



MHS PRIMARY CARE, INC.

Financial Statements

September 30, 2010 and 2009

(With Independent Auditors' Report Thereon)

MHS PRIMARY CARE, INC.

Financial Statements

September 30, 2010 and 2009

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KPMG LLP
One Financial Plaza
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Hartford, CT 06103

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, 2010 and 2009, 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, 2010 and 2009, 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, 2010

MHS PRIMARY CARE, INC.

Balance Sheets

September 30, 2010 and 2009

Assets	2010	2009
Current assets:		
Cash	\$ 473,104	121,617
Accounts receivable, less allowances of \$62,000 in 2010 and \$304,000 in 2009	863,310	718,893
Prepaid expenses and other receivables	93,371	151,996
Due from affiliates	—	8,158
Total current assets	<u>1,429,785</u>	<u>1,000,664</u>
Property and equipment, net of accumulated depreciation	<u>2,430,558</u>	<u>1,494,628</u>
Total assets	<u><u>\$ 3,860,343</u></u>	<u><u>2,495,292</u></u>
Liabilities and Net Assets		
Current liabilities:		
Current portion – related party notes payable (note 6)	\$ 18,932	17,655
Current portion – notes payable (note 5)	39,559	38,241
Accounts payable and accrued expenses	1,289,108	1,181,032
Due to affiliates	898,778	—
Total current liabilities	<u>2,246,377</u>	<u>1,236,928</u>
Long-term liabilities:		
Related party notes payable (note 6)	47,753	66,684
Notes payable (note 5)	259,331	298,890
Capital lease obligation (note 5)	835,200	—
Retention compensation	91,034	63,889
Total liabilities	<u>3,479,695</u>	<u>1,666,391</u>
Commitments and contingencies (note 6)		
Unrestricted net assets	<u>380,648</u>	<u>828,901</u>
Total liabilities and net assets	<u><u>\$ 3,860,343</u></u>	<u><u>2,495,292</u></u>

See accompanying notes to financial statements.

MHS PRIMARY CARE, INC.

Statements of Operations and Changes in Net Assets

Years ended September 30, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Revenues:		
Net patient service revenue	\$ 9,788,212	10,243,212
Other revenue	194,373	202,708
Total revenues	<u>9,982,585</u>	<u>10,445,920</u>
Expenses:		
Salaries and wages	8,192,749	7,833,404
Fringe benefits	1,720,788	1,442,558
Medical supplies and drugs	443,428	558,904
Depreciation and amortization	328,189	254,230
Provision for bad debts	36,608	51,584
Professional fees	25,997	57,169
Interest	31,297	16,066
Rent	708,244	710,135
Purchased services	293,064	666,660
Insurance	311,852	326,737
Other	804,622	540,774
Total expenses	<u>12,896,838</u>	<u>12,458,221</u>
Operating loss	(2,914,253)	(2,012,301)
Contributed capital from Middlesex Health System, Inc.	<u>2,466,000</u>	<u>1,960,000</u>
Change in net assets	(448,253)	(52,301)
Unrestricted net assets, beginning of year	<u>828,901</u>	<u>881,202</u>
Unrestricted net assets, end of year	<u>\$ 380,648</u>	<u>828,901</u>

See accompanying notes to financial statements.

MHS PRIMARY CARE, INC.

Statements of Cash Flows

Years ended September 30, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Cash flows from operating activities:		
Change in net assets	\$ (448,253)	(52,301)
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Contributed capital from Middlesex Health System, Inc.	(2,466,000)	(1,960,000)
Depreciation and amortization	328,189	254,229
Changes in assets and liabilities:		
Accounts receivable, net	(144,417)	(184,672)
Prepaid expenses and other receivables	58,625	(109,646)
Accounts payable and accrued expenses	108,076	322,267
Due from/to affiliate	906,936	(25,864)
Retention compensation	27,145	63,889
Net cash used in operating activities	<u>(1,629,699)</u>	<u>(1,692,098)</u>
Cash flows from investing activities:		
Purchases of property and equipment	<u>(428,919)</u>	<u>(937,882)</u>
Net cash used in investing activities	<u>(428,919)</u>	<u>(937,882)</u>
Cash flows from financing activities:		
Contributed capital from Middlesex Health System, Inc.	2,466,000	1,960,000
Proceeds from note payable	—	100,000
Payments for related party notes payable and note payable	<u>(55,895)</u>	<u>(47,668)</u>
Net cash provided by financing activities	<u>2,410,105</u>	<u>2,012,332</u>
Net increase (decrease) in cash	351,487	(617,648)
Cash, beginning of year	<u>121,617</u>	<u>739,265</u>
Cash, end of year	\$ <u><u>473,104</u></u>	\$ <u><u>121,617</u></u>
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 13,286	16,066
Supplemental disclosure of noncash item:		
Assets acquired under capital lease	\$ 835,200	—

See accompanying notes to financial statements.

MHS PRIMARY CARE, INC.

Notes to Financial Statements

September 30, 2010 and 2009

(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, 2011.

(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, 2010 and 2009 is reported net of contractual allowances as follows:

	<u>2010</u>	<u>2009</u>
Gross patient service revenue	\$ 15,493,403	15,895,404
Less contractual allowances	<u>(5,705,191)</u>	<u>(5,652,192)</u>
Net patient service revenue	<u>\$ 9,788,212</u>	<u>10,243,212</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, 2010, the Company had net operating loss carryforwards available to reduce its future Federal taxable income of approximately \$22,015,800. The carryforward periods expire at various dates through 2029. The Company had net operating loss carryforwards available to reduce its future state taxable income of approximately \$11,119,800. The state carryforward periods expire at various dates through 2029. 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 Adopted Accounting Standards

Effective October 1, 2009, the Company adopted FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, included in ASC Topic 740, *Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in a company'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. FIN 48 also provides related guidance on measurement, derecognition, classification, interest and penalties, and disclosure. The adoption of this standard did not have an impact on the Company's financial statements

(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.

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(4) Property and Equipment

Property and equipment consists of the following as of September 30, 2010 and 2009:

	<u>2010</u>	<u>2009</u>
Leasehold improvements	\$ 2,727,320	1,965,181
Buildings and improvements	835,200	—
Furniture and equipment	1,075,222	950,643
	<u>4,637,742</u>	<u>2,915,824</u>
Less accumulated depreciation	(2,207,184)	(1,421,196)
	<u>\$ 2,430,558</u>	<u>1,494,628</u>

In addition, the Company rents certain equipment under operating lease agreements. For the years ended September 30, 2010 and 2009, total rental and related expenses were \$56,563 and \$56,178, respectively.

Property under capital leases had a net book value of \$817,239 and \$0 at September 30, 2010 and 2009, respectively.

(5) Notes Payable and Capital Leases

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 (0.26% and 0.25 % at September 30, 2010 and 2009, respectively) plus 0.90%. The outstanding balance of this note as of September 30, 2010 and 2009 was \$229,999 and \$250,000, 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, 2010 and 2009 was \$68,891 and \$87,131, respectively.

In 2010, the Company entered into a 15-year capital lease in the amount of \$835,200 with an interest rate of 6.5% for a building. The outstanding balance on this capital lease at September 30, 2010 was \$835,200.

Aggregate scheduled repayments on long-term debt and capital lease payments are as follows:

	<u>Long-term debt</u>	<u>Capital leases</u>
2011	\$ 39,559	62,500
2012	230,971	80,000
2013	22,490	90,000
2014	5,870	90,000
2015	—	90,000
Thereafter	—	915,000
	<u>298,890</u>	<u>1,327,500</u>
Less interest	—	(492,300)
	<u>\$ 298,890</u>	<u>835,200</u>

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(6) Related Party Transactions and Notes Payable

For the fiscal years 2010 and 2009, the Company received \$2,466,000 and \$1,960,000 in capital contributions from System, respectively.

The Company purchases general and administrative supplies and services and leases space from the Hospital. These totaled \$104,494 and \$99,642 for the years ended September 30, 2010 and 2009, respectively. The balance due to the Hospital from the Company as of September 30, 2010 was \$898,778 and balance due from the Hospital to the Company as of September 30, 2009 was \$8,158.

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, 2010 and 2009 was \$66,685 and \$84,339, respectively. The interest rate on the notes is 7%. The Company paid the Hospital interest in the amount of \$5,344 and \$6,535 for the years ended September 30, 2010 and 2009, 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, 2010 and 2009 to related parties was \$708,244 and \$710,135, 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:	
2011	\$ 567,934
2012	502,350
2013	459,100
2014	424,240
2015	424,240
Thereafter	<u>1,236,418</u>
	<u>\$ 3,614,282</u>

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 2008, 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 \$91,034 and \$63,889 as of September 30, 2010 and 2009, respectively.

(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, 2010 and 2009, the Company made matching contributions in the amount of \$254,364 and \$225,781, respectively.

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(8) Subsequent Events

The Company has evaluated events through December 23, 2010, which represents the date the financial statements were available to be issued and noted no subsequent events that would have impacted the Company's financial statements.