

AUDITED FINANCIAL STATEMENTS

Natchaug Hospital, Inc.  
Years Ended September 30, 2009 and 2008  
With Report of Independent Auditors

Natchaug Hospital, Inc.

Audited Financial Statements

Years Ended September 30, 2009 and 2008

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## Report of Independent Auditors

The Board of Directors  
Natchaug Hospital, Inc.

We have audited the accompanying balance sheets of Natchaug Hospital, Inc. (the Hospital) 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 Hospital'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 and the Standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Hospital's internal control over financial reporting. Our audits included 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 Hospital'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, and 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 Natchaug Hospital, Inc. at September 30, 2009 and 2008, and the results of its operations and changes in net assets and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

A handwritten signature in black ink that reads 'Ernst & Young LLP'.

January 5, 2010

Natchaug Hospital, Inc.

Balance Sheets

	September 30	
	2009	2008
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 594,090	\$ 484,199
Accounts receivable, less allowance for uncollectible accounts of \$1,665,000 in 2009 and \$2,544,000 in 2008	4,443,082	5,729,182
Other receivables	258,851	350,313
Inventory and prepaid expenses	237,193	196,372
Due from third-party reimbursement agencies	77,139	94,282
Total current assets	<u>5,610,355</u>	<u>6,854,348</u>
Property, plant, and equipment:		
Land	195,897	195,897
Buildings and leasehold improvements	13,464,240	13,214,907
Equipment	3,323,476	2,984,335
Vehicles	820,876	776,800
	<u>17,804,489</u>	<u>17,171,939</u>
Accumulated depreciation and amortization	(6,345,735)	(5,548,897)
	<u>11,458,754</u>	<u>11,623,042</u>
Construction in process	11,000	-
Net property, plant, and equipment	<u>11,469,754</u>	<u>11,623,042</u>
Other assets	134,755	216,071
	<u>\$ 17,214,864</u>	<u>\$ 18,693,461</u>
<b>Liabilities and net assets</b>		
Current liabilities:		
Accounts payable and other accrued expenses	\$ 526,343	\$ 940,634
Payroll-related accruals	1,615,358	2,328,112
Due to affiliated corporation	141,733	676,506
Current portion of long-term debt	180,242	180,766
Total current liabilities	<u>2,463,676</u>	<u>4,126,018</u>
Accrued pension obligation and other	2,289,788	710,338
Long-term debt, less current portion	3,893,170	4,114,577
Net assets:		
Unrestricted	8,387,400	9,481,842
Temporarily restricted	180,830	260,687
	<u>8,568,230</u>	<u>9,742,529</u>
	<u>\$ 17,214,864</u>	<u>\$ 18,693,461</u>

See accompanying notes.

Natchaug Hospital, Inc.

Statements of Operations and Changes in Net Assets

	<b>Years Ended September 30</b>	
	<b>2009</b>	<b>2008</b>
Unrestricted revenues, gains, and other support:		
Net patient service revenue	\$ 40,229,374	\$ 37,896,892
Other revenue	38,247	44,727
Net assets released from restriction for operations	32,310	25,808
	<u>40,299,931</u>	<u>37,967,427</u>
Operating expenses:		
Salaries and employee benefits	30,637,189	28,040,324
Purchased services and professional fees	2,875,883	3,138,333
Supplies and other	4,513,444	4,122,031
Provision for uncollectible accounts	668,742	877,266
Depreciation and amortization	905,649	843,433
Interest	297,085	272,433
	<u>39,897,992</u>	<u>37,293,820</u>
Excess of revenues over expenses	401,939	673,607
Change in net assets related to pension plan	(1,648,852)	230,926
Net assets released from restriction for property, plant, and equipment	152,471	710,787
(Decrease) increase in unrestricted assets	<u>(1,094,442)</u>	<u>1,615,320</u>
Temporarily restricted contributions	104,924	819,751
Net assets released from restriction for property, plant, and equipment	(152,471)	(710,787)
Net assets released from restriction for operations	(32,310)	(25,808)
Increase in temporarily restricted net assets	<u>(79,857)</u>	<u>83,156</u>
Increase in net assets	<u>(1,174,299)</u>	<u>1,698,476</u>
Net assets at beginning of year	9,742,529	8,044,053
Net assets at end of year	<u>\$ 8,568,230</u>	<u>\$ 9,742,529</u>

*See accompanying notes.*

Natchaug Hospital, Inc.  
Statements of Cash Flows

	<b>Years Ended September 30</b>	
	<b>2009</b>	<b>2008</b>
<b>Operating activities</b>		
Change in net assets	\$ (1,174,299)	\$ 1,698,476
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Noncash items:		
Depreciation and amortization	905,649	843,433
Provision for uncollectible accounts	668,742	877,266
Other changes in net assets:		
Temporarily restricted contributions	(104,924)	(819,751)
Change in net assets related to pension plan	1,648,852	(230,926)
Changes in assets and liabilities:		
Accounts receivable	617,358	(713,439)
Other receivables, inventory and prepaid expenses	50,641	(338,251)
Other assets	18,370	(21,738)
Accounts payable, other accrued expenses, and payroll-related accruals	(1,127,045)	300,671
Due from third-party reimbursement agencies	17,143	906
Accrued pension obligation and other	(69,401)	(111,473)
Due to affiliated corporation	(534,773)	(107,142)
Net cash provided by operating activities	916,313	1,378,032
<b>Investing activity</b>		
Purchases of property, plant, and equipment, net	(689,415)	(2,364,788)
Net cash used in investing activity	(689,415)	(2,364,788)
<b>Financing activities</b>		
Temporarily restricted contributions	104,924	819,751
Proceeds from issuance of debt	69,169	89,968
Principal payments on obligations	(291,100)	(211,956)
Net cash (used in) provided by financing activities	(117,007)	697,763
Increase (decrease) in cash and cash equivalents	109,891	(288,993)
Cash and cash equivalents at beginning of year	484,199	773,192
Cash and cash equivalents at end of year	\$ 594,090	\$ 484,199

*See accompanying notes.*

# Natchaug Hospital, Inc.

## Notes to Financial Statements

September 30, 2009

### **1. Significant Accounting Policies**

#### **Organization**

Natchaug Hospital, Inc. (the Hospital) is a nonprofit organization incorporated under the General Statutes of the State of Connecticut. The Hospital provides inpatient and outpatient psychiatric healthcare services. Effective August 1998, Hartford Health Care Corporation (HHCC) became the sole member of the Hospital. Accordingly, the Board of Directors of HHCC elects the Board of Directors of the Hospital.

#### **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 amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. There is at least a reasonable possibility that certain estimates will change by material amounts in the near term. Actual results could differ from those estimates.

#### **Cash and Cash Equivalents**

Cash and cash equivalents include highly liquid investments with a maturity date of three months or less. Cash and cash equivalents are maintained with domestic financial institutions with deposits that exceed federally insured limits. It is the Hospital's policy to monitor the financial strength of these institutions.

#### **Temporarily Restricted Net Assets**

Temporarily restricted net assets are those where use by the Hospital has been limited by donors to a specific time frame or purpose. Temporarily restricted net assets include donations and grant proceeds.

# Natchaug Hospital, Inc.

## Notes to Financial Statements (continued)

### **1. Significant Accounting Policies (continued)**

#### **Donor Restricted Gifts**

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. The gifts are reported as temporarily 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 as unrestricted net assets and reported in the statements of operations and changes in net assets as net assets released from restrictions. Donor restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying statements of operations and changes in net assets.

#### **Fair Values of Financial Instruments**

The carrying values of financial instruments classified as current assets and current liabilities approximate fair value. The fair values of other financial instruments are disclosed in their respective notes.

#### **Income Taxes**

The Hospital is a not-for-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code (the Code) and is exempt from federal income taxes on related income pursuant to Section 501(a) of the Code.

#### **Patient Accounts Receivable**

Patient accounts receivable result from health care services provided by the Hospital. Additions to the allowance for uncollectible accounts result from the provision for uncollectible accounts. Accounts written off as uncollectible are deducted from the allowance for uncollectible accounts.

The amount of the allowance for uncollectible accounts is based upon management's assessment of historical and expected net collections, business and economic conditions, trends in Medicare and Medicaid health care coverage and other collection indicators. See Note 2 for additional information relative to third party payor programs.

## Natchaug Hospital, Inc.

### Notes to Financial Statements (continued)

#### 1. Significant Accounting Policies (continued)

The Hospital's primary concentration of credit risk is patient accounts receivable, which consist of amounts owed by various governmental agencies, insurance companies and private patients. The Hospital manages the receivables by regularly reviewing its patient accounts and contracts, and by providing appropriate allowances for uncollectible amounts. Significant concentrations of gross patient accounts receivable are as follows as of September 30:

	<u>2009</u>	<u>2008</u>
Medicare	11%	13%
Medicaid	28%	27%
Commercial and other	28%	37%
Self-pay	33%	23%
	<u>100%</u>	<u>100%</u>

#### Property, Plant, and Equipment

Property, plant, and equipment are stated at cost. The Hospital provides for depreciation of property, plant, and equipment using the straight-line method in amounts sufficient to depreciate the cost of the assets over their estimated useful lives.

#### Medical Malpractice Insurance

Coverage for medical malpractice insurance is provided on a claims-made basis. The primary level of coverage is \$10,000,000 per claim and \$39,000,000 in the aggregate. The excess indemnity coverage is layered with three different insurance companies at \$15,000,000 per claim and \$15,000,000 in the aggregate for each layer. The primary coverage is with CHS Insurance Limited, a captive insurance company, which is owned by affiliates of HHCC. The Hospital has recorded a liability for claims incurred but not reported of approximately \$296,000 and \$269,000 at September 30, 2009 and 2008, respectively.

#### Excess of Revenues over Expenses

The statements of operations and changes in net assets include the excess of revenues over expenses as the performance indicator. Changes in unrestricted net assets which are excluded from the excess of revenues over expenses, consistent with industry practice, include changes in net assets related to a pension plan, and net assets released from restrictions for property, plant, and equipment.

# Natchaug Hospital, Inc.

## Notes to Financial Statements (continued)

### 1. Significant Accounting Policies (continued)

#### Adoption of New Accounting Standards

In June 2009, the Financial Accounting Standards Board (FASB) issued ASC 105, *Generally Accepted Accounting Principles* (ASC 105), which establishes the FASB Accounting Standards Codification as the sole source of authoritative generally accepted accounting principles. Pursuant to the provisions of ASC 105, the Hospital has updated references to accounting principles generally accepted in the United States in its financial statements issued for the year ended September 30, 2009. The adoption of ASC 105 did not impact the Hospital's financial position or results of operations.

Effective October 1, 2008, the Hospital adopted ASC 820-10, *Fair Value Measurements and Disclosures* (ASC 820-10). ASC 820-10 defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States and expands disclosure about fair value measurements. The Hospital's adoption of ASC 820-10 did not significantly affect its financial statements (see Note 9).

Effective October 1, 2008, the Hospital adopted ASC 825-10, *The Fair Value Option for Financial Assets and Liabilities* (ASC 825-10). ASC 825-10 permits companies to choose to measure certain financial instruments and other items at fair value that currently are not required to be measured at fair value under accounting principles generally accepted in the United States. The Hospital chose not to elect the fair value option for its financial assets and liabilities. Consequently, the adoption of ASC 825-10 did not have any effect on its financial statements.

During 2009, FASB issued FASB ASC 855-10, *Subsequent Events* (ASC 855-10). ASC 855-10 establishes general standards of accounting and disclosure requirements for subsequent events, events that occur after the balance sheet date but before the financial statements are issued. In addition, certain events subsequent to the balance sheet date may require recognition in the financial statements as of the balance sheet date under the requirements of ASC 855-10. The Hospital adopted the provisions of ASC 855-10 as of September 30, 2009, and evaluated the impact of subsequent events through January 5, 2010, representing the date at which the consolidated financial statements were issued.

Effective October 1, 2007, the Hospital adopted ASC 740-10, *Accounting for Uncertainty in Income Taxes* (ASC 740-10). ASC 740-10 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, and disclosure requirements for uncertain tax positions. The adoption of ASC 740-10 did not have a material impact on the Hospital's financial statements.

# Natchaug Hospital, Inc.

## Notes to Financial Statements (continued)

### 1. Significant Accounting Policies (continued)

#### Reclassifications

Certain reclassifications have been made to the year ended September 30, 2008 balances previously reported in the consolidated balance sheets and statements of operations and changes in net assets in order to conform with the year ended September 30, 2009 presentation. For the year ended September 30, 2008, \$219,845 of amounts previously recorded net in other receivables were reclassified to accounts payable and other accrued expenses.

### 2. Patient Service Revenue and Charity Care

Revenues from the Medicare and Medicaid programs accounted for approximately 10% and 38%, and 10% and 38%, respectively, of the Hospital's net patient service revenue for the years ended September 30, 2009 and 2008, respectively. Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by material amounts in the near term.

The Hospital believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. While no such regulatory inquiries are outstanding, 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. Changes in the Medicare and Medicaid programs and the reduction of funding levels could have an adverse impact on the Hospital.

The following table summarizes net patient service revenue:

	<b>Years Ended September 30</b>	
	<b>2009</b>	<b>2008</b>
Gross patient service revenue	<b>\$ 53,373,972</b>	\$ 50,318,284
Deductions:		
Allowances	<b>12,949,300</b>	12,107,336
Charity care	<b>195,298</b>	314,056
Net patient service revenue	<b>\$ 40,229,374</b>	\$ 37,896,892

## Natchaug Hospital, Inc.

### Notes to Financial Statements (continued)

#### **2. Patient Service Revenue and Charity Care (continued)**

Patient accounts receivable and revenues are recorded when patient services are performed. Amounts received from certain payors are different from established billing rates of the Hospital and the differences are accounted for as allowances.

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered. Revenue under certain third-party payor agreements is subject to audit and retroactive adjustments. Provisions for estimated third-party payor settlements and adjustments are estimated in the period the related services are rendered and adjusted in future periods as final settlements are determined.

A patient is classified as a charity care patient by reference to the established policies of the Hospital. Essentially, these policies define charity services as those services for which no payment is anticipated. In assessing a patient's inability to pay, the Hospital utilizes the generally recognized poverty income levels for the State of Connecticut, but also includes certain cases where incurred charges are significant when compared to patients' income. These charges are not included in net patient service revenue for financial reporting purposes.

#### **3. Pension Plan**

The Hospital has a defined benefit pension plan (the Plan). The Plan covers all employees of the Hospital represented by the New England Healthcare Employees Union. The benefits for the Plan are based on years of service and the employees' compensation during the last five years of employment.

Included in unrestricted net assets at September 30, 2009, but not yet been recognized in net periodic pension cost is unrecognized actuarial loss of \$2,208,210. The actuarial loss included in unrestricted net assets and expected to be recognized in net periodic pension cost during the year ending September 30, 2010 is \$163,265.

Natchaug Hospital, Inc.

Notes to Financial Statements (continued)

**3. Pension Plan (continued)**

The following table sets forth the Plan's funded status and amounts recognized in the Hospital's balance sheets:

	<b>September 30</b>	
	<b>2009</b>	<b>2008</b>
<b>Change in benefit obligation</b>		
Benefit obligation at beginning of year	\$ 3,108,291	\$ 3,389,761
Service cost	227,287	273,552
Interest cost	237,762	214,318
Net benefit payments and transfers	(138,855)	(92,656)
Liability loss (gain)	1,553,725	(676,684)
Benefit obligation at end of year	<u>4,988,210</u>	<u>3,108,291</u>
<b>Change in plan assets</b>		
Fair value of plan assets at beginning of year	2,679,454	2,617,025
Actual return on plan assets	93,743	(275,463)
Employer contribution	354,830	430,548
Net benefit payments and transfers	(138,855)	(92,656)
Fair value of plan assets at end of year	<u>2,989,172</u>	<u>2,679,454</u>
Funded status of the plan	<u>\$ (1,999,038)</u>	<u>\$ (428,837)</u>
<b>Components of net periodic benefit cost</b>		
Service cost	\$ 227,287	\$ 273,552
Interest cost	237,762	214,318
Expected return on plan assets	(222,668)	(221,534)
Net amortization and deferral	33,798	51,239
Benefit cost	<u>\$ 276,179</u>	<u>\$ 317,575</u>

The measurement date for the Plan is September 30. The actuarial assumptions used are as follows for September 30, 2009 and 2008:

	<b>2009</b>	<b>2008</b>
Discount rate used for projected benefit obligation	<b>5.50%</b>	7.50%
Discount rate used for benefit cost	<b>7.50%</b>	6.25%
Expected long-term rate of return on plan assets	<b>8.00%</b>	8.00%
Average rate of increase in compensation	<b>3.50%</b>	3.50%

## Natchaug Hospital, Inc.

### Notes to Financial Statements (continued)

#### 3. Pension Plan (continued)

The expected long-term rate of return on plan assets was developed through analysis of historical market returns, current market conditions, and the Plan's past experience. Estimates of future market returns by asset category are lower than actual long-term historical returns in order to reflect current market conditions.

The accumulated benefit obligation at September 30, 2009 and 2008 was \$4,129,316 and \$2,610,456, respectively.

#### Plan Assets

The Hospital's retirement plan assets are managed by outside investment managers. The investment strategy with respect to pension assets is to maximize return while protecting principal. The Hospital, through the Executive Committee of the Board, establishes the overall investment allocation strategy for the Plan. The investment manager has the flexibility to adjust the asset allocation and move funds to the asset class that offers the most opportunity given the established investment strategy. Investment performance is periodically reviewed by the Hospital's Executive Committee and revised as appropriate.

The Hospital's pension plan weighted-average allocations at September 30, 2009 and 2008, by asset category, are as follows:

<u>Asset Category</u>	<u>2009</u>	<u>2008</u>
Equities	56%	47%
Fixed-income securities	26%	35%
Cash and cash equivalents	18%	18%
Total	<u>100%</u>	<u>100%</u>

Assets invested in the defined benefit cash balance plan are carried at fair value. Debt securities and equity securities with readily determinable values are carried at fair value as determined based on independent published sources.

The Hospital's target allocation for pension plan assets is 50% equities, 48% fixed-income securities, and 2% cash and cash equivalents.

#### Contributions

The Hospital expects to contribute \$10,790 to the Plan in 2010.

Natchaug Hospital, Inc.

Notes to Financial Statements (continued)

**3. Pension Plan (continued)**

**Estimated Future Benefit Payments**

Benefit payments are expected to be paid as follows:

<u>Fiscal Year Ending:</u>	<u>Pension Benefits</u>
2010	\$ 122,000
2011	125,000
2012	139,000
2013	136,000
2014	153,000
Years 2015 – 2019	1,247,000

The Hospital also has two defined contribution retirement plans. Under these plans, the Hospital contributes 5% to 7% of the employees' compensation, based upon years of service. The Hospital's expenses for these plans totaled \$742,277 and \$674,642 for the years ended September 30, 2009 and 2008, respectively. Effective September 30, 2008, the two defined contribution retirement plans merged into one plan.

**4. Long-Term Debt**

Long-term debt and obligations under capital leases are as follows:

	<u>September 30</u>	
	<u>2009</u>	<u>2008</u>
Mortgage loans payable	\$ 3,058,718	\$ 3,152,026
Installment loan payable	849,156	952,741
Various installment loans	165,538	190,576
	<u>4,073,412</u>	<u>4,295,343</u>
Less current portion	<u>(180,242)</u>	<u>(180,766)</u>
	<u>\$ 3,893,170</u>	<u>\$ 4,114,577</u>

## Natchaug Hospital, Inc.

### Notes to Financial Statements (continued)

#### 4. Long-Term Debt (continued)

The following is a schedule of future principal payments due by fiscal year on long-term debt, as of September 30, 2009:

<u>Fiscal Year Ending:</u>	<u>Amount</u>
2010	\$ 180,242
2011	1,021,918
2012	144,019
2013	131,144
2014	239,840
Thereafter	2,356,249
	<u>\$ 4,073,412</u>

The Hospital has a revolving line of credit, which provides for borrowings up to \$800,000, bearing interest at .5% above the prime rate (3.75% at September 30, 2009). All outstanding principal is due on May 27, 2010. The line is secured by all tangible and intangible personal property of the Hospital. There were no borrowings under this line of credit on either September 30, 2009 or September 30, 2008.

The Hospital has four mortgage loans payable to various entities and individuals. The first mortgage loan is payable to a bank, carries a five-year adjustable interest rate (fixed at 7.625% through 2013), and is payable in monthly installments of \$22,050. The final payment is due on October 1, 2018. The loan is secured by a first-position mortgage on the Hospital building. The second mortgage loan, to the estate of the former owner, carries a fixed interest rate of 7.50% and is payable in monthly installments of \$2,991. The final payment is due on February 1, 2017. The loan is secured by a third-position mortgage on the Hospital building.

The Hospital also has two mortgage loans related to the acquisition of the Conantville Medical Office Building. The former owners of the property hold these mortgage loans. Each loan carries a fixed interest rate of 6.00% and is payable in monthly installments of \$1,213. The final payments are due in September 2013. Both loans are secured by mortgages on the medical office building, its real property, and the equipment therein. The two mortgages are equal in priority.

The Hospital has one installment loan payable to the Hospital's parent corporation. The loan carries a one-year variable interest rate (4.15% at September 30, 2009) and is payable in monthly installments of interest only. The loan is due on October 1, 2010.

## Natchaug Hospital, Inc.

### Notes to Financial Statements (continued)

#### **4. Long-Term Debt (continued)**

Various other installment loans exist relating to auto loans with interest rates ranging from 0% to 12%. The loans are secured by vehicles.

The Hospital paid interest of \$297,085 and \$272,433 in fiscal years 2009 and 2008, respectively.

The carrying value and fair value of the Hospital's fixed rate debt was \$3,058,718 and \$3,259,896, respectively, as of September 30, 2009. The carrying value of the Hospital's other long-term debt approximates fair value.

In addition to the above-reference mortgage loans, the Hospital has signed a lien agreement in favor of the State of Connecticut related to a State grant award. This award provided funding for the construction of a residential treatment facility on a portion of the Hospital's main campus. The facility is operated under contract with the State Department of Children and Families. Under the award, the Hospital is obligated to repay all monies previously advanced by the State should it fail to maintain a license to operate the facility or fail to enter into an agreement covering such operation. Payment shall be equal to the full amount of the award less 10% for each full year of continuous operation, amounting to \$2,287,219, as of September 30, 2009. The calculation of the annual 10% reduction in repayment will start on the date the final payment becomes due. Under the grant award, the State shall release the lien either at the end of the ten-year period, provided that the facility has been continuously operated in accordance with the grant award, or sooner if the Hospital repays to the State the amount owed upon termination of the grant award.

#### **5. Transactions with Affiliated Corporations**

At September 30, 2009 and 2008, \$141,733 and \$676,506, respectively, was owed to HHCC affiliates relating to intercompany exchanges of services, management fees, corporate fees and certain other expenses.

## Natchaug Hospital, Inc.

### Notes to Financial Statements (continued)

#### 6. Pledges Receivable

Pledges receivable, included in the accompanying balance sheets, are expected to be received as follows:

	<b>September 30</b>	
	<b>2009</b>	<b>2008</b>
Due within one year	<b>\$ 89,450</b>	\$ 142,014
Due in one to five years	<b>30,822</b>	76,332
	<b>120,272</b>	218,346
Less allowance	<b>(10,334)</b>	(10,334)
Net pledge receivable	<b>\$ 109,938</b>	\$ 208,012

The allowance recognizes the estimated uncollectible portion of the pledges and the discount of the pledges to net present value.

#### 7. Commitments and Contingencies

Various lawsuits and claims arising in the normal course of operations are pending or are in progress against the Hospital. Such lawsuits and claims are either specifically covered by insurance as explained in Note 1 or are deemed to be immaterial. While the outcomes of the lawsuits cannot be determined at this time, management believes that any loss which may arise from these actions will not have a material adverse effect on the Hospital's financial position or changes in net assets of the Hospital.

The Hospital has several operating lease agreements for certain real estate. Certain of these leases have renewal options for periods up to five years and escalation clauses. Rent is payable in equal monthly installments. Rent expense was \$510,664 and \$439,260 for the years ended September 30, 2009 and 2008, respectively.

## Natchaug Hospital, Inc.

### Notes to Financial Statements (continued)

#### 7. Commitments and Contingencies (continued)

The future minimum lease payments are as follows:

2010	\$ 207,000
2011	193,000
2012	188,000
2013	133,000
2014	79,000
Thereafter	184,000
	<u>\$ 984,000</u>

#### 8. Functional Expenses

The Hospital provides psychiatric healthcare services to residents. Expenses related to providing these services are as follows:

	Years Ended September 30	
	2009	2008
Healthcare services	\$ 32,061,800	\$ 29,993,559
General and administrative	7,836,192	7,300,261
	<u>\$ 39,897,992</u>	<u>\$ 37,293,820</u>

#### 9. Fair Values of Financial Instruments

As described in Note 1, the Hospital adopted the methods of calculating fair value as described in ASC 820-10 to value its financial assets and liabilities, when applicable. As defined in ASC 820-10, fair value is based on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In order to increase consistency and comparability in fair value measurements, ASC 820-10 establishes a fair value hierarchy that prioritizes observable and unobservable inputs used to measure fair value into three broad levels, which are described below:

## Natchaug Hospital, Inc.

### Notes to Financial Statements (continued)

#### 9. Fair Values of Financial Instruments (continued)

*Level 1:* Quoted prices (unadjusted) in active markets that are accessible at the measurement date for identical assets or liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.

*Level 2:* Observable inputs that are based on inputs not quoted in active markets, but corroborated by market data.

*Level 3:* Unobservable inputs are used when little or no market data is available. The fair value hierarchy gives the lowest priority to Level 3 inputs.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. In determining fair value, the Hospital utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible. In addition, the Hospital considers counterparty credit risk in its assessment of fair value.

Financial assets carried at fair value as of September 30, 2009 are classified in the table below in one of the three categories described above:

	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
<b>Assets</b>				
Cash and cash equivalents	\$ 594,090	\$ -	\$ -	\$594,090

The above table excludes assets invested in the Hospital's defined benefit pension plan and long-term debt (see Notes 3 and 4, respectively).