
Rehoboth McKinley Christian Health Care Services, Inc. and Subsidiary

*Consolidated Financial Statements with Supplementary Information
and
Independent Auditor's Report
December 31, 2013 and 2012*

Rehoboth McKinley Christian Health Care Services, Inc. and Subsidiary

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**Rehoboth McKinley Christian
Health Care Services, Inc. and Subsidiary
Board of Trustees and Principal Employees
December 31, 2013**

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

Board of Trustees

Priscilla Smith, Chairman
Kathy Head, Vice Chairman
Yogash Kumar, Secretary
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Principal Employees

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Bart Hansen, CPA, CFO
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**Rehoboth McKinley Christian
Health Care Services Foundation**

Board of Trustees

Mark Gartner, Chairman
Paul McCollum, Vice Chairman
Heather Nasi, Secretary
Kevin Taira, Treasurer
Liz Sanchez
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Principal Employees

Ina Burmeister, Executive Director
Barry L. Mousa, FACHE, CEO

Independent Auditor's Report

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 statement of financial position as of December 31, 2013, and the related consolidated statements of activities and cash flows for the year then ended, and the related notes to the financial statements, which collectively comprise the Hospital's basic financial statements, as listed in the table of contents.

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 opinions on these consolidated financial statements based on our audit. We conducted our audit 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 audit 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 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 financial position of the Hospital as of December 31, 2013, and the change in its net assets and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note 20 to the financial statements, in April 2014 the Hospital entered a verbal agreement to sell the assets of the Hospital to Healthcare Integrity, PPC of Bonham, Texas. Our opinion is not modified with respect to that matter.

Other Matters

Adjustments to Prior Period Financial Statements

The financial statements of the Hospital as of December 31, 2012, were audited by other auditors whose report dated June 6, 2013, expressed an unmodified opinion on those financial statements. As discussed in Note 18 to the financial statements, the Hospital has adjusted its 2012 financial statements to correct an error. The other auditors reported on the financial statements before the adjustment.

As part of our audit of the 2013 consolidated financial statements, we also audited the adjustment to the 2012 consolidated financial statements to correct the error. In our opinion, such adjustment is appropriate and has been properly applied. We were not engaged to audit, review, or apply any procedures to the Hospital's 2012 consolidated financial statements other than with respect to the adjustment and, accordingly, we do not express an opinion or any other form of assurance on the consolidated 2012 financial statements as a whole.

Other Information

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 are presented for the purposes of additional analysis and to meet the requirements of the New Mexico Office of the State Auditor, and are 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.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated May 20, 2014, 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.

REDW LLC

Albuquerque, New Mexico
May 20, 2014

Consolidated Financial Statements

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary**
Consolidated Statements of Financial Position
December 31,

	<u>2013</u>	<u>2012</u> (as restated)
Assets		
Current assets		
Cash and cash equivalents	\$ 2,547,135	\$ 1,705,511
Patient accounts receivable, net of allowance for doubtful accounts of \$5,488,968 in 2013 and \$6,520,899 in 2012	5,404,711	6,575,799
Estimated third party payor settlement	100,000	255,712
Sole community provider	1,194,627	1,171,115
Other receivables	481,279	667,991
Inventories	1,393,701	1,360,260
Prepaid expenses and deposits	<u>313,205</u>	<u>335,833</u>
Total current assets	11,434,658	12,072,221
Property, plant and equipment, net	13,445,913	14,771,216
Assets limited as to use		
Assets held by trustee	977,897	967,356
Assets held for 457(b) plan	332,441	251,249
Investment in risk retention group	2,570,086	2,488,224
Bond issuance costs, net	<u>504,763</u>	<u>542,858</u>
Total assets	<u>\$ 29,265,758</u>	<u>\$ 31,093,124</u>
Liabilities and Net Assets		
Current liabilities		
Accounts payable	\$ 3,678,226	\$ 5,207,493
Accrued salaries and related liabilities	2,901,752	3,914,222
Other accrued liabilities	2,189,590	1,133,626
Estimated third party payor settlements	1,254,286	2,341,248
Current portion of long-term debt	<u>1,552,616</u>	<u>454,707</u>
Total current liabilities	11,576,470	13,051,296
Long-term debt, less current portion	<u>6,568,519</u>	<u>6,064,948</u>
Total liabilities	<u>18,144,989</u>	<u>19,116,244</u>
Net assets		
Unrestricted	10,831,090	11,513,767
Temporarily restricted	218,097	366,525
Permanently restricted	<u>71,582</u>	<u>96,588</u>
Total net assets	<u>11,120,769</u>	<u>11,976,880</u>
Total liabilities and net assets	<u>\$ 29,265,758</u>	<u>\$ 31,093,124</u>

The accompanying notes are an integral part of these financial statements.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary**
Consolidated Statements of Activities
For the Year Ended December 31, 2013

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Operating Revenue				
Net patient service	\$ 49,156,384	\$ -	\$ -	\$ 49,156,384
Provision for uncollectible accounts	<u>6,783,620</u>	<u>-</u>	<u>-</u>	<u>6,783,620</u>
Net patient service revenue less provision for uncollectible accounts	42,372,764	-	-	42,372,764
Sole community provider	6,042,497	94,015	-	6,136,512
Other operating revenue	3,122,500	-	-	3,122,500
Net assets released from restrictions	<u>267,449</u>	<u>(242,443)</u>	<u>(25,006)</u>	<u>-</u>
Total operating revenue	51,805,210	(148,428)	(25,006)	51,631,776
Operating Expenses				
Salaries, benefits, contract labor, and payroll taxes	29,918,108	-	-	29,918,108
Supplies and other	5,101,636	-	-	5,101,636
Other operating expenses	4,627,666	-	-	4,627,666
Professional fees	3,441,814	-	-	3,441,814
Purchased services	3,293,049	-	-	3,293,049
Rentals and leases	2,355,548	-	-	2,355,548
Depreciation and amortization	2,222,420	-	-	2,222,420
Insurance	<u>1,102,098</u>	<u>-</u>	<u>-</u>	<u>1,102,098</u>
Total operating expenses	<u>52,062,339</u>	<u>-</u>	<u>-</u>	<u>52,062,339</u>
Operating loss	<u>(257,129)</u>	<u>(148,428)</u>	<u>(25,006)</u>	<u>(430,563)</u>
Nonoperating income (expense)				
Investment income	85,338	-	-	85,338
Gain on sale of capital assets	6,356	-	-	6,356
Interest expense	<u>(517,242)</u>	<u>-</u>	<u>-</u>	<u>(517,242)</u>
Total nonoperating expense, net	<u>(425,548)</u>	<u>-</u>	<u>-</u>	<u>(425,548)</u>
Change in net assets/revenues and gains over expenses and losses	(682,677)	(148,428)	(25,006)	(856,111)
Net assets, beginning of year (as restated)	<u>11,513,767</u>	<u>366,525</u>	<u>96,588</u>	<u>11,976,880</u>
Net assets, end of year	<u>\$ 10,831,090</u>	<u>\$ 218,097</u>	<u>\$ 71,582</u>	<u>\$ 11,120,769</u>

The accompanying notes are an integral part of these financial statements.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary**
Consolidated Statements of Activities
For the Year Ended December 31, 2012 (as restated)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Operating Revenue				
Net patient service	\$ 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	8,362,583	330,466	-	8,693,049
Other operating revenue	2,844,308	-	-	2,844,308
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 other	5,816,426	-	-	5,816,426
Other operating expenses	5,338,165	-	-	5,338,165
Professional fees	3,247,771	-	-	3,247,771
Purchased services	2,840,965	-	-	2,840,965
Rentals and leases	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 income (loss)	(155,155)	17,761	-	(137,394)
Nonoperating income (expense)				
Investment income	419,762	-	-	419,762
Loss on sale of dialysis operation	(65,340)	-	-	(65,340)
Interest expense	(450,645)	-	-	(450,645)
Total nonoperating expense, net	(96,223)	-	-	(96,223)
Change in net assets/revenues and gains over expenses and losses, as restated (notes 16 and 17)	(251,378)	17,761	-	(233,617)
Net assets, beginning of year	11,765,145	348,764	96,588	12,210,497
Net assets, end of year	<u>\$ 11,513,767</u>	<u>\$ 366,525</u>	<u>\$ 96,588</u>	<u>\$ 11,976,880</u>

The accompanying notes are an integral part of these financial statements.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary**
Consolidated Statements of Cash Flows
December 31,

	<u>2013</u>	<u>2012</u> (as restated)
Cash flows from operating activities		
Cash received from patients and third-party payors	\$ 35,910,844	\$ 49,955,455
Cash received from sole community provider and other operating receipts	9,422,212	13,280,248
Cash paid to employees and suppliers	(44,726,480)	(61,035,978)
Interest and dividends received	3,476	213,458
Interest paid	<u>(517,242)</u>	<u>(450,645)</u>
Net cash provided by operating activities	<u>92,810</u>	<u>1,962,538</u>
Cash flows from investing activities		
Purchase of property, plant and equipment	(735,462)	(670,996)
Proceeds from sale of equipment	<u>10,004</u>	<u>-</u>
Net cash used in investing activities	<u>(725,458)</u>	<u>(670,996)</u>
Cash flows from financing activities		
Proceeds from long-term debt	2,500,000	-
Payments on long-term debt	<u>(1,025,728)</u>	<u>(497,300)</u>
Net cash provided by (used in) financing activities	<u>1,474,272</u>	<u>(497,300)</u>
Net increase in cash and cash equivalents	841,624	794,242
Cash and cash equivalents, beginning of year	<u>1,705,511</u>	<u>911,269</u>
Cash and cash equivalents, end of year	<u><u>\$ 2,547,135</u></u>	<u><u>\$ 1,705,511</u></u>

The accompanying notes are an integral part of these financial statements.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary**
Consolidated Statements of Cash Flows — continued
December 31,

Reconciliation of change in net assets to net cash provided by operating activities	2013	2012 (as restated)
Change in net assets	\$ (856,111)	\$ (233,617)
Adjustments to reconcile change in net assets to net cash provided by operating activities		
Depreciation and amortization	2,222,420	2,503,627
Provision for uncollectible accounts	6,783,620	4,073,946
Loss (gain) on disposal of assets	(6,356)	65,340
Unrealized gains on investments	(81,862)	(206,304)
Net changes in operating assets and liabilities		
Patient accounts receivable	(5,612,532)	(2,472,512)
Sole community provider	(23,512)	1,700,000
Other receivables	186,712	42,891
Inventories	(33,441)	27,198
Prepaid expenses and deposits	22,628	129,345
Accounts payable	(1,529,267)	(1,354,519)
Accrued salaries and related liabilities	(1,012,470)	(157,470)
Other accrued liabilities	964,231	631,100
Estimated third-party payor settlements	(931,250)	(2,786,487)
Net cash provided by operating activities	<u>\$ 92,810</u>	<u>\$ 1,962,538</u>
Supplemental schedule of noncash investing and financing activities		
Equipment acquired through capital lease	\$ 127,208	\$ -
Increase in 457(b) investments recorded to other accrued liabilities	\$ 91,733	\$ 56,582

The accompanying notes are an integral part of these financial statements.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary**
Notes to Consolidated Financial Statements
December 31, 2013 and 2012

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. The Hospital is not required to and does not have a legally adopted budget.

These financial statements include the Hospital as well as Rehoboth McKinley Christian Health Care Services Foundation (“RMCHCS Foundation” or the “Foundation”), a not-for-profit subsidiary (see Note 19). The Hospital is the sole stated beneficiary of the Foundation, and the Foundation is authorized by the Hospital to solicit contributions on its behalf. The financial statements have been consolidated given that the Hospital meets the criteria of having an economic interest in the Foundation. Intercompany balances and transactions have been eliminated in consolidation.

This summary of significant accounting policies 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 GAAP require 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 allowances, estimated third party payor settlements, depreciation and amortization, Recovery Audit Contractor (RAC) audit liability, health insurance incurred but not reported claims, sole community provider receivables, and legal liability claims.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary**
Notes to Consolidated Financial Statements
December 31, 2013 and 2012

Cash and Cash Equivalents

The Hospital considers all highly liquid debt instruments with original maturities of three months or less to be cash equivalents. Management does not believe the Hospital is 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 periodically by payor class and line of business. Contractual allowances are deducted from gross patient accounts receivable on the consolidated statements of financial position.

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. During 2013 and 2012, the Hospital wrote off approximately \$6.8 million and \$4.1 million, respectively to bad debt expense. The Hospital's allowance for doubtful accounts was approximately 50% of accounts receivable at December 31, 2012 and 2013. The Hospital did not change its charity care or uninsured discount policies during fiscal years 2012 or 2013.

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.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary**
Notes to Consolidated Financial Statements
December 31, 2013 and 2012

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.

Assets Limited as To Use

Assets limited as to use includes the following:

	<u>2013</u>	<u>2012</u>
Held by trustee under indenture agreement related to Series 2007 Revenue Bond - cash equivalents	<u>\$ 977,897</u>	<u>\$ 967,356</u>
Irrevocable trust - 457(b) plan		
Cash and cash equivalents	10,847	14,579
U.S. equity securities	233,858	176,843
Mutual funds	54,561	25,343
U.S. government securities	<u>33,175</u>	<u>34,484</u>
Total of irrevocable trust - 457(b) plan	<u>332,441</u>	<u>251,249</u>
	<u>\$ 1,310,338</u>	<u>\$ 1,218,605</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.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary**
Notes to Consolidated Financial Statements
December 31, 2013 and 2012

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.

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 \$38,095 is included in the accompanying consolidated statements of activities for 2013 and 2012. Total bond issuance costs were \$761,905 and the accumulated amortized costs were \$257,142 and \$219,047 at December 31, 2013 and 2012, respectively, resulting in a balance of \$504,763 and \$542,858 at December 31, 2013 and 2012, respectively, which is included in the accompanying consolidated statements of financial position.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary**
Notes to Consolidated Financial Statements
December 31, 2013 and 2012

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 activities 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.

New Mexico Electronic Health Record Incentive Program Revenue

In 2011, the Hospital joined the New Mexico Electronic Health Record (EHR) Incentive Program whose purpose is to encourage eligible Medicaid providers to adopt and meaningfully use certified EHR technology by offering payments to offset some of the costs incurred by the providers. The Hospital accounts for EHR incentive payments in accordance with FASB ASC 450-30, *Gain Contingencies*. In accordance with FASB ASC 450-30, the Hospital recognizes EHR incentive payments when all contingencies relating to the incentive payment have been satisfied with no subsequent payment adjustment. Certain contingencies require the demonstration of meaningful use which is based on meeting a series of objectives. Additionally, meeting the series of objectives in order to demonstrate meaningful use becomes progressively more stringent as its implementation is phased in through stages as outlined by the Centers for Medicare and Medicaid Services. The amounts recorded are subject to audit by the Centers for Medicare and Medicaid Services. The Hospital recognized \$830,603 and \$0 related to EHR during 2013 and 2012, respectively.

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 qualify 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
December 31, 2013 and 2012

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, 2013 and 2012. The Hospital and the Foundation file an exempt organization return and, if applicable, unrelated business income tax or other returns with the U.S. Internal Revenue Service, New Mexico Attorney General and New Mexico Department of Taxation and Revenue. The Hospital and the Foundation are no longer subject to income tax examinations by taxing authorities for years before fiscal year 2011 for its federal and state filings.

Advertising Costs

Advertising costs are expensed as incurred. Advertising expense totaled \$76,310 and \$130,296 for the years ended December 31, 2013 and 2012, respectively.

Reclassifications

Certain reclassifications have been made to the 2012 financial information to conform to the 2013 financial statement presentation.

Subsequent Events

Subsequent events through May 20, 2014, the date which the financial statements were made available to be issued, were evaluated for recognition and disclosure in the December 31, 2013, financial statements.

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 when final settlements are determined.

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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 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 their 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 reimbursements are based on a simplified Medicare Ambulatory Payment Classification (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 48% and 47%, respectively, of the Hospital’s net patient revenue for the years ended December 31, 2013 and 2012.

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

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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:

	Third-Party Payors	Self-Pay	Total All Payors
Year ended December 31, 2013	\$ 39,648,885	\$ 9,507,499	\$ 49,156,384
Year ended December 31, 2012	\$ 41,146,273	\$ 9,994,235	\$ 51,140,508

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

	December 31,		Current Status
	<u>2013</u>	<u>2012</u>	
Medicare			
2011	\$ -	\$ 55,712	Settled
2012	-	200,000	Settled
2013	<u>100,000</u>	<u>-</u>	In progress
	<u>100,000</u>	<u>255,712</u>	
Medicaid			
2009	(737,692)	(737,692)	Tentative settlement
2010	(300,000)	(1,386,962)	Tentative settlement
2011	(80,228)	(80,228)	Tentative settlement
2012	(136,366)	(136,366)	Tentative settlement
2013	<u>-</u>	<u>-</u>	In progress
	<u>(1,254,286)</u>	<u>(2,341,248)</u>	
Total	<u>\$ (1,154,286)</u>	<u>\$ (2,085,536)</u>	

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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.

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.

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

	<u>2013</u>	<u>2012</u>
Gross charges - inpatient	\$ 38,069,796	\$ 41,521,798
Gross charges - outpatient	72,704,705	76,102,995
Third party contractual allowances	<u>(61,618,117)</u>	<u>(66,484,285)</u>
Net patient service revenue	<u>\$ 49,156,384</u>	<u>\$ 51,140,508</u>

3) Investment Income

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

	<u>2013</u>	<u>2012</u>
Interest and dividends	\$ 3,476	\$ 213,458
Net unrealized gains	<u>81,862</u>	<u>206,304</u>
	<u>\$ 85,338</u>	<u>\$ 419,762</u>

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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.

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, 2013 and 2012.

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, 2013 and 2012.

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.

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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, 2013, about the Hospital's financial assets and liabilities measured at fair value on a recurring basis.

	Balance at		
	December 31, 2013	Level 1	Level 2
Assets included in			
Assets limited as to use			
Cash and cash equivalents	\$ 988,880	\$ 988,880	\$ -
U.S. equity securities - various sectors	233,858	233,858	-
U.S. treasury notes	46,043	-	46,043
Mutual funds	33,175	33,175	-
FNMA mortgage backed securities	8,382	-	8,382
	<u>\$ 1,310,338</u>	<u>\$ 1,255,913</u>	<u>\$ 54,425</u>

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
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>\$ 1,218,605</u>	<u>\$ 1,184,120</u>	<u>\$ 34,485</u>

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5) Property, Plant and Equipment

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

	<u>2013</u>	<u>2012</u>
Equipment	\$ 28,563,008	\$ 27,923,687
Buildings and improvements	28,774,345	28,603,053
Land improvements	<u>1,804,422</u>	<u>1,804,422</u>
	59,141,775	58,331,162
Accumulated depreciation and amortization	<u>(46,559,237)</u>	<u>(44,414,743)</u>
	12,582,538	13,916,419
Land	734,969	734,969
Construction in progress	<u>128,406</u>	<u>119,828</u>
	<u>\$ 13,445,913</u>	<u>\$ 14,771,216</u>

6) Long-Term Debt

Long-term debt consists of the following:

	<u>2013</u>	<u>2012</u>
Series 2007A bonds	\$ 5,960,000	\$ 6,280,000
Note payable	1,875,000	-
Capital lease obligations	<u>286,135</u>	<u>239,655</u>
	8,121,135	6,519,655
Less current portion	<u>(1,552,616)</u>	<u>(454,707)</u>
	<u>\$ 6,568,519</u>	<u>\$ 6,064,948</u>

Series 2007A Bonds

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

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“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 August 2026, and are collateralized by the lease between the Hospital and the McKinley County, New Mexico, and buildings, equipment, machinery and fixtures owned by the Hospital, and are secured by pledged revenues.

Debt Covenants

The Hospital is subject to certain bond covenant requirements specified in the Series 2007A bond agreements, including limits on the incurrence of additional debt and certain measures of financial performance. As of December 31, 2013, the Hospital was not in compliance with the days cash on-hand requirement; however, this, in itself, did not constitute an event of default. The agreement also requires that the Hospital maintain a debt coverage service ratio of 1.5 to 1. Management believes that the Hospital was in compliance with this requirement at December 31, 2013. Should the Hospital’s debt service coverage ratio fall below 1.5, but not below 1.0, an event of default does not occur if the Hospital retains a consultant to submit a written report and make recommendations which the hospital adopts and complies with to increase the debt service ratio to the 1.5 requirement. Refer to management plans at footnote 20.

Note Payable

On March 22, 2013, the Hospital entered into a loan agreement with a financial institution in the principal amount of \$2,500,000 to provide financing for maintenance and operating expenditures. The balance on this loan at December 31, 2013, was \$1,875,000. On April 15, 2014, the loan agreement was amended and an additional \$1,125,000 was borrowed. Under this revised agreement, the principal balance must be reduced to \$1,300,000 by January 15, 2015, to \$450,000 by June 15, 2015, and paid in full by December 15, 2015. 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 three 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 mill property tax payments directly to the financial institution where 2/3 is used to pay down the loan until it reaches the specified principal balances above and any amounts remaining are returned directly to the Hospital. The loan is subordinate to the 2007A bonds, bears an interest rate of 4.5% and matures December 15, 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.

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Capital Leases

The cost of equipment under capital leases is included in property, plant and equipment in the consolidated statements of financial position and was \$1,317,070 and \$1,189,862 at December 31, 2013 and 2012, 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 November 2017, accrue interest at rates ranging from 3.31% to 4.36%, and are secured by the related equipment.

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

	Bonds Payable	Note Payable	Capital Leases
Year ending December 31,			
2014	\$ 335,000	\$ 1,044,106	\$ 142,616
2015	350,000	830,894	86,044
2016	370,000	-	29,503
2017	385,000	-	27,972
2018	405,000	-	-
Thereafter	4,115,000	-	-
	<u>\$ 5,960,000</u>	<u>\$ 1,875,000</u>	<u>\$ 286,135</u>

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 the 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, 2013 and 2012, the Hospital had unpaid rent and leases of \$500,000 and \$0 included in accounts payable in the accompanying consolidated statements of financial positions. Total rent, lease and related expenses were \$2,355,548 and \$2,510,756 for the years ended December 31, 2013 and 2012, respectively.

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The future minimum lease payments under the leases at December 31, 2013, are as follows:

Year ending December 31,	Operating Leases
2014	\$ 1,782,836
2015	1,631,175
2016	1,500,000
2017	1,500,000
2018	1,500,000
Thereafter	<u>14,375,000</u>
Total minimum lease payments	<u>\$ 22,289,011</u>

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 contribution. Prior to 2013, the Hospital made 100% employer match contributions up to 3% of the employee’s salary. Additionally, the Hospital would match 50% of additional contributions up to 5% of the employee’s salary. Beginning in 2013, the Hospital will match 30% of contributions up to 3% of the employee’s salary. At December 31, 2013 and 2012, accrued employer contributions of \$130,000 and \$547,775, 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, 2013 and 2012, was \$332,441 and \$251,249, 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 \$332,441 and \$251,249 as of December 31, 2013 and 2012, respectively, are included in accrued salaries and benefits in the accompanying consolidated statements of financial position.

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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, 2013 and 2012, 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.

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, 2013 and 2012, totaled approximately \$6.1 million and \$8.4 million, respectively. Approximately \$1.2 million as of December 31, 2013 and 2012, is included in sole community provider in the consolidated statements of financial position.

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 June 2012, McKinley County voters had approved a property tax levy of two mills. Effective July 1, 2013, voters approved a property tax levy of four mills. The County Commission has approved three mills effective for the tax year beginning July 1, 2013. Revenue from the mill levies was approximately \$1.5 million during each of the years ended December 31, 2013 and 2012.

Other

Other operating revenue also includes cafeteria, gift shop, donation, rent, grant and New Mexico EHR Incentive Program revenues.

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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 were \$2,578,062 and \$2,595,019 during the years ended December 31, 2013 and 2012, respectively.

13) Concentrations of Risk

The Hospital provides credit, in the normal course of business, primarily to residents of the city of Gallup, McKinley County and the 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:

	<u>2013</u>	<u>2012</u>
Medicare	24%	26%
Medicaid	15%	23%
Other third-party payors	38%	37%
Self-pay	23%	14%
	<u>100%</u>	<u>100%</u>

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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. The government continues to conduct reviews and investigations of 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 together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed.

Management believes that the Hospital is in compliance with fraud and abuse as well as other applicable 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.

The Health Insurance Portability and Accountability Act (HIPAA) was enacted August 21, 1996, to assure health insurance portability, guarantee security and privacy of health information, and enforce standards for health information. Under the Health Information Technology for Economic and Clinical Health (HITECH) Act, several of the HIPAA security and privacy requirements have been expanded, including business associates being subject to civil and criminal penalties and enforcement proceedings for violations of HIPAA. Management believes that the Hospital is in compliance with all applicable provisions of HIPAA and HITECH.

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 Hospital's ownership percentage was 4.5% and 4.4% at December 31, 2013 and 2012, respectively. 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, 2013 and 2012, 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.

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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. Estimated deductibles for pending claims are accrued at December 31, 2013, and included with other accrued liabilities on the accompanying statements of financial position.

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, 2013 and 2012, 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.

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:

	<u>2013</u>	<u>2012</u>
Health care services	\$ 29,590,623	\$ 33,487,978
Management and general	22,369,840	25,064,000
Fundraising	<u>101,876</u>	<u>189,335</u>
	<u>\$ 52,062,339</u>	<u>\$ 58,741,313</u>

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16) Economic Dependency

As previously described, the Hospital receives a significant amount of revenue from the State's Sole Community Provider program (see Note 10) and from ad valorem tax levies (see Note 11). The Hospital is economically dependent on the continuation of these revenues 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.

17) Change in Accounting Principle

In 2013, the Hospital elected to change its policy related to the counting and recording of inventory on-hand at year end. The Hospital includes store room and pharmacy inventory in the year-end annual inventory count; however, in 2013, floor inventory, which is inventory that had been dispensed to various departments, was also included. This change resulted in a \$381,000 increase in the overall December 31, 2013, inventory balance. Prior to 2013, floor inventory was expensed and removed from inventory at the time it was dispersed to the various Hospital departments. Management believes that the new method results in a better matching of current costs with current revenues. Given that floor inventory levels are fairly static, the \$381,000 adjustment was applied retrospectively, which resulted in an increase to the beginning net assets and inventory at December 31, 2012.

18) Correction of an Error

The Hospital has restated its previously issued 2012 consolidated financial statements for matters related to a third party payor receivable and the related effects on net assets. The accompanying financial statements for 2012 have been restated to reflect the corrections. Net assets and the third party payor receivable were reduced by \$614,054 at January 1, 2012, as a result of the adjustment.

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19) RMCHCS Foundation Summarized Financial Statements

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

	2013	2012
Assets		
Current assets	\$ 533,645	\$ 530,855
Total assets	\$ 533,645	\$ 530,855
Liabilities and Net Assets		
Current liabilities	\$ 318,940	\$ 286,229
Total liabilities	318,940	286,229
Net assets (deficit)		
Unrestricted	(74,974)	(218,487)
Temporarily restricted	218,097	366,525
Permanently restricted	71,582	96,588
Total net assets	214,705	244,626
Total liabilities and net assets	\$ 533,645	\$ 530,855

	2013			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenue	\$ 12,574	\$ 94,015	\$ -	\$ 106,589
Net assets released from restrictions	267,449	(242,443)	(25,006)	-
Total revenue	280,023	(148,428)	(25,006)	106,589
Total expenses	136,510	-	-	136,510
Operating income (loss)	143,513	(148,428)	(25,006)	(29,921)
Net assets (deficit), beginning of year	(218,487)	366,525	96,588	244,626
Net assets (deficit), end of year	\$ (74,974)	\$ 218,097	\$ 71,582	\$ 214,705

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	2012			
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenue	\$ 119,179	\$ 330,466	\$ -	\$ 449,645
Net assets released from restrictions	-	(312,705)	-	(312,705)
Total revenue	119,179	17,761	-	136,940
Total expenses	188,714	-	-	188,714
Operating income (loss)	(69,535)	17,761	-	(51,774)
Net assets, beginning of year	(148,952)	348,764	96,588	296,400
Net assets (deficit), end of year	<u>\$ (218,487)</u>	<u>\$ 366,525</u>	<u>\$ 96,588</u>	<u>\$ 244,626</u>

20) Management's Plans and Anticipated Sale

Management has the following plans to improve cash flows and profitability and stabilize operations:

- Close the inpatient chemical dependency unit, relocate the home health/hospice and relocate outpatient counselors that have positive cash flow.
- For hospitalist services, the contract will be renegotiated to reduce staffing.
- Remonetize the mill levy funds to obtain additional cash flow. Request that the mill levy be increased to four mills, which if approved, could result in the possibility of another working capital loan.
- Outsource coding and billing and work to establish consistency and accuracy in the overall revenue cycle.
- Consider upgrading systems and pursuing meaningful use incentive payments.
- Renegotiate the General Electric lease and convert the maintenance agreement from General Electric to Phillips.

In April 2014, the Hospital Board of Trustees made a decision to enter into an agreement to sell the assets of the Hospital to Healthcare Integrity, LLC of Bonham, Texas, which is owned and co-founded by David Conejo and Pablo Chapa. Mr. Conejo has indicated that he will bring in NewLight Healthcare from Austin, Texas to assist in evaluating and managing the Hospital. NewLight Healthcare currently manages a number of hospitals in Texas and Oklahoma and is exploring another facility in New Mexico in addition to the Hospital. The parties have a verbal understanding but have not signed a letter of intent as of May 20, 2014.

New Mexico State Auditor's Supplementary Information

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary**
Schedule of Pledged Collateral
December 31, 2013

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	\$ 249,572	\$ 249,572	\$ -	\$ -	\$ -
Wells Fargo Bank - Bond Fund**	977,897	428	488,735	-	(488,735)
Zia Trust	10,847	10,847	-	-	-
Bank of Colorado - Pinnacle Bank**	554,018	250,000	152,009	-	(152,009)
Total	<u>\$ 1,792,334</u>	<u>\$ 510,847</u>	<u>\$ 640,744</u>	<u>\$ -</u>	<u>\$ (640,744)</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>\$ 1,788,397</u>	<u>\$ -</u>	<u>\$ 1,824,165</u>	<u>\$ 1,824,165</u>	<u>\$ -</u>

Pledged Collateral

Type of security	Type of Security	CUSIP Number	Sequence Number	Maturity Date	Fair Value
FN-30 AB8855	Wells Fargo	31417FZV3	123013	3/1/2043	<u>\$ 1,824,165</u>

** 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, 2013, in the Bond Fund or Pinnacle Bank accounts; accordingly, there is no requirement for collateralization on the Wells Fargo Bank – Bond Fund or the Bank of Colorado – Pinnacle Bank.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary
Schedule of Deposits and Investments
December 31, 2013**

Account Title	Account Type	Bank Balance	Reconciling Items	Book Balance
Cash and cash equivalents				
Wells Fargo Bank				
Operational	Operating	\$ 215,661	\$ 323	\$ 215,984
Operational	Depository	-	77,310	77,310
Operational	Accounts payable	-	(105,108)	(105,108)
Operational	Payroll	-	(20,661)	(20,661)
Operational	Pension	33,911	-	33,911
Bank of Colorado - Pinnacle Bank				
Foundation Restricted Checking	Checking	20,622	(1,387)	19,235
Foundation Restricted	Money market account	472,339	-	472,339
Foundation Unrestricted Checking	Checking	39,398	-	39,398
Foundation Unrestricted Checking	Money market account	2,673	-	2,673
Auxiliary - Gift Shop	Checking	16,692	1,159	17,851
Auxiliary - General Account	Checking	1,899	-	1,899
Auxiliary - Thrift Shop	Checking	395	-	395
Total deposits		803,590	(48,364)	755,226
Wells Fargo Bank				
Repurchase agreement	Sweep	1,788,397	-	1,788,397
Other				
Petty cash	Cash	-	4,170	4,170
Flex comprehensive cash	Cash	-	(658)	(658)
Total cash and cash equivalents		\$ 2,591,987	\$ (44,852)	\$ 2,547,135
Cash and investments - restricted				
Wells Fargo Bank				
Improvement Fund	Money market account	\$ 59,432	\$ -	\$ 59,432
Series 2007 Bond Principal Fund	Money market account	273,143	-	273,143
Series 2007 Bond Reserve Fund	Money market account	645,322	-	645,322
Zia Trust				
Irrevocable trust - 457(b) plan	Cash equivalent	10,847	-	10,847
Irrevocable trust - 457(b) plan	Equity securities	233,858	-	233,858
Irrevocable trust - 457(b) plan	Fixed income securities and mutual funds	87,736	-	87,736
Total bond funds and other investments		\$ 1,310,338	\$ -	\$ 1,310,338

Independent Auditor's Report 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 statement of financial position as of December 31, 2013, and the related consolidated statements of activities and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated May 20, 2014.

Internal Control Over Financial Reporting

In planning and performing our audit of the consolidated 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 opinion 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.

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 and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying schedule of findings and responses, we identified a certain deficiency in internal control that we consider to be a material weakness.

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. We consider the deficiency described in the accompanying schedule of findings and responses as item 2013-001 to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Hospital's consolidated 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 instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings and responses as items 2013-002 through 2013-006.

The Hospital's Responses to Findings

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

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.

REDW LLC

Albuquerque, New Mexico
May 20, 2014

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary**
Schedule of Findings and Responses
For the Year Ended December 31, 2013

Section I — Financial Statement Finding

2013-001 – Analysis of Balance Sheet Accounts – Material Weakness

Criteria or Specific Requirement: All balance sheet accounts should be analyzed throughout the year and at year end to record allowance estimates and accruals for accurate financial presentation.

Condition: The Hospital did not complete an adequate analysis of several balance sheet accounts. Specifically:

- Bad debt allowance estimates at December 31, 2013, were based on a write-off study completed in 2009. No cash collections lookback analysis was performed to update the bad debt allowance percentages, by aging category. Therefore accounts receivable allowances were understated.
- An accrual for outstanding Recovery Audit Contractor (RAC) audits that were not finalized or for those that were finalized but not paid till after year end was not recorded.
- A third-party payor receivable was improperly included on the December 31, 2012, financial statements when the payment had already been received in a prior year.

Cause: A current and thorough analysis of some balance sheet accounts was not performed in a timely manner.

Effect: There were material errors in the unaudited financial statements including:

- Net patient accounts receivable was overstated by approximately \$500,000
- Liabilities were understated by approximately \$171,000.
- The third-party payor receivable was overstated by approximately \$614,000 at December 31, 2012, which resulted in restatement of prior year financial statements.

Auditor Recommendation: The Hospital should analyze all balance sheet accounts on a regular basis to ensure that balances are accurately presented. The estimation for the allowance for doubtful accounts should give consideration to the payment trends of specific payers based off of the most recent prior period historical collections. Management should implement a review process whereby an estimation of the RAC audit liability can be calculated and accrued at least at year end. Third party payor receivables and liabilities should be removed at the time of receipt and/or payment.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary
Schedule of Findings and Responses — continued
For the Year Ended December 31, 2013**

Section I — Financial Statement Finding — continued

2013-001 – Analysis of Balance Sheet Accounts – Material Weakness — continued

Management Response: The bad debt allowance is being reviewed concurrently and on a historical basis. Additionally, a thorough analysis is being performed on the aged accounts receivable to eliminate uncollectible accounts that have not been previously written off.

A RAC audit log was initiated in 2013 and is being maintained on a concurrent basis. Management will evaluate and update the RAC liability at least annually. Balance sheet accounts are being reviewed on a monthly basis, and adjusted accordingly.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary**
Schedule of Findings and Responses — continued
For the Year Ended December 31, 2013

The following findings are reported in accordance with the New Mexico State Audit Rule 2 NMAC 2.2., *Requirements for Contracting and Conducting Audits of Agencies*.

2013-002 (12-01) - Security and Access Controls – Finding That Does Not Rise to the Level of a Significant Deficiency

Criteria or Specific Requirement: The Hospital should ensure that proper access controls are in place in order to protect sensitive patient information and financial information systems. It is important that employees who have voluntarily or involuntarily separated from the Hospital be promptly reported to the Information Technology (IT) department in order to restrict their access to the Hospital's systems.

Condition: During our testing of IT controls, we identified one employee out of a sample of three terminations/retirements who was terminated on January 4, 2013; however, systems access was not removed until March 13, 2013. This employee did not have remote access.

Cause: IT policies and procedures had 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 terminated employees access, there is a possibility for the loss of confidential patient and financial information.

Auditor Recommendation: Management should review and enforce policies and procedures related to the reporting of terminated employees to the IT department in order to ensure access rights are immediately restricted.

Management Response: The 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 IT department for use in terminating computer access. Access for highly visible employees is terminated on the day of discharge. We are aware of no incidents where terminated employees have obtained access to personal health or financial information. The Hospital also has software to monitor unauthorized access to information systems.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary
Schedule of Findings and Responses — continued
For the Year Ended December 31, 2013**

2013-003 - Fixed Asset Count – Material Noncompliance

Criteria or Specific Requirement: A periodic physical inventory of fixed assets is necessary to determine whether fixed assets are impaired and help detect the loss or unauthorized use of property and equipment. New Mexico State Statute Section 12-6-10, NMSA 1978, requires all organizations conduct an annual equipment physical inventory.

Condition: The Hospital did not conduct an annual fixed asset inventory during the year ended December 31, 2013.

Cause: The Hospital was performing inventory counts on selected department's fixed assets; however, they were unaware that a full Hospital-wide annual fixed asset inventory was required.

Effect: Without a periodic fixed asset physical inventory, the Hospital may be exposed to the risk of loss or unauthorized use of property and equipment, and may fail to identify fixed assets whose use has been impaired.

Auditor Recommendation: Management should implement a process to ensure that a full fixed asset inventory is performed annually.

Management Response: Fixed asset inventories have been conducted on a periodic basis for targeted departments. A comprehensive equipment inventory will be conducted on an annual basis.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary
Schedule of Findings and Responses — continued
For the Year Ended December 31, 2013**

2013-004 - Segregation of Duties – Pharmacy - Finding That Does Not Rise to the Level of a Significant Deficiency

Criteria or Specific Requirement: Ordering and receiving functions should always be segregated in any purchasing workflow to reduce the opportunity for theft to occur and to provide a sound internal control environment.

Condition: There were times, depending on the availability of employees, where pharmacy employees may have been responsible for completing both the ordering and receiving functions for drugs.

Cause: The Pharmacy Department is very small, and at times, duties were shared due to staffing levels or unforeseen events.

Effect: The lack of segregation between the ordering and receiving functions creates opportunities for theft to occur.

Auditor Recommendation: The Hospital should implement adequate controls to ensure that the ordering and receiving functions are not performed by the same employee. If this is impractical, consider implementing an additional layer of review of the items received and having the first and second reviewer sign off on the invoice as evidence that the reviews occurred.

Management Response: The procedure has changed to require the ordering individual to be different than the person verifying the order. Orders received will be checked by either a technician or pharmacist (not the person that placed the original order). All controlled substances will be logged into inventory records to allow for a perpetual inventory to be kept, and discrepancies will require the signature of two pharmacists.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary
Schedule of Findings and Responses — continued
For the Year Ended December 31, 2013**

2013-005 - Cash Disbursements - Finding That Does Not Rise to the Level of a Significant Deficiency

Criteria or Specific Requirement: To help prevent error or fraud, supporting documentation should be maintained for all disbursements.

Condition: During our analysis of the support for 25 general cash disbursements, we identified one instance in which the support and cancelled check could not be located.

Cause: The documentation to support the disbursement may have been misfiled or inadvertently disposed of.

Effect: Without support for all disbursements, the Hospital does not know that processes were followed to properly disburse payments and to detect misstated or fraudulent disbursements. Documentation may not be available if questions are raised about a disbursement.

Auditor Recommendation: The Hospital should implement a process to ensure that all supporting documents are properly filed after disbursements are made.

Management Response: Checks are produced and attached to back-up after each check run. Filing is completed promptly after each check run. This process will be evaluated to insure that inadvertent destruction and misfiling is avoided.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary
Schedule of Findings and Responses — continued
For the Year Ended December 31, 2013**

2013-006 - Personnel File Pay Rate Support and New Hire Review - Finding That Does Not Rise to the Level of a Significant Deficiency

Criteria or Specific Requirement: All pay rates should be properly supported with a Personal Action Form (PAF), Letter of Intent (LOI) or an Offer Letter. Additionally, a 100% review of all new hire information should be completed on a monthly basis by the Chief HR Officer (CHRO) or the HR Coordinator to ensure accuracy and completeness of the personal information entered into the HR system.

Condition: During our analysis of the support for 25 payroll disbursements, we identified one instance in which an employee's payable on the paycheck was higher than the last documented PAF on file. Additionally, based on walkthroughs completed over the new hire process, we determined that no documentation of the new hire information review is retained.

Cause: The PAF may have been misfiled or not completed and the review procedures surrounding the new hire quality control processes have traditionally not been formally documented.

Effect: No documentation exists to support the employee's rate of pay or the assertion that a 100% review of all new hire information is conducted by the CHRO or the HR Coordinator.

Auditor Recommendation: The HR Department should implement a process to ensure that supporting documentation is retained to indicate that rates of pay are accurate and properly approved and that a review is performed on all new hire information entered into the system.

Management Response: The policy requires that all increases of salary, including new hires, to be documented by a properly authorized PAF. Wage changes related to increases, new hires or promotions, must have the Chief Executive Officer (CEO) and CHRO signature. Changes in status, salary, withholding, dependents, and other areas are entered into the payroll system by the Human Resources department, and the original PAF is filed in the employee's personnel file.

On a monthly basis, the CHRO/designee will review all PAFs for proper authorization. The CHRO/designee will verify that changes have been properly updated in the Payroll system, and that the PAF is filed in the respective personnel file.

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary
Current Status Schedule of 2012 Audit Findings
For the Year Ended December 31, 2013**

Prior-Year Number	Description	Current Status
10-03	Reconciliation of Cash and Net Assets	Resolved
10-04	Review and Analysis of Professional Liability Claims	Resolved
12-01	Security and Access Controls	Unresolved (2013-002)

**Rehoboth McKinley Christian Health
Care Services, Inc. and Subsidiary
Exit Conference and Board of Trustees Presentation**

An exit conference was held on May 12, 2014, with the following attending:

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

Barry L. Mousa, FACHE, CEO
Bart Hansen, CPA, CFO

Healthcare Integrity, LLC

David Conejo, Co-founder

REDW_{LLC}:

Steve Cogan, Principal
Halie Garcia, Senior Manager

A presentation was made to a closed session of the Board of Trustees on May 20, 2014, with the following attendees:

Rehoboth McKinley Christian Health Care Services, Inc. and Subsidiary (includes 2014 Board members and titles):

David Bischoff, Chairman
Kathy Head, Vice President
Yogash Kumar, Board Member
Shannon Tanner, Board Member
David Dallago, Board Member
Brett Newberry, Board Member
Priscilla Newberry, Board Member
Bart Hansen, CPA, CFO
Shelly Stam-MacLaren, MD, Chief of Staff
John Mezoff, MD, CMO, Staff
Teresa Lopez, Administrative Assistant, Staff

Healthcare Integrity, LLC

Pablo Chapo, Co-founder

REDW_{LLC}:

Steve Cogan, Principal
Halie Garcia, 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.