

Ashland Hospital Corporation and Subsidiaries  
d/b/a King's Daughters Medical Center

Consolidated Balance Sheets

	<b>Unaudited</b>	<b>Audited</b>
	<b>December 31, 2009</b>	<b>September 30, 2009</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 62,654,466	\$ 79,587,819
Short-term investments	16,174,650	6,425,000
Patient accounts receivable, net	79,831,608	76,736,337
Inventories	10,724,597	11,293,101
Current portion of assets limited as to use	5,595,962	4,303,456
Other current assets	15,495,492	15,149,939
Total current assets	190,476,775	193,495,652
Assets limited as to use:		
By Board of Directors	150,623,570	144,361,764
By Donors	807,365	796,901
By self-insurance trust agreements	6,701,215	6,364,008
By bond indenture agreements	3,992,021	4,216,225
	162,124,171	155,738,898
Less assets limited as to use that are required for current liabilities	5,595,962	4,303,456
	156,528,209	151,435,442
Property, plant and equipment, net of accumulated depreciation	312,909,246	308,046,825
Other assets:		
Deferred financing costs, net	2,178,149	2,209,166
Other	6,507,146	5,863,814
	8,685,295	8,072,980
Total assets	\$ 668,599,525	\$ 661,050,899

Ashland Hospital Corporation and Subsidiaries  
d/b/a King's Daughters Medical Center

Consolidated Balance Sheets (continued)

	<b>Unaudited</b>	<b>Audited</b>
	<b>December 31,</b>	<b>September 30,</b>
	<b>2009</b>	<b>2009</b>
<b>Liabilities and unrestricted net assets</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 3,890,167	\$ 32,156,492
Accrued salaries, wages and related liabilities	110,004	25,326,503
Accrued interest payable	-	1,292,291
Estimated third-party payor settlements	-	6,661,785
Notes Payable	-	15,000,000
Current portion of long-term debt	-	4,247,064
Total current liabilities	<b>4,000,171</b>	84,684,135
Estimated malpractice liabilities, net of current portion	-	8,280,123
Long-term debt, net of current portion	-	186,448,904
Interest Rate Swap Agreements	-	11,535,700
Accrued Pension Obligation	-	17,618,000
Other long-term liabilities	-	3,108,400
Total liabilities	<b>4,000,171</b>	311,675,262
Net assets:		
Unrestricted net assets	(134,706)	348,176,091
Temporarily restricted net assets	-	1,080,645
Permanently restricted net assets	-	118,901
Total net assets	<b>(134,706)</b>	349,375,637
Total liabilities and unrestricted net assets	<b>\$ 3,865,465</b>	\$ 661,050,899

Ashland Hospital Corporation and Subsidiaries  
d/b/a King's Daughters Medical Center

Consolidated Statements of Operations and  
Changes in Net Assets

	<b>Unaudited</b>		<b>Audited</b>
	<b>Quarter Ended December 31,</b>		<b>Year Ended</b>
	<b>2009</b>	<b>2008</b>	<b>September 30,</b>
			<b>2009</b>
Unrestricted revenues:			
Net patient service revenue	\$ 152,707,594	\$ 126,166,294	\$ 545,757,518
Other revenue	2,708,293	1,273,422	9,050,542
Total unrestricted revenues	<b>155,415,887</b>	127,439,716	554,808,060
Expenses:			
Salaries and wages	55,319,037	44,169,696	184,898,747
Employee benefits	14,492,935	11,855,657	51,221,745
Supplies and other expenses	46,036,437	40,446,239	168,680,265
Purchased services	8,310,878	7,016,836	30,035,372
Provision for depreciation and amortization	8,677,288	7,671,339	33,538,257
Interest expense	2,200,249	2,738,686	9,432,128
Provision for bad debts	15,219,821	10,243,879	49,445,091
Total expenses	<b>150,256,645</b>	124,142,332	527,251,605
Operating income	<b>5,159,242</b>	3,297,384	27,556,455
Investment income, net	3,386,955	(6,562,559)	9,185,186
Change in fair value of interest rate swap agreements	5,200,410	(16,343,539)	(5,058,441)
Other income, net	1,260	4,917	(80,467)
Loss on early extinguishment of debt			-
Excess of revenues over expenses	<b>13,747,866</b>	(19,603,797)	31,602,733
Minimum pension liability adjustments	-	-	(11,938,326)
Effect of initial adoption of FASB Statement No. 158	-	-	-
Contributions and other	<b>19,889</b>	767,007	875,403
Increase in net assets	<b>13,767,755</b>	(18,836,790)	20,539,810
Net assets, beginning of year	<b>349,375,637</b>	328,835,827	328,835,827
Net assets, end of year	<b>\$ 363,143,392</b>	\$ 309,999,037	\$ 349,375,637

Ashland Hospital Corporation and Subsidiaries  
d/b/a King's Daughters Medical Center

Consolidated Statements of Cash Flows

	Unaudited		Audited
	Quarter Ended December 31,		Year Ended
	2009	2008	September 30, 2009
<b>Operating activities and other income</b>			
Changes in net assets	\$ 13,767,755	\$ (18,836,790)	\$ 20,539,810
Adjustments to reconcile increase in net assets to net cash provided by operating activities and other income:			
Loss on early extinguishment of debt			-
Change in fair value of interest rate swap agreements	(5,200,410)	16,343,539	5,058,441
Minimum pension liability adjustment	911,760	574,903	11,938,326
Provision for depreciation and amortization	8,677,288	7,671,339	33,538,257
Provision for bad debts	15,219,821	10,243,879	49,445,091
Change in assets as limited to use	(6,385,273)	10,598,247	(3,709,699)
Other changes in assets and liabilities:			
Patient accounts receivable	(18,315,092)	(17,258,520)	(55,705,213)
Trading securities	(9,749,650)	-	(6,425,000)
Other current and noncurrent assets	(420,382)	(2,432,035)	(8,982,302)
Estimated third-party payor settlements	741,760	246,748	3,660,901
Other current liabilities	(3,600,264)	4,021	(3,327,153)
Estimated malpractice liabilities	1,270,000	380,000	1,963,214
Other long-term liabilities	2,856,679	3,696,553	-
Net cash provided by operating activities	(226,007)	11,231,884	47,994,673
<b>Investing activities</b>			
Purchases of property, plant, and equipment, net	(13,539,709)	(14,456,208)	(34,870,832)
Net cash used in investing activities	(13,539,709)	(14,456,208)	(34,870,832)
<b>Financing activities</b>			
Proceeds from long-term debt	-	-	-
Repayment of long-term debt	(3,198,654)	(4,348,829)	(3,933,530)
Net proceeds from notes payable	-	-	-
Repayment of notes payable	-	(56,500)	(1,085,551)
Deferred financing costs	31,017	31,749	-
Net cash (used in) provided by financing activities	(3,167,637)	(4,373,580)	(5,019,081)
Increase (decrease) in cash and cash equivalents	(16,933,353)	(7,597,904)	8,104,760
Cash and cash equivalents, beginning of year	79,587,819	71,483,059	71,483,059
Cash and cash equivalents, end of year	\$ 62,654,466	\$ 63,885,155	\$ 79,587,819

**Ashland Hospital Corporation and Subsidiaries  
d/b/a King's Daughters Medical Center**

**Notes to Consolidated Financial Statements**

**December 31, 2009**

**1. Organization**

The accompanying consolidated financial statements of Ashland Hospital Corporation and Subsidiaries d/b/a King's Daughters Medical Center (the Medical Center) include the transactions and accounts of Ashland Hospital Corporation (the Controlling Company), Ashland Medical Properties, Inc. (AMP), Kentucky Heart Foundation (KHF), Child Development Center (CDC), Kingsbrook Lifecare Center (KBNH), Kentucky Heart Institute (KHI), King's Daughters Medical Transport (KDMT) and KDMC Health Foundation (Foundation). The Medical Center's primary mission is to provide health care services to the citizens of the communities it serves through its acute and specialty care operations. All significant intercompany transactions and balances have been eliminated in consolidation.

**2. Basis of Presentation**

The accompanying consolidated financial statements as of and for each of the first quarters ended December 31, 2009 and 2008 have been prepared in accordance with accounting principles generally accepted in the United States applied on a basis substantially consistent with that of the September 30, 2009 audited consolidated financial statements. They do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter ended December 31, 2009 are not necessarily indicative of the results that may be experienced during the year ended September 30, 2010.

**3. Accounting Policies**

**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 its financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Adjustments to estimates are recorded, as appropriate, in periods in which they are determined.

## **Cash and Cash Equivalents and Short-Term Investments**

Cash and cash equivalents include highly liquid investments with a maturity at the time of acquisition of three months or less. Short-term investments represent investments with original maturities extending beyond three months that management has identified as available to meet current operating needs. Such deposits exceed the FDIC insured limits.

## **Patient Receivables and Net Patient Service Revenue**

Patient receivables and net patient service revenues are derived primarily from patients who reside in Kentucky and surrounding states. Patient receivables consist of amounts due from third-party payors, including federal and state indemnity and managed care programs, managed care health plans and commercial insurance companies, and individual patients for health care services rendered. The Medical Center does not require collateral or other security on its patient receivables. Management maintains an allowance for doubtful accounts to reserve for estimated losses based on the length of time the account has been past due and historical experience.

The Medical Center has agreements with third-party payors that provide for payments to the Medical Center at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments.

Net patient service revenues are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered and includes estimated retroactive revenue adjustments due to future audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, and investigations.

## **Charity Care**

The Medical Center provides medically necessary services without charge or at amounts less than its established rates to patients who meet certain criteria under its charity care policy. Essentially, these policies define charity services as those services for which no payment is anticipated. In assessing a patient's ability to pay, the Medical Center utilizes the generally recognized poverty income levels of their community, but also includes certain cases where incurred charges are significant when compared to income.

## **Inventories**

Inventories, which primarily consist of pharmaceuticals and medical supplies, are stated at the lower of cost (first-in, first-out) or market.

## **Assets Limited as to Use and Investments**

Assets limited as to use include assets set aside by the Board of Directors for plant replacement, over which the Board of Directors retains control and may at its discretion subsequently use for other purposes, and assets held by trustees under bond indenture agreements and self-insurance trust arrangements. Assets limited as to use that are required for obligations classified as current liabilities are reported in current assets.

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value. Investment income or loss (including realized gains and losses on investments and interest and dividends) is included in the excess of revenues over expenses unless the income or loss is restricted by donor or law. Investment income on proceeds of borrowings that are held by a trustee, to the extent not capitalized, and investment income on assets deposited in the malpractice trust are reported as other revenue. Investment income from all other investments are reported as investment income.

## **Interest Rate Swap Agreements**

The Medical Center has entered into certain interest rate swap arrangements in connection with its debt management program. Under Financial Accounting Standards Board Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, (Statement 133), the Medical Center records its derivative instruments as either assets or liabilities in the accompanying consolidated balance sheets at fair value. The accounting for changes in the fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. In 2007, certain derivative instruments were designated as hedges and the corresponding change in fair value was reflected as a component of other changes in net assets. Effective October 1, 2007, none of the Medical Center's derivatives are designated as hedges. Accordingly, the derivative gain or loss related to the change in fair value is included in the excess of revenues over expenses.

## **Property, Plant, and Equipment**

Property, plant, and equipment amounts are recorded at cost or at fair market value if acquired by gift. The Medical Center provides for depreciation of property, plant, and equipment on a straight-line basis over the expected useful lives of the assets. Upon retirement or disposal, the asset and accumulated depreciation accounts are adjusted, and any gain or loss is recorded in the consolidated statement of operations. Maintenance costs and repairs are expensed as incurred.

Management reviews the recoverability of the carrying value of long-lived assets as prescribed in SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The Medical Center also reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Any write-downs due to impairment are charged to operations at the time

impairment is identified. Management determined that no impairment write-downs were necessary in 2009 and 2008.

Management has considered Financial Accounting Standards Board Interpretation No. 47 *Accounting for Conditional Asset Retirement Obligation*, specifically as it relates to its legal obligation to perform asset retirement activities, such as asbestos removal, on its existing properties. Management believes that there is an indeterminate settlement date for the asset retirement obligations because the range of time over which the Medical Center may settle the obligations is unknown and cannot be estimated.

### **Deferred Financing Costs**

Deferred financing costs consist of the costs incurred in conjunction with the issuance of bonds. The Medical Center's policy is to amortize deferred financing costs over the term of the bonds using the bonds outstanding method.

### **Unamortized Bond Discount and Premium**

Unamortized bond discount and premium are being amortized over the period the bonds are outstanding using the bonds outstanding method.

### **Estimated Malpractice Liabilities**

The provision for estimated self-insured medical malpractice claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported.

### **Excess of Revenues Over Expenses**

The statement of operations includes excess of revenues over expenses. Changes in unrestricted net assets that are excluded from excess of revenues over expenses, consistent with industry practice, include contributions received for the acquisition of property and equipment and the effects of changes in accounting methods and extraordinary items.

### **Operating Income and Nonoperating Gains**

Only those activities directly associated with the furtherance of the Medical Center's primary mission are considered to be operating activities. Other activities that result in gains or losses are considered to be nonoperating. Nonoperating gains include investment income, changes in the fair value of derivatives, and other miscellaneous nonoperating revenues and expenses.

### **Federal Income Taxes**

The Medical Center, KHF, KBNH, CDC, KHI, KDMT and Health Foundation have been recognized by the IRS as Section 501(c)(3) charitable organizations. Section 501(c)(3)

organizations are exempt from federal and State income taxes on related income. These organizations do not engage in significant unrelated activities and therefore no tax is recorded. AMP is a small taxable entity subject to federal and state income taxation.

**King's Daughters Medical Center**  
**Management Discussion and Analysis**  
**December 2009**

**Significant Variances & Trends in Financial and Utilization Data**

The first fiscal quarter ended December 31, 2009 operating income of approximately \$5.2 million was greater than the prior year first quarter operating income of \$3.3 million. Revenues for the quarter increased a very strong 22.0% over the prior year due to a 7.0% increase in inpatient admissions, increases in outpatient volumes, and increases in physician practice revenues. The outpatient volume growth was concentrated in several areas, including outpatient surgical procedures (up 24.8%), observation visits (up 8.8%), Emergency Department visits (up 11.0%), CT scans (up 6.0%), and Radiology procedures (up 10.7%). Net income for the quarter of \$13.7 million is well ahead of the prior year net loss of (\$19.6) million due to market value adjustments reflected in non-operating income relating to the investment portfolio and interest rate swap agreements.

Total expenses for the quarter increased 21.0% over the prior year first quarter. More specifically, the 25.2% increase in salary expense was due to a 7.9% increase in hospital FTEs, a 4.2% increase in the hospital average wage, and an increase in physician employment. Over the past year, physician employment has continued to grow with the purchase of a second cardiology group, the employment of our cardiac surgeons, and the recent purchase of a urology group in December 2009, among others. The Medical Center employed 88 physicians as of December 2009, compared to 54 in the prior year.

Supply expenses increased 13.2% primarily due to growth in outpatient surgical volumes and increased pharmaceutical supplies. Purchased services increased 18.4% primarily due to increased consulting expenses related to revenue cycle enhancements. Other operating expenses increased 27.9% as a result of increased malpractice expenses associated with the growth in the number of employed physicians. Bad debt and charity write-offs for the quarter equaled 7.0% of gross patient revenue compared to 5.8% in the prior year. Management attributes this increase to the downturn in economic conditions, coupled with steadily rising patient co-payment and deductibles. The Medical Center recently implemented up-front collections at the point of service, which will help to partially slow the pace of the rise in bad debts. Depreciation expense increased 13.1% due to the completion of the Heart & Vascular Center fourth floor and equipment purchases within the last year totaling approximately \$8 million.

Total days cash on hand of 162.0 days was higher than the prior year of 158.4 days, primarily due to accelerated cash collections and increases in investment performance. Total cash and investments increased \$38.5 million over the prior year first quarter. The investment portfolio consisted of approximately 65% fixed income securities, 34% equity investments, and 1% cash equivalent securities at December 31, 2009. This is in line with the Medical Center's investment policy which strategically targets 65% fixed

income and 35% equities. The current policy precludes investments in hedge funds and private equity, among other investments.

## **Material Events**

### ***Changes in Senior Management:***

There were no changes in senior management during the first quarter of fiscal year 2010.

### ***Medical Staff changes:***

KDMC experienced a net increase of 16 physicians from December 31, 2008 to December 31, 2009. Current active and courtesy staff totaled 268 at December 31, 2009. Net physician increases resulted in the key areas of Anesthesiology (+3), Cardiology (+2), Emergency Medicine (+3), Family Practice (+1), Internal Medicine (+1), Otolaryngology (+2), Pediatrics (+1), and Hematology/Oncology (+3). It is not anticipated that any of the resignations will have a material impact on future admissions.

### ***Capital projects:***

#### **Hospital Information System**

The Board of Directors approved a \$38.5 million project in May 2007 for the purchase and implementation of a new hospital information system (including both clinical information systems and revenue cycle systems) from Epic Systems Corporation (Epic). The first phase of the Epic system went live successfully in November 2008, including all revenue cycle areas, nursing documentation, radiology, cardiology, pharmacy, and bar-coded medication administration, among others. Additional modules are to be implemented in 2010, and 2011, including physician order entry, physician documentation, ER documentation, and surgical documentation. To date, approximately \$26.7 million has been expended. The implementation is on-time and on-budget.

#### **Information Services and Technology Data Center**

In September 2008, the Board of Directors approved the construction of a free-standing Information Services and Technology Data Center. The proposed facility has been designed to withstand winds in excess of 150 miles per hour, flooding and power failures, and will include many specialty systems such as redundant HVAC and electrical power conditioners to support continued operations. The main reasons for this capital project include the importance of information technology to clinical quality improvement and the need for system up-time once the Medical Center implements an Electronic Medical Record (EMR). To date, approximately \$2.7 million has been spent, with the total project expected to cost \$4.6 million, including equipment.

#### **Fifth and Sixth Floors of the Heart & Vascular Center**

In September 2009, the Board of Directors approved the development of the Heart and Vascular Center Fifth and Sixth Floors and power plant expansion. The next phase of the Medical Center's modernization and expansion is to add two additional floors to the Heart & Vascular Center building, with the fifth floor being finished immediately to provide 50 private patient rooms, and a shelled sixth floor for future expansion. The two new units being developed include a 26 bed Neuroscience Unit and a 24 bed Cardiac Medical Unit. The new units will not require additional licenses for the 50 beds. The

licenses will be transferred from existing inpatient beds, which will in turn become observation beds. In addition, there is a need to increase the power plant capacity at KDMC, which is presently at capacity. The total projected expenditure is estimated at \$22.1 million. Approximately \$15 million of the project expenses will be incurred in FY2010 with the remaining \$7.1 million to occur in FY2011. To date, approximately \$1.9 million has been spent. Construction of the additional floors began in September 2009 with completion expected by the end of December 2010. The power plant expansion will begin in February 2010 and will become operational in October 2010.

#### Equipment

During the first quarter of fiscal year 2010, KDMC purchased approximately \$2.1 million of equipment, including the purchase of a Brilliance ICT system CT scanner for \$1.8 million.

#### ***Tax exempt debt issuance:***

The Medical Center currently has plans to issue additional debt during fiscal year 2010 in an expected amount of \$75 million, not to exceed \$90 million. It is expected that the issuance will reimburse the Medical Center for expenditures related to the Fifth and Sixth Floor addition to the Heart & Vascular Center, and other capital expenditures that are expected to occur in fiscal years 2010 through 2012.

#### ***Signing of new interest rate swap agreements:***

No new swap agreements have been signed, and no new swap agreements are being contemplated at this time.

#### ***Significant legal proceedings:***

King's Daughters Medical Center is involved in litigation arising in the ordinary course of business. Malpractice claims have been alleged against KDMC and are currently in various stages of litigation. Management is under the opinion that the resolution of pending liability claims will not have a material effect on the consolidated financial statements. An irrevocable trust fund exists for the payment of medical malpractice claim settlements. KDMC is self-insured for malpractice claims and currently has excess insurance for claims over the self-insured limit.

#### ***Merger or acquisition activity:***

In December 2009, KDMC acquired a local urology physician practice including four urologists, and formed a new subsidiary corporation, King's Daughters Medical Specialties. The new corporation will house the hospital's physician specialty practices with the exception of cardiology, which is included within a separate subsidiary corporation called Kentucky Heart Institute that was established in 2008.

As part of its ongoing planning process, KDMC will continually consider potential mergers and acquisitions of operations or properties which may benefit the organization, as well as the potential disposition of certain existing operations or properties. However, no such transactions are imminent.