

PINNACLE HEALTHCARE, LLC  
AUDITED FINANCIAL STATEMENTS  
FOR THE YEAR ENDED  
DECEMBER 31, 2007

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**Terry McMahon & Co., P.C.** CERTIFIED PUBLIC ACCOUNTANTS

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## INDEPENDENT AUDITORS' REPORT

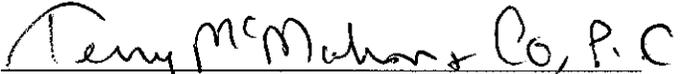
Board of Managers  
Pinnacle Healthcare, LLC  
Crown Point, Indiana

We have audited the accompanying balance sheet of Pinnacle Healthcare, LLC (a Limited Liability Company) as of December 31, 2007 and the related statement of income and members' equity and cash flows for the year then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement that our audit provides a reasonable basis for our opinion.

As more fully described in Note 11 to the financial statements, the Company has not consolidated a variable interest entity in these financial statements. In our opinion, accounting principles generally accepted in the United States of America require that these entities be consolidated in the financial statements.

In our opinion, except for the effects of not including the financial information of the variable interest entity, as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of Pinnacle Healthcare, LLC as of December 31, 2007 and the results of its operations and cash flow for the year ended, in conformity with accounting principles generally accepted in the United States of America.

  
Certified Public Accountants

August 13, 2008



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PINNACLE HEALTHCARE, LLC

BALANCE SHEET  
DECEMBER 31, 2007

ASSETS

CURRENT ASSETS:

Cash	\$	95,458
Restricted cash		1,300,000
Patient receivables		7,756,904
Other receivables		572,725
Prepaid expenses		169,927
Prepaid supplies		873,602
Total current assets		<u>10,768,616</u>

PROPERTY AND EQUIPMENT:

Property and equipment		9,744,831
Less: Accumulated depreciation		<u>(1,012,688)</u>
Total property and equipment		<u>8,732,143</u>

TOTAL ASSETS

\$ 19,500,759

LIABILITIES AND MEMBERS' EQUITY

CURRENT LIABILITIES:

Current portion - leases payable	\$	1,962,256
Accounts payable		2,144,805
Accrued expenses payable		1,104,867
Due to related party		1,625,000
Total current liabilities		<u>6,836,928</u>

LONG TERM DEBT:

Note payable		6,004,032
Leases payable, net of current portion		7,086,370
Total long-term debt		<u>13,090,402</u>
Total liabilities		<u>19,927,330</u>

MEMBERS' EQUITY

(426,571)

TOTAL LIABILITIES AND MEMBERS' EQUITY

\$ 19,500,759

PINNACLE HEALTHCARE, LLC

STATEMENT OF INCOME AND CHANGES IN MEMBERS' EQUITY  
FOR THE YEAR ENDING DECEMBER 31, 2007

REVENUE:

Net patient revenue	\$ 12,707,943
Other operating revenue	41,926
Total revenue	<u>12,749,869</u>

EXPENSES:

Ancillary services	744,373
Advertising	101,016
Contract labor	428,486
Depreciation	1,007,531
Dietary	68,094
Dues and subscriptions	14,271
Equipment rental	61,909
Facility rent	1,088,306
Hospital license fees	6,125
Insurance	104,227
Medical/surgical supplies and drugs	2,740,944
Miscellaneous	146,222
Other supplies	132,167
Postage and shipping	15,231
Professional fees	486,443
Repairs and maintenance	156,689
Salaries and benefits	5,144,940
Training and development	8,494
Travel and entertainment	54,940
Taxes- property	236,291
Taxes - sales	8,803
Utilities	345,076
Total expenses	<u>13,100,578</u>
Percentage to revenue	102.75%

GROSS MARGIN

Gross margin percentage	<u>(350,709)</u> -2.75%
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OTHER INCOME (EXPENSE):

Interest expense	(322,301)
Bad debt	(168,646)
Total other income (expense)	<u>(490,947)</u>

NET LOSS

(841,656)

BEGINNING MEMBERS' EQUITY

230,085

MEMBERS' CONTRIBUTIONS

185,000

ENDING MEMBERS' EQUITY

\$ (426,571)

PINNACLE HEALTHCARE, LLC

STATEMENT OF CASH FLOWS  
FOR THE YEAR ENDED DECEMBER 31, 2007

OPERATING ACTIVITIES:

Cash collected from patients	\$ 4,420,240
Cash paid for operating expenses	(9,790,780)
Interest paid	(322,301)
Net cash used by operating activities	<u>(5,692,841)</u>

<u>INVESTING ACTIVITIES</u> - Purchase of property and equipment	(9,659,568)
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FINANCING ACTIVITIES:

Borrowings	15,124,087
Repayment of borrowings	(71,429)
Capital contributions	185,000
Net cash provided by financing activities	<u>15,237,658</u>

NET DECREASE IN CASH	(114,751)
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CASH - BEGINNING OF YEAR	<u>210,209</u>
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<u>CASH - END OF YEAR</u>	<u>\$ 95,458</u>
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RECONCILIATION OF NET LOSS TO CASH

USED BY OPERATING ACTIVITIES:

Net loss	\$ (841,656)
Add: Non-cash items	
Depreciation	1,007,531
Bad debt	168,646
Decrease (increase) in assets:	
Restricted cash	(1,300,000)
Patient receivables	(7,925,550)
Other receivables	(572,725)
Prepaid expenses	(169,927)
Prepaid supplies	(873,602)
Deposits	19,318
Increase (decrease) in liabilities:	
Accounts payable	2,144,805
Accrued expenses payable	1,104,867
Due to former member	(8,000)
Due to related party	<u>1,553,452</u>

<u>NET CASH USED BY OPERATING ACTIVITIES</u>	<u>\$ (5,692,841)</u>
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PINNACLE HEALTHCARE, LLC

NOTES TO FINANCIAL STATEMENTS

December 31, 2007

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General - Pinnacle Healthcare, LLC is a privately owned hospital that provides inpatient and outpatient surgery services to patients in Northwest Indiana. The Company is physician-owned and began operations on July 10, 2007.

Accounting Method - The Hospital uses the accrual basis of accounting for financial statement purposes.

Cash and Cash Equivalents - Cash and cash equivalents include all monies in banks and highly liquid investments with maturity dates of less than three months.

Patient Receivables - The Hospital carries its accounts receivable for medical services provided at the total cost. The Hospital provides care to patients under Medicare and commercial insurance, as well as private pay. Net patient accounts receivable and revenue are reported at the estimated net realizable amounts from patients, third-party payers, and other for services rendered. The Hospital evaluates the collectibility of its accounts receivable based on certain factors, such as payer type, historical collection trends and aging categories. The allowance that is applied to the receivable balances is based on the historical experience and time limits, if any, for each particular payer source, such as private, insurance, Medicare and Medicaid. Actual results could differ from the estimated allowances.

Provision for Bad Debts - The Hospital grants credit without collateral to its patients, most of whom are local residents and insured by third-party payers. The amount of the provision for bad debts is based upon management's assessment of historical and expected net collections, trends in collections with individual insurance companies, and other collection indicators.

Improvements and Equipment - Leasehold improvements and equipment are recorded at cost. Depreciation is provided using the straight-line and accelerated cost recovery methods over the estimated useful lives of the respective assets for both financial reporting and income tax purposes. Maintenance and repairs are charged to expense as incurred; major renewals and betterments are capitalized.

Commitments and Contingencies - The Hospital is subject to claims and lawsuits which arise primarily in the ordinary course of business. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the financial position of the Company.

Advertising - Advertising costs are charged to operations when incurred. Advertising costs for 2007 are \$101,016.

Use of Estimates - The process of preparing financial statements in conformity with generally accepted accounting principles requires the use of estimates and assumptions regarding certain types of assets, liabilities, revenues and expenses. Such estimates primarily relate to unsettled transactions and events as of the date of the financial statements. Accordingly, upon settlement, actual results may differ from estimated amounts.

PINNACLE HEALTHCARE, LLC

NOTES TO FINANCIAL STATEMENTS

December 31, 2007

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - (Continued)

Income Taxes - The Company has elected to operate as Limited Liability Corporation. The Company files a partnership tax return. Income and losses are passed on to the members, who report the incomes and losses on their personal tax returns.

Prepaid Supplies - Prepaid supplies consist primarily of medical supplies and pharmaceuticals, and are stated at cost.

NOTE 2 – RESTRICTED CASH

As of December 31, 2007, \$1,300,000 is held in a an interest bearing deposit account pursuant to the provision of a letter of credit with First Midwest Bank - see note 8.

NOTE 3 – PROPERTY AND EQUIPMENT

The breakdown of cost, accumulated depreciation and cash value as of December 31, 2007 follows:

	<u>Cost</u>	<u>Accumulated Depreciation</u>	<u>Book Value</u>
Leasehold Improvements	\$ 64,771	\$ 3,580	\$ 61,191
Office furniture and equipment	214,058	17,777	196,281
Land deposit	25,000	0	25,000
Medical Equipment	<u>9,441,002</u>	<u>991,331</u>	<u>8,449,671</u>
Total	<u>\$ 9,744,831</u>	<u>\$ 1,012,688</u>	<u>\$ 8,732,143</u>

NOTE 4 – OPERATING LEASE

The Hospital leases its facilities from a related party, Medical Realty Associates, LLC. The lease is a fifteen year lease, commencing in 2007, with a base rent for the first year of \$1,800,000. The terms of the lease can be renegotiated upon the first anniversary of the commencement date or upon the refinancing of the property by the landlord. This is a “triple net” lease; therefore the tenant is also responsible for the property taxes, utilities, insurance, and maintenance on the property. Included in facility lease was \$900,00 paid to Medical Realty Associates, LLC as of December 31, 2007.

Minimum future lease expenses are:

2008	\$1,800,000
2009	1,800,000
2010	1,800,000
2011	1,800,000
2012	1,800,000
Thereafter	<u>17,100,000</u>
Total	<u>\$26,100,000</u>

PINNACLE HEALTHCARE, LLC

NOTES TO FINANCIAL STATEMENTS

December 31, 2007

NOTE 5 – CAPITAL LEASES

The Hospital acquired equipment under several long-term leases. For reporting purposes, the present value of the minimum lease payments has been capitalized. The leases expire at various times within the next five years. As of December 31, 2007 the property under capital lease had a total cost of \$8,479,974, accumulated depreciation of \$1,050,016, and a net book value of 7,429,958. The future minimum lease payments under these capital leases at December 31, 2007 are as follows:

2008	\$ 2,452,414
2009	2,365,486
2010	2,160,030
2011	1,936,277
2012	<u>951,800</u>
Total minimum lease payments	\$ 9,866,007
Less amount representing interest	<u>817,381</u>
Present value of net minimum obligations	9,048,626
Less current obligation under capital lease	<u>1,962,256</u>
Long term obligation under capital lease	<u>\$ 7,086,370</u>

NOTE 6 – LONG TERM DEBT

At December 31, 2007, the Hospital has the following long-term debt:

Note payable to First Midwest Bank, Interest rate Wall Street Journal Prime, (7.25% at December 31, 2007), due May 1, 2009, interest only payments, secured by Business assets of the Hospital and a related entity and personal guarantors.	\$ 6,004,032
Less: current portion	<u>0</u>
Total Long-term debt	<u>\$ 6,004,032</u>

Maturities of long-term debt in each of the next five years is as follows:

2008	0
2009	6,004,032

NOTE 7 – LINE OF CREDIT

The Hospital has a working capital line of credit available with First Midwest Bank in the amount of \$1,000,000, maturing May 1, 2008. The balance as of December 31, 2007 is \$0. The line is secured by accounts receivable, business property and personal guarantors. The interest is the current Wall Street Journal Prime.

PINNACLE HEALTHCARE, LLC

NOTES TO FINANCIAL STATEMENTS

December 31, 2007

NOTE 8 – LETTER OF CREDIT

The Hospital has a letter of credit with First Midwest Bank. The letter of credit amount is \$2,600,000. At December 31, 2007, the letter has not been drawn on, and the balance is \$0. The letter is secured by business assets of the Hospital and a related Company, as well as \$1,300,000 cash held in a restricted deposit account. The letter matures on July 24, 2008. The interest rate is the current Wall Street Journal Prime.

NOTE 9 – RELATED PARTIES

The Hospital and Medical Realty Associates, LLC are owned by the same 53 individuals. The financing agreement between the Hospital and First Midwest Bank is cross-collateralized with the business assets of Medical Realty Associates, LLC and property located at 9301 Connecticut Dr., Crown Point, IN.

NOTE 10 – PROFESSIONAL LIABILITY INSURANCE

The Hospital maintains its professional liability insurance coverage on a claims made basis. The provisions for estimated professional liability claims include estimates of the ultimate costs for both reported and unreported claims. The Hospital does not have any professional or other litigation which is expected to have a material financial impact.

NOTE 11 – CONSOLIDATION OF A VARIABLE INTEREST ENTITY

The Financial Accounting Standards board has issued FIN 46(R), *Consolidation of Variable Interest Entities*, effective December, 2003. FIN 46(R) requires that the entities with a level of invested equity that is not sufficient to fund future activities to permit them to operate on a stand alone basis, or whose equity holders lack certain characteristics of a controlling financial interest, be identified as the Hospital's participation in variable interest entities. For entities identified as a variable interest entity, FIN 46(R) sets forth a model to evaluate potential consolidation based on an assessment of which party to the variable interest entity, if any, bears a majority of the exposure to it expected losses, or stands to gain from a majority of its expected returns. FIN 46(R) also sets forth certain disclosures regarding interests in variable interest entities that are deemed significant, even if consolidation is not required. The Hospital has elected not to adopt the provisions of FIN 46(R) for the variable interest entity described below.

Medical Realty Associates LLC is an operating entity that owns and leases the land and building to Pinnacle Healthcare, LLC. Pinnacle Healthcare, LLC has a working capital loan and a letter of credit that is cross-collateralized with the business assets of Medical Realty Associates LLC.

If this entity has been consolidated in these financial statements, an increase would have occurred in current assets of \$23,299, an increase in land and building of \$20,261,584, an increase in other assets of \$25,000, an increase in current liabilities of \$3,704,747, an increase in long term debt of \$15,325,881, an increase in equity of \$1,234,769, a decrease in due to related party of \$1,625,000 and a decrease in net income of \$588,275.

PINNACLE HEALTHCARE INC.

NOTES TO FINANCIAL STATEMENTS

December 31, 2007

NOTE 12 – SUBSEQUENT EVENT

Subsequent to the year end December 31, 2007, three civil lawsuits have been filed by various groups of members against other member groups, and in one case, Pinnacle, regarding Pinnacle's leadership and Board control. As of the issuance of this report, a judicial order is in place for Pinnacle to not make any major changes to its Board or Management while the issues are being litigated.