



MHS PRIMARY CARE, INC.

Financial Statements

September 30, 2009 and 2008

(With Independent Auditors' Report Thereon)

MHS PRIMARY CARE, INC.

Financial Statements

September 30, 2009 and 2008

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KPMG LLP
One Financial Plaza
Hartford, CT 06103-4103

Independent Auditors' Report

The Board of Directors
MHS Primary Care, Inc.:

We have audited the accompanying balance sheets of MHS Primary Care, Inc., a taxable Connecticut, nonstock corporation, (the Company) as of September 30, 2009 and 2008, and the related statements of operations and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Company'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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 MHS Primary Care, Inc., as of September 30, 2009 and 2008, and the results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

KPMG LLP

December 23, 2009

MHS PRIMARY CARE, INC.

Balance Sheets

September 30, 2009 and 2008

Assets	2009	2008
Current assets:		
Cash	\$ 121,617	739,265
Accounts receivable, less allowances of \$304,000 in 2009 and \$341,000 in 2008	718,893	534,221
Prepaid expenses and other receivables	151,996	42,350
Due from affiliates	8,158	—
Total current assets	<u>1,000,664</u>	<u>1,315,836</u>
Property and equipment, net of accumulated depreciation	1,494,628	810,975
Total assets	<u>\$ 2,495,292</u>	<u>2,126,811</u>
Liabilities and Net Assets		
Current liabilities:		
Current portion – related party notes payable	\$ 17,655	16,465
Current portion – notes payable	38,241	20,000
Accounts payable and accrued expenses	1,181,032	858,765
Due to affiliates	—	17,706
Total current liabilities	<u>1,236,928</u>	<u>912,936</u>
Long-term liabilities:		
Related party notes payable	66,684	84,340
Notes payable	298,890	248,333
Retention compensation	63,889	—
Commitments and contingencies (note 6)		
Unrestricted net assets	<u>828,901</u>	<u>881,202</u>
Total liabilities and net assets	<u>\$ 2,495,292</u>	<u>2,126,811</u>

See accompanying notes to financial statements.

MHS PRIMARY CARE, INC.

Statements of Operations and Changes in Net Assets

Years ended September 30, 2009 and 2008

	<u>2009</u>	<u>2008</u>
Revenues:		
Net patient service revenue	\$ 10,243,212	9,991,010
Other revenue	202,708	155,862
Total revenues	<u>10,445,920</u>	<u>10,146,872</u>
Expenses:		
Salaries and wages	7,833,403	7,590,866
Payroll taxes and employee benefits	1,442,559	1,381,440
Rent	710,135	587,396
Supplies	691,829	742,450
Depreciation and amortization	254,229	228,500
Professional fees	522,651	429,756
Insurance	326,737	323,964
Occupancy expenses	261,159	218,184
Provision for bad debts	51,584	57,161
Equipment rental	56,178	48,780
Other	307,757	232,412
Total expenses	<u>12,458,221</u>	<u>11,840,909</u>
Operating loss	(2,012,301)	(1,694,037)
Contributed capital from Middlesex Health System, Inc.	<u>1,960,000</u>	<u>1,650,000</u>
Change in net assets	(52,301)	(44,037)
Unrestricted net assets, beginning of year	<u>881,202</u>	<u>925,239</u>
Unrestricted net assets, end of year	<u>\$ 828,901</u>	<u>881,202</u>

See accompanying notes to financial statements.

MHS PRIMARY CARE, INC.

Statements of Cash Flows

Years ended September 30, 2009 and 2008

	<u>2009</u>	<u>2008</u>
Cash flows from operating activities:		
Change in net assets	\$ (52,301)	(44,037)
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Contributed capital from Middlesex Health System, Inc.	(1,960,000)	(1,650,000)
Depreciation and amortization	254,229	228,500
Changes in assets and liabilities:		
Accounts receivable, net	(184,672)	(280,355)
Prepaid expenses and other receivables	(109,646)	14,788
Accounts payable and accrued expenses	322,267	216,523
Due from/to affiliate	(25,864)	9,143
Retention compensation	63,889	—
Net cash used in operating activities	<u>(1,692,098)</u>	<u>(1,505,438)</u>
Cash flows from investing activities:		
Purchases of property and equipment	<u>(937,882)</u>	<u>(203,130)</u>
Net cash used in investing activities	<u>(937,882)</u>	<u>(203,130)</u>
Cash flows from financing activities:		
Contributed capital from Middlesex Health System, Inc.	1,960,000	1,650,000
Proceeds from note payable	100,000	—
Payments for related party notes payable and note payable	<u>(47,668)</u>	<u>(35,355)</u>
Net cash provided by financing activities	<u>2,012,332</u>	<u>1,614,645</u>
Net decrease in cash	(617,648)	(93,923)
Cash, beginning of year	<u>739,265</u>	<u>833,188</u>
Cash, end of year	\$ <u><u>121,617</u></u>	\$ <u><u>739,265</u></u>
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 16,066	19,778

See accompanying notes to financial statements.

MHS PRIMARY CARE, INC.

Notes to Financial Statements

September 30, 2009 and 2008

(1) Organization

MHS Primary Care, Inc. (the Company) is a taxable Connecticut, nonstock corporation, and wholly owned subsidiary of Middlesex Health System, Inc. (System). System is the sole member/shareholder of its other wholly owned subsidiaries as follows: Middlesex Hospital (the Hospital), Middlesex Health Resources, Inc. (Resources), and Middlesex Health Services, Inc. (Services). The Company's purpose is to operate a number of primary care physician offices. The System and its wholly owned subsidiaries have committed to financially support the Company through September 30, 2010.

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation

The accompanying financial statements have been prepared on the accrual basis of accounting in conformity with U.S. generally accepted accounting principles.

(b) Property and Equipment

Property and equipment are stated at cost. Depreciation and amortization are being provided using the straight-line method over five to fifteen years. Leasehold improvements are depreciated over the shorter of the lease term or the useful life of the asset.

(c) 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.

Contractual allowances represent the differences between established billing rates for patient services and the amounts reimbursable by third-party payors.

Net patient service revenue for the years ended September 30, 2009 and 2008 is reported net of contractual allowances as follows:

	<u>2009</u>	<u>2008</u>
Gross patient service revenue	\$ 15,895,404	14,989,980
Less contractual allowances	(5,652,192)	(4,998,970)
Net patient service revenue	<u>\$ 10,243,212</u>	<u>9,991,010</u>

MHS PRIMARY CARE, INC.

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(d) Use of Estimates

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

(e) Income Taxes

Deferred tax assets and liabilities are recognized for the differences between the financial and income tax reporting basis of assets and liabilities.

As of September 30, 2009, the Company had net operating loss carryforwards available to reduce its future Federal taxable income of approximately \$19,300,000. The carryforward periods expire at various dates through 2028. The Company had net operating loss carryforwards available to reduce its future state taxable income of approximately \$8,400,000. The state carryforward periods expire at various dates through 2028. The deferred tax asset associated with the Company's loss carryforwards was offset by a corresponding valuation allowance, as realization of such loss carryforwards is not assured.

(f) Recently Issued Accounting Standards

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (now part of ASC 740, Income Taxes), which addresses the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a threshold of more-likely-than-not for recognition of tax benefits of uncertain tax positions taken or expected to be taken in a tax return and also provides related guidance on measurement, derecognition, classification, interest and penalties, and disclosure. The provisions of ASC 740 addressed above will be effective for the Company on October 1, 2009, with any cumulative effect of the change in accounting principle recorded as an adjustment to opening unrestricted net assets. The Company is in the process of assessing the impact of adopting these provisions and does not anticipate that the adoption will have a material impact on its results of operations and financial position.

In May 2009, the FASB issued guidance which established principles and requirements for recognition and disclosure of subsequent events. In particular, it sets forth the period after the balance sheet date during which management of a reporting entity shall evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity shall recognize events or transactions occurring after the balance sheet date in its financial statements and the disclosures that an entity shall make about events or transactions that occurred after the balance sheet date. This guidance is to be applied to the accounting for and disclosure of subsequent events not addressed in other applicable GAAP and was effective for the year ended September 30, 2009. In accordance with the guidance, management has evaluated events subsequent to September 30, 2009 and through December 23, 2009.

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(3) Health Care Regulatory Environment

The healthcare industry is subject to numerous laws and regulations of Federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations of healthcare providers. Violations of these laws and regulations could result in expulsion from government healthcare programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Management believes that the Company is in compliance with fraud and abuse regulations as well as other applicable government laws and regulations. While no known regulatory inquiries are pending, compliance with such laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time.

(4) Property and Equipment

Property and equipment consists of the following as of September 30, 2009 and 2008:

	<u>2009</u>	<u>2008</u>
Leasehold improvements	\$ 1,965,181	1,005,236
Furniture and equipment	950,643	799,769
Construction in progress	—	172,937
	<u>2,915,824</u>	<u>1,977,942</u>
Less accumulated depreciation	<u>(1,421,196)</u>	<u>(1,166,967)</u>
	<u>\$ 1,494,628</u>	<u>810,975</u>

In addition, the Company rents certain equipment under operating lease agreements. For the years ended September 30, 2009 and 2008, total rental and related expenses were \$56,178 and \$48,780, respectively.

(5) Note Payable

Repayment of a note payable of \$300,000 began on April 1, 2007 at \$1,667 per month plus interest with a final balloon payment of \$200,000 due March 1, 2012. The interest rate is the LIBOR Market Index Rate (0.25% and 3.93 % at September 30, 2009 and 2008, respectively) plus 0.90%. The outstanding balance of this note as of September 30, 2009 and 2008 was \$250,000 and \$268,333, respectively.

Repayment of a five (5) year note of \$100,000 began on January 1, 2009 with the final payment due December 1, 2013. The interest rate on this note is 7% and the outstanding balance of this note as of September 30, 2009 was \$87,131.

(6) Related Party Transactions and Notes Payable

For the fiscal years 2009 and 2008, the Company received \$1,960,000 and \$1,650,000 in capital contributions from System, respectively.

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The Company purchases general and administrative supplies and services and leases space from the Hospital. These totaled \$99,642 and \$110,013 for the years ended September 30, 2009 and 2008, respectively. The balance due to the Company from the Hospital as of September 30, 2009 was \$8,158 and balance due to the Hospital from the Company as of September 30, 2008 was \$17,706.

The Company has two unsecured promissory notes payable to the Hospital for lines of credit to finance leasehold improvements at two sites. Repayment of the notes in 120 monthly installments of \$1,917 including interest began upon completion of the renovations in 2004. The outstanding balance on the notes as of September 30, 2009 and 2008 was \$84,339 and \$100,805, respectively. The interest rate on the notes is 7%. The Company paid the Hospital interest in the amount of \$6,535 and \$7,645 for the years ended September 30, 2009 and 2008, respectively.

The Company leases ten of its facilities under noncancelable operating lease agreements (collectively, the leases). Of these leases, three of the facilities are owned by physicians who are employed by the Company; two facilities are owned by the Hospital; one facility is owned by Resources; and another is owned by Middletown Professional Park Limited Partnership I, an affiliate of Resources. Rental expense for the years ended September 30, 2009 and 2008 to related parties was \$710,135 and \$587,396, respectively. Under the terms of the lease agreements, the Company is responsible for common area maintenance costs. Estimated future payments under the leases are as follows:

Year ending September 30:	
2010	\$ 767,333
2011	754,297
2012	743,519
2013	743,720
2014	713,255
	<hr/>
	\$ 3,722,124
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The Company also has employment contracts and various compensation arrangements with certain physicians. Under the terms of the contracts, the Company is obligated to pay the employees certain salaries and other negotiated amounts. During 2009, the Company implemented a retention program under which certain physicians would receive a retention bonus after completing 5 years of service. The amount accrued under this arrangement was \$63,889 as of September 30, 2009.

(7) Employee Profit Sharing Plan

The Company sponsors a defined contribution profit sharing plan (the Plan) for its eligible employees. Participants may elect to defer amounts as allowed under the Plan and Internal Revenue Code. The employer match equals 100% of the first 3% of participant elective deferrals plus 50% of the next 2% of participant elective deferrals. In addition, the Company may make discretionary contributions as determined by the board of directors of the Company. For the years ended September 30, 2009 and 2008, the Company made matching contributions in the amount of \$225,781 and \$237,881, respectively.