policies

Reporting Entity - Portage Health (the "Hospital") and Subsidiaries (together, the "Organization") provides inpatient, outpatient, and long-term care services primarily to the citizens of the northwest region of Michigan's Upper Peninsula. Admitting physicians are primarily practitioners in the local area. The Hospital is responsible for the overall direction of its subsidiaries. Each subsidiary operates independently with its own board of directors and management. Each of the subsidiaries is described below:

- Copper Country Apothecaries, Inc. (CCA), a Michigan for-profit corporation, operates a retail pharmacy for the sale of pharmaceuticals to residents of the surrounding area.
- Portage Health Resources, Inc. (PHR), a Michigan not-for-profit corporation, distributes a variety of meals to homebound residents in the local area.
- Portage Health Foundation (the "Foundation"), a Michigan not-for-profit corporation, was organized to provide fundraising activities for the benefit of Portage Health.
- Portage Health Home Services, Inc. (Home Services), a Michigan not-for-profit corporation, provides private-duty care to residents of the surrounding area.

Principles of Consolidation - The accompanying consolidated financial statements include the accounts of Portage Health and its subsidiaries. Intercompany transactions and balances have been eliminated in consolidation.

Use of Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents - Cash and cash equivalents include cash and investments in highly liquid investments purchased with an original maturity of three months or less, excluding those amounts included in assets limited as to use.

The Hospital and its subsidiaries maintain cash and investment balances at several financial institutions located in northern Michigan. At June 30, 2010 and 2009, accounts at each institution are insured by the Federal Deposit Insurance Corporation up to \$250,000 or 100 percent for qualifying institutions. As of June 30, 2010 and 2009, the uninsured cash balance was \$1,526,559 and \$415,537, respectively.

As of July 1, 2010, the Federal Deposit Insurance Corporation coverage significantly declined due to the opt-out provisions in the Transaction Account Guarantee Program.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note I - Nature of Business and Significant Accounting Policies (Continued)

Investments - Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the consolidated balance sheet. Investment income or loss, including realized and unrealized gains and losses on investments, interest, and dividends, is included in nonoperating income unless the income or loss is restricted by donor or law.

Substantially all of the Organization's investment portfolio is comprised of trading securities, with unrealized gains and losses included in excess of revenue over (under) expenses.

Investments - Equity Method - Investments in companies in which the Hospital has a 20 percent to 50 percent interest are carried at cost, adjusted for the Hospital's proportionate share of its undistributed earnings or losses.

Assets Limited as to Use - Assets limited as to use include assets designated by the board of directors for future capital improvement, over which the board retains control, and may, at its discretion, subsequently use for other purposes and assets held by trustee under bond indentures and other arrangements.

Risks and Uncertainties - The Organization invests in various investment securities. Investment securities are exposed to various risks such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the consolidated balance sheet.

Property and Equipment - Property and equipment acquisitions are recorded at cost. Donated property and equipment are recorded at the estimated fair market value at the time of donation. Depreciation is computed on the straight-line basis over the estimated useful lives of the assets. Costs of maintenance and repairs are charged to expense when incurred.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note I - Nature of Business and Significant Accounting Policies (Continued)

Contributions - The Organization reports gifts of cash and other assets as restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statement of changes in net assets as net assets released from restriction. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying consolidated financial statements.

The Organization reports gifts of property and equipment as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, the Organization reports the expiration of donor restrictions when the assets are placed in service.

Bond Issuance Costs - Bond issuance costs were incurred by the Hospital in connection with obtaining the Series 2006 bonds. These costs are amortized over the term of the related debt.

Professional and Other Liability Insurance - The Organization accrues an estimate of the ultimate expense, including litigation and settlement expense, for incidents of potential improper professional services and other liability claims occurring during the year as well as for those claims that have not been reported at year end (see Note 9).

Interest Rate Swap - The Hospital entered into an interest rate swap transaction to reduce economic risks associated with variability in cash outflows for interest required under provisions of variable rate revenue bonds. Interest rate swaps are recognized as assets or liabilities at fair value. Realized gains and losses on interest rate swaps are classified as a component of income from operations and are presented as part of interest expense in the consolidated statement of changes in net assets. Unrealized changes in the fair value of the interest rate swap are recognized as part of other income, separate from income from operations.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note I - Nature of Business and Significant Accounting Policies (Continued)

Net Patient Service Revenue - The Organization has agreements with third-party payors that provide for payments to the Organization at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactively calculated adjustments arising under reimbursement agreements with third-party payors are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods, as final settlements are determined.

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. Management believes that it is in compliance with all applicable laws and regulations. Final determination of compliance with such laws and regulations is subject to future government review and interpretation. Violations may result in significant regulatory action including fines, penalties, and exclusions from the Medicare and Medicaid programs.

Excess of Revenue Over Expenses - The consolidated statement of operations includes excess of revenue over expenses. Changes in unrestricted net assets, which are excluded from excess of revenue over expenses, consistent with industry practice, include permanent transfers of assets to and from affiliates for other than goods and services.

Charity Care - The Organization provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than established rates. Because the Organization does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. Charity care totaled approximately \$900,000 and \$1,252,000 for the years ended June 30, 2010 and 2009, respectively.

Tax Status - The Organization is a nonprofit organization under Section 501(c)(3) of the Internal Revenue Code and is not subject to income tax. CCA is the only entity subject to income taxes; therefore, any tax provisions reflected in the consolidated financial statements are associated with this company.

Subsequent Events - The consolidated financial statements and related disclosures include evaluation of events up through and including November 10, 2010, which is the date the consolidated financial statements were available to be issued.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note 1 - Nature of Business and Significant Accounting Policies (Continued)

Fair Value of Financial Instruments - The fair value of financial instruments, including cash, accounts receivable, accounts payable, and debt, approximates carrying values. Investments are recorded at fair value under generally accepted accounting principles. The fair value of debt approximates carrying value because of the variable rate nature of the instrument. The interest rate swap is recorded at fair value on the Hospital's consolidated balance sheet.

Note 2 - Accounts Receivable

The details of patient accounts receivable are set forth below:

	2010	2009
Patient accounts receivable	\$ 13,276,178	\$ 13,003,185
Less:		
Allowance for uncollectible accounts	(1,493,977)	(1,325,127)
Allowance for contractual adjustments	(4,854,539)	(5,876,395)
Net patient accounts receivable	6,927,662	5,801,663
Other	1,045,086	911,492
Total accounts receivable	\$ 7,972,748	\$ 6,713,155

Accounts receivable for patients, insurance companies, and governmental agencies are based on gross charges. An allowance for uncollectible accounts is established on an aggregate basis by using historical loss rate factors applied to unpaid accounts based on aging. Loss rate factors are based on historical loss experience adjusted for economic conditions and other trends affecting the Hospital's ability to collect outstanding amounts. Uncollectible amounts are written off against the allowance for uncollectible accounts in the period they are deemed to be uncollectible. The allowance for contractual adjustments and interim payment advances is based on expected payment rates from payors based on current reimbursement methodologies. This amount also included amounts received as interim payments against unpaid claims by certain payors.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note 2 - Accounts Receivable (Continued)

The Hospital grants credit without collateral to patients, most of whom are local residents and are insured under third-party payor agreements. The composition of receivables from patients and third-party payors was as follows:

	Percentage	
	2010	2009
Medicare	20	20
Blue Cross/Blue Shield of Michigan	12	20
Medicaid	13	17
Commercial insurance and HMOs	33	15
Self-pay	22	28
Total	100	100

Note 3 - Cost Report Settlements

The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. Approximately 76.9 percent of the Hospital's net patient service revenue is received from the Medicare, Medicaid, and Blue Cross/Blue Shield of Michigan programs. A summary of the basis of reimbursement is as follows:

- **Medicare** - Inpatient, acute-care services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system based on clinical, diagnostic, and other factors. Most outpatient services, including ambulatory surgery, outpatient radiology, and other diagnostic-related services, are reimbursed on a prospectively determined ambulatory payment classification system. Physical therapy, outpatient laboratory, and physician services are reimbursed on a fee-for-service methodology.
- **Medicaid** - Inpatient, acute-care services rendered to Medicaid program beneficiaries are also paid at prospectively determined rates per discharge. Capital costs relating to Medicaid patients are paid on a cost-reimbursement method. Outpatient and physician services are reimbursed on an established fee-for-service methodology. Long-term care services are reimbursed at established per diem rates plus the cost for allowable ancillary services.
- **Blue Cross/Blue Shield of Michigan** - Services rendered to Blue Cross/Blue Shield of Michigan subscribers are reimbursed as a percent of charges subject to a limitation on the annual rate of increase.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note 3 - Cost Report Settlements (Continued)

Cost report settlements result from the adjustment of interim payments to final reimbursement under these programs that are subject to audit by fiscal intermediaries. Although these audits may result in some changes in these amounts, they are not expected to have a material effect on the accompanying consolidated financial statements.

The Medicare program has initiated a recovery audit contractor (RAC) initiative, whereby claims subsequent to October 1, 2007 will be reviewed by contractors for validity, accuracy, and proper documentation. A demonstration project completed in several other states resulted in the identification of potential significant overpayments. The RAC program began for Michigan hospitals in 2009. The Hospital has been selected for audit, but is unable to determine the extent of liability for overpayments, if any.

Note 4 - Fair Value

Accounting standards require certain assets and liabilities be reported at fair value in the financial statements and provide a framework for measuring that fair value. The framework for determining fair value is based on a hierarchy that prioritizes the valuation techniques and inputs used to measure fair value.

In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities that the Organization has the ability to access.

Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs are unobservable inputs, including inputs that are available in situations where there is little, if any, market activity for the related asset. These Level 3 fair value measurements are based primarily on management's own estimates using pricing models, discounted cash flow methodologies, or similar techniques taking into account the characteristics of the asset.

In instances where inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Organization's assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset or liability.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note 4 - Fair Value (Continued)

Assets and Liabilities Measured at Fair Value on a Recurring Basis at June 30, 2010

	Balance at June 30, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Cash and cash equivalents	\$ 3,711,639	\$ 3,711,639	\$ -	\$ -
Mutual funds	916,309	916,309	-	-
U.S. government securities	226,859	-	226,859	-
Investment certificates	1,153,880	1,153,880	-	-
Corporate bonds	3,172,298	-	3,172,298	-
Common stocks	4,303,487	4,303,487	-	-
Mortgage- and asset-backed securities	866,501	-	866,501	-
Other	118,179	-	118,179	-
Assets Limited as to Use	\$ 14,469,152	\$ 10,085,315	\$ 4,384,837	\$ -
Liabilities - Interest rate swap	\$ 2,598,082	\$ -	\$ 2,598,082	\$ -

Assets and Liabilities Measured at Fair Value on a Recurring Basis at June 30, 2009

	Balance at June 30, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Cash and cash equivalents	\$ 3,024,828	\$ 3,024,828	\$ -	\$ -
Mutual funds	771,833	771,833	-	-
U.S. government securities	1,004,097	-	1,004,097	-
Investment certificates	1,779,866	1,779,866	-	-
Corporate bonds	1,855,179	-	1,855,179	-
Common stocks	3,932,833	3,932,833	-	-
Mortgage- and asset-backed securities	574,284	-	574,284	-
Other	154,051	-	154,051	-
Assets Limited as to Use	\$ 13,096,971	\$ 9,509,360	\$ 3,587,611	\$ -
Liabilities - Interest rate swap	\$ 1,778,553	\$ -	\$ 1,778,553	\$ -

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note 5 - Assets Limited as to Use

The composition of assets limited as to use at June 30, 2010 and 2009 is set forth in the following tables. Investments are stated at fair value.

	2010	2009
Purpose:		
Designated by Hospital board of directors for future use and capital improvements	\$ 10,370,623	\$ 9,840,469
Mortgage reserve fund - Bonds (Note 7)	2,446,481	1,621,757
Designated by the Foundation board of directors for benefit of the Hospital and its affiliates	1,560,586	1,501,685
Other	91,462	133,060
Total assets limited as to use	<u>\$ 14,469,152</u>	<u>\$ 13,096,971</u>

Assets limited as to use are comprised of the following:

	2010	2009
Cash and cash equivalents	\$ 3,711,639	\$ 3,024,828
Mutual funds	916,309	771,833
U.S. government securities	226,859	1,004,097
Investment certificates	1,153,880	1,779,866
Corporate bonds	3,172,298	1,855,179
Common stocks	4,303,487	3,932,833
Other	984,680	728,335
Total	<u>\$ 14,469,152</u>	<u>\$ 13,096,971</u>

Investment income and realized and unrealized gains (losses) included in increase in unrestricted net assets are comprised of the following for the years ended June 30, 2010 and 2009:

	2010	2009
Income (expense):		
Interest and dividend income	\$ 711,688	\$ 784,998
Realized gains (losses) on investments	2,539,942	(320,823)
Change in unrealized gains (losses) on investments	452,664	(545,212)
Total	<u>\$ 3,704,294</u>	<u>\$ (81,037)</u>

Interest and dividend income includes amounts for dividends from Upper Peninsula Health Plan, Inc., which were \$346,465 and \$180,047 for 2010 and 2009, respectively.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note 5 - Assets Limited as to Use (Continued)

During the fiscal year ended June 30, 2010, the Hospital recognized a gain of \$2,544,298 on the sale of FinCor Holdings, Inc. (FinCor) stock pursuant to the acquisition of FinCor by Medical Professional Mutual Insurance Company. This gain is included in the realized gain (loss) on sale of investments amount above.

Note 6 - Property and Equipment

Cost of property and equipment and depreciable lives are summarized as follows.

	2010	2009	Depreciable Life - Years
Land	\$ 176,339	\$ 176,339	-
Land improvements	1,320,954	1,320,954	10-15
Buildings	53,828,642	51,971,977	7-40
Equipment	27,152,364	26,155,503	3-10
Construction in progress	768,461	881,922	-
Total cost	83,246,760	80,506,695	
Accumulated depreciation	(40,864,277)	(36,464,389)	
Net property and equipment	<u>\$ 42,382,483</u>	<u>\$ 44,042,306</u>	

Construction in progress at year end is comprised of various renovation and remodeling projects to be financed from operations.

Note 7 - Long-term Debt

Long-term debt at June 30, 2010 and 2009 is as follows:

	2010	2009
Variable rate demand revenue refunding bonds, Series 2006	\$ 24,234,900	\$ 25,555,000
Less current portion	<u>1,365,000</u>	<u>1,320,000</u>
Long-term portion	<u>\$ 22,869,900</u>	<u>\$ 24,235,000</u>

Variable Rate Demand Revenue Refunding Bonds - Series 2006 were issued on December 20, 2006 and consist of City of Hancock Hospital Finance Authority Variable Rate Demand Revenue Refunding Bonds. The bonds mature on August 1, 2026 and have a variable interest rate established on a weekly basis. The effective interest rate as of June 30, 2010 and 2009 was 0.24 percent and 0.22 percent, respectively.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note 7 - Long-term Debt (Continued)

The bonds are secured by an irrevocable direct-pay letter of credit which expires on December 1, 2011. The bonds are subject to mandatory redemption upon the expiration or termination of the letter of credit unless the existing letter of credit has been extended or an alternate letter of credit has been issued. The letter of credit is secured by gross revenue of the Hospital.

Beginning August 1, 2007, the bonds require annual payments (funded monthly into an escrow account, the Mortgage Reserve Fund - see Note 5) ranging from \$585,000 to \$2,190,000 through August 1, 2026.

The bonds are remarketed on a weekly basis. Should the remarketing agent be unable to remarket the bonds based on its best efforts, these bonds would be "put" back to the bond trustee, who would draw down on the letter of credit to pay down the 2006 bonds. Under the terms of the reimbursement agreement, the Hospital may defer reimbursement of amounts advanced by the bank. Such reimbursement obligations would be considered a term loan with payment due upon expiration of the letter of credit or upon other conditions detailed in the reimbursement agreement.

In conjunction with the issuance of the irrevocable letter of credit and related agreement, the Hospital has agreed to certain quarterly and annual reporting requirements, certain financial covenants, and various other operational covenants, including restrictions on transfers of assets and additional indebtedness.

In addition, to manage the economic risks associated with fluctuations in interest rates, the Hospital has entered into an interest rate swap agreement to reduce the impact of changes in the interest rate on the Series 2006 bonds. At June 30, 2010 and 2009, the notional principal amount of the Hospital's portion of the outstanding interest rate swap was \$24,234,900 and \$25,555,000, respectively, which matures August 1, 2026. Under the terms of the agreement, the Hospital pays the counterparty a fixed rate of 3.438 percent.

Standards require all derivative instruments, such as interest rate swaps, to be recorded on the consolidated balance sheet at estimated fair value. The fair value of the interest rate swap as of June 30, 2010 and 2009 was a liability in the accompanying consolidated balance sheet of \$2,598,082 and \$1,778,553, respectively. Management has recorded the change in the liability as other expense in the consolidated statement of operations.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note 7 - Long-term Debt (Continued)

Minimum principal payments on long-term debt to maturity as of June 30, 2010 are as follows:

2011	\$ 1,365,000
2012	1,410,000
2013	1,170,000
2014	1,215,000
2015	1,250,000
Thereafter	<u>17,824,900</u>
Total	<u>\$ 24,234,900</u>

Note 8 - Pension Plan

The Organization entered into a defined contribution noncontributory pension plan effective January 1, 2007. The plan covers substantially all employees of the Organization who meet the minimum service and age requirements. The plan calls for a base contribution of 5 percent of eligible employee wages and an employer-matching contribution equal to \$.50 for every dollar contributed by employees up to a maximum of 2 percent of eligible compensation. Certain union employees who meet the minimum service and age requirements continue to be covered under the prior defined contribution pension plan. Contributions to this plan are made based on employee earnings of 4 percent up to \$24,000 and 8 percent for amounts over \$24,000. Pension expense included in the consolidated statement of operations was \$1,857,293 and \$1,869,009 in 2010 and 2009, respectively.

As of July 1, 2008, the Organization terminated the 403(b) Annuity Program for employees who are not represented by the Michigan Nurses Association. All accounts maintained under this plan were distributed in accordance with the participants' written elections.

As of November 9, 2008, the Organization terminated the 403(b) Annuity Program for employees who are represented by the Michigan Nurses Association. All accounts maintained under this plan were distributed in accordance with the participants' written elections.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note 9 - Professional Liability Self-insurance

The Hospital is insured against professional liability claims under a claims-made policy, whereby only the claims reported to the insurance carrier during the policy period are covered regardless of when the incident giving rise to the claim occurred. Under the terms of the policy, the Hospital must pay a deductible toward the costs of litigating or settling any asserted claims. The Hospital has accrued \$150,000 for this contingency at June 30, 2010 and 2009. In addition, the Hospital bears the risk of the ultimate costs exceeding the policy limits of \$2,000,000 for individual claims and \$6,000,000 for total claims asserted in the policy year.

Should the claims-made policy not be renewed or replaced with equivalent insurance, claims based on occurrences during the claims-made term, but reported subsequently, will be uninsured.

Note 10 - Cash Flows

A reconciliation of the increase in net assets to net cash from operating activities is as follows:

	2010	2009
Increase in net assets	\$ 4,684,211	\$ 698,629
Adjustments to reconcile increase in net assets to net cash from operating activities:		
Depreciation and amortization	4,578,195	4,427,989
Provision for doubtful accounts	1,257,529	1,143,937
Loss on sale of property and equipment	1,605	26,968
Change in fair value of interest rate swap	819,529	1,267,968
Net realized and unrealized (gain) loss on investments	(2,992,606)	866,035
Loss attributable to joint ventures	239,598	188,721
(Increase) decrease in assets:		
Accounts receivable	(2,713,785)	805,468
Prepaid expenses and other	(122,942)	111,862
Cost report settlements receivable	(419,523)	428,309
Increase in liabilities:		
Accounts payable	530,847	389,610
Accrued liabilities	136,224	162,593
Cost report settlements payable	131,906	879,078
Net cash provided by operating activities	\$ 6,130,788	\$ 11,397,167

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note 11 - Functional Expenses

The Organization provides inpatient, long-term care and outpatient healthcare services primarily to the citizens of the northwest region of Michigan's Upper Peninsula. Expenses related to providing these services for the years ended June 30, 2010 and 2009 are as follows:

	2010	2009
Healthcare services	\$ 69,068,875	\$ 65,838,791
General and administrative	13,179,333	12,429,891
Fundraising	156,662	99,815
Total	<u>\$ 82,404,870</u>	<u>\$ 78,368,497</u>

Note 12 - Investments in Joint Ventures

The Hospital has a 50 percent interest in both Mercy EMS, Inc. and Ontonagon Community Health Center, Inc. Mercy EMS, Inc. is an ambulance service providing transport and life support services to the surrounding areas. The Ontonagon Community Health Center provides medical diagnosis and treatment for patients in Ontonagon County. Transactions with the joint ventures were immaterial. Investment loss relating to the ambulance service was \$52,597 and \$71,201 during June 30, 2010 and 2009, respectively. Investment loss relating to the health center was \$187,001 and \$117,520 during June 30, 2010 and 2009, respectively. Both are reported as other expenses.

The Hospital has a 10 percent interest in Upper Peninsula Health Plan, Inc., with an investment carried at cost of \$360,095. Transactions with the health plan were immaterial.

The following is a summary of financial position and results of operations of the joint ventures as of June 30, 2010 and 2009:

	2010	2009
Total assets	\$ 46,221,057	\$ 35,468,974
Total liabilities	17,507,065	13,426,840
Net assets	<u>\$ 28,713,992</u>	<u>\$ 22,042,134</u>
Increase in net assets	<u>\$ 3,299,591</u>	<u>\$ 2,110,895</u>

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2010 and 2009

Note 13 - Union Contracts

As of June 30, 2010 and 2009, approximately 35 percent and 33 percent, respectively, of the Hospital's employees belong to one of two unions at the Hospital. The AFSCME union contract agreement expires on October 31, 2012 and the MNA union contract agreement expires on June 6, 2012.

Note 14 - Prior Period Adjustment

The consolidated accompanying financial statements for 2009 have been restated to correct an error related to understatement of the LIFO inventory reserve made in 2009 for Copper Country Apothecaries, Inc.

As a result of the prior period adjustment, net assets as of June 30, 2008 decreased from \$47,099,109, as originally reported, to \$46,902,438. Operating supplies and expenses for the year ended June 30, 2009 decreased from \$17,353,417, as originally reported, to \$17,333,616.

Additional Information



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To the Board of Directors
Portage Health and Subsidiaries

We have audited the consolidated financial statements of Portage Health and Subsidiaries as of June 30, 2010 and 2009. Our audits were made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. We did not audit the financial statements or additional information of Copper Country Apothecaries, Inc., Portage Health Resources, Inc., or Portage Health Home Services, Inc., wholly owned subsidiaries, for the years ended June 30, 2010 and 2009. Those statements were audited by other auditors, whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for Copper Country Apothecaries, Inc., Portage Health Resources, Inc., and Portage Health Home Services, Inc., is based solely on the reports of the other auditors. The consolidating information and schedule of net patient service revenue are presented for the purpose of additional analysis of the consolidated financial statements rather than to present the financial position and results of operations of the individual entities or the details of the net service patient revenue. The accompanying additional information has been subjected to the procedures applied in the audits of the consolidated financial statements and, in our opinion, based on our audits and the reports of other auditors, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

Plante & Moran, PLLC

November 10, 2010

Portage Health and Subsidiaries

Consolidating Balance Sheet June 30, 2010 (with comparative totals as of June 30, 2009)

	Portage Health	Copper Country Apothecaries, Inc.	Portage Health Resources, Inc.	Portage Health Foundation	Portage Health Home Services, Inc.	Eliminating Entries	June 30, 2010 Consolidated	June 30, 2009 Consolidated (as restated)
Assets								
Current Assets								
Cash and cash equivalents	\$ 15,033,735	\$ 1,295,446	\$ 246,158	\$ 42,819	\$ 348,235	\$ -	\$ 16,966,393	\$ 13,434,031
Accounts receivable	7,206,382	638,670	9,745	-	164,888	(46,937)	7,972,748	6,713,155
Estimated third-party payor settlements	1,025,696	-	-	-	-	-	1,025,696	606,173
Prepaid expenses and other	1,581,337	588,571	565	-	-	-	2,170,473	2,047,531
Total current assets	24,847,150	2,522,687	256,468	42,819	513,123	(46,937)	28,135,310	22,800,890
Assets Limited as to Use	15,550,452	-	-	1,560,586	-	(2,641,886)	14,469,152	13,096,971
Property and Equipment - Net	42,358,250	24,233	-	-	-	-	42,382,483	44,042,306
Other Assets								
Investments in joint ventures	668,562	-	-	-	-	-	668,562	711,497
Bond issue costs	359,075	-	-	-	-	-	359,075	380,301
Total assets	\$ 83,783,489	\$ 2,546,920	\$ 256,468	\$ 1,603,405	\$ 513,123	\$ (2,688,823)	\$ 86,014,582	\$ 81,031,965
Liabilities and Net Assets								
Current Liabilities								
Current portion of long-term debt	\$ 1,365,000	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1,365,000	\$ 1,320,000
Accounts payable	2,279,633	311,021	2,687	-	12,358	-	2,605,699	2,074,852
Estimated third-party payor settlements	1,010,984	-	-	-	-	-	1,010,984	879,078
Accrued liabilities and other	3,223,764	14,995	5,239	-	73,951	(38,310)	3,279,639	3,143,415
Total current liabilities	7,879,381	326,016	7,926	-	86,309	(38,310)	8,261,322	7,417,345
Long-term Debt - Net of current portion	22,869,900	-	-	-	-	-	22,869,900	24,235,000
Fair Value of Interest Rate Swap Agreement	2,598,082	-	-	-	-	-	2,598,082	1,778,553
Total liabilities	33,347,363	326,016	7,926	-	86,309	(38,310)	33,729,304	33,430,898
Stockholders' Equity	-	2,220,904	-	-	-	(2,220,904)	-	-
Net Assets - Unrestricted	50,436,126	-	248,542	1,603,405	426,814	(429,609)	52,285,278	47,601,067
Total liabilities and net assets	\$ 83,783,489	\$ 2,546,920	\$ 256,468	\$ 1,603,405	\$ 513,123	\$ (2,688,823)	\$ 86,014,582	\$ 81,031,965

Portage Health and Subsidiaries

Consolidating Statement of Operations Year Ended June 30, 2010 (with comparative totals for the year ended June 30, 2009)

	Portage Health	Copper Country Apothecaries, Inc.	Portage Health Resources, Inc.	Portage Health Foundation	Portage Health Home Services, Inc.	Eliminating Entries	June 30, 2010 Consolidated	June 30, 2009 Consolidated (as restated)
Unrestricted Revenue, Gains, and Other Support								
Total patient service revenue	\$ 113,690,159	\$ -	\$ -	\$ -	\$ 1,104,949	\$ -	\$ 114,795,108	\$ 108,595,803
Revenue deductions	(41,336,788)	-	-	-	-	-	(41,336,788)	(38,467,679)
Net patient service revenue	72,353,371	-	-	-	1,104,949	-	73,458,320	70,128,124
Apothecary retail pharmacy revenue	-	9,242,514	-	-	-	(257,239)	8,985,275	8,484,350
Other	2,965,851	-	581,302	-	-	(1,566,653)	1,980,500	1,835,247
Total unrestricted revenue, gains, and other support	75,319,222	9,242,514	581,302	-	1,104,949	(1,823,892)	84,424,095	80,447,721
Expenses								
Salaries and wages	32,843,210	-	166,782	-	703,035	-	33,713,027	32,415,343
Employee benefits and payroll taxes	10,519,794	-	-	-	102,492	(257,239)	10,365,047	9,246,889
Operating supplies and expenses	10,644,812	7,126,675	203,015	-	12,005	-	17,986,507	17,333,616
Professional services and consultant fees	472,102	-	-	-	-	-	472,102	541,443
Purchased services	7,080,343	1,617,592	136,226	-	66,505	(1,660,310)	7,240,356	6,578,003
Insurance	764,832	-	-	-	6,026	-	770,858	929,043
Utilities	1,321,900	6,218	-	-	10,939	-	1,339,057	1,245,705
Depreciation	4,547,496	7,241	-	2,232	-	-	4,556,969	4,406,763
Provision for bad debts	1,257,529	-	-	-	-	-	1,257,529	1,143,937
Interest expense	1,055,379	-	-	-	-	-	1,055,379	1,248,133
Other	3,296,539	75,922	67,157	128,616	62,715	17,090	3,648,039	3,279,622
Total expenses	73,803,936	8,833,648	573,180	130,848	963,717	(1,900,459)	82,404,870	78,368,497
Operating Income (Loss)	1,515,286	408,866	8,122	(130,848)	141,232	76,567	2,019,225	2,079,224
Other Income (Expense)	3,144,304	(97,336)	-	188,452	-	(570,434)	2,664,986	(1,380,595)
Increase in Unrestricted Net Assets	\$ 4,659,590	\$ 311,530	\$ 8,122	\$ 57,604	\$ 141,232	\$ (493,867)	\$ 4,684,211	\$ 698,629

Portage Health and Subsidiaries

Schedule of Net Patient Service Revenue

	Year Ended June 30	
	2010	2009
Patient service revenue:		
Inpatient services:		
Routine services	\$ 12,294,809	\$ 11,710,088
Ancillary services	18,612,940	16,801,481
Outpatient ancillary services	83,887,359	80,084,234
Total patient service revenue	114,795,108	108,595,803
Revenue deductions:		
Medicare	18,449,444	16,817,905
Medicaid	5,307,127	4,704,288
Blue Cross/Blue Shield of Michigan	4,670,921	5,021,108
Other	12,013,110	10,672,861
Charity care	896,186	1,251,517
Total revenue deductions	41,336,788	38,467,679
Total net patient service revenue	<u>\$ 73,458,320</u>	<u>\$ 70,128,124</u>