



AUDITED FINANCIAL STATEMENTS

Natchaug Hospital, Inc.
Years Ended September 30, 2011 and 2010
With Report of Independent Auditors

Ernst & Young LLP

 **ERNST & YOUNG**

Natchaug Hospital, Inc.
Audited Financial Statements

Years Ended September 30, 2011 and 2010

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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, 2011 and 2010, 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, 2011 and 2010, 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'.

February 3, 2012

Natchaug Hospital, Inc.

Balance Sheets

	September 30	
	2011	2010
Assets		
Current assets:		
Cash and cash equivalents	\$ 901,687	\$ 989,113
Accounts receivable, less allowance for uncollectible accounts of approximately \$2,168,000 in 2011 and \$2,073,000 in 2010	4,380,141	4,284,711
Other receivables	115,101	205,773
Inventory and prepaid expenses	605,733	533,556
Due from third-party reimbursement agencies	41,533	119,241
Total current assets	<u>6,044,195</u>	<u>6,132,394</u>
Property, plant, and equipment:		
Land	195,897	195,897
Buildings and leasehold improvements	14,049,530	13,834,745
Equipment	4,069,178	3,717,876
Vehicles	976,406	900,958
	<u>19,291,011</u>	<u>18,649,476</u>
Accumulated depreciation and amortization	<u>(8,127,445)</u>	<u>(7,220,504)</u>
	<u>11,163,566</u>	<u>11,428,972</u>
Construction in process	13,998	1,520
Net property, plant, and equipment	<u>11,177,564</u>	<u>11,430,492</u>
Other assets	126,933	134,550
	<u>\$ 17,348,692</u>	<u>\$ 17,697,436</u>
Liabilities and net assets		
Current liabilities:		
Accounts payable and other accrued expenses	\$ 711,595	\$ 619,576
Payroll-related accruals	1,470,194	1,345,110
Due to related parties	349,034	142,508
Current portion of long-term debt	132,159	158,317
Total current liabilities	<u>2,662,982</u>	<u>2,265,511</u>
Accrued pension obligation and other	3,541,737	2,978,837
Long-term debt, less current portion	3,102,491	3,603,807
Net assets:		
Unrestricted	7,868,019	8,639,928
Temporarily restricted	173,463	209,353
	<u>8,041,482</u>	<u>8,849,281</u>
	<u>\$ 17,348,692</u>	<u>\$ 17,697,436</u>

See accompanying notes.

Natchaug Hospital, Inc.

Statements of Operations and Changes in Net Assets

	Years Ended September 30	
	2011	2010
Unrestricted revenues, gains, and other support:		
Net patient service revenue	\$ 44,467,751	\$ 42,671,670
Other revenue	17,780	17,348
Net assets released from restriction for operations	67,442	44,638
	44,552,973	42,733,656
Operating expenses:		
Salaries and employee benefits	35,500,968	32,876,780
Purchased services and professional fees	3,475,659	3,188,205
Supplies and other	4,329,082	4,210,117
Provision for uncollectible accounts	577,661	774,965
Depreciation and amortization	926,858	968,333
Interest	242,189	265,707
	45,052,417	42,284,107
(Deficiency) excess of revenues over expenses	(499,444)	449,549
Change in net assets related to pension plan	(368,721)	(276,590)
Net assets released from restriction for property, plant, and equipment	96,256	79,569
(Decrease) increase in unrestricted assets	(771,909)	252,528
Temporarily restricted contributions	127,808	152,730
Net assets released from restriction for property, plant, and equipment	(96,256)	(79,569)
Net assets released from restriction for operations	(67,442)	(44,638)
(Decrease) increase in temporarily restricted net assets	(35,890)	28,523
(Decrease) increase in net assets	(807,799)	281,051
Net assets at beginning of year	8,849,281	8,568,230
Net assets at end of year	\$ 8,041,482	\$ 8,849,281

See accompanying notes.

Natchaug Hospital, Inc.

Statements of Cash Flows

	Years Ended	
	September 30	
	2011	2010
Operating activities		
Change in net assets	\$ (807,799)	\$ 281,051
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Noncash items:		
Depreciation and amortization	926,858	968,333
Provision for uncollectible accounts	577,661	774,965
Change in net assets related to pension plan	368,721	276,590
Other changes in net assets:		
Temporarily restricted contributions	(127,808)	(152,730)
Changes in assets and liabilities:		
Accounts receivable	(673,091)	(616,594)
Other receivables, inventory and prepaid expenses	18,495	(243,285)
Other assets	(12,300)	(93,359)
Accounts payable, other accrued expenses, and payroll-related accruals	217,103	(177,015)
Due from third-party reimbursement agencies	77,708	(42,102)
Accrued pension obligation and other	194,179	412,459
Due to related parties	206,526	775
Net cash provided by operating activities	<u>966,253</u>	<u>1,389,088</u>
Investing activity		
Purchases of property, plant, and equipment, net	(654,013)	(835,507)
Net cash used in investing activity	<u>(654,013)</u>	<u>(835,507)</u>
Financing activities		
Temporarily restricted contributions	127,808	152,730
Principal payments on long-term debt	(527,474)	(311,288)
Net cash used in financing activities	<u>(399,666)</u>	<u>(158,558)</u>
(Decrease) increase in cash and cash equivalents	<u>(87,426)</u>	<u>395,023</u>
Cash and cash equivalents at beginning of year	989,113	594,090
Cash and cash equivalents at end of year	<u>\$ 901,687</u>	<u>\$ 989,113</u>

See accompanying notes.

Natchaug Hospital, Inc.

Notes to Financial Statements

September 30, 2011

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 HealthCare Corporation (HHC) became the sole member of the Hospital. Accordingly, the Board of Directors of HHC 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.

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 financial instruments are disclosed in Note 9.

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>2011</u>	<u>2010</u>
Medicare	13%	13%
Medicaid	22%	21%
Commercial and other	30%	28%
Self-pay	35%	38%
	<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 four 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 HHC. The Hospital has recorded a liability for claims incurred but not reported of approximately \$294,000 and \$309,000 at September 30, 2011 and 2010, respectively.

(Deficiency) Excess of Revenues over Expenses

The statements of operations and changes in net assets include the (deficiency) excess of revenues over expenses as the performance indicator. Changes in unrestricted net assets which are excluded from the (deficiency) 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)

New Accounting Standards

In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-06, *Improving Disclosures about Fair Value Measurements*, (ASU 2010-06). ASU 2010-06 amended ASC 820 to clarify certain existing fair value disclosures and require a number of additional disclosures. The guidance in ASU 2010-06 clarified that disclosures should be presented separately for each “class” of assets and liabilities measured at fair value and provided guidance on how to determine the appropriate classes of assets and liabilities to be presented. ASU 2010-06 also clarified the requirement for entities to disclose information about both the valuation techniques and inputs used in estimating Level 2 and Level 3 fair value measurements. In addition, ASU 2010-06 introduced new requirements to disclose the amounts (on a gross basis) and reasons for any significant transfers between Levels 1, 2 and 3 of the fair value hierarchy and present information regarding the purchases, sales, issuances and settlements of Level 3 assets and liabilities on a gross basis. With the exception of the requirement to present changes in Level 3 measurements on a gross basis, which is delayed until 2012, the guidance in ASU 2010-06 becomes effective for reporting periods beginning after December 15, 2009. The adoption of the provisions of ASU 2010-06 did not have a material impact on the Hospital’s financial statements.

In August 2010, the FASB issued ASC 2010-23, *Measuring Charity Care for Disclosure*. ASC 2010-23 requires that the level of charity care provided be presented based on the direct and indirect costs of the charity services provided. ASC 2010-23 also requires separate disclosure of the amount of any cash reimbursements received for providing charity care. ASC 2010-23 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. The Hospital is evaluating the effect of ASC 2010-23 on its financial statements.

In July 2011, FASB issued ASU 2011-07, *Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts*. ASU 2011-07 requires certain health care entities to present the bad debt expense associated with patient service revenue as a deduction from patient service revenue (net of contractual allowances and discounts) rather than as an operating expense with enhanced footnote disclosures on the policies for recognizing revenue and assessing bad debts, and qualitative and quantitative information about changes in the allowance for doubtful accounts. The guidance is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2011, with early adoption permitted. The Hospital is evaluating the effect of ASU 2011-07 on its financial statements.

Natchaug Hospital, Inc.

Notes to Financial Statements (continued)

1. Significant Accounting Policies (continued)

In August 2010, the FASB also issued ASU 2010-24, *Presentation of Insurance Claims and Related Insurance Recoveries*. Under ASU 2010-24 anticipated insurance recoveries and estimated liabilities for medical malpractice claims or similar contingent liabilities will be presented separately on the balance sheet. The guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. The Hospital is evaluating the effect of ASU 2010-24 on its financial statements.

2. Patient Service Revenue and Charity Care

Revenues from the Medicare and Medicaid programs accounted for approximately 9% and 36%, and 11% and 37%, of the Hospital's net patient service revenue for the years ended September 30, 2011 and 2010, 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:

	Years Ended September 30	
	2011	2010
Gross patient service revenue	\$ 65,591,612	\$ 61,513,130
Deductions:		
Allowances	20,882,800	18,655,714
Charity care	241,061	185,746
Net patient service revenue	\$ 44,467,751	\$ 42,671,670

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.

Natchaug Hospital, Inc.

Notes to Financial Statements (continued)

2. Patient Service Revenue and Charity Care (continued)

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, 2011 and 2010, but not yet been recognized in net periodic pension cost is unrecognized actuarial loss of \$2,853,521 and \$2,484,800, respectively. The actuarial loss included in unrestricted net assets and expected to be recognized in net periodic pension cost during the year ending September 30, 2012 is \$216,088.

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:

	September 30	
	2011	2010
Change in benefit obligation		
Benefit obligation at beginning of year	\$ 5,893,736	\$ 4,988,210
Service cost	444,768	368,592
Interest cost	319,743	276,162
Net benefit payments and transfers	(171,156)	(147,612)
Liability loss	281,540	408,384
Benefit obligation at end of year	<u>6,768,631</u>	<u>5,893,736</u>
Change in plan assets		
Fair value of plan assets at beginning of year	3,228,399	2,989,172
Actual return on plan assets	(43,622)	202,230
Employer contribution	507,273	184,609
Net benefit payments and transfers	(171,156)	(147,612)
Fair value of plan assets at end of year	<u>3,520,894</u>	<u>3,228,399</u>
Funded status of the plan	<u>\$ (3,247,737)</u>	<u>\$ (2,665,337)</u>
Components of net periodic benefit cost		
Service cost	\$ 444,768	\$ 368,592
Interest cost	319,743	276,162
Expected return on plan assets	(271,119)	(241,579)
Net amortization and deferral	227,560	171,143
Benefit cost	<u>\$ 720,952</u>	<u>\$ 574,318</u>

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

	2011	2010
Discount rate used for projected benefit obligation	5.45%	5.20%
Discount rate used for benefit cost	5.20%	5.50%
Expected long-term rate of return on plan assets	8.00%	8.00%
Average rate of increase in compensation	3.50%	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, 2011 and 2010 was \$5,622,487 and \$4,918,239, 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, 2011 and 2010, by asset category, are as follows:

<u>Asset Category</u>	<u>2011</u>	<u>2010</u>
Equities	51%	55%
Fixed-income securities	48%	39%
Cash and cash equivalents	1%	6%
Total	<u>100%</u>	<u>100%</u>

As discussed in the Fair Value Measurements note (Note 9), the Hospital follows a three-level hierarchy to categorize assets measured at fair value. In accordance with this hierarchy, as of September 30, 2010, 100% of the Hospital Plan's assets which are measured at fair value on a recurring basis were categorized as Level 1 investments. 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.

Natchaug Hospital, Inc.

Notes to Financial Statements (continued)

3. Pension Plan (continued)

Contributions

The Hospital expects to contribute \$930,000 to the Plan in 2012.

Estimated Future Benefit Payments

Benefit payments are expected to be paid as follows:

<u>Fiscal Year Ending:</u>	<u>Pension Benefits</u>
2012	\$ 138,764
2013	147,489
2014	155,433
2015	188,190
2016	223,409
Years 2017 – 2021	1,658,176

The Hospital also has a defined contribution retirement plan. Under this plan, the Hospital contributes 5% to 7% of the employees' compensation, based upon years of service. The Hospital's expenses for this plan totaled \$920,879 and \$881,736 for the years ended September 30, 2011 and 2010, respectively.

4. Long-Term Debt

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

	<u>September 30</u>	
	<u>2011</u>	<u>2010</u>
Mortgage loans payable	\$ 2,850,189	\$ 2,958,287
Installment loan payable	370,561	745,634
Various installment loans	13,900	58,203
	3,234,650	3,762,124
Less current portion	(132,159)	(158,317)
	<u>\$ 3,102,491</u>	<u>\$ 3,603,807</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, 2011:

<u>Fiscal Year Ending:</u>	<u>Amount</u>
2012	\$ 132,159
2013	499,516
2014	239,296
2015	124,638
2016	134,439
Thereafter	<u>2,104,602</u>
	<u>\$ 3,234,650</u>

The Hospital has a revolving line of credit, which provides for borrowings up to \$800,000, bearing interest at 0.5% above the prime rate (3.25% at September 30, 2011). All outstanding principal is due on May 27, 2012. 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, 2011 or September 30, 2010.

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 (2.42% at September 30, 2011) and is payable in monthly installments of interest only. The loan is due on October 1, 2012.

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 9.44%. The loans are secured by vehicles.

The Hospital paid interest of \$242,189 and \$265,707 in fiscal years 2011 and 2010, respectively.

The carrying value and fair value of the Hospital's fixed rate debt was \$2,850,188 and \$3,198,277, respectively, as of September 30, 2011. The carrying value of the Hospital's other long-term debt approximates fair value. The fair value of the Hospital's long-term debt was determined by the Hospital's investment advisor using a discounted cash flow analysis.

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 \$1,609,524, as of September 30, 2011. 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, 2011 and 2010, \$349,034 and \$142,508, respectively, was owed to HHC 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:

	September 30	
	2011	2010
Due within one year	\$ 29,564	\$ 49,906
Due in one to five years	–	7,000
	29,564	56,906
Less allowance	(1,840)	(2,494)
Net pledge receivable	\$ 27,724	\$ 54,412

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 \$553,139 and \$479,916 for the years ended September 30, 2011 and 2010, respectively.

The future minimum lease payments are as follows:

2012	\$ 422,959
2013	373,082
2014	266,155
2015	184,632
2016	103,400
Thereafter	73,600
	\$ 1,423,828

Natchaug Hospital, Inc.

Notes to Financial Statements (continued)

8. Functional Expenses

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

	Years Ended September 30	
	2011	2010
Healthcare services	\$ 36,539,666	\$ 34,164,592
General and administrative	8,512,751	8,119,515
	<u>\$ 45,052,417</u>	<u>\$ 42,284,107</u>

9. Fair Values of Financial Instruments

For assets and liabilities required to be measured at fair value, the Hospital measures fair value 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. Fair value measurements are applied based on the unit of account from the Hospital's perspective. The unit of account determines what is being measured by reference to the level at which the asset or liability is aggregated (or disaggregated) for purposes of applying other accounting pronouncements.

The Hospital follows a valuation hierarchy that is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

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 that 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 uses valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible and considers nonperformance risk in its assessment of fair value.

Natchaug Hospital, Inc.

Notes to Financial Statements (continued)

9. Fair Values of Financial Instruments (continued)

Financial assets carried at fair value as of September 30, 2011 in the accompanying consolidated balance sheets are classified in the table below in one of the three categories described above:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets				
Cash and cash equivalents	\$ 901,687	\$ —	\$ —	\$ 901,687
Postretirement pension plan assets:				
Cash	28,082	—	—	28,082
Fixed income securities:				
U.S.	1,410,405	—	—	1,410,405
International	44,938	—	—	44,938
Mutual funds:				
U.S.	815,648	—	—	815,648
International	342,528	—	—	342,528
Marketable equity securities:				
U.S.	840,110	—	—	840,110
International	39,183	—	—	39,183

Financial assets carried at fair value as of September 30, 2010 are classified in the table below in one of the three categories described above:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets				
Cash and cash equivalents	\$ 989,113	\$ —	\$ —	\$ 989,113
Postretirement pension plan assets:				
Cash	183,738	—	—	183,738
Fixed income securities:				
U.S.	1,032,842	—	—	1,032,842
Mutual funds:				
U.S.	827,924	—	—	827,924
International	381,523	—	—	381,523
Marketable equity securities:				
U.S.	783,797	—	—	783,797
International	18,575	—	—	18,575

Fair value for Level 1 is based upon quoted market prices.

Natchaug Hospital, Inc.

Notes to Financial Statements (continued)

10. Subsequent Events

For the year ended September 30, 2011, the Hospital evaluated subsequent events through February 3, 2012, which is the date the financial statement were available to be issued. No events occurred that require disclosure or adjustment to the financial statements.

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