



Report of Independent Auditors
and Consolidated Financial Statements
with Supplementary Information for

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary**

December 31, 2012 and 2011

MOSS ADAMS LLP

Certified Public Accountants | Business Consultants

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**REHOBOTH MCKINLEY CHRISTIAN
HEALTH CARE SERVICES, INC. AND SUBSIDIARY
BOARD OF TRUSTEES AND PRINCIPAL EMPLOYEES
December 31, 2012**

**Rehoboth McKinley Christian
Health Care Services, Inc.**

Board of Trustees

Kathy Head, Chairman
John Mezoff, MD, Vice Chairman
Yogash Kumar, Secretary
David Bischoff, Treasurer
Angelo DiPaolo
Jennifer Dowling
Sue Eddy
Erwin Elber, MD
Tony Gonzales
John Luginbuhl
Priscilla Smith
Shelley Stam-MacLaren, MD
Shannon Tanner

Principal Employees

Roger Gleisner, Acting CEO

**Rehoboth McKinley Christian
Health Care Services Foundation**

Board of Trustees

Tommy Haws, Chairman
Paul McCollum, Vice-Chairman
Heather Nasi, Secretary
Mark Gartner, Treasurer
Teresa Duran-Diaz
Curtis Fortney
Jeannette Gartner
Nate Haveman
Arlene High
Danny Oweis
Bruce Tempest, MD

Principal Employee

Ina Burmeister, Executive Director
Roger Gleisner, Acting CEO

REPORT OF INDEPENDENT AUDITORS

Board of Trustees and Management of
Rehoboth McKinley Christian Health Care Services, Inc. and Subsidiary
and
Mr. Hector H. Balderas, New Mexico State Auditor

Report on Financial Statements

We have audited the accompanying consolidated financial statements of Rehoboth McKinley Christian Health Care Services, Inc. and Subsidiary (the "Hospital"), a New Mexico not-for-profit corporation which comprise the consolidated statements of financial position as of December 31, 2012 and 2011, and the related consolidated statements of activities, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, as issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in

Board of Trustees and Management of
Rehoboth McKinley Christian Health Care Services, Inc. and Subsidiary
and
Mr. Hector H. Balderas, New Mexico State Auditor

order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Hospital as of December 31, 2012 and 2011, and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying schedule of pledged collateral and schedule of deposits and investments as presented in the table of contents under supplementary information is presented for the purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects, in relation to the consolidated financial statements as a whole.

Board of Trustees and Management of
Rehoboth McKinley Christian Health Care Services, Inc. and Subsidiary
and
Mr. Hector H. Balderas, New Mexico State Auditor

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated June 6, 2013 on our consideration of the Hospital's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Hospital's internal control over financial reporting and compliance.

Mess Adams LLP

Albuquerque, New Mexico
June 6, 2013

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**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION**

ASSETS

	December 31,	
	2012	2011
CURRENT ASSETS		
Cash and cash equivalents	\$ 1,705,511	\$ 911,269
Patient accounts receivable, net of allowance for doubtful accounts of \$6,520,899 in 2012 and \$7,035,365 in 2011	6,575,799	8,177,233
Estimated third party payor settlements	869,766	836,051
Sole community provider and other receivables	1,839,106	3,581,997
Inventories	979,139	1,006,337
Prepaid expenses and deposits	335,833	465,178
Total current assets	<u>12,305,154</u>	<u>14,978,065</u>
Property, plant, and equipment, net	14,771,216	16,631,089
Assets limited as to use		
Assets held by trustee	967,356	953,851
Assets held for 457(b) plan	251,249	208,172
Investment in risk retention group	2,488,224	2,281,920
Bond issuance costs	542,858	580,956
Total assets	<u>\$ 31,326,057</u>	<u>\$ 35,634,053</u>

LIABILITIES AND NET ASSETS

CURRENT LIABILITIES		
Accounts payable	\$ 5,207,493	\$ 6,505,430
Accrued salaries and benefits	3,914,222	4,071,692
Other accrued liabilities	1,133,626	502,526
Estimated third party payor settlements	2,341,248	5,094,020
Current portion of long-term debt	454,707	486,337
Total current liabilities	<u>13,051,296</u>	<u>16,660,005</u>
LONG-TERM DEBT, less current portion	<u>6,064,948</u>	<u>6,530,618</u>
Total liabilities	<u>19,116,244</u>	<u>23,190,623</u>
COMMITMENTS AND CONTINGENCIES (Note 14)		
NET ASSETS		
Unrestricted	11,746,700	11,998,078
Temporarily restricted	366,525	348,764
Permanently restricted	96,588	96,588
Total net assets	<u>12,209,813</u>	<u>12,443,430</u>
Total liabilities and net assets	<u>\$ 31,326,057</u>	<u>\$ 35,634,053</u>

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF ACTIVITIES**

	Year Ended December 31, 2012			Total
	Unrestricted	Temporarily Restricted	Permanently Restricted	
OPERATING REVENUE				
Net patient service revenue	\$ 51,140,508	\$ -	\$ -	\$ 51,140,508
Provision for uncollectible accounts	4,073,946	-	-	4,073,946
Net patient service revenue less provision for uncollectible accounts	47,066,562	-	-	47,066,562
 Sole community provider and other	 11,206,891	 330,466	 -	 11,537,357
Net assets released from restrictions	312,705	(312,705)	-	-
Total operating revenue	58,586,158	17,761	-	58,603,919
 OPERATING EXPENSES				
Salaries, benefits, contract labor, and payroll taxes	35,429,189	-	-	35,429,189
Supplies and pharmaceuticals	5,816,426	-	-	5,816,426
Other operating expenses	5,338,165	-	-	5,338,165
Purchased services	2,840,965	-	-	2,840,965
Professional fees	3,247,771	-	-	3,247,771
Rentals and lease	2,510,756	-	-	2,510,756
Depreciation and amortization	2,503,627	-	-	2,503,627
Insurance	1,054,414	-	-	1,054,414
Total operating expenses	58,741,313	-	-	58,741,313
Operating (loss) gain	(155,155)	17,761	-	(137,394)
 NONOPERATING INCOME (EXPENSE)				
Investment income	419,762	-	-	419,762
Loss on disposal of capital assets	(65,340)	-	-	(65,340)
Interest expense	(450,645)	-	-	(450,645)
Total nonoperating expense, net	(96,223)	-	-	(96,223)
 CHANGE IN NET ASSETS	 (251,378)	 17,761	 -	 (233,617)
 NET ASSETS, December 31, 2011	 11,998,078	 348,764	 96,588	 12,443,430
 NET ASSETS, December 31, 2012	 \$ 11,746,700	 \$ 366,525	 \$ 96,588	 \$ 12,209,813

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF ACTIVITIES**

	Year Ended December 31, 2011			Total
	Unrestricted	Temporarily Restricted	Permanently Restricted	
OPERATING REVENUE				
Net patient service revenue	\$ 54,389,871	\$ -	\$ -	\$ 54,389,871
Provision for uncollectible accounts	5,118,460	-	-	5,118,460
Net patient service revenue less provision for uncollectible accounts	49,271,411			49,271,411
Sole community provider and other	9,652,943	341,530	-	9,994,473
Net assets released from restrictions	478,198	(478,198)	-	-
Total operating revenue	59,402,552	(136,668)	-	59,265,884
OPERATING EXPENSES				
Salaries, benefits, contract labor, and payroll taxes	37,970,253	-	-	37,970,253
Supplies and pharmaceuticals	7,060,301	-	-	7,060,301
Other operating expenses	6,113,162	-	-	6,113,162
Purchased services	4,688,566	-	-	4,688,566
Professional fees	4,069,976	-	-	4,069,976
Rentals and leases	2,458,092	-	-	2,458,092
Depreciation and amortization	2,364,353	-	-	2,364,353
Insurance	1,155,551	-	-	1,155,551
Total operating expenses	65,880,254	-	-	65,880,254
Operating loss	(6,477,702)	(136,668)	-	(6,614,370)
NONOPERATING INCOME (EXPENSE)				
Investment income	385,155	-	-	385,155
Gain on disposal of capital assets	2,622	-	-	2,622
Interest expense	(406,266)	-	-	(406,266)
Total nonoperating expense, net	(18,489)	-	-	(18,489)
CHANGE IN NET ASSETS	(6,496,191)	(136,668)	-	(6,632,859)
NET ASSETS, December 31, 2010	18,494,269	485,432	96,588	19,076,289
NET ASSETS, December 31, 2011	\$ 11,998,078	\$ 348,764	\$ 96,588	\$ 12,443,430

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Years Ended December 31,	
	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from patients and third-party payors	\$ 49,955,455	\$ 50,944,342
Other receipts from operations	13,280,248	9,406,339
Cash paid to employees and suppliers	(61,035,978)	(65,900,158)
Interest and dividends received	213,458	6,266
Interest paid	(450,645)	(406,266)
Net cash provided by (used in) operating activities	<u>1,962,538</u>	<u>(5,949,477)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(670,996)	(2,957,580)
Proceeds from sale of property and equipment	-	2,802
Maturities of bond funds and other investments	-	2,547
Net cash used in investing activities	<u>(670,996)</u>	<u>(2,952,231)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Payment on long-term debt	(497,300)	(576,220)
Net cash used in financing activities	<u>(497,300)</u>	<u>(576,220)</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	794,242	(9,477,928)
CASH AND CASH EQUIVALENTS, beginning of period	<u>911,269</u>	<u>10,389,197</u>
CASH AND CASH EQUIVALENTS, end of period	<u>\$ 1,705,511</u>	<u>\$ 911,269</u>

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)**

	Years Ended December 31,	
	2012	2011
RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES		
CHANGE IN NET ASSETS	\$ (233,617)	\$ (6,632,859)
ADJUSTMENTS TO RECONCILE CHANGE IN NET ASSETS TO NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES		
Depreciation and amortization	2,503,627	2,364,353
Provision for uncollectible accounts	4,073,946	5,118,460
Loss (gain) on disposal of assets	65,340	(2,622)
Unrealized gains on investments	(206,304)	(378,889)
Net changes in operating assets and liabilities		
Patient accounts receivable	(2,472,512)	(6,925,015)
Sole community provider and other receivables	1,742,891	(588,134)
Inventories	27,198	46,538
Prepaid expenses and deposits	129,345	19,754
Accounts payable	(1,354,519)	3,069,203
Accrued salaries and benefits	(157,470)	394,916
Other accrued liabilities	631,100	(796,208)
Estimated third-party payor settlements	(2,786,487)	(1,638,974)
Net cash provided by (used in) operating activities	<u>\$ 1,962,538</u>	<u>\$ (5,949,477)</u>
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES		
Increase in 457(b) investments recorded to other accrued liabilities	<u>\$ 56,582</u>	<u>\$ -</u>

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 1 – Organization and Summary of Significant Accounting Policies

Organization – Rehoboth McKinley Christian Health Care Services, Inc. (the “Hospital”) is a not-for-profit acute care hospital located in Gallup, New Mexico. The Hospital provides inpatient, outpatient, and emergency care services to the residents of Gallup, McKinley County and the surrounding area.

These financial statements include the Hospital as well as Rehoboth McKinley Christian Health Care Services Foundation (“RMCHCS Foundation” or the “Foundation”), a wholly-owned not-for-profit subsidiary (see Note 16). The Hospital is the sole stated beneficiary of the Foundation. The Foundation is authorized by the Hospital to solicit contributions on its behalf. Intercompany balances and transactions have been eliminated in consolidation.

This summary of significant accounting policies of the Hospital is presented to assist in the understanding of the Hospital’s financial statements. The financial statements and notes are the representations of the Hospital’s management who is responsible for their integrity and objectivity. The financial statements have been prepared in conformity with U.S. generally accepted accounting principles (GAAP) as applied to not-for-profit entities.

Basis of presentation – Financial statement presentation follows the requirements of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 958-205, *Not-for-Profit Entities–Presentation of Financial Statements*. Under this guidance, the Hospital is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets.

Use of estimates – Financial statement preparation 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 financial statement date and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates contained in the Hospital’s financial statements include the allowance for doubtful accounts, contractual allowance, estimated third party payor settlements and depreciation and amortization.

Cash and cash equivalents – The Hospital includes all highly liquid debt instruments with original maturities of three months or less to be cash equivalents. The Hospital is not exposed to any significant credit risk on its cash and cash equivalent balances.

Accounts receivable allowances – Contractual allowances represent the amounts which reduce patient accounts receivable to amounts that are considered to be due from third-party payors based on existing contracts the Hospital has with these payors. The contractual allowance percentages are updated several times per year by payor class and line of business. Contractual allowances are deducted from gross patient accounts receivable on the consolidated statements of financial position.

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 1 – Organization and Summary of Significant Accounting Policies (continued)

The allowance for doubtful patient accounts receivable is that amount which, in management's judgment, is considered adequate to reduce patient accounts receivable to an amount that is considered to be ultimately collectible. The Hospital calculates its allowance for doubtful accounts based on percentages of accounts receivable aging categories that consider historical write-offs by major payor categories over the past several years.

Management believes that the allowances for doubtful accounts and contractual allowances are adequate. Because of the uncertainty regarding the ultimate collectability of patient accounts receivable, there is a possibility that recorded estimates of the allowance for doubtful accounts and contractual allowances will change by a material amount in the near term.

On a monthly basis, the Hospital evaluates patient accounts receivable balances older than six months to determine collectability. Accounts are considered uncollectible when there has been no recent payment activity and no other indication that payment will be received. Those balances that are considered uncollectible are written off upon approval from the Director of Patient Financial Services, Chief Financial Officer and Chief Executive Officer depending on the balance of the account. The Hospital did not have significant write-offs during fiscal years 2011 or 2012.

The Hospital's allowance for doubtful accounts for self-pay patients increased from 70 percent of self-pay accounts receivable at December 31, 2011, to 76 percent of self-pay accounts receivable at December 31, 2012. In addition, the Hospital's allowance for doubtful accounts for third-party payors increased from 15 percent of third-party payors accounts receivable at December 31, 2011, to 20 percent of third-party payors accounts receivable at December 31, 2012. Both increases were the result of negative trends experienced in collections. The Hospital has not changed its charity care or uninsured discount policies during fiscal years 2011 or 2012. The Hospital did not have significant write-offs from third-party payors or self-pay patients during fiscal years 2011 or 2012.

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

Property, plant and equipment – Property, plant and equipment are recorded at cost. Property and equipment donated for Hospital operations are recorded at fair value at the date of donation as additions to temporarily restricted net assets when the assets are placed in service. Assets held under capital leases are recorded at the lower of the net present value of the minimum lease payments or the fair value of the leased asset at the inception of the lease. Additions, improvements and other capital outlays that significantly extend the useful life of an asset and are greater than \$1,000 are capitalized. Costs incurred for repair and maintenance are expensed as incurred.

Depreciation is computed using the straight-line method over the assets' estimated useful lives ranging from 3 to 40 years. Leasehold improvements are amortized over their useful lives not to exceed the term of the related lease.

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 1 – Organization and Summary of Significant Accounting Policies (continued)

Assets limited as to use – Assets limited as to use includes the following:

	December 31,	
	<u>2012</u>	<u>2011</u>
Held by trustee under indenture agreement related to Series 2007 Revenue Bonds - cash equivalents	\$ 967,356	\$ 953,851
Irrevocable trust - 457(b) plan		
Cash and cash equivalents	14,579	14,269
U.S. equity securities	176,843	140,520
U.S. corporate bonds	-	1,004
Mutual funds	25,343	21,566
U.S. government securities	<u>34,484</u>	<u>30,813</u>
Total of irrevocable trust - 457(b) plan	251,249	208,172
	<u>\$ 1,218,605</u>	<u>\$ 1,162,023</u>

Investments – Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value. Investment income or loss includes realized and unrealized gains and losses on investments, interest, and dividends.

The investment in risk retention group is recorded on the equity method of accounting. Under the equity method, the investment is initially recorded at cost, and thereafter, the carrying amount is adjusted for the Hospital's proportionate share of the investee's earnings and any distributions.

Net assets and changes therein – Net assets and income, expenses, gains and losses are classified based on the existence or absence of donor-imposed restrictions. Accordingly, the net assets of the Hospital and changes therein are classified and reported as follows:

Unrestricted – Unrestricted net assets represent those resources that are not restricted by donors, or for which donor-imposed restrictions have expired.

Temporarily restricted – Temporarily restricted net assets reflect donor-imposed restrictions that require the Hospital to use or expend the related assets as specified. The restrictions are satisfied either by the passage of time or by the satisfaction of donor specified use.

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 1 – Organization and Summary of Significant Accounting Policies (continued)

The Hospital records contributions as temporarily restricted if they are received with donor stipulations that limit their use through either purpose or time restrictions. When donor restrictions expire, that is, when a time restriction ends or a purpose restriction is fulfilled, temporarily restricted net assets are reclassified to unrestricted net assets. Temporarily restricted contributions received and expended in the same accounting period are recorded in the unrestricted net asset category.

Permanently restricted – Permanently restricted net assets reflect donor-imposed restrictions which stipulate that the related resources be maintained in perpetuity, but which permit the Hospital to expend part or all of the income and capital appreciation derived from the donated assets for either specified or unspecified purposes.

Bond issuance costs – Deferred bond issuance costs are amortized using the straight-line method over the term of the related debt. Amortization of deferred bond issuance costs of \$38,098 is included in the accompanying consolidated statements of activities. Total bond issuance costs were \$761,905 and the accumulated amortized costs were \$219,047 and \$180,949 at December 31, 2012 and 2011, respectively, resulting in a balance of \$542,858 and \$580,956 at December 31, 2012 and 2011, respectively, which is included in the accompanying consolidated financial position.

Recent Accounting Pronouncement – Effective December 31, 2012, management adopted ASU 2011-07, *Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*, which requires health care entities to present the provision for uncollectible accounts relating to patient service revenue as a deduction from patient service revenue in the statements of income rather than as an operating expense, and requires enhanced disclosures in situations where an entity recognizes significant amounts of patient service revenues at the time the services are provided even though it does not assess a patient's ability to pay. The provision for uncollectible accounts has been reclassified from operating expenses to operating revenues in the accompanying statements of activities in accordance with the provisions of ASU 2011-07, and the Hospital's disclosures pertaining to net patient service revenues and patient accounts receivable have been enhanced on a prospective basis effective December 31, 2012.

Charity care – The Hospital provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. The Hospital does not pursue collection of amounts determined to qualify as charity care; therefore, they are deducted from gross revenue.

Income taxes – The Hospital and the Foundation are not-for-profit corporations, exempt from Federal income tax under Section 501(c)(3) of the Internal Revenue Code. In addition, the Hospital and Foundation have been classified as entities that are not private foundation within the meaning of Section 509 (a) and qualifies for deductible contributions as provided by Section 170(b)(1)(A)(vi). Accordingly, no provision has been made for income taxes in the financial statements.

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 1 – Organization and Summary of Significant Accounting Policies (continued)

The Hospital recognizes the tax benefit from uncertain tax positions only if it is more likely than not that the tax positions will be sustained on examination by the tax authorities, based on the technical merits of the position. The tax benefit is measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The Hospital had no unrecognized tax benefits at December 31, 2012 and 2011. The Hospital and the Foundation file an exempt organization return and, if applicable, unrelated business income tax return in the U.S. Federal jurisdiction, New Mexico Attorney General and New Mexico Department of Revenue. The Hospital and the Foundation are no longer subject to income tax examinations by taxing authorities for years before fiscal year 2008 for its federal and state filings.

Advertising costs – Advertising costs are expensed as incurred. Advertising expense totaled \$130,296 and \$106,192 for the year ended December 31, 2012 and December 31, 2011, respectively.

Reclassifications – Certain reclassifications have been made to the 2011 financial information to conform to the 2012 financial statement presentation.

Subsequent events – Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are available to be issued. The Hospital recognizes in the consolidated financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing the consolidated financial statements. The Hospital's consolidated financial statements do not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date and before consolidated financial statements were available to be issued. Note 17 provides disclosure of certain subsequent events that did not result in recognition in the financial statements. The Hospital has evaluated subsequent events through June 6, 2013, which is the date the consolidated financial statements were available to be issued.

Note 2 – Net Patient Service Revenue

Agreements with third-party payors provide for payments to the Hospital 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 revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on the estimated basis in the period the related services are rendered and adjusted in future periods as more information is available to improve estimates or final settlements are determined.

A summary of payment arrangements with major third-party payors follows:

Medicare – Services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 2 – Net Patient Service Revenue (continued)

based on clinical, diagnostic, and other factors. Inpatient nonacute services, behavioral inpatient services, certain outpatient services, and defined capital and medical education costs related to Medicare beneficiaries are paid based on a cost reimbursement methodology. The Hospital is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual costs reports by the Hospital and audits thereof by the Medicare fiscal intermediary.

Medicaid – The State of New Mexico (the “State”) administers its Medicaid program through both traditional Medicaid and through contracts with Managed Care Organizations (MCOs). For MCOs, Medicaid beneficiaries are required to enroll with one of the MCOs. The State pays each MCO a per member, per month rate based on their current enrollment. These amounts are allocated by each MCO to separate pools for the hospital, physicians, and ancillary providers. As a result, the MCOs assume the financial risk of providing health care to its members. This arrangement is commonly referred to as “SALUD!”.

Through traditional Medicaid and contracts with MCOs, inpatient and outpatient services are paid at prospectively determined rates per discharge and discounted fee schedules. The Hospital is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by the Hospital and audits thereof by the Medicaid fiscal intermediary.

Through the New Mexico Medicaid program outpatient payment reimbursement are based on a simplified Medicare APC method. The prospective payment system (OPPS) reimbursements are set to 100% of the Medicare standard rate.

Revenue from the Medicare and Medicaid programs accounted for approximately 33% and 29%, respectively, of the Hospital’s patient revenue for the years ended December 31, 2012 and 2011.

The Hospital recognizes patient service revenue associated with services provided to patients who have third-party payor coverage on the basis of contractual rates for the services rendered. For uninsured patients that do not qualify for charity care, the Hospital recognizes revenue on the basis of its standard rates for services provided (or on the basis of discounted rates, if negotiated or provided by policy). On the basis of historical experience, a significant portion of the Hospital’s uninsured patients will be unable or unwilling to pay for the services provided. Thus, the Hospital records a significant provision for bad debts related to uninsured patients in the period the services are provided. Patient service revenue, net of contractual allowances and discounts (but before the provision for bad debts), recognized in the period from these major payor sources, is as follows:

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 2 – Net Patient Service Revenue (continued)

	Third-Party Payers	Self-Pay	Total All Payers
Year Ended December 31, 2012	\$ 42,856,808	\$ 8,283,700	\$ 51,140,508
Year Ended December 31, 2011	\$ 46,975,230	\$ 7,414,641	\$ 54,389,871

Medicare and Medicaid cost report receivable (liabilities) are as follows:

	December 31,		Current Status
	2012	2011	
Medicare			
2010	\$ 614,054	\$ 836,051	Tentative settlement
2011	55,712	-	Tentative settlement
2012	200,000	-	Tentative settlement
	<u>869,766</u>	<u>836,051</u>	
Medicaid			
2008	-	(1,205,357)	Settled
2009	(737,692)	(1,710,335)	Settled
2010	(1,386,962)	(1,938,328)	Settled
2011	(80,228)	(240,000)	Tentative settlement
2012	(136,366)	-	Tentative settlement
	<u>(2,341,248)</u>	<u>(5,094,020)</u>	
Total	<u>\$ (1,471,482)</u>	<u>\$ (4,257,969)</u>	

Management believes that these estimates are adequate. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Estimates are continually monitored and reviewed, and as settlements are made or more information is available to improve estimates, differences are reflected in current operations.

Settlements of prior-year cost reports and changes in estimates resulted in increases to net patient service revenue of approximately \$915,000 and \$27,000 for the years ended December 31, 2012 and December 31, 2011, respectively.

Other third-party payors – The Hospital has also entered into payment agreements with certain commercial insurance carriers. The basis for payment to the Hospital under these agreements includes prospectively determined rates per discharge, discounts from established charges and prospectively determined daily rates.

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 2 – Net Patient Service Revenue (continued)

The following summary details the components of net patient service revenue for the years ended December 31, 2012 and 2011:

	December 31,	
	2012	2011
Gross charges - inpatient	\$ 40,214,120	\$ 41,400,612
Gross charges - outpatient	74,251,327	74,709,452
Third party contractual allowances	<u>(63,324,939)</u>	<u>(61,720,193)</u>
Net patient service revenue	<u>\$ 51,140,508</u>	<u>\$ 54,389,871</u>

Note 3 – Investment Income

Investment income from cash, cash equivalents, and investments consists of the following for the years ended December 31, 2012 and 2011:

	December 31,	
	2012	2011
Interest and dividends	\$ 213,458	\$ 6,266
Net unrealized gains (losses)	<u>206,304</u>	<u>378,889</u>
	<u>\$ 419,762</u>	<u>\$ 385,155</u>

Note 4 – Fair Value Measurements

Fair value measurements used by the Hospital for all financial assets and liabilities that are recognized or disclosed at fair value in the consolidated financial statements are based on the premise that fair value represents an exit price representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, the following three-tier fair value hierarchy has been used in determining the input used in measuring fair value:

Level 1	Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the plan has the ability to access.
Level 2	Quoted prices in markets that are not considered to be active or financial instruments without quoted market prices, but for which all significant inputs are observable, either directly or indirectly.
Level 3	Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 4 – Fair Value Measurements (continued)

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs. The Hospital has no Level 3 fair value measurements. In addition, the Hospital had no transfers between levels during the years ended December 31, 2012 and 2011.

The investment in the risk retention group, as described in Note 14, is accounted for under the equity method of accounting and, accordingly, does not require a fair value measurement.

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at December 31, 2012 and 2011.

U.S. equity securities and mutual funds are valued using quoted market prices in active markets. They are classified within Level 1 of the fair value hierarchy.

U.S. Treasury Notes, FNMA mortgage backed securities, and U.S. Corporate Bonds: These fixed income securities are valued using a bid evaluation or a mid evaluation. A bid evaluation is an estimated price at which a dealer would pay for a security. A mid evaluation is the average of the estimated price at which a dealer would sell a security and the estimated price at which a dealer would pay for a security. These evaluations are based on quoted prices, if available, or models that use observable inputs and, as such, are classified within Level 2 of the fair value hierarchy.

The following table provides information as of December 31, 2012, about the Hospital's financial assets and liabilities measured at fair value on a recurring basis.

	Balance at December 31, 2012	Level 1	Level 2
	<u>2012</u>	<u>Level 1</u>	<u>Level 2</u>
Assets included in:			
Assets limited as to use			
Cash and cash equivalents	\$ 982,022	\$ 982,022	\$ -
U.S. equity securities - various sectors	176,843	176,843	-
U.S. Treasury Notes	29,751	-	29,751
Mutual funds	25,255	25,255	-
FNMA mortgage backed securities	4,734	-	4,734
	<u> </u>	<u> </u>	<u> </u>
Total	<u>\$ 1,218,605</u>	<u>\$ 1,184,120</u>	<u>\$ 34,485</u>

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 4 – Fair Value Measurements (continued)

The following table provides information as of December 31, 2011, about the Hospital's financial assets and liabilities measured at fair value on a recurring basis.

	Balance at December 31, 2011	Level 1	Level 2
Assets included in:			
Assets limited as to use			
Cash and cash equivalents	\$ 968,120	\$ 968,120	\$ -
U.S. equity securities - various sectors	140,520	140,520	-
U.S. Treasury Notes	28,124	-	28,124
Mutual funds	21,566	21,566	-
FNMA mortgage backed securities	2,689	-	2,689
U.S. corporate bonds	1,004	-	1,004
Total	<u>\$ 1,162,023</u>	<u>\$ 1,130,206</u>	<u>\$ 31,817</u>

Note 5 – Property, Plant and Equipment

A summary of property, plant and equipment at December 31, 2012 and 2011 follows:

	December 31,	
	2012	2011
Equipment	\$ 27,923,687	\$ 28,846,423
Buildings and improvements	28,603,053	28,824,212
Land improvements	1,804,422	1,804,422
	<u>58,331,162</u>	<u>59,475,057</u>
Accumulated depreciation and amortization	<u>(44,414,743)</u>	<u>(43,722,378)</u>
	13,916,419	15,752,679
Land	734,969	734,969
Construction in progress	119,828	143,441
	<u>\$ 14,771,216</u>	<u>\$ 16,631,089</u>

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 6 – Long-Term Debt

Long-term debt consists of the following:

	December 31,	
	2012	2011
Series 2007A bonds	\$ 6,280,000	\$ 6,580,000
Capital lease obligations	239,655	436,955
	6,519,655	7,016,955
Less current portion	(454,707)	(486,337)
Long-term debt, excluding current portion	\$ 6,064,948	\$ 6,530,618

In March 2007, the Hospital issued the Series 2007A New Mexico Hospital Equipment Loan Council Hospital Facility Refunding and Improvement Bonds to refund the outstanding Series 1996 and Series 2000 bonds, to finance the costs of the acquisition of certain equipment, to fund a project fund, and to pay certain costs of issuance for the Series 2007A bonds. The Refunding and Improvement Bond Master Trust Indenture (the “Indenture”) requires the Hospital to make monthly deposits with a trustee for payment on the bonds. See Note 1 for the amounts held by the trustee under the Indenture agreement related to the 2007A bonds.

The Series 2007A bonds accrue interest at 5.00% until 2017, and thereafter accrue at 5.25%. The bonds mature in 2026, and are collateralized by the lease between the Hospital and the County of McKinley and buildings owned by the Hospital, and are secured by pledged revenues. The bond agreement also places certain limits on the incurrence of additional debt and requires that the Hospital satisfy certain measures of financial performance as long as the bonds are outstanding.

The cost of equipment under capital leases is included in property, plant and equipment in the consolidated statements of financial position and was \$1,189,862 at December 31, 2012 and 2011, respectively. Accumulated amortization on the leased equipment at December 31, 2012 and 2011 was \$940,313 and \$492,548, respectively. Amortization of assets under capital leases is included in depreciation and amortization expense in the consolidated statements of activities. The capital leases expire at various dates through February 2014; and accrue interest at rates ranging from 3.6% to 10.7%, and are secured by the underlying equipment.

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 6 – Long-Term Debt (continued)

Required principal payments on long-term debt are as follows:

	<u>Bonds Payable</u>	<u>Capital Leases</u>
Year ending December 31,		
2013	\$ 320,000	\$ 135,000
2014	335,000	115,260
2015	350,000	-
2016	370,000	-
2017	385,000	-
Thereafter	4,520,000	-
	<u>\$ 6,280,000</u>	<u>250,260</u>
Less amounts representing interest payments		<u>(10,605)</u>
		<u>\$ 239,655</u>

Note 7 – Operating Leases

In September 1995, the Hospital renewed its facility lease agreement with McKinley County, New Mexico for 25 additional years. The annual rent paid to the County for the use of the Hospital facility was \$1 per year. Effective July 2010, the lease agreement was amended to change the base rent to \$1,500,000 per year, and to add a new dialysis building to the lease premises. Prior to July 1, 2015, and every five years thereafter, the base rent will be reevaluated based on updated appraisal that has been reviewed and concurred by Property Tax Division of the New Mexico Taxation and Revenue Department. The building lease with McKinley County began in July of 2010 and requires monthly payments of \$125,000 through August 31, 2028.

The Hospital has noncancelable operating leases consisting of the lease of the hospital building and various equipment. As of December 31, 2012 and 2011, the Hospital had unpaid rent and leases of \$0 and \$336,271 included in accounts payable in the accompanying consolidated statements of financial positions. Total rental expense under operating leases was approximately \$2,510,756 and \$2,458,092 for the years ended December 31, 2012 and 2011, respectively.

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 7 – Operating Leases (continued)

The future minimum lease payments under the leases at December 31, 2012 are as follows:

Year ending December 31,	<u>Operating Leases</u>
2013	\$ 2,007,201
2014	1,815,462
2015	1,637,898
2016	1,500,000
2017	1,500,000
Thereafter	<u>15,875,000</u>
Total minimum lease payments	<u>\$ 24,335,561</u>

Note 8 – Employee Benefits

The Hospital has established a Section 403(b) retirement plan (the “plan”). There is no minimum period of service or age in order to be eligible to participate; however, employees must make a minimum contribution to be eligible for a discretionary 100% employer match contribution of up to 3% of the employee’s salary. Additionally, the Hospital will match 50% of additional contributions up to 5% of the employee’s salary. At December 31, 2012 and 2011, accrued employer contributions of \$547,775 and \$570,240, were included in accrued salaries and benefits in the accompanying consolidated statements of financial position.

Effective January 1, 2003, the Hospital adopted a nonqualified deferred compensation plan under Section 457(b) of the Internal Revenue Code. The plan enables certain key employees to enhance their retirement security by deferring compensation in addition to 403(b) deferrals. An irrevocable trust was established to satisfy the financial obligations to provide benefits to participants under the plan. Participants do not have a secured interest in the assets held in the trust; as such assets remain the property of the Hospital and are subject to creditor claims. The amount funded to the trust as of December 31, 2012 and 2011 was \$251,249 and \$208,172, respectively. The funded amount is included in assets limited as to use in the consolidated statements of financial position – see Note 1. The related liabilities of \$251,249 and \$208,172 as of December 31, 2012 and 2011, respectively, are included in accrued salaries and benefits in the accompanying consolidated statements of financial position.

Note 9 – Employee Health Insurance Benefit Program

The Hospital has retained liability for certain employee health claims up to \$100,000 per claim and has purchased insurance for claims in excess of these amounts. Management believes that adequate reserves have been established as of December 31, 2012 and 2011 to cover claims which have been incurred but not reported. Such reserves are included in accrued salaries and benefits in the accompanying consolidated statements of financial position.

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 10 – Sole Community Provider Funding

The Hospital participates in a sole community provider indigent care program administered by the State of New Mexico. Revenue from this program for the years ended December 31, 2012 and December 31, 2011 totaled approximately \$8 million and \$7 million, respectively. Approximately \$1.2 million and \$2.9 million as of December 31, 2012 and 2011, respectively, are included in sole community provider and other receivables in the consolidated statements of financial position.

Note 11 – Other Operating Revenue

Other operating revenue includes the following:

Ad valorem tax levy – A New Mexico state law, the Hospital Funding Act, was adopted in 1980 and amended in 1981 and allowed for counties to provide tax support to qualifying hospitals. Through 2012, McKinley County voters had approved a property tax levy of two mills. Revenue from the two mill levy was approximately \$1.5 million and \$1.6 million for the years ended December 31, 2012 and 2011, respectively. During 2012, and effective July 1, 2013, McKinley County voters approved a property tax levy for up to 4 mills. Further, the referendum allowed the funds to be used as a match for the Sole Community Provider funding. The Hospital’s receipt of the 4 mills is contingent on McKinley County’s approval of such funding.

Other – Other operating revenue also includes cafeteria, gift shop, donation and grant revenues.

Note 12 – Charity Care

The Hospital provides charity care to patients who are financially unable to pay for health care services they receive. The Hospital’s policy is not to pursue collection of amounts determined to qualify as charity care. The Hospital maintains records to identify and monitor the level of charity care it provides. These records include the amount of charges foregone for services and supplies furnished under its charity care policy. Direct and indirect costs for providing charity care are estimated by calculating a ratio of cost to gross charges and then multiplying that ratio by the gross uncompensated charges associated with providing care to charity patients. The estimated total direct and indirect costs of charity care services and unpaid cost of services is as follows:

	December 31,	
	2012	2011
Estimated costs and expenses incurred to provide charity care	\$ 1,270,057	\$ 1,764,820

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 13 – Concentrations of Risk

The Hospital provides credit, in the normal course of business, primarily to residents of the city of Gallup and the county of McKinley, as well as surrounding areas. The Hospital does not require collateral with the extension of credit. The Hospital maintains an allowance for doubtful accounts based on management’s assessment of collectability, current economic conditions, and prior experience. Because of the uncertainty regarding the ultimate collectability of patient accounts receivable, there is at least a reasonable possibility that recorded estimates of the allowance for doubtful accounts and contractual allowances will change by a material amount in the near term.

The mix of gross accounts receivable from patients and third-party payors was as follows at December 31, 2012 and 2011:

	December 31,	
	2012	2011
Medicare	26%	28%
Medicaid	23%	23%
Other third-party payors	37%	37%
Self pay	14%	12%
	<u>100%</u>	<u>100%</u>

Note 14 – Commitments and Contingencies

Healthcare regulatory environment – The healthcare industry is subject to laws and regulations of federal, state and local governments. These laws and regulations include, but are not limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. In recent years, government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by healthcare providers. Violations of these laws and regulations could result in expulsion from government healthcare programs, the imposition of significant fines and penalties and significant repayments for patient services previously billed.

Management believes that the Hospital is in compliance with applicable government laws and regulations. Compliance with such laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time.

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 14 – Commitments and Contingencies (continued)

Malpractice insurance – Effective March 1, 2003, pursuant to the Federal Risk Retention Act and under the captive insurance Hospital provisions of Vermont law, the Hospital is insured under and is a founding subscriber in the VHA Mountain States Reciprocal Risk Retention Group for the purpose of providing insurance for malpractice and general liability coverage. The policy is on a claims-made basis with a per occurrence deductible of \$25,000, with maximum coverage per occurrence of \$1,000,000 and an aggregate of \$3,000,000 for professional liability and \$1,000,000 for general liability. The premiums accrue based on the ultimate experience of the group of health care entities. At December 31, 2012 and 2011, the Hospital cannot estimate the additional premiums, if any, which may accrue as a result of the Group’s experience to date. Additional premiums, if any, are not expected to be significant.

Employed physicians are covered under the same risk retention group on a claims-made basis with maximum coverage of \$1,000,000 per occurrence and an aggregate of \$3,000,000.

Litigation – The Hospital is involved in litigation arising in the ordinary course of business. Claims alleging malpractice have been asserted against the Hospital and are currently in various stages of litigation. In management’s opinion, upon consultation with legal counsel, malpractice coverage is adequate to cover adverse judgments, if any, made against the Hospital.

Workers’ compensation insurance – Pursuant to the New Mexico Self Insurance Act, the Hospital is insured under the New Mexico Hospital Workers Compensation Group for the purpose of providing insurance for workers’ compensation coverage. The policy is retrospectively rated; premiums accrue based on the ultimate cost of the experience of a group of health care entities. At December 31, 2012 and 2011, the Hospital cannot estimate the additional premiums or refunds, if any, which may accrue as a result of the Group’s experience to date. Additional premiums, if any, are not expected to be significant.

Other operating revenues – As previously described, the Hospital receives significant amounts of Sole Community Provider (see Note 10) and Mill Levy funds (see Note 11). The Hospital is significantly dependent on the continuation of these funding levels, and significant reductions in either source of funds from current levels could negatively impact the ability of the Hospital to continue its existing levels of service.

Note 15 – Functional Expense Classification

In recording the activities of the Hospital, expenses are specifically tracked or allocated on the basis of periodic time and expense studies, and recorded in the following functional categories for the years ended December 31, 2012 and 2011:

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 15 – Functional Expense Classification (continued)

	December 31,	
	2012	2011
Health care services	\$ 34,261,615	\$ 38,255,670
Management and general	24,290,364	27,472,552
Fundraising	189,334	152,032
	<u>58,741,313</u>	<u>65,880,254</u>
Total expenses	<u>\$ 58,741,313</u>	<u>\$ 65,880,254</u>

Note 16 – RMCHCS Foundation Summarized Financial Statements

Summarized financial statements for RMCHCS Foundation as of December 31, 2012 and 2011, and for the years ended December 31, 2012 and 2011 are as follows:

	December 31,	
	2012	2011
Assets		
Current assets	\$ 530,855	\$ 556,966
Other assets	-	437
Total assets	<u>\$ 530,855</u>	<u>\$ 557,403</u>
Liabilities and net assets		
Current liabilities	<u>\$ 286,229</u>	<u>\$ 261,003</u>
Net assets (deficit)		
Unrestricted	(218,487)	(148,952)
Temporarily restricted	366,525	348,764
Permanently restricted	96,588	96,588
Total net assets	<u>244,626</u>	<u>296,400</u>
Total liabilities and net assets	<u>\$ 530,855</u>	<u>\$ 557,403</u>

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 16 – RMCHCS Foundation Summarized Financial Statements (continued)

	December 31, 2012			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Other revenue	\$ 119,179	\$ 330,466	\$ -	\$ 449,645
Net assets released from restrictions	-	(312,705)	-	(312,705)
Total operating revenue	119,179	17,761	-	136,940
Total operating expenses	188,714	-	-	188,714
Total operating loss	(69,535)	17,761	-	(51,774)
Net assets (deficit), beginning of period	(148,952)	348,764	96,588	296,400
Net assets (deficit), end of period	<u>\$ (218,487)</u>	<u>\$ 366,525</u>	<u>\$ 96,588</u>	<u>\$ 244,626</u>
	December 31, 2011			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Other revenue	\$ 33,303	\$ 341,530	\$ -	\$ 374,833
Net assets released from restrictions	-	(478,198)	-	(478,198)
Total operating revenue	33,303	(136,668)	-	(103,365)
Total operating expenses	62,038	-	-	62,038
Total operating loss	(28,735)	(136,668)	-	(165,403)
Net assets (deficit), beginning of period	(120,217)	485,432	96,588	461,803
Net assets (deficit), end of period	<u>\$ (148,952)</u>	<u>\$ 348,764</u>	<u>\$ 96,588</u>	<u>\$ 296,400</u>

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 17 – Subsequent Events

Additional financing – On March 22, 2013, the Hospital entered into a loan agreement with a financial institution in the principal amount of \$2,500,000 for the purpose of providing financing for maintenance and operating expenditures. The loan is secured by mill levy funds collected by McKinley County and derived from property taxes imposed under the Hospital Funding Act, specifically by the 2 mills as described in Note 11. Under the terms of the loan and related agreements, McKinley County has been instructed to transfer the proceeds of the two mill property tax imposed under the Hospital Funding Act directly to the financial institution for repayment of the loan amount. The loan is subordinate to the Series 2007A bonds, bears interest at 4.5%, and requires the outstanding loan amount to be reduced to the following principal balances:

<u>Dates</u>	<u>Principal Balance</u>
December 31, 2013	\$ 1,875,000
June 30, 2014	1,250,000
December 31, 2014	800,000
June 30, 2015	-

While management expects the mill levy funds to be sufficient to reduce the outstanding loan amount to the above principal balances, in the event such funds are insufficient, the Hospital would be required to pay such deficiency from other operating funds.

Sole Community Provider Funding – As previously described, the Hospital receives significant amounts of Sole Community Provider funding. This funding was suspended in December 2012 after CMS raised some concerns about the State of New Mexico’s calculation of funding levels, and in particular, the calculation of the Upper Payment Limit. Subsequent to December 31, 2012, an agreement was reached that resumed the payment of Sole Community Provider funds to hospitals within the State of New Mexico, although at reduced levels. Based on the agreement reached, management is projecting 2013 funding to approximate \$6 million, which is a reduction of approximately \$2 million from 2012 funding and an approximate reduction of \$860,000 from amounts budgeted by management. Effective January 1, 2014, the State of New Mexico is transitioning to Centennial Care. The process for reimbursing hospitals for uncompensated care including indigent care and Medicaid reimbursement below cost is still being developed, however, funding levels are expected to be reduced.

Affiliation – Subsequent to December 31, 2012, the Hospital began exploring the possibility of affiliating with a partner to secure the long-term financial and operational strength and stability of the Hospital. As of the date of these financial statements, no agreement had been entered into.

SUPPLEMENTARY INFORMATION

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**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
SCHEDULE OF PLEDGED COLLATERAL
DECEMBER 31, 2012**

Deposits

Financial Institution	Total Amount of Deposit in Bank	Insured Portion	Required Collateralization 50% of Uninsured Portion	Collateral Pledged	Over/ (Under) Collateralized
Wells Fargo Bank	\$ 137,617	\$ 137,617	\$ -	\$ -	\$ -
Bank of Colorado - Pinnacle Bank	519,588	519,588	-	-	-
Washington Federal	1,001	1,001	-	-	-
Total	<u>\$ 658,206</u>	<u>\$ 658,206</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

Repurchase Agreement

Financial Institution	Total Amount of Repurchase Agreement	Insured Portion	Required Collateralization 102% of Uninsured Portion**	Collateral Pledged	Over/ (Under) Collateralized
Wells Fargo Bank	<u>\$ 953,864</u>	<u>\$ -</u>	<u>N/A</u>	<u>\$ 891,569</u>	<u>\$ 891,569</u>

Pledged Collateral

Type of Security	Custodian	CUSIP Number	Sequence Number	Maturity Date	Fair Value
FEDL HOME LN MTG CRPPOOL	Wells Fargo	31414ANH1	123112	12/1/2037	\$ 891,569

**The Hospital is subject to collateralization requirements on the unexpended portion of its mill levy monies, which are considered "Public Monies" per the New Mexico State Audit Rule section 2.2.2.10 N. There were no unexpended mill levy monies at December 31, 2012 beyond the amounts held in deposit accounts, which were fully insured; accordingly, there is no requirement for collateralization on their Repurchase Agreement.

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
SCHEDULE OF DEPOSITS AND INVESTMENTS
DECEMBER 31, 2012**

Account Title	Account Type	Bank Balance	Reconciling Items	Book Balance
<u>Cash and cash equivalents</u>				
Wells Fargo Bank				
Operational	Checking	\$ 103,706	\$ -	\$ 103,706
Operational	Depository	-	588,176	588,176
Operational	Accounts payable zero balance account	-	(497,556)	(497,556)
Operational	Payroll zero balance account	-	(29,227)	(29,227)
Operational	Pension account	33,911	-	33,911
Washington Federal				
Foundation Operational	Checking	1,001	(212)	789
Bank of Colorado - Pinnacle Bank				
Foundation Restricted Checking	Checking	21,596	(257)	21,339
Foundation Restricted	Money market account	429,570	30,000	459,570
Foundation Unrestricted Checking	Checking	4,422	-	4,422
Foundation Unrestricted	Money market account	28,014	-	28,014
Auxiliary - Gift Shop	Checking	17,301	(1,350)	15,951
Auxiliary - General Account	Checking	12,113	-	12,113
Auxiliary - Thrift Shop	Checking	6,572	-	6,572
Total deposits		<u>658,206</u>	<u>89,574</u>	<u>747,780</u>
Wells Fargo Bank				
Repurchase agreement	Sweep	953,863	-	953,863
Other				
Petty cash	Cash	-	4,470	4,470
Flex comprehensive cash	Cash	-	(602)	(602)
Total cash and cash equivalents		<u>\$ 1,612,069</u>	<u>\$ 93,442</u>	<u>\$ 1,705,511</u>
<u>Cash and investments - restricted</u>				
Wells Fargo Bank				
Improvement Fund	Cash equivalent	\$ 53,010	\$ -	\$ 53,010
Series 2007 Bond Principal Fund	Cash equivalent	268,891	139	269,030
Series 2007 Bond Reserve Fund	Cash equivalent	645,316	-	645,316
Zia Trust				
Irrevocable trust - 457(b) plan	Cash equivalent	14,579	-	14,579
Irrevocable trust - 457(b) plan	Equity securities	176,843	-	176,843
Irrevocable trust - 457(b) plan	Fixed income securities	59,827	-	59,827
Total bond funds and other investments		<u>\$ 1,218,466</u>	<u>\$ 139</u>	<u>\$ 1,218,605</u>

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OTHER INFORMATION

**REPORT OF INDEPENDENT AUDITORS ON INTERNAL CONTROL OVER FINANCIAL
REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN
AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

Board of Trustees and Management of
Rehoboth McKinley Christian Health Care Services, Inc. and Subsidiary
and
Mr. Hector H. Balderas, New Mexico State Auditor

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the consolidated financial statements of Rehoboth McKinley Christian Health Care Services, Inc. and Subsidiary, (the "Hospital") a New Mexico not-for-profit corporation, which comprise the consolidated statements of financial position as of December 31, 2012 and 2011, and the related consolidated statements of activities and cash flows for the years then ended, and the related notes to the financial statements, and have issued our report thereon dated June 6, 2013.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Hospital's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Hospital's internal control. Accordingly, we do not express an opinion on the effectiveness of the Hospital's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Board of Trustees and Management of
Rehoboth McKinley Christian Health Care Services, Inc. and Subsidiary
and
Mr. Hector H. Balderas, New Mexico State Auditor

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Hospital's financial statements are free from material misstatement we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

However, we noted certain other matters that are required to be reported pursuant to Section 12-6-5, NMSA 1978, which are described in the accompanying schedule of findings and responses as findings 12-01, 10-03 and 10-04.

The Hospital's Response to Findings

The Hospital's responses to the other matters identified in our audit are described in the accompanying schedule of findings and responses. The Hospital's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Board of Trustees and Management of
Rehoboth McKinley Christian Health Care Services, Inc. and Subsidiary
and
Mr. Hector H. Balderas, New Mexico State Auditor

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance, and the result of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Mess Adams LLP

Albuquerque, New Mexico
June 6, 2013

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
SCHEDULE OF FINDINGS AND RESPONSES
DECEMBER 31, 2012**

12-01 Security and Access Controls

Condition

During our testing of IT controls, we noted one employee out of a sample of 3 terminations/retirements who had provided a letter of retirement with an effective date of March 22, 2013. The separation from the hospital was not reported to the Information Technology department until April 19, 2013.

Criteria

The hospital should ensure that proper access controls are in place within the organization as there is sensitive patient information as well as access to financial information systems. It is imperative that employees who have voluntarily or involuntarily separated from the hospital be promptly reported to the IT department in order to restrict their access to the hospital's systems.

Cause

IT policies and procedures have not been established to provide an effective timeline to require the reporting of an employee separation to the IT department.

Effect

When controls are not in place to restrict the access of terminated employees there is a possibility for the loss of confidential patient information.

Recommendation

We recommend that management review their policies and procedures related to the reporting of terminated employees to the IT department in order to ensure access rights have been restricted.

Management Response

Policy requires the human resources department to complete a separation notice for each terminated employee before a final check is provided. Each week, a listing of terminated employees is sent to the Information Technology department for use in terminating computer access. Access for Highly visible employees is terminated on the day of discharge.

The Hospital has a SAM server which is monitored by the Information Technology department for unauthorized access to information systems. Profiles built in Meditech limit access to individual users on a need to know basis. We are aware of no compliance issues relating to terminated employees improperly accessing personal health or financial information.

The Hospital will continue to monitor this process to insure that it is being completed in a timely manner.

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
SCHEDULE OF FINDINGS AND RESPONSES
DECEMBER 31, 2012**

Finding 10-03: Reconciliation of Cash (Repeat and Modified)

Condition

During our testwork, we noted that the depository account was not reconciled timely for approximately 9 months of the year, although as of year-end, the necessary reconciliation was completed.

Criteria

Account reconciliations represent a key internal control over the complete and accurate accounting and classification of balance sheet accounts and should be designed to enable personnel to timely identify and correct financial statement balances.

Effect

There is a potential that reconciling items are not timely identified and corrected, resulting in misstatements or misclassifications of financial statement balances.

Cause

Due to staff turnover, the depository account was not reconciled timely for approximately 9 months of the year. Staff fell significantly behind in the accurate completion of the monthly depository account reconciliations during 2011. During 2012, management required staff to reconcile the depository accounting beginning with 2011 and thus the completion of the 2012 reconciliations could not be completed timely for approximately 9 months of the year.

Recommendation

We recommend management monitor the newly implemented reconciliation process to ensure all reconciliations are prepared timely and accurately.

Management Response

Reconciliations of the depository account have been completed for all months of the audit period. Due to their complexity, they were not completed concurrently. However, an adjusting entry was made to this audit period, based on the December 2012 reconciliation. Management is reviewing the subsequent reconciliations and appropriate entries are being made.

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
SCHEDULE OF FINDINGS AND RESPONSES
DECEMBER 31, 2012**

Finding 10-04: Review and Analysis of Professional Liability Claims (Repeat and Modified)

Condition

In testing professional liability contingencies (medical malpractice liabilities), we noted the Hospital retains \$25,000 on its professional liability risks under a claims made insurance policy, and no analysis is performed to assess the need for, and measurement of, an accrual for the ultimate costs of settling those claims.

Criteria

Pursuant to generally accepted accounting principles (GAAP), the ultimate costs of malpractice claims, which includes the costs associated with litigating and settling those claims, should be accrued when the incidents that give rise to the claims occur. An entity that is indemnified for these liabilities shall recognize an insurance receivable at the same time that it recognizes the liability measure on the same basis as the liability, subject to the need for a valuation allowance for uncollectible amounts.

Effect

The consolidated financial statements may not include professional liability contingencies in accordance with GAAP, causing liabilities to be understated and net income to be overstated.

Cause

Currently, management does not perform separate review and analysis of professional liability claims.

Recommendation

We recommend management perform an analysis of professional liability claims at least on an annual basis, and accrue estimated liabilities in accordance with GAAP.

Management Response

Professional liability claims are being monitored monthly. The accrual for expected receipts and payments has not been recorded to date. Management will establish a procedure to record expected receipts and payments on a monthly basis.

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
CURRENT STATUS OF PRIOR YEAR FINDINGS
DECEMBER 31, 2012**

Prior Year Number	Description	Current Status
11-01	Information Technology	Cleared
11-02	Timely Verification of Patient Insurance	Cleared
11-03	Late Audit Report	Cleared
10-01	Physical Inventory and Reconciliation of Fixed Assets	Cleared
10-02	Verification that Payments Received are in Accordance with Terms of Insurance Contracts	Cleared
10-03	Reconciliation of Cash and Net Assets	Repeated and Modified
10-04	Review and Analysis of Professional Liability Claims	Repeated and Modified
10-05	Review of Journal Entries	Cleared

**REHOBOTH MCKINLEY CHRISTIAN HEALTH CARE
SERVICES, INC. AND SUBSIDIARY
EXIT CONFERENCE
DECEMBER 31, 2012**

A closed meeting exit conference was held on May 31, 2013, with the following attending:

Rehoboth McKinley Christian Health Care Services, Inc. and Subsidiary:

David Bischoff, member of Board of Trustees
Bart Hansen, Interim Chief Financial Officer

Moss Adams LLP:

Brandon Fryar, Partner
Purvi Mody, Senior Manager

Financial Statement Preparation

The Hospital's independent public accountants prepared the accompanying financial statements; however, the Hospital is responsible for the contents of the financial statements and related footnotes.