# West Shore Medical Center

## Contents


| | |
|---|---|
| **Report Letter** | 1 |
| **Management's Discussion and Analysis** | 2-9 |
| **Financial Statements** | |
| Balance Sheet | 10 |
| Statement of Revenue, Expenses, and Changes in Net Assets | 11 |
| Statement of Cash Flows | 12-13 |
| Notes to Financial Statements | 14-28 |

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# Independent Auditor's Report

To the Board of Trustees
West Shore Medical Center

We have audited the accompanying balance sheet of West Shore Medical Center (the "Center") (a component unit of Manistee County) as of June 30, 2006 and 2005 and the related statements of revenue, expenses, and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Center's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 financial statements referred to above present fairly, in all material respects, the financial position of West Shore Medical Center at June 30, 2006 and 2005 and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis is presented for the purpose of additional analysis and is not a required part of the financial statements of West Shore Medical Center, but is supplemental information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management, regarding the methods of measurement and presentation of the supplemental information. However, we did not audit the information and, accordingly, do not express an opinion thereon.

Plante & Moran, PLLC

September 13, 2006

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This discussion and analysis of West Shore Medical Center's (the "Center") financial statements provides an overview of financial activities for the year ended June 30, 2006. Management is responsible for the completeness and fairness of the financial statements, the related footnote disclosures, and this discussion and analysis.

### Using this Annual Report

The Center's financial statements consist of three statements - a balance sheet; a statement of revenue, expenses, and changes in net assets; and a statement of cash flows. These financial statements and related notes provide information about the activities of the Center, including resources held by the Center but restricted for specific purposes by contributors, grantors, or enabling legislation.

### Financial Overview

The Center's overall financial condition remained stable from 2005 to 2006 as net assets decreased $0.17 million, from $28.75 million to $28.58 million (0.6 percent decrease). Total cash and investments, including those limited as to use, decreased from $18.5 million to $18.2 million (1.6 percent decrease) as the Center began to expend funds for additional facility improvements and technological enhancements.

Investments in capital assets totaled $2.0 million and $1.7 million in fiscal years 2006 and 2005, respectively. No additional debt was required in 2006 or 2005 for the financing of these capital assets.

As mentioned, net assets decreased by $0.17 million in fiscal year 2006 and increased $1.27 million in fiscal year 2005, and were generated from the following sources (in thousands):

| | Year Ended June 30 | |
|---|---|---|
| | 2006 | 2005 |
| Income (loss) from operations | $ (534) | $ 984 |
| Nonoperating income (expense) - Net | 216 | 206 |
| Contributions restricted for capital assets | 150 | 80 |
| **(Decrease) Increase in Net Assets** | **$ (168)** | **$ 1,270** |

Net assets by classification for fiscal years 2006 and 2005, were as follows (in thousands):

| | Year Ended June 30 | |
|---|---|---|
| | 2006 | 2005 |
| Invested in capital assets - Net of related debt | $ 9,614 | $ 9,861 |
| Restricted for capital asset expenditures | 94 | 45 |
| Unrestricted | 18,871 | 18,841 |
| Total net assets | **$ 28,579** | **$ 28,747** |

### Balance Sheet and the Statement of Revenues, Expenses, and Changes in Net Assets

The balance sheet and the statement of revenues, expenses, and changes in net assets report information on the Center as a whole and on its activities in a manner that helps present changes in its overall financial condition and operating performance.

These two statements taken together report the Center's net assets and changes thereto from year to year, thus reflecting the financial health of the Center. Many other factors should also be considered such as trends in patient days, outpatient visits, reimbursement levels, conditions of facilities, and strength of medical staff to assess the overall health of the Center.

The statements include all assets and liabilities using the accrual basis of accounting. Revenue and expenses are recognized and accounted for regardless of when cash is received or paid.

### Condensed Financial Information

The following is a comparative analysis of the major components of the balance sheet for fiscal years 2006 and 2005 (in thousands):

| | Year Ended June 30 | | Change | |
|---|---|---|---|---|
| | 2006 | 2005 | Amount | Percent |
| Current assets | $ 23,523 | $ 22,217 | $ 1,306 | 5.9 |
| Noncurrent assets | 1,348 | 2,134 | (786) | (36.8) |
| Capital assets | 20,125 | 20,796 | (671) | (3.2) |
| Total assets | **$ 44,996** | **$ 45,147** | **$ (331)** | **(0.1)** |
| Current liabilities | $ 6,352 | $ 5,890 | $ 462 | 7.8 |
| Long-term liabilities | 10,065 | 10,510 | (445) | (4.2) |
| Total liabilities | **$ 16,417** | **$ 16,400** | **$ (463)** | **(2.8)** |
| Invested in capital assets - Net of debt | $ 9,614 | $ 9,861 | $ (247) | (2.5) |
| Restricted assets | 94 | 45 | 49 | 108.9 |
| Unrestricted | 18,871 | 18,841 | 30 | 0.2 |
| Total net assets | **$ 28,579** | **$ 28,747** | **$ (168)** | **(0.6)** |

The primary changes to assets were a shift from long-term to short-term investments and an increased Blue Cross cost report receivable. Long-term debt decreased due to retirement of the 2001 bonds. Net assets decreased due to net losses from operations, offset by nonoperating income and contributions.

## Operating Results for the Year

A comparative summary of operating results for the years ended June 30, 2006 and 2005 is as follows (in thousands):

| | Year Ended June 30 | | Change | |
|---|---|---|---|---|
| | 2006 | 2005 | Amount | Percent |
| **Operating Revenues** | | | | |
| Net patient service revenue | $ 33,847 | $ 33,293 | $ 554 | 1.7 |
| Other | 1,215 | 783 | 432 | 55.2 |
| Total operating revenues | 35,062 | 34,076 | 986 | 2.9 |
| **Operating Expenses** | | | | |
| Salaries | 14,541 | 13,693 | 848 | 6.2 |
| Benefits | 4,668 | 4,507 | 161 | 3.6 |
| Supplies | 4,227 | 4,144 | 83 | 2.0 |
| Outside services | 5,719 | 4,365 | 1,354 | 31.0 |
| Depreciation | 2,650 | 2,860 | (210) | (7.3) |
| Other | 3,791 | 3,523 | 268 | 7.6 |
| Total operating expenses | 35,596 | 33,092 | 2,504 | 7.6 |
| **Income (Loss) from Operations** | (534) | 984 | (1,518) | (154.3) |
| **Nonoperating Income (Expense)** - Net | 216 | 206 | 10 | 4.9 |
| **Excess of Revenues Over (Under) Expenses** - Before restricted contributions | (318) | 1,190 | (1,508) | (126.7) |
| **Restricted Contributions** | 150 | 80 | 70 | 87.5 |
| **Increase (Decrease) in Net Assets** | (168) | 1,270 | **$ (1,438)** | **(113.2)** |
| **Net Assets** - Beginning of year | 28,747 | 27,477 | | |
| **Net Assets** - End of year | **$ 28,579** | **$ 28,747** | | |

### Operating Revenue

Operating revenue includes all transactions from health care and related service activity such as inpatient stays, outpatient visits, and physician office rentals. In addition, certain state and private grants are operating in nature if they are not for capital purposes.

Operating revenue changes were a result of the following factors:

- Gross charges for patient services grew 23.5 percent from $61.4 million in fiscal year 2005 to $75.8 million in fiscal year 2006, due to price increases. Inpatient admissions decreased 4.5 percent in fiscal year 2006, while outpatient visits increased 4.1 percent.
- After accounting for adjustments and discounts under third-party payor programs, primarily Medicare, Medicaid, and Blue Cross/Blue Shield of Michigan, and providing for uncollectible accounts (bad debts), the Center realized an increase in net patient revenue of 1.7 percent, from $33.3 million in fiscal year 2005 to $33.8 million in fiscal year 2006.
- Deductions from revenue for third-party discounts and bad debts represented 55.3 percent and 45.8 percent of gross charges in fiscal years 2006 and 2005, respectively.
- Other operating revenue increased 73.4 percent from $787,000 in fiscal year 2005 to $1,215,000 in fiscal year 2006 due to increased rentals, more membership at the Center's health and fitness center, and a new rehabilitation services contract with a local long-term care facility.

Gross patient charges and other income, as a percent of total for 2006 and 2005, were as follows:

| | Percent | |
|---|---|---|
| | 2006 | 2005 |
| Inpatient | 30 | 33 |
| Outpatient | 68 | 66 |
| Other | 2 | 1 |
| Total | **100** | **100** |

### Operating Expenses

Operating expenses are all costs necessary to provide health care services. Significant changes in operating expenses in fiscal year 2006 were as follows:

- Salaries increased $848,000 or 6.2 percent due to annual cost-of-living and market adjustments and to additional clinical staffing requirements resulting from continuing outpatient service growth.
- Benefit costs increased $161,000 or 3.6 percent due to increased health insurance costs, which in part is why the Center became self-insured for health insurance purposes in May 2006.
- Supplies increased $83,000 or 2.0 percent in 2006 due to routine inflationary cost increases.
- Outside services increased $1,354,000 or 31.0 percent due mainly to the Center contracting for anesthesiology, rehabilitation, and various nursing services throughout the year. In addition, MRI contract fees and recruitment costs increased in 2006.
- Depreciation and amortization decreased $210,000 or 7.3 percent due to certain diagnostic equipment becoming fully depreciated in 2005.
- Other operating expense remained consistent, decreasing $268,000 or 7.6 percent.

Operating expenses as a percent of total incurred in fiscal years 2006 and 2005 were as follows:

| | Percent | |
|---|---|---|
| | 2006 | 2005 |
| Salaries | 40.8 | 41.4 |
| Benefits | 13.1 | 13.6 |
| Supplies | 11.9 | 12.5 |
| Outside services | 16.1 | 13.2 |
| Depreciation | 7.4 | 8.7 |
| Other | 10.7 | 10.6 |
| Total | **100.0** | **100.0** |

### Nonoperating Revenues - Net of Expenses

Nonoperating revenues are from other sources and for certain uses that are not primary to the Center's operating activity, consisting primarily of investment earnings (including realized and unrealized gains and losses), offset by interest expense.

Nonoperating revenue, net of related expenses, increased from $206,000 to $216,000 in fiscal year 2006.

### Contributions Restricted for Capital Assets

Contributions restricted for capital assets relate primarily to gifts pledged or received in support of certain equipment needs.

## Statement of Cash Flows

The primary purpose of the statement of cash flows is to provide relevant information about the Center's sources and uses of cash. The statement of cash flows also helps assess:

- The Center's ability to generate future positive cash flows
- Its ability to meet obligations as they come due
- Its ability to invest in capital assets for long-term growth and viability

| | 2006 | 2005 | Increase (Decrease) |
|---|---|---|---|
| Cash provided by (used in) (in thousands): | | | |
| Operating activities | $ 1,737 | $ 4,609 | $ (2,872) |
| Capital and related financing activities - Net | (2,552) | (2,306) | (246) |
| Noncapital financing activities | 50 | 20 | 30 |
| Investing activities | 44 | (1,219) | 1,263 |
| **Net Increase (Decrease) in Cash** | (721) | 1,104 | **$ (1,825)** |
| **Cash** - Beginning of year | 1,959 | 855 | |
| **Cash** - End of year | **$ 1,236** | **$ 1,959** | |

Cash provided by operating activities in 2006 decreased $2.9 million from the prior year due primarily to less cash received under interim payment programs from nonprimary payors and to increased cash paid for expenses during 2006.

Capital and related financing activities increased from $2.3 million to $2.6 million in fiscal year 2006. Expenditures for property and equipment totaled $1.7 million in 2005 and $2.0 million in 2006. Debt service payments (principal and interest) totaled $686,000 and $757,000 in 2005 and 2006, respectively.

## Capital Asset and Debt Administration

### Capital Assets

At June 30, 2006, the Center's capital assets totaled $20.1 million, net of accumulated depreciation of $23.8 million. The Center's capital position represents an average age of 9.1 years in 2006, compared with 7.5 years in 2005.

### Debt

In April 2001, the Center incurred long-term debt totaling $12.1 million to support a facility expansion and modernization program. Debt outstanding at June 2006 totaled $10.5 million, of which $445,000 was short-term in nature, consisted of adjustable rate (4.02 percent at June 30, 2006), tax-exempt revenue bonds, and secured by an irrevocable direct-pay letter of credit.

In November 2002, the Center entered into an interest rate swap agreement to reduce interest rate risk on a beginning notational amount of $6.0 million, decreasing to $5.0 million by the end of the five-year agreement. The interest rate under the swap agreement is fixed at 2.935 percent for the five-year period ending November 2007.

Refer to Notes 7 and 8 to the financial statements for additional information relating to debt and the interest rate swap agreement.

## Economic Factors that will Affect the Future

For fiscal 2006, the Center was not able to generate adequate revenues to meet operating expenses. Like other hospitals, the Center continues to be challenged in an environment where reimbursement gains from third-party payors are not keeping pace with primary cost drivers, such as wages, health insurance, and contract labor. In addition, during the year the Center lost the services of long-established surgeons and anesthesia coverage was disrupted. Management has worked to fully restore the availability of surgical services in fiscal 2007 and expects to not only recover, but grow its key service lines.

In recent years, net revenue from growth in outpatient activity has not been adequate to offset the impact of decreasing inpatient admissions and daily occupancy. As reflected in the Center's 2006 financial results, operating margins decreased from 2.9 percent to (1.5) percent in spite of a year with an increase in outpatient visits of 4.1 percent. Management believes the Center's future success will be driven by its continued ability to recruit physicians, to grow health services and to access capital to fund facility expansion and technological enhancements.

The Center is continuing its aggressive physician recruitment initiative. This initiative will require significant investment in physician practice start-up activities and office facilities. By helping to create a larger network of physicians, the Center will enhance local access to quality care and be better positioned to meet the growing healthcare needs of communities served. In addition, the Center has committed to a $8.8 million hospital facility expansion project expected to be completed in December 2007. Improvements are expected to enhance patient safety and clinical outcomes, provide for a more healing experience, and create a more positive work environment.

## Contacting the Center's Management

This financial report is intended to provide interested parties with a general overview of the Center's financial position and performance. The Center has achieved a strong financial position during difficult economic times for the health services industry in the state of Michigan. Management believes the Center is well positioned not only to provide but enhance health care services for years to come.

If you have any questions about this report or need additional information, please contact the Vice President of Finance.

Donn Lemmer
Vice President, Finance
231.398.1188

# West Shore Medical Center

## Balance Sheet

| | June 30, 2006 | June 30, 2005 |
|---|---|---|
| **Assets** | | |
| **Current Assets** | | |
| Cash and cash equivalents (Note 2) | $ 845,765 | $ 1,566,190 |
| Investments and assets limited as to use (Notes 2 and 5) | 16,343,554 | 15,173,952 |
| Accounts receivable (Note 3) | 4,313,584 | 3,786,351 |
| Cost report settlements receivable (Note 4) | 400,000 | - |
| Prepaid expenses | 632,002 | 583,082 |
| Inventories | 988,162 | 1,107,430 |
| Total current assets | 23,523,067 | 22,217,005 |
| **Investments and Assets Limited as to Use** (Notes 2 and 5) | 1,054,530 | 1,771,709 |
| **Capital Assets** - Net (Note 6) | 20,124,537 | 20,795,765 |
| **Other Assets** | 294,272 | 362,397 |
| Total assets | **$ 44,996,406** | **$ 45,146,876** |
| **Liabilities and Net Assets** | | |
| **Current Liabilities** | | |
| Current portion of long-term debt (Note 7) | $ 445,000 | $ 425,000 |
| Accounts payable | 1,703,620 | 1,808,677 |
| Cost report settlements payable (Note 4) | 1,012,154 | 579,595 |
| Accrued liabilities (Note 9) | 3,191,407 | 3,076,654 |
| Total current liabilities | 6,352,181 | 5,889,926 |
| **Long-term Debt** (Note 7) | 10,065,000 | 10,510,000 |
| Total liabilities | 16,417,181 | 16,399,926 |
| **Net Assets** | | |
| Invested in capital assets - Net of related debt | 9,614,537 | 9,860,765 |
| Restricted for capital asset expenditures | 93,778 | 44,817 |
| Unrestricted | 18,870,910 | 18,841,368 |
| Total net assets | 28,579,225 | 28,746,950 |
| Total liabilities and net assets | **$ 44,996,406** | **$ 45,146,876** |

See Notes to Financial Statements.

# West Shore Medical Center

## Statement of Revenue, Expenses, and Changes in Net Assets

| | Year Ended | |
|---|---|---|
| | June 30, 2006 | June 30, 2005 |
| **Operating Revenue** | | |
| Net patient service revenue (Note 13) | $ 33,847,066 | $ 33,293,515 |
| Other operating revenue | 1,214,949 | 782,925 |
| Total operating revenue | 35,062,015 | 34,076,440 |
| **Operating Expenses** | | |
| Salaries | 14,540,456 | 13,693,060 |
| Benefits | 4,668,138 | 4,506,725 |
| Supplies | 4,226,500 | 4,144,181 |
| Professional fees and outside services | 5,719,162 | 4,365,290 |
| Depreciation and amortization | 2,650,390 | 2,860,236 |
| Other | 3,791,084 | 3,523,002 |
| Total operating expenses | 35,595,730 | 33,092,494 |
| **Income (Loss) from Operations** | (533,715) | 983,946 |
| **Nonoperating Income (Expenses)** - Net (Note 14) | 215,690 | 206,178 |
| **Excess of Revenue (Under) Over Expenses Before Contributions Restricted for Capital Assets** | (318,025) | 1,190,124 |
| **Contributions Restricted for Capital Assets** | 150,300 | 79,612 |
| **(Decrease) Increase in Net Assets** | (167,725) | 1,269,736 |
| **Net Assets** - Beginning of year | 28,746,950 | 27,477,215 |
| **Net Assets** - End of year | **$ 28,579,225** | **$ 28,746,951** |

See Notes to Financial Statements.

# West Shore Medical Center

## Statement of Cash Flows

| | Year Ended June 30, 2006 | Year Ended June 30, 2005 |
|---|---|---|
| **Cash Flows from Operating and Nonoperating Activities** | | |
| Cash received from patients and third-party payors | $ 32,919,831 | $ 33,724,502 |
| Cash paid to suppliers and employees | (32,404,196) | (29,812,222) |
| Other receipts and payments | 1,221,142 | 696,792 |
| Net cash provided by operating activities | 1,736,777 | 4,609,072 |
| **Cash Flows from Noncapital Financing Activities** | | |
| Noncapital contributions | 49,967 | 20,572 |
| Net payments made on scholarship loans | - | (347) |
| Net cash provided by noncapital financing activities | 49,967 | 20,225 |
| **Cash Flows from Investing Activities** | | |
| Purchase of investments | (2,898,828) | (3,167,087) |
| Interest received on investments | 664,339 | 454,059 |
| Proceeds from the sale of investments | 2,379,214 | 1,703,540 |
| Other investing | (100,372) | (209,426) |
| Net cash provided by (used in) investing activities | 44,353 | (1,218,914) |
| **Cash Flows from Capital and Related Financing Activities** | | |
| Purchase of property and equipment | (2,032,000) | (1,699,344) |
| Proceeds from sale of capital assets | 86,232 | - |
| Restricted contributions received for capital assets | 150,300 | 79,612 |
| Interest paid on long-term debt | (332,315) | (280,760) |
| Principal paid on long-term debt | (425,000) | (405,000) |
| Net cash used in capital and related financing activities | (2,552,783) | (2,305,492) |
| **Net (Decrease) Increase in Cash and Cash Equivalents** | (721,686) | 1,104,891 |
| **Cash and Cash Equivalents** - Beginning of year | 1,959,439 | 854,548 |
| **Cash and Cash Equivalents** - End of year | **$ 1,237,753** | **$ 1,959,439** |
| **Balance Sheet Classification of Cash** | | |
| General Fund - Cash and cash equivalents | $ 845,765 | $ 1,566,190 |
| Restricted funds and assets limited as to use - Cash and cash equivalents | 391,988 | 393,249 |
| Total | **$ 1,237,753** | **$ 1,959,439** |

See Notes to Financial Statements.

## Statement of Cash Flows (Continued)

| | Year Ended | |
|---|---|---|
| | June 30, 2006 | June 30, 2005 |
| **Reconciliation of Income (Loss) from Operations to Net Cash from Operating Activities** | | |
| Income (loss) from operations | $ (533,715) | $ 983,946 |
| Adjustments to reconcile income (loss) from operations to net cash from operating activities: | | |
| Depreciation and amortization | 2,650,390 | 2,860,232 |
| Provision for bad debts | 2,091,897 | 1,563,015 |
| Loss (gain) on sale of assets | 6,193 | (90,438) |
| Changes in assets and liabilities which provided (used) cash: | | |
| Accounts receivable | (2,619,130) | (1,861,315) |
| Cost report settlement receivables | (400,000) | 400,000 |
| Inventories | 119,269 | (45,202) |
| Prepaid expenses | 159,619 | (54,861) |
| Accounts payable | (105,058) | 247,917 |
| Accrued liabilities | (65,247) | 272,185 |
| Cost report settlements payable | 432,559 | 333,593 |
| Net cash provided by operating activities | $ 1,736,777 | $ 4,609,072 |

There were no noncash capital and related financing activities, noncapital financing activities, and investing activities during 2006 and 2005.

## Note 1 - Nature of Business and Significant Accounting Policies

**Reporting Entity** - West Shore Medical Center (the "Center") operates as a short-term, acute-care facility offering inpatient and outpatient health care services primarily to citizens of northwest Michigan. A significant portion of the Center's net patient service revenue is receivable under contractual arrangements with Medicare, Medicaid, and Blue Cross/Blue Shield of Michigan programs. The Center is organized under Public Act 230 of the Public Acts of 1987.

The Center is a component unit of Manistee County and is governed by its own board of trustees, who are appointed by the County of Manistee, and functions as a separate and distinct corporate body from the County. The Center is not empowered to create, in any fashion, debt or liabilities on behalf of the County or to pledge the full faith and credit of the County.

The West Shore Healthcare Foundation (the "Foundation"), which is controlled by West Shore Medical Center, was established to solicit contributions from the general public solely for the funding of capital asset acquisitions by the Center. Funds are distributed to the Center as determined by the Foundation's board of trustees. The assets and activities of the Foundation, which are not material, are included with the Center's financial statements.

**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 certain reported amounts and disclosures in the financial statements. Actual results could differ from those estimates.

**Basis of Presentation** - The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, issued in June 1999. The Center follows the "business-type" activities reporting requirements of GASB Statement No. 34 that provides a comprehensive look at the Center's financial activities. No component units are required to be reported in the Center's financial statements.

**Enterprise Fund Accounting** - The Center uses enterprise fund accounting. Revenues and expenses are recognized on the accrual basis using the economic resources measurement focus. Based on Governmental Accounting Standards (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*, as amended, the Center has elected to apply the provisions of all relevant pronouncements of the Financial Accounting Standards Board (FASB), including those issued after November 30, 1989, that do not conflict with or contradict GASB pronouncements.

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

**Cash and Cash Equivalents** - The Center considers all liquid investments purchased with an original maturity date of three months or less to be cash and cash equivalents.

**Accounts Receivable** - 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 write-off rate factors applied to unpaid accounts based on aging. Loss rate factors are based on historical loss experience and adjusted for economic conditions and other trends affecting the Center's ability to collect outstanding amounts. Uncollectible amounts are written off against the allowance for doubtful accounts in the period they are determined to be uncollectible. An allowance for contractual adjustments and interim payment advances is based on expected payment rates from payors based on current reimbursement methodologies. This amount also includes amounts received as interim payments against unpaid claims by certain payors.

**Investments** - Investments are stated at fair market value. 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.

**Inventories** - Inventories are stated at the lower of cost, determined by the first-in, first-out method or market. Inventoriable items include dietary, pharmacy, laboratory, surgical, and patient billable supplies.

**Capital Assets** - Capital asset acquisitions consisting of property and equipment are recorded at cost. Donations of capital assets are stated at fair market value at date of donation. Depreciation is computed principally 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 Center routinely receives contributions from individuals and private organizations. Revenues from these sources (including contributions of capital assets) are recognized when all eligibility requirements, including time requirements, are met. Contributions may be restricted for either specific operating purposes or for capital purposes. Contributions restricted for operating purposes are reported as nonoperating income. Contributions restricted for capital acquisitions are reported after nonoperating income.

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

**Net Assets** - Net assets of the Center are classified in three components. Net assets invested in capital assets net of related debt consist of capital assets net of accumulated depreciation and reduced by outstanding borrowings used to finance the purchase or construction of those assets. Restricted net assets are noncapital net assets that must be used for a particular purpose, as specified by creditors, grantors, or contributors external to the Center, including amounts deposited with trustees as required by revenue bond indentures, discussed in Note 5. Unrestricted net assets are the remaining net assets that do not meet the definition of net assets invested in capital assets net of related debt or restricted net assets.

**Operating Revenue and Expenses** - The Center's statement of revenue, expenses, and changes in net assets distinguishes between operating and nonoperating revenue and expenses. Operating revenue results from transactions associated with providing health care services - the Center's principal activity. Nonoperating revenue, including investment income, contributions received for purposes other than capital asset acquisition, and interest expense, are reported as nonoperating income. Operating expenses are all expenses incurred to provide health care services, other than financing costs.

**Net Patient Service Revenue** - 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. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined (see Note 4).

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation, and management believes it is in compliance with these laws and regulations. Compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs.

**Pension Plans** - The Center has four noncontributory, trustee-defined contribution pension plans covering substantially all employees. The Center's policy is to fund pension cost as participants qualify for contributions (see Note 10). The Center also offers a deferred compensation plan under Section 457 of the Internal Revenue Code to employees who wish to participate.

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

**Professional Liability Insurance** - The Center accrues the estimated ultimate expense, including litigation and settlement expense, for the reported incidents of alleged medical malpractice occurring during the year, as well as the estimated cost of those claims that have not been reported to the insurance carrier at year end (see Note 11).

**Charity Care** - The Center provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because the Center does not pursue collection of amounts determined to qualify as charity care, they are not reported as operating revenue. Charity care for the years ended June 30, 2006 and 2005 totaled approximately $394,000 and $14,000, respectively.

**Tax Status** - The Center is a municipal health facilities organization under Public Act 230 of State of Michigan law and is tax exempt under the Internal Revenue Code. Accordingly, no tax provision is reflected in the financial statements.

**Reclassification** - Certain 2005 amounts have been reclassified to conform to the 2006 presentation.

## Note 2 - Deposits and Investments

The Center's investment policy authorizes the Center to make deposits in the accounts of federally insured banks, credit unions, and savings and loan associations that have offices in Michigan.

The Center designated National City Bank for the deposit of its funds.

The Center's cash and investments are subject to several types of risk, which are examined in more detail below:

**Custodial Credit Risk of Bank Deposits** - Custodial credit risk is the risk that in the event of a bank failure, the Center's deposits may not be returned to it. The Center does not have a deposit policy for custodial credit risk of bank deposits. At June 30, 2006, the Center's deposit balance of $1,600,159 had $1,395,600 of bank deposits (certificates of deposit, checking, and savings accounts) that were uninsured and uncollateralized. The Center believes that due to the dollar amounts of cash deposits and the limits of FDIC insurance, it is impractical to insure all deposits. As a result, the Center evaluates each financial institution with which it deposits funds and assesses the level of risk of each institution; only those institutions with an acceptable estimated risk level are used as depositories.

## Note 2 - Deposits and Investments (Continued)

**Interest Rate Risk** - Interest rate risk is the risk that the value of investments will decrease as a result of a rise in interest rates. The Center's investment policy does not restrict investment maturities. The Center's policy minimizes interest rate risk by structuring the investment portfolio so that securities mature to meet cash requirements for ongoing operations, thereby avoiding the need to sell securities in the open market and limiting the average maturities in accordance with the Center's cash requirements.

At June 30, 2006, the average maturities of investments are as follows:

| Investment Type | Fair Value | Weighted Average Maturity (Years) |
|---|---|---|
| U.S. agencies and pass-throughs | $ 6,199,177 | 0.28 |
| Variable rate demand notes | 481,965 | 17.08 |
| Mutual funds | 9,969,915 | - |
| Money market funds | 265,556 | - |
| Total fair value | $ 16,916,613 | |
| Portfolio weighted average maturity | - | 1.49 |

At June 30, 2005, the average maturities of investments are as follows:

| Investment Type | Fair Value | Weighted Average Maturity (Years) |
|---|---|---|
| U.S. agencies and pass-throughs | $ 5,718,548 | 0.67 |
| Variable rate demand notes | 681,693 | 20.41 |
| Mutual funds | 8,509,113 | - |
| Money market funds | 1,572,518 | - |
| Total fair value | $ 16,483,872 | |
| Portfolio weighted average maturity | - | 2.76 |

## Note 2 - Deposits and Investments (Continued)

**Credit Risk** - Credit risk is the risk that an insurer to an investment will not fulfill its obligations. The Center's investments are goverened, and limited, by Public Act 20 of the Michigan Public Acts of 1943. The Center's investment policy has been designed and approved to comply with this requirement. In accordance with Public Act 20, the Center's surplus funds may only be invested as follows:

- Bonds, securities, or other obligations of the United States or an agency instrumentality of the United States,
- Certificates of deposit, savings accounts, deposit accounts, or depository receipts of a financial instution and interest bearing accounts in a financial institution organized under law in the State of Michigan or the United States,
- Commercial paper rated at time of purchase within the two highest classifications established by not less than two standard rating services and that matures not more than 270 days after the purchase date,
- Repurchase agreements of the United States or an agency instrumentality of the United States,
- Bankers' acceptance of United States banks,
- Obligations of the State of Michigan or any of its political divisions that at time of purchase are rated as investment grade by not less than one standard rating service,
- Mutual funds registered under the Investment Company Act of 1940, Title I of Chapter 686, with authority to purchase only investment vehciles that are legal for direct investment by a public corporation, and
- Investment pools organized under the Surplus Funds Investment Pool Act of 1982, Public Act 367 and under the Local Government Investment Pool Act of 1985, Public Act 121.

At June 30, 2006, the credit quality ratings of investment type were as follows:

| Investment | Fair Value | Rating | Rating Organization |
|---|---|---|---|
| U.S. agencies and pass-throughs | $ 6,199,177 | Aaa | Moody's |
| Variable rate demand notes | 481,965 | AA- | S&P |

## Note 2 - Deposits and Investments (Continued)

At June 30, 2005, the credit quality ratings of investment type were as follows:

| Investment | Fair Value | Rating | Rating Organization |
|---|---|---|---|
| U.S. agencies and pass-throughs | $ 5,718,548 | Aaa | Moody's |
| Variable rate demand notes | 681,693 | Aa2 | S&P |

**Concentration of Credit Risk** - The Center places no limit on the amount the Center may invest in any one issuer. Investments that individually exceed 5 percent of the Center's total investments at June 30, 2006 are as follows:

| Investment | Fair Value |
|---|---|
| Franklin Adjustable U.S. Government Fund A - Mutual fund | $ 4,843,733 |
| Allegiant Government Mortgage Fund I - Mutual fund | 5,126,182 |

Total investments at June 30, 2005 are as follows:

| Investment | Fair Value |
|---|---|
| Franklin U.S. Government Fund A - Mutual fund | $ 2,393,034 |
| Franklin Adjustable U.S. Government Fund A - Mutual fund | 2,349,570 |
| Allegiant Government Mortgage Fund I - Mutual fund | 3,766,509 |
| Allegiant Government Money Market Fund | 1,528,674 |

## Note 3 - Accounts Receivable

The details of accounts receivable are set forth below.

| | 2006 | 2005 |
|---|---|---|
| Patient accounts receivable | $ 8,883,209 | $ 8,597,763 |
| Less: | | |
| Allowance of uncollectible accounts | (793,178) | (623,335) |
| Allowance for contractual adjustments | (4,220,917) | (4,434,553) |
| Total patient accounts receivable | 3,869,114 | 3,539,875 |
| Other | 444,470 | 246,476 |
| Total accounts receivable | $ 4,313,584 | $ 3,786,351 |

## Note 3 - Accounts Receivable (Continued)

The Center 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:

| | Percent | |
|---|---|---|
| | 2006 | 2005 |
| Medicare | 33 | 35 |
| Blue Cross/Blue Shield of Michigan | 12 | 18 |
| Medicaid | 12 | 10 |
| Commercial insurance and HMOs | 17 | 19 |
| Self-pay | 26 | 18 |
| Total | 100 | 100 |

## Note 4 - Cost Report Settlements

The Center has agreements with these payors that provide for reimbursement to the Center at amounts different from its established rates. 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 and outpatient laboratory 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. Inpatient capital costs relating to Medicaid patients are paid on a cost-reimbursement method. Outpatient services are reimbursed on an established fee-for-service methodology.
- **Blue Cross/Blue Shield of Michigan** - All services rendered to Blue Cross/ Blue Shield of Michigan subscribers are reimbursed based on a percentage of Center charges.

## Note 4 - Cost Report Settlements (Continued)

Cost report settlements receivable and payable result from the adjustment of interim payments to final reimbursement under these programs, and is subject to audit by each responsible intermediary. These audits may result in changes to these estimated cost report settlement balances and will be adjusted in future periods as final settlements are determined. Final cost report settlements increased net patient service revenue by approximately $200,000 and $650,000 for the years ended June 30, 2006 and 2005, respectively, reflecting settlements received for prior years in excess of previously estimated amounts.

## Note 5 - Investments and Assets Limited as to Use

The details of investments and assets limited as to use for the years ended June 30, 2006 and 2005 are detailed below. The composition of investments is detailed in Note 2.

| | 2006 | 2005 |
|---|---|---|
| Assets limited as to use: | | |
| Designated by the board for: | | |
| Payment of potential professional liability claims - Municipal investment fund - Cash and cash equivalents | $ 166,000 | $ 169,443 |
| Endowments - Cash and cash equivalents | 57,990 | 67,927 |
| Scholarship loans | 79,283 | 56,340 |
| Other - Cash and cash equivalents | 74,420 | 113,262 |
| Restricted by Foundation for: | | |
| Equipment - Cash and cash equivalents | 93,578 | 42,617 |
| Building improvements - Contributions receivable | - | 2,000 |
| Other | 200 | 200 |
| Total assets limited as to use | 471,471 | 451,789 |
| Unrestricted investments: | | |
| Investments | 16,916,613 | 16,483,872 |
| Other | 10,000 | 10,000 |
| Total investments and assets limited as to use | 17,398,084 | 16,945,661 |
| Less current portion of short-term investments | (16,343,554) | (15,173,952) |
| Total long-term investments and assets limited as to use | $ 1,054,530 | $ 1,771,709 |

## Note 6 - Capital Assets

Capital asset activity for the year ended June 30, 2006 was as follows:

| | July 1, 2005 | Additions | Transfers | Retirements | June 30, 2006 | Depreciable Life - Years |
|---|---|---|---|---|---|---|
| Land | $ 91,192 | $ - | $ - | $ - | $ 91,192 | |
| Land improvements | 788,619 | 9,184 | - | - | 797,803 | 10 - 20 |
| Building and improvements | 20,446,410 | 56,094 | 167,218 | - | 20,669,722 | 10 - 40 |
| Equipment and furnishings | 20,423,471 | 1,075,407 | 176,410 | (75,183) | 21,600,105 | 3 - 20 |
| Construction in progress | 223,054 | 891,315 | (343,628) | (63,863) | 706,878 | |
| Total | 41,972,746 | 2,032,000 | - | (139,046) | 43,865,700 | |
| Less accumulated depreciation: | | | | | | |
| Land improvements | 562,140 | 49,512 | - | - | 611,652 | |
| Building and improvements | 6,290,799 | 1,119,551 | - | - | 7,410,350 | |
| Equipment and furnishings | 14,324,042 | 1,441,744 | - | (46,625) | 15,719,161 | |
| Total | 21,176,981 | 2,610,807 | - | (46,625) | 23,741,163 | |
| Net carrying amount | $ 20,795,765 | $ (578,807) | $ - | $ (92,421) | $ 20,124,537 | |

Capital asset activity for the year ended June 30, 2005 was as follows:

| | July 1, 2004 | Additions | Transfers | Retirements | June 30, 2005 | Depreciable Life - Years |
|---|---|---|---|---|---|---|
| Land | $ 91,192 | $ - | $ - | $ - | $ 91,192 | |
| Land improvements | 788,619 | - | - | - | 788,619 | 10 - 20 |
| Building and improvements | 20,134,127 | 233,350 | 78,933 | - | 20,446,410 | 10 - 40 |
| Equipment and furnishings | 19,327,470 | 1,019,316 | 376,549 | (299,864) | 20,423,471 | 3 - 20 |
| Construction in progress | 231,858 | 446,678 | (455,482) | - | 223,054 | |
| Total | 40,573,266 | 1,699,344 | - | (299,864) | 41,972,746 | |
| Less accumulated depreciation: | | | | | | |
| Land improvements | 473,708 | 88,432 | - | - | 562,140 | |
| Building and improvements | 5,211,916 | 1,078,883 | - | - | 6,290,799 | |
| Equipment and furnishings | 12,947,256 | 1,647,088 | - | (270,302) | 14,324,042 | |
| Total | 18,632,880 | 2,814,403 | - | (270,302) | 21,176,981 | |
| Net carrying amount | $ 21,940,386 | $ (1,115,059) | $ - | $ (29,562) | $ 20,795,765 | |

Subsequent to June 30, 2006, the Center applied for and was approved for a Certificate of Need for hospital renovation and expansion. The Center has obtained a general contractor and total costs are estimated to be $8,800,000. The project is expected to be completed in fiscal year 2008. The Center plans on financing this project with tax-exempt bond financing of $8 million, with an option for an additional $2 million.

## Note 7 - Long-term Debt

Long-term debt for the years ended June 30, 2006 and 2005 was as follows:

| | July 1, 2005 | Current Year Additions | Current Year Reductions | June 30, 2006 | Current Portion |
|---|---|---|---|---|---|
| Bonds payable - 2001 Series | $ 10,935,000 | $ - | $ 425,000 | $ 10,510,000 | $ 445,000 |

| | July 1, 2004 | Current Year Additions | Current Year Reductions | June 30, 2005 | Current Portion |
|---|---|---|---|---|---|
| Bonds payable - 2001 Series | $ 11,340,000 | $ - | $ 405,000 | $ 10,935,000 | $ 425,000 |

Long-term debt consists of Adjustable Rate Demand Bonds, Series 2001 issued by the Center. These bonds mature on April 1, 2022 and have a variable interest rate established on a weekly basis. The effective interest rate was 4.02 percent and 2.38 percent at June 30, 2006 and 2005, respectively. The bonds require annual payments ranging from $445,000 to $920,000 through April 1, 2022.

The bonds are secured by an irrevocable direct-pay letter of credit which expires in October 2007. 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 variable rate Series 2001 Bonds described above are remarketed on a weekly basis. Should the remarketing agent be unable to remarket the bonds and notes based on its best efforts, the bonds and notes would be "put" back to the trustee, who would draw down on the letter of credit to pay down the Series 2001 Bonds.

In conjunction with the issuance of the irrevocable direct-pay letter of credit and related agreements, the Center has agreed to certain quarterly and annual reporting requirements, certain financial covenants, and various other operational covenants.

## Note 7 - Long-term Debt (Continued)

A schedule of the principal and estimated interest payments on long-term debt at June 30, 2006 is as follows:

| | Bonds Payable | Estimated Interest at Effective Rate of 4.02 Percent at June 30, 2006 |
|---|---|---|
| 2007 | $ 445,000 | $ 418,030 |
| 2008 | 470,000 | 399,890 |
| 2009 | 490,000 | 380,795 |
| 2010 | 515,000 | 360,845 |
| 2011 | 540,000 | 339,891 |
| 2012-2016 | 3,135,000 | 1,346,549 |
| 2017-2021 | 3,995,000 | 642,044 |
| 2022 | 920,000 | 27,738 |
| Total payments | $ 10,510,000 | $ 3,915,782 |

## Note 8 - Interest Rate Swap Agreement

During the year ended June 30, 2003, the Center entered into an interest rate swap agreement related to its Adjustable Rate Demand Health Facilities Revenue Bonds in notation amounts as detailed in the table below to reduce the impact of changes in the interest rate on its variable rate long-term debt. The swap agreement matures in November 2007. The effect of the swap was to effectively change the Center's variable interest rate on bonds to a synthetic fixed rate of 2.935 percent. Due to increasing interest rates, at June 30, 2006 and 2005, the swap had a positive fair value of approximately $81,000 and $3,000, respectively. Since the fair value of the swap was positive, the Center is exposed to credit risk in the amount of the interest rate swap's fair value. The swap's counterparty is rated AA3 by Moody's, A+ by Standard and Poor's, and AA- by Fitch. The Center or counterparty may terminate the interest rate swap agreement if either party fails to perform under the terms of a standard ISDA Master Agreement as amended. If terminated, the Center has the option to enter into a new interest rate swap agreement with another counterparty or to convert its variable rate bonds into fixed rate bonds. The Center does not anticipate nonperformance by the counterparties.

## Note 8 - Interest Rate Swap Agreement (Continued)

The notational amount for each year in which the fixed rate will apply under the interest rate swap agreement, is as follows:

| | Notational Amount |
|---|---|
| Effective date | $ 6,000,000 |
| April 1, 2004 | 5,622,500 |
| April 1, 2005 | 5,420,000 |
| April 1, 2006 | 5,207,000 |
| April 1, 2007 | 4,985,000 |

## Note 9 - Accrued Liabilities

The detail of accrued liabilities is given below:

| | 2006 | 2005 |
|---|---|---|
| Payroll and related amounts | $ 421,460 | $ 857,263 |
| Pension | 421,814 | 440,084 |
| Compensated absences | 1,529,532 | 1,376,955 |
| Professional liability and health insurance claims | 596,515 | 371,515 |
| Other | 222,086 | 30,837 |
| Total accrued liabilities | $ 3,191,407 | $ 3,076,654 |

Compensated absences represent the estimated liability to be paid to employees under the Center's sick and vacation policy. Under the Center's policy, employees earn sick and vacation time based on length of service with the Center.

## Note 10 - Pension

The Center provides benefits through four participant-directed defined contribution plans to substantially all employees who accumulate at least 1,000 hours of service per year. In a defined contribution plan, benefits depend solely on amounts contributed to the plan plus investment earnings. Generally, employees are eligible to participate after one year of service and the attainment of age 21. The Center's contributions for each employee plus net investment income and interest allocated to each employee's account are fully vested in periods ranging from 5 years to 10 years of continuous service. Center contributions for, and interest forfeited by, employees who leave employment prior to being fully vested are used to reduce the Center's current-period contribution requirement. Pension expense, net of forfeitures, to the plans for the years ended June 30, 2006 and 2005 totaled approximately $782,000 and $767,000, respectively.

## Note 11 - Risk Management

The Center is exposed to various risks of loss related to property loss, torts, professional liability, errors and omissions, and employee injuries. The Hospital has purchased commercial insurance for the various risks described above. Medical benefits provided to employees are paid directly by the Center. To assist in reducing the Center's exposure to large specific cases, the Center has purchased excess insurance contracts which permit the recovery of a portion of the losses in excess of amounts detailed in the excess insurance contract.

The Center is insured against potential professional and general 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 Center must pay a deductible toward the costs of litigation or settling any asserted claims. In addition, the Center bears the risk of the ultimate costs of any individual claim exceeding the policy limits for claims asserted in the policy year. At June 30, 2006 and 2005, the Center has made a provision for the estimated loss in connection with those professional liability claims for incidents occurring during the year for which an amount can be reasonably estimated, including a provision for claims incurred but not reported at year end.

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, may be uninsured if the Center does not purchase prepaid tail coverage.

## Note 12 - Physician Guarantees

In connection with the recruitment of physicians, the Center may enter into minimum revenue guarantees. In the event that a physician is unable to generate revenue in excess of expenses, the Center is obligated to reimburse the shortage to the physician. For guarantees entered into on or after January 1, 2006, the Center is required to recognize a liability for the estimated fair value of the guarantees. As of June 30, 2006, the maximum amount payable under such guarantees is $300,000. As of June 30, 2006, a deferred asset and a liability in the amount of $180,000 is included in the accompanying balance sheet; that amount represents the Center's estimate of the aggregated fair value of the outstanding guarantees entered into after January 1, 2006.

The Center has other guarantees, entered into before January 1, 2006, which are not required to be recognized as a liability. In relation to these guarantees, the Center has maximum income payments to various physicians totaling approximately $1,000,000. Total payments expected to be made by the Center for these contracts is approximately $536,000.

## Note 13 - Net Patient Service Revenue

Net patient service revenue consists of the following:

| | 2006 | 2005 |
|---|---|---|
| Patient revenue: | | |
| Inpatient | $ 23,141,191 | $ 20,252,731 |
| Outpatient | 52,663,622 | 41,174,947 |
| Total patient revenue | 75,804,813 | 61,427,678 |
| Revenue deductions: | | |
| Provision for third-party payors | 39,865,850 | 26,571,148 |
| Provision for uncollectible accounts | 2,091,897 | 1,563,015 |
| Total revenue deductions | 41,957,747 | 28,134,163 |
| Net patient service revenue | $ 33,847,066 | $ 33,293,515 |

## Note 14 - Nonoperating Income and Expenses

The details of nonoperating income (loss) are shown below:

| | 2006 | 2005 |
|---|---|---|
| Interest income | $ 663,268 | $ 453,151 |
| Net unrealized and realized gains (losses) on investments | (166,300) | 12,307 |
| Interest expense | (332,315) | (280,760) |
| Restricted contributions | 49,967 | 20,572 |
| Restricted investment income | 1,070 | 908 |
| Total other income (loss) | $ 215,690 | $ 206,178 |