

Portage Health and Subsidiaries

**Consolidated Financial Report
with Additional Information
June 30, 2012**

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, 2012 and 2011 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, Portage Health Resources, Inc. and Portage Health Home Services, Inc., whose statements reflect total assets of \$1,115,213 and \$844,249 and total revenue of \$2,146,738 and \$1,909,513 as of and for the years ended June 30, 2012 and 2011, respectively. Additionally, we did not audit the financial statements of wholly owned subsidiary, Copper Country Apothecaries, Inc., whose statements reflect total assets of \$2,283,821 and total revenue of \$8,478,319 as of and for the year ended June 30, 2011. 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 provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Portage Health and Subsidiaries at June 30, 2012 and 2011 and the consolidated results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Plante & Moran, PLLC

October 1, 2012

Portage Health and Subsidiaries

Consolidated Balance Sheet

	<u>June 30, 2012</u>	<u>June 30, 2011</u>
Assets		
Current Assets		
Cash and cash equivalents	\$ 10,638,340	\$ 12,989,035
Accounts receivable (Note 2)	10,978,969	8,409,751
Estimated third-party payor settlements (Note 3)	2,603,830	880,125
Prepaid expenses and other	<u>2,751,037</u>	<u>2,398,192</u>
Total current assets	26,972,176	24,677,103
Assets Limited as to Use (Note 5)	30,347,091	29,718,651
Property and Equipment - Net (Note 6)	43,405,013	41,105,771
Other Assets		
Investments in joint ventures (Note 12)	604,266	669,668
Bond issue costs	<u>410,911</u>	<u>433,363</u>
Total assets	<u>\$ 101,739,457</u>	<u>\$ 96,604,556</u>
Liabilities and Net Assets		
Current Liabilities		
Current portion of long-term debt (Note 7)	\$ 1,385,000	\$ 1,540,000
Accounts payable	2,631,833	2,459,540
Estimated third-party payor settlements (Note 3)	1,212,585	1,404,228
Accrued liabilities and other	<u>4,894,958</u>	<u>3,622,004</u>
Total current liabilities	10,124,376	9,025,772
Long-term Debt - Net of current portion (Note 7)	23,944,900	25,329,900
Fair Value of Interest Rate Swap Agreement (Note 7)	<u>3,782,431</u>	<u>2,263,565</u>
Total liabilities	37,851,707	36,619,237
Net Assets - Unrestricted	<u>63,887,750</u>	<u>59,985,319</u>
Total liabilities and net assets	<u>\$ 101,739,457</u>	<u>\$ 96,604,556</u>

Portage Health and Subsidiaries

Consolidated Statement of Operations

	Year Ended	
	June 30, 2012	June 30, 2011
Unrestricted Revenue, Gains, and Other Support		
Net patient service revenue	\$ 81,428,575	\$ 71,941,040
Apothecary retail pharmacy revenue	6,286,349	8,452,221
Other	<u>1,601,570</u>	<u>1,936,103</u>
Total unrestricted revenue, gains, and other support	89,316,494	82,329,364
Expenses		
Salaries and wages	36,275,837	34,757,720
Employee benefits and payroll taxes	10,102,641	9,024,760
Operating supplies and expenses	16,818,426	16,531,422
Professional services and consultant fees	553,773	390,729
Purchased services	8,078,714	6,745,161
Insurance	526,366	516,487
Utilities	1,369,615	1,299,818
Depreciation	4,041,503	4,281,298
Provision for bad debts	1,874,895	1,195,555
Interest expense	1,266,314	1,222,794
Other	<u>3,315,890</u>	<u>3,494,278</u>
Total expenses (Note 11)	<u>84,223,974</u>	<u>79,460,022</u>
Operating Income	5,092,520	2,869,342
Other Income (Loss)		
Interest income (Note 5)	801,475	2,299,783
Equity in losses of unconsolidated investees	(175,076)	(234,449)
Realized gain on sale of investments (Note 5)	42,936	810,343
Other income (expense)	141,779	(26,663)
Change in unrealized investment (loss) gain (Note 5)	(236,431)	1,626,564
Change in fair value of interest swap agreements	(1,518,866)	334,517
Rent income	48,925	182,598
Other expense	<u>(294,831)</u>	<u>(161,994)</u>
Total other (loss) income	<u>(1,190,089)</u>	<u>4,830,699</u>
Excess of Revenue Over Expenses	<u><u>\$ 3,902,431</u></u>	<u><u>\$ 7,700,041</u></u>

Portage Health and Subsidiaries

Consolidated Statement of Changes in Net Assets

	Year Ended	
	June 30, 2012	June 30, 2011
Net Assets - Beginning of year	\$ 59,985,319	\$ 52,285,278
Excess of Revenue Over Expenses	3,902,431	7,700,041
Net Assets - End of year	<u><u>\$ 63,887,750</u></u>	<u><u>\$ 59,985,319</u></u>

Portage Health and Subsidiaries

Consolidated Statement of Cash Flows

	Year Ended	
	June 30, 2012	June 30, 2011
Cash Flows from Operating Activities		
Cash received from patients and third-party payors	\$ 75,501,108	\$ 73,238,407
Cash paid to suppliers and employees	(79,698,650)	(75,182,998)
Interest and dividends received	801,475	2,299,783
Interest paid	(1,243,862)	(1,196,541)
Other receipts from operations	10,988,914	10,188,954
Net cash provided by operating activities (Note 10)	6,348,985	9,347,605
Cash Flows from Investing Activities		
Purchase of property and equipment	(6,340,745)	(3,084,279)
Proceeds from sale of property and equipment	3,000	37,449
Purchase of investments	(4,120,190)	(23,064,220)
Proceeds from sales and maturities of investments	3,298,255	10,251,628
Net cash used in investing activities	(7,159,680)	(15,859,422)
Cash Flows from Financing Activities		
Proceeds from issuance of debt obligations	-	4,000,000
Principal payments on debt obligations	(1,540,000)	(1,365,000)
Payment of bond issue costs	-	(100,541)
Net cash (used in) provided by financing activities	(1,540,000)	2,534,459
Net Decrease in Cash and Cash Equivalents	(2,350,695)	(3,977,358)
Cash and Cash Equivalents - Beginning of year	12,989,035	16,966,393
Cash and Cash Equivalents - End of year	\$ 10,638,340	\$ 12,989,035

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2012 and 2011

Note 1 - 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. There is one board of directors that oversees the operations of the Hospital, Copper Country Apothecaries, Inc., Portage Health Resources, Inc., and Portage Health Home Services, Inc. The Portage Health Foundation has a separate board of directors. 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, 2012 and 2011, 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, 2012 and 2011, the uninsured cash balance was \$728,751 and \$376,498, respectively.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2012 and 2011

Note 1 - 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 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.

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.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2012 and 2011

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

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 2010 and 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.

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.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2012 and 2011

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

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. The estimated cost of providing charity care, calculated by applying an overall operating expense to gross revenue ratio to the gross charity care write-offs, totaled approximately \$550,000 and \$700,000 for the years ended June 30, 2012 and 2011, 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. CCAI is the only entity subject to income taxes; therefore, any tax provisions reflected in the consolidated financial statements are associated with this company. The Organization is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress. Management believes it is no longer subject to income tax examinations for years prior to June 30, 2007.

Accounting principles generally accepted in the United States of America require management to evaluate tax positions taken by the organization and recognize a tax liability if the organization has taken an uncertain position that more likely than not would not be sustained upon examination by the IRS or other applicable taxing authorities. Management has analyzed the tax positions taken by the Organization and has concluded that as of June 30, 2012, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the financial statements.

Fair Value of Financial Instruments - The fair value of financial instruments, including cash, accounts receivable, accounts payable, and debt, approximate 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.

Subsequent Events - The consolidated financial statements and related disclosures include evaluation of events up through and including October 1, 2012, which is the date the consolidated financial statements were available to be issued.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2012 and 2011

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

New Accounting Pronouncements

Revenue Recognition - During 2011, the Financial Accounting Standards Board (FASB) adopted Accounting Standards Update (ASU) 2011-07, *Health Care Entities (Topic 954) Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*, establishing accounting and disclosures for healthcare entities to recognize significant amounts of patient service revenue at the time services are rendered even though the entities do not assess a patient's ability to pay. The amendments in the ASU change the presentation of the statement of operations and add new disclosures that are not required under current GAAP for entities within the scope of this update. The provision for bad debts associated with patient service revenue for certain entities is required to be presented on a separate line as a deduction from patient service revenue (net of contractual allowances and discounts) in the statement of operations. The ASU is effective for the Organization for the year ending June 30, 2013.

Healthcare Claims and Charity Care - The Organization has adopted Accounting Standards Update (ASU) 2010-24 *Health, Care Entities (Topic 954) Presentation of Insurance Claims and Related Insurance Recoveries*, for the year ended June 30, 2012. In accordance with the ASU, the accrued liability for malpractice claims and similar liabilities and the related insurance recovery receivable have been presented separately on the consolidated balance sheet on a gross basis for the years ended June 30, 2012 and 2011. Prior guidance allowed the liability to be reported net of the estimated insurance recovery receivable. There was no impact on beginning net assets related to the implementation of this ASU.

The Organization has also adopted new guidance on how to measure the amount of charity care provided to patients. The new guidance requires that cost be used as the measurement basis for charity care disclosure purposes and that the cost be identified as the direct and indirect costs of providing the charity care. No other measurement basis should be used. Prior guidance did not dictate how charity care should be measured.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2012 and 2011

Note 2 - Accounts Receivable

The details of patient accounts receivable are set forth below:

	2012	2011
Patient accounts receivable	\$ 14,773,053	\$ 13,156,243
Less:		
Allowance for uncollectible accounts	(1,194,483)	(1,190,037)
Allowance for contractual adjustments	(4,449,275)	(4,405,825)
Net patient accounts receivable	9,129,295	7,560,381
Other	1,849,674	849,370
Total accounts receivable	<u>\$ 10,978,969</u>	<u>\$ 8,409,751</u>

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.

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	
	2012	2011
Medicare	24	25
Blue Cross/Blue Shield of Michigan	16	19
Medicaid	13	15
Commercial insurance and HMOs	26	30
Self-pay	21	11
Total	<u>100</u>	<u>100</u>

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2012 and 2011

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 75 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.

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 and as of June 30, 2012 and 2011, the Hospital has no open audits related to this area.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2012 and 2011

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, 2012 and 2011

Note 4 - Fair Value (Continued)

Assets and Liabilities Measured at Fair Value on a Recurring Basis at June 30, 2012

	Balance at June 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Mutual funds:				
Fixed-income investments	\$ 4,584,986	\$ 4,584,986	\$ -	\$ -
Equity investments	3,025,055	3,025,055	-	-
U.S. government securities	726,415	-	726,415	-
Investment certificates	439,292	439,292	-	-
Corporate bonds	1,810,956	-	1,810,956	-
Common stocks:				
Information technology	2,142,444	2,142,444	-	-
Financial	1,801,231	1,801,231	-	-
Health care	1,509,678	1,509,678	-	-
Industrials	1,171,276	1,171,276	-	-
Energy	937,992	937,992	-	-
Consumer staples	1,182,492	1,182,492	-	-
Consumer discretionary	1,360,532	1,360,532	-	-
Other	2,121,515	2,121,515	-	-
Mortgage- and asset-backed securities	1,088,247	-	1,088,247	-
Other	135,165	-	135,165	-
Total assets	<u>\$ 24,037,276</u>	<u>\$ 20,276,493</u>	<u>\$ 3,760,783</u>	<u>\$ -</u>
Liabilities - Interest rate swap	<u>\$ 3,782,431</u>	<u>\$ -</u>	<u>\$ 3,782,431</u>	<u>\$ -</u>

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2012 and 2011

Note 4 - Fair Value (Continued)

Assets and Liabilities Measured at Fair Value on a Recurring Basis at June 30, 2011

	Balance at June 30, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Mutual funds:				
Fixed-income investments	\$ 4,405,859	\$ 4,405,859	\$ -	\$ -
Equity investments	3,005,273	3,005,273	-	-
U.S. government securities	1,004,240	-	1,004,240	-
Investment certificates	1,591,727	1,591,727	-	-
Corporate bonds	1,695,407	-	1,695,407	-
Common stocks:				
Information technology	2,001,490	2,001,490	-	-
Financial	1,719,449	1,719,449	-	-
Health care	1,574,781	1,574,781	-	-
Industrials	1,370,124	1,370,124	-	-
Energy	1,298,156	1,298,156	-	-
Consumer staples	1,210,126	1,210,126	-	-
Consumer discretionary	1,188,886	1,188,886	-	-
Other	2,375,804	2,375,804	-	-
Mortgage- and asset-backed securities	453,404	-	453,404	-
Other	136,626	-	136,626	-
Total assets	\$ 25,031,352	\$ 21,741,675	\$ 3,289,677	\$ -
Liabilities - Interest rate swap	\$ 2,263,565	\$ -	\$ 2,263,565	\$ -

Note 5 - Assets Limited as to Use

The composition of assets limited as to use at June 30, 2012 and 2011 is set forth in the following tables. Investments are stated at fair value.

	2012	2011
Purpose:		
Designated by the Hospital board of directors for future use and capital improvements	\$ 25,173,498	\$ 24,775,941
Mortgage Reserve Fund - Bonds (Note 7)	3,236,634	3,074,611
Designated by the Foundation board of directors for benefit of the Hospital and its affiliates	1,842,209	1,773,349
Other	94,750	94,750
Total assets limited as to use	\$ 30,347,091	\$ 29,718,651

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2012 and 2011

Note 5 - Assets Limited as to Use (Continued)

Assets limited as to use are comprised of the following:

	2012	2011
Cash and cash equivalents	\$ 6,309,815	\$ 4,687,299
Mutual funds	7,610,041	7,411,132
U.S. government securities	726,415	1,004,240
Investment certificates	439,292	1,591,727
Corporate bonds	1,810,956	1,695,407
Common stocks	12,227,160	12,738,816
Other	1,223,412	590,030
Total	<u>\$ 30,347,091</u>	<u>\$ 29,718,651</u>

Investment income and realized and unrealized gains included in increase in unrestricted net assets are comprised of the following for the years ended June 30, 2012 and 2011:

	2012	2011
Income:		
Interest and dividend income	\$ 801,475	\$ 2,299,783
Realized gains on investments	42,936	810,343
Change in unrealized gains on investments	(236,431)	1,626,564
Total	<u>\$ 607,980</u>	<u>\$ 4,736,690</u>

Interest and dividend income includes amounts for dividends from Upper Peninsula Health Plan, Inc., which were \$200,879 and \$1,553,052 for 2012 and 2011, respectively.

Note 6 - Property and Equipment

The cost of property and equipment and depreciable lives are summarized as follows.

	2012	2011	Depreciable Life - Years
Land	\$ 176,339	\$ 176,339	-
Land improvements	1,329,074	1,329,074	10-15
Buildings	55,136,403	54,440,130	7-40
Equipment	30,817,807	29,456,345	3-10
Construction in progress	4,442,627	310,654	-
Total cost	91,902,250	85,712,542	
Accumulated depreciation	<u>(48,497,237)</u>	<u>(44,606,771)</u>	
Net property and equipment	<u>\$ 43,405,013</u>	<u>\$ 41,105,771</u>	

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2012 and 2011

Note 6 - Property and Equipment (Continued)

Construction in progress at year end is comprised of a clinic expansion financed by the Series 2010 bonds (see Note 7). The Hospital has commitments remaining at June 30, 2012 of approximately \$665,000 related to the clinic expansion.

Note 7 - Long-term Debt

Long-term debt at June 30, 2012 and 2011 is as follows:

	2012	2011
Multi-modal limited obligation revenue bonds, Series 2010	\$ 3,870,000	\$ 4,000,000
Variable rate demand revenue refunding bonds, Series 2006	<u>21,459,900</u>	<u>22,869,900</u>
Total	25,329,900	26,869,900
Less current portion	<u>(1,385,000)</u>	<u>(1,540,000)</u>
Long-term portion	<u>\$ 23,944,900</u>	<u>\$ 25,329,900</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, 2012 and 2011 was 0.17 percent and 0.10 percent, respectively.

The bonds are secured by an irrevocable direct-pay letter of credit which expires on December 1, 2015. 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. The fee for the letter of credit is 1.5 percent.

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.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2012 and 2011

Note 7 - Long-term Debt (Continued)

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, 2012 and 2011, the notional principal amount of the Hospital's portion of the outstanding interest rate swap was \$27,920,000, 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, 2012 and 2011 was a liability in the accompanying consolidated balance sheet of \$3,550,022 and \$2,163,013, respectively. Management has recorded the change in the liability as other expense in the consolidated statement of operations.

Multi-Modal Limited Obligation Revenue Bonds - Series 2010 were issued on December 30, 2010 under a Bank Qualified Direct Purchase arrangement. The bonds mature on December 30, 2030 and have a variable interest rate established on a weekly basis, plus 270 basis points. The indicative floating rate was 1.913437 percent and 1.875770 percent as of June 30, 2012 and 2011, respectively.

The bonds are secured by the gross revenue of the Hospital and its affiliate, Copper Country Apothecary, Inc.

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 2010 bonds. The notional principal amount of the Hospital's portion of the outstanding interest rate swap was \$3,870,000 and \$4,000,000 as of June 30, 2012 and 2011, respectively, which matures January 1, 2021. Under the terms of the agreement, the Hospital pays the counterparty a fixed rate of 4.06 percent.

The Hospital has the right, but not the obligation, to terminate the transaction, without cause, on January 1, 2016 through 2020, subject to no adjustment as an early termination. The Hospital would not be obligated to pay PNC any termination payment with respect to an early termination. The Hospital would give notice of its election to terminate the transaction to PNC in writing at least two business days prior to the applicable early termination date.

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2012 and 2011

Note 7 - Long-term Debt (Continued)

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, 2012 and 2011 was a liability in the accompanying consolidated balance sheet of \$232,409 and \$100,552, respectively. Management has recorded the change in the liability as other expense in the consolidated statement of operations.

Minimum principal payments on long-term debt to maturity as of June 30, 2012 are as follows:

2013	\$ 1,385,000
2014	1,440,000
2015	1,480,000
2016	1,540,000
2017	1,585,000
Thereafter	<u>17,899,900</u>
Total	<u>\$ 25,329,900</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 \$1,866,413 and \$1,847,121 in 2012 and 2011, 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, 2012 and 2011

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 policies for the policy years ended September 30, 2011 and prior, the Hospital must pay a deductible toward the costs of litigating or settling any asserted claims. Effective for the policy years beginning October 1, 2011 and after, the Hospital has reduced the deductible to zero. The Hospital has accrued approximately \$720,000 and \$820,000 for this contingency and has a receivable from the insurance carrier of approximately \$570,000 and \$670,000 at June 30, 2012 and 2011, respectively, for a net eligibility of \$150,000 at June 30, 2012 and 2011. In addition, the Hospital bears the risk of the ultimate costs exceeding the policy limits of \$1,000,000 for individual claims and \$5,000,000 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:

	2012	2011
Excess of revenue over expenses	\$ 3,902,431	\$ 7,700,041
Adjustments to reconcile excess of revenue over expenses to net cash from operating activities:		
Depreciation and amortization	4,063,955	4,307,551
Provision for doubtful accounts	1,874,895	1,195,555
(Gain) loss on sale of property and equipment	(3,000)	42,244
Change in fair value of interest rate swap	1,518,866	(334,517)
Net realized and unrealized loss (gain) on investments	193,495	(2,436,907)
Loss attributable to joint ventures	175,076	234,449
(Increase) decrease in assets:		
Accounts receivable	(4,553,787)	(1,868,113)
Prepaid expenses and other	(352,845)	(227,719)
Cost report settlements receivable	(1,723,705)	145,571
Increase (decrease) in liabilities:		
Accounts payable	172,293	(146,159)
Accrued liabilities	1,272,954	342,365
Cost report settlements payable	(191,643)	393,244
Net cash provided by operating activities	<u>\$ 6,348,985</u>	<u>\$ 9,347,605</u>

Portage Health and Subsidiaries

Notes to Consolidated Financial Statements June 30, 2012 and 2011

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, 2012 and 2011 are as follows:

	2012	2011
Healthcare services	\$ 70,611,918	\$ 66,239,400
General and administrative	13,535,520	13,040,570
Fundraising	76,536	180,052
Total	<u>\$ 84,223,974</u>	<u>\$ 79,460,022</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 \$65,401 during the year ended June 30, 2012 and investment income was \$1,105 during the year ended June 30, 2011. Investment loss relating to the health center was \$109,675 and \$235,554 during June 30, 2012 and 2011, 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, 2012 and 2011:

	2012	2011
Total assets	\$ 34,297,620	\$ 38,360,874
Total liabilities	15,306,209	21,532,672
Net assets	<u>\$ 18,991,411</u>	<u>\$ 16,828,202</u>
Increase (decrease) in net assets	<u>\$ 2,163,209</u>	<u>\$ (2,291,227)</u>

Note 13 - Union Contracts

As of June 30, 2012 and 2011, approximately 32 percent 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, 2014.

Additional Information



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Independent Auditor's Report on Additional Information

To the Board of Directors
Portage Health and Subsidiaries

We have audited the consolidated financial statements of Portage Health and Subsidiaries as of and for the years ended June 30, 2012 and 2011. Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. We did not audit the financial statements or additional information of wholly owned subsidiaries Portage Health Resources, Inc. or Portage Health Home Services, Inc. for the years ended June 30, 2012 and 2011, or Copper Country Apothecaries, Inc. for the year ended June 30, 2011. 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 rather than to present the financial position and results of operations of the individual entities or the details of the net service patient revenue and are not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Plante & Moran, PLLC

October 1, 2012

Portage Health and Subsidiaries

Consolidating Balance Sheet June 30, 2012 (with comparative totals as of June 30, 2011)

	Portage Health	Copper Country Apothecaries, Inc.	Portage Health Resources, Inc.	Portage Health Foundation	Portage Health Home Services, Inc.	Eliminating Entries	Total	
							June 30, 2012	June 30, 2011
Assets								
Current Assets								
Cash and cash equivalents	\$ 9,114,796	\$ 709,873	\$ 141,451	\$ 49,728	\$ 622,492	\$ -	\$ 10,638,340	\$ 12,989,035
Accounts receivable	9,710,243	1,331,699	14,067	-	337,203	(414,243)	10,978,969	8,409,751
Estimated third-party payor settlements	2,603,830	-	-	-	-	-	2,603,830	880,125
Prepaid expenses and other	2,144,372	606,665	-	-	-	-	2,751,037	2,398,192
Total current assets	23,573,241	2,648,237	155,518	49,728	959,695	(414,243)	26,972,176	24,677,103
Assets Limited as to Use	31,655,880	-	-	1,842,209	-	(3,150,998)	30,347,091	29,718,651
Property and Equipment - Net	43,367,712	37,301	-	-	-	-	43,405,013	41,105,771
Other Assets	604,266	-	-	-	-	-	604,266	669,668
Investments in joint ventures	410,911	-	-	-	-	-	410,911	433,363
Total assets	\$ 99,612,010	\$ 2,685,538	\$ 155,518	\$ 1,891,937	\$ 959,695	\$ (3,565,241)	\$ 101,739,457	\$ 96,604,556
Liabilities and Net Assets								
Current Liabilities								
Current portion of long-term debt	\$ 1,385,000	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1,385,000	\$ 1,540,000
Accounts payable	2,790,446	(167,516)	5,115	-	3,788	-	2,631,833	2,459,540
Estimated third-party payor settlements	1,212,585	-	-	-	-	-	1,212,585	1,404,228
Accrued liabilities and other	4,647,318	516,900	6,715	-	138,268	(414,243)	4,894,958	3,622,004
Total current liabilities	10,035,349	349,384	11,830	-	142,056	(414,243)	10,124,376	9,025,772
Long-term Debt - Net of current portion	23,944,900	-	-	-	-	-	23,944,900	25,329,900
Fair Value of Interest Rate Swap Agreement	3,782,431	-	-	-	-	-	3,782,431	2,263,565
Total liabilities	37,762,680	349,384	11,830	-	142,056	(414,243)	37,851,707	36,619,237
Stockholders' Equity	-	2,336,154	-	-	-	(2,336,154)	-	-
Net Assets - Unrestricted	61,849,330	-	143,688	1,891,937	817,639	(814,844)	63,887,750	59,985,319
Total liabilities and net assets	\$ 99,612,010	\$ 2,685,538	\$ 155,518	\$ 1,891,937	\$ 959,695	\$ (3,565,241)	\$ 101,739,457	\$ 96,604,556

Portage Health and Subsidiaries

Consolidating Statement of Operations Year Ended June 30, 2012 (with comparative totals for the year ended June 30, 2011)

	Portage Health	Copper Country Apothecaries, Inc.	Portage Health Resources, Inc.	Portage Health Foundation	Portage Health Home Services, Inc.	Eliminating Entries	Total	
	Portage Health	Copper Country Apothecaries, Inc.	Portage Health Resources, Inc.	Portage Health Foundation	Portage Health Home Services, Inc.	Eliminating Entries	June 30, 2012	June 30, 2011
Unrestricted Revenue, Gains, and Other Support								
Total patient service revenue	\$ 126,874,666	\$ -	\$ -	\$ -	\$ 1,592,950	\$ -	\$ 128,467,616	\$ 114,516,120
Revenue deductions	(47,037,758)	(1,283)	-	-	-	-	(47,039,041)	(42,575,080)
Net patient service revenue	79,836,908	(1,283)	-	-	1,592,950	-	81,428,575	71,941,040
Apothecary retail pharmacy revenue	-	6,807,017	-	-	-	(520,668)	6,286,349	8,452,221
Other	2,629,907	38	553,788	-	-	(1,582,163)	1,601,570	1,936,103
Total unrestricted revenue, gains, and other support	82,466,815	6,805,772	553,788	-	1,592,950	(2,102,831)	89,316,494	82,329,364
Expenses								
Salaries and wages	35,076,318	1,585	161,653	-	1,036,281	-	36,275,837	34,757,720
Employee benefits and payroll taxes	9,952,250	512	-	-	149,879	-	10,102,641	9,024,760
Operating supplies and expenses	12,281,245	4,319,618	202,948	-	14,615	-	16,818,426	16,531,422
Professional services and consultant fees	553,773	-	-	-	-	-	553,773	390,729
Purchased services	8,492,880	1,629,509	136,572	-	70,899	(2,251,146)	8,078,714	6,745,161
Insurance	521,622	-	-	-	4,744	-	526,366	516,487
Utilities	1,353,454	7,722	-	-	8,439	-	1,369,615	1,299,818
Depreciation	4,034,374	7,129	-	-	-	-	4,041,503	4,281,298
Provision for bad debts	1,874,895	-	-	-	-	-	1,874,895	1,195,555
Interest expense	1,266,314	-	-	-	-	-	1,266,314	1,222,794
Other	3,017,503	95,965	59,965	64,042	61,325	17,090	3,315,890	3,494,278
Total expenses	78,424,628	6,062,040	561,138	64,042	1,346,182	(2,234,056)	84,223,974	79,460,022
Operating Income (Loss)	4,042,187	743,732	(7,350)	(64,042)	246,768	131,225	5,092,520	2,869,342
Other (Loss) Income	(194,917)	(274,769)	-	126,553	-	(846,956)	(1,190,089)	4,830,699
Increase (Decrease) in Unrestricted Net Assets	\$ 3,847,270	\$ 468,963	\$ (7,350)	\$ 62,511	\$ 246,768	\$ (715,731)	\$ 3,902,431	\$ 7,700,041

Portage Health and Subsidiaries

Schedule of Net Patient Service Revenue

	Year Ended June 30	
	2012	2011
Patient service revenue:		
Inpatient services:		
Routine services	\$ 13,515,124	\$ 12,705,269
Ancillary services	20,276,230	19,593,639
Outpatient ancillary services	94,676,262	82,217,212
Total patient service revenue	128,467,616	114,516,120
Revenue deductions:		
Medicare	19,690,246	17,001,041
Medicaid	4,379,029	4,189,556
Blue Cross/Blue Shield of Michigan	5,074,928	3,390,012
Other	17,073,513	16,957,710
Charity care	821,325	1,036,761
Total revenue deductions	47,039,041	42,575,080
Total net patient service revenue	<u>\$ 81,428,575</u>	<u>\$ 71,941,040</u>