# Indiana Orthopaedic Hospital, LLC

## Auditor’s Report and Consolidated Financial Statements

December 31, 2012 and 2011

# Indiana Orthopaedic Hospital, LLC

## December 31, 2012 and 2011

## Contents

BKD LLP
CPAs & Advisors

201 N. Illinois Street, Suite 700
P.O. Box 44998
Indianapolis, IN 46244-0998
317.383.4000 Fax 317.383.4200 www.bkd.com

# Independent Auditor's Report

Board of Managers
Indiana Orthopaedic Hospital, LLC
Indianapolis, Indiana

We have audited the accompanying consolidated financial statements of Indiana Orthopaedic Hospital, LLC (Hospital), which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of income, changes in members' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

***Management's Responsibility for the Financial Statements***

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

***Auditor's Responsibility***

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

***Basis for Qualified Opinion***

In accordance with the terms of our engagement, we did not audit the Hospital's investment in Southeast Surgery Center, LLC, a 50% owned affiliate, for which the investment is stated at $0 as of December 31, 2011 and the equity in earnings for the year then ended is stated at $809,850, which is included in net income for the year then ended as described in Note 10 to the consolidated financial statements.

As discussed in Note 10 to the consolidated financial statements, the Hospital acquired OI South, LLC in a business combination on July 1, 2007. The Hospital recorded the acquisition at the historical carrying value of the assets acquired, which in our opinion, is not in accordance with accounting principles generally accepted in the United States of America. The effects of this matter on the 2011 consolidated financial statements are not reasonably determinable.

***Qualified Opinion***

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraphs for 2011, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Indiana Orthopaedic Hospital, LLC as of December 31, 2012 and 2011, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

BKD, LLP

Indianapolis, Indiana
March 12, 2013

# Indiana Orthopaedic Hospital, LLC

## Consolidated Balance Sheets
## December 31, 2012 and 2011

### Assets

| | 2012 | 2011 |
|---|---|---|
| **Current Assets** | | |
| Cash and cash equivalents | $ 14,644,556 | $ 14,930,943 |
| Patient accounts receivable, net of allowance: 2012 - $5,000,000, 2011 - $3,200,000 | 13,373,665 | 16,118,075 |
| Supplies | 1,175,874 | 1,097,323 |
| Prepaid expenses and other | 388,585 | 248,529 |
| Total current assets | 29,582,680 | 32,394,870 |
| **Property and Equipment**, at cost | | |
| Land and land improvements | 4,472,195 | 4,171,823 |
| Buildings and improvements | 2,620,419 | 2,290,087 |
| Equipment | 21,864,893 | 24,244,322 |
| | 28,957,507 | 30,706,232 |
| Less accumulated depreciation | 13,523,849 | 16,554,474 |
| | 15,433,658 | 14,151,758 |
| **Other Assets** | | |
| Other | 407,698 | 71,400 |
| Total assets | $ 45,424,036 | $ 46,618,028 |

### Liabilities and Members' Equity

| | 2012 | 2011 |
|---|---|---|
| **Current Liabilities** | | |
| Accounts payable | $ 5,911,125 | $ 4,494,260 |
| Accrued expenses | 3,029,820 | 3,114,483 |
| Current maturities of long-term obligations | 1,198,720 | 1,122,887 |
| Total current liabilities | 10,139,665 | 8,731,630 |
| **Long-Term Obligations** | 4,900,456 | 6,098,753 |
| Total liabilities | 15,040,121 | 14,830,383 |
| **Members' Equity** | 30,383,915 | 31,787,645 |
| Total liabilities and members' equity | $ 45,424,036 | $ 46,618,028 |

# Indiana Orthopaedic Hospital, LLC
## Consolidated Statements of Income
## Years Ended December 31, 2012 and 2011

| | 2012 | 2011 |
|---|---|---|
| **Operating Revenues** | | |
| Net patient service revenue | $ 130,825,925 | $ 119,833,444 |
| Provision for uncollectible accounts | (1,633,778) | (1,718,552) |
| Net patient service revenue less provision for uncollectible accounts | 129,192,147 | 118,114,892 |
| Other | 677,509 | 554,680 |
| Total operating revenues | 129,869,656 | 118,669,572 |
| **Expenses and Losses** | | |
| Salaries and wages | 21,440,320 | 19,585,844 |
| Employee benefits | 4,377,952 | 3,713,188 |
| Purchased services and professional fees | 6,638,223 | 5,941,583 |
| Medical supplies | 28,171,146 | 25,039,380 |
| Facility expense | 11,318,031 | 11,399,730 |
| Management fees | 6,148,100 | 5,202,000 |
| Depreciation and amortization | 1,981,697 | 1,766,617 |
| (Gain) loss on sale of property | 255,111 | (228,968) |
| Interest | 277,392 | 296,218 |
| Provider hospital assessment fee | 1,887,938 | - |
| Other expenses | 3,540,555 | 3,870,059 |
| Total operating expenses | 86,036,465 | 76,585,651 |
| **Operating Income** | 43,833,191 | 42,083,921 |
| **Other Income (Expense)** | | |
| Income from joint venture activities | - | 809,850 |
| Loss on joint venture divestiture | - | (1,491,168) |
| Investment return | 3,106 | 8,163 |
| Total other income (expense) | 3,106 | (673,155) |
| **Net Income** | $ 43,836,297 | $ 41,410,766 |

# Indiana Orthopaedic Hospital, LLC
## Consolidated Statements of Members' Equity
## Years Ended December 31, 2012 and 2011

| | |
|---|---|
| **Balance, January 1, 2011** | $ 28,837,166 |
| Net income | 41,410,766 |
| Membership units issued | 1,024,000 |
| Membership units redeemed | (44,957) |
| Distributions to members | (39,439,330) |
| **Balance, December 31, 2011** | 31,787,645 |
| Net income | 43,836,297 |
| Distributions to members | (45,240,027) |
| **Balance, December 31, 2012** | $ 30,383,915 |

# Indiana Orthopaedic Hospital, LLC

## Consolidated Statements of Cash Flows
## Years Ended December 31, 2012 and 2011

| | 2012 | 2011 |
|---|---|---|
| **Operating Activities** | | |
| Net income | $ 43,836,297 | $ 41,410,766 |
| Items not requiring (providing) cash | | |
| Depreciation and amortization | 1,981,697 | 1,766,617 |
| Loss on write-off of joint venture | - | 1,491,168 |
| (Gain) loss on sale of property and equipment | 255,111 | (228,968) |
| Provision for uncollectible accounts | 1,633,778 | 1,718,552 |
| Changes in | | |
| Patient accounts receivable, net | 1,110,632 | (6,551,250) |
| Accounts payable and accrued expenses | 1,332,202 | 2,452,532 |
| Other current assets | (554,905) | 1,927,606 |
| Net cash provided by operating activities | 49,594,812 | 43,987,023 |
| **Investing Activities** | | |
| Proceeds from sale of property and equipment | - | 289,325 |
| Purchase of property and equipment | (3,518,708) | (1,561,477) |
| Net cash used in investing activities | (3,518,708) | (1,272,152) |
| **Financing Activities** | | |
| Net borrowings under a line-of-credit agreement | - | 918,058 |
| Proceeds from capital lease obligation | - | 4,059,347 |
| Principal payments under long-term obligations | (1,122,464) | (1,766,671) |
| Proceeds from issuance of membership units | - | 1,024,000 |
| Distributions to members | (45,240,027) | (39,439,330) |
| Unit redemption | - | (44,957) |
| Net cash used in financing activities | (46,362,491) | (35,249,553) |
| **Increase (Decrease) in Cash and Cash Equivalents** | (286,387) | 7,465,318 |
| **Cash and Cash Equivalents, Beginning of Year** | 14,930,943 | 7,465,625 |
| **Cash and Cash Equivalents, End of Year** | $ 14,644,556 | $ 14,930,943 |
| **Supplemental Cash Flows Information** | | |
| Interest paid | $ 277,392 | $ 296,218 |

## Note 1: Nature of Operations and Summary of Significant Accounting Policies

### *Nature of Operations*

Indiana Orthopaedic Hospital, LLC primarily earns revenues by providing inpatient and outpatient musculoskeletal and related surgical services to patients in the greater Indianapolis, Indiana area.

NNS, LLC was formed in 2008 in the state of Indiana for the purpose to own, manage, invest, develop, lease and otherwise deal in real property.

### *Principles of Consolidation*

The consolidated financial statements include the accounts of Indiana Orthopaedic Hospital, LLC and NNS, LLC (collectively, "the Hospital"). All material inter-organization accounts and transactions have been eliminated in consolidation.

### *Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### *Cash and Cash Equivalents*

The Hospital considers all liquid investments with original maturities of three months or less to be cash equivalents. At December 31, 2012 and 2011, cash equivalents consisted primarily of money market accounts.

Through December 31, 2012, deposits held in noninterest-bearing transaction accounts are fully insured, regardless of the amount in the account, at all FDIC-insured institutions. For interest-bearing cash accounts, the FDIC's insurance limits were permanently increased to $250,000, effective July 21, 2010. At December 31, 2012, the Hospital did not have any balances in interest-bearing cash accounts exceeding federally insured limits. This legislation expired on December 31, 2012. Beginning January 1, 2013, noninterest-bearing transaction accounts are subject to the $250,000 limit on FDIC insurance per covered institution.

### *Investment Return*

Investment return is comprised primarily of interest income earned on the operating cash accounts.

### *Patient Accounts Receivable*

Accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectibility of accounts receivable, the Hospital analyzes its past history and identifies trends for each of its major payer sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. Management regularly reviews data about these major payer sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts.

For receivables associated with services provided to patients who have third-party coverage, the Hospital analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts, if necessary (for example, for expected uncollectible deductibles and copayments on accounts for which the third-party payer has not yet paid, or for payers who are known to be having financial difficulties that make the realization of amounts due unlikely).

For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the Hospital records a significant provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates if negotiated or provided by policy) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

### *Supplies*

The Hospital states supply inventories at the lower of cost, determined using the first-in, first-out (FIFO) method or market.

### *Property and Equipment*

Property and equipment are depreciated on a straight-line basis over the estimated useful life of each asset. Assets under capital lease obligations and leasehold improvements are depreciated over the shorter of the lease term or their respective estimated useful lives.

### *Long-Lived Asset Impairment*

The Hospital evaluates the recoverability of the carrying value of long-lived assets whenever events or circumstances indicate the carrying amount may not be recoverable. If a long-lived asset is tested for recoverability and the undiscounted estimated future cash flows expected to result from the use and eventual disposition of the asset is less than the carrying amount of the asset, the asset cost is adjusted to fair value and an impairment loss is recognized as the amount by which the carrying amount of a long-lived asset exceeds its fair value.

No asset impairment was recognized during the years ended December 31, 2012 and 2011.

### *Net Patient Service Revenue*

The Hospital has agreements with third-party payers that provide for payments to the Hospital at amounts different from its established rates. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payers and others for services rendered and includes estimated retroactive revenue adjustments. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such estimated amounts are revised in future periods as adjustments become known.

Substantially all of the net patient service revenue received by the Hospital is from third-party payer sources.

### *Charity Care*

The Hospital provides charity care to patients who are unable to pay for services. The amount of charity care is included in net patient service revenue and is not separately classified from the provision for uncollectible accounts.

### *Estimated Malpractice Costs*

The Hospital recognizes an accrual for claim liabilities based on estimated ultimate losses and costs associated with settling claims and a receivable to reflect the estimated insurance recoveries, if any. Malpractice claims are described more fully in Note 4.

### *Income Taxes*

The Hospital is organized as a pass-through Limited Liability Company under the Internal Revenue Code. As such, the Hospital is not taxed at the entity level, and income is passed through to the members of the Hospital at the individual level. Accordingly, the Hospital does not recognize income taxes in the accompanying consolidated financial statements. The Hospital’s tax years still subject to examination by taxing authorities are years subsequent to December 31, 2009.

### *Reclassifications*

Certain reclassifications have been made to the 2011 financial statements to conform to the 2012 financial statement presentation. These reclassifications had no effect on the change in net assets.

### Note 2: Net Patient Service Revenue

The Hospital recognizes patient service revenue associated with services provided to patients who have third-party payer coverage on the basis of contractual rates for the services rendered. For uninsured patients who do not qualify for charity care, the Hospital recognizes revenue on the basis of its standard rates for services provided. 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. This provision for bad debts is presented on the consolidated statements of income as a component of net patient service revenue.

The Hospital has agreements with third-party payers that provide for payments to the Hospital at amounts different from its established rates. These payment arrangements include:

*Medicare*. Inpatient acute care services and substantially all outpatient 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. The Hospital is reimbursed for certain services at tentative rates with final settlement determined after submission of annual cost reports by the Hospital and audits thereof by the Medicare fiscal intermediary.

*Medicaid.* Inpatient acute care services and substantially all outpatient services rendered to Medicaid 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.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation and change. As a result, it is reasonably possible that recorded estimates will change materially in the near term.

The Hospital received approximately $317,000 during 2012 due to the enactment of a state specific provider assessment program to increase Medicaid payments to hospitals. This revenue is recorded within net patient service revenue in the consolidated statement of operations for 2012. Approximately $110,000 of these increased payments were related to the Hospital's fiscal year 2011. The Hospital paid approximately $1.9 million into this Medicaid program, which is recorded as an operating expense in the consolidated statement of operations. Approximately, $406,000 of the payments to the Medicaid program were related to the Hospital's fiscal year 2011 but are included in 2012 net patient service revenue as a result of when the assessment program was approved. There is no assurance this program will continue in the future.

The Hospital has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations and preferred provider organizations. 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. Approximately 35% and 34% of the Hospital's receivables are due from a single commercial insurance carrier for the years ended December 31, 2012 and 2011, respectively.

Patient service revenue, net of contractual allowances and discounts (but before the provision for bad debts), recognized in the year ended December 31, was approximately:

| | 2012 | 2011 |
|---|---|---|
| Medicaid | $ 1,915,705 | $ 958,088 |
| Medicare | 40,468,292 | 33,385,838 |
| Other third-party payers and self-pay | 88,441,928 | 85,489,518 |
| Total | $ 130,825,925 | $ 119,833,444 |

## Note 3: Limited Liability Company

The Hospital is organized as an Indiana limited liability company and is governed by a five-member board of managers. The board of managers is generally responsible for the direction and management of the Hospital. The Hospital is owned by three classes of units and members, referred to as Classes A, B and D. At the time a Class A or B member disassociates from the Hospital, the units will be purchased by the Hospital for a purchase price defined in the operating agreement.

Class A members control a total of 11,757 and 11,997 units at December 31, 2012 and 2011, respectively, and generally receive a pro-rata percentage of operating profits from the Hospital as defined in the operating agreement. Class A members' voting responsibilities include the election of members to serve on the board of managers. They vote on all matters subject to a membership vote and also retain certain reserved powers. The reserved powers limit certain decisions that can only be decided by Class A members and also limit when Class B members can vote on general membership voting matters. Total members' equity of Class A units approximates $22,091,896 and $23,708,561 at December 31, 2012 and 2011, respectively. During 2012, a member converted 240 Class A units to Class B.

Class B members control a total of 1,049 and 809 units at December 31, 2012 and 2011, and generally receive a pro-rata percentage of operating profits from the Hospital, with certain limitations, as defined in the operating agreement. Their units allow them to vote on matters submitted to the membership; however, the Class A members reserved powers may limit the ability for Class B members to vote on certain matters. Total members' equity of Class B units approximated $2,215,236 and $1,721,555 at December 31, 2012 and 2011, respectively. During 2011, the Hospital created an irrevocable trust, which is considered a Class B member. At December 31, 2012 and 2011, the trust owned a 3.15% and 1.57%, respectively, interest in the Hospital, including all economic attributes and assets owned and utilized by the Hospital. The trust is not entitled to a vote, but does share in a pro-rata share of the profits and losses of the Hospital. Total members' equity of the trust approximated $957,093 and $499,978 at December 31, 2012 and 2011, respectively.

During 2009, the Hospital amended and restated its operating agreement to permit a Class D member. The Class D member owns a 20% interest in the Hospital, including all economic attributes and assets owned and utilized by the Hospital. The Class D member is entitled to a single vote equal to 20% interest in all of the Hospital's issues other than issues related to the issuance or redemption of Class A units or issues pertaining specifically to Southeast Surgery Center, LLC and/or the South Campus (as described in Note 10). The Class D member shares in a pro-rata share of the profits or losses of the Hospital except for those profits and losses attributed to the Southeast Surgery Center, LLC and/or the South Campus. Total members' equity of Class D units approximated $6,076,783 and $6,357,529 at December 31, 2012 and 2011, respectively. Under the terms of the Class D units, for any reason, the Class D member may elect to require the Hospital to purchase the Class D units. Additionally, voting Class A members may elect to call the outstanding units. Such transactions will be based upon the then fair market value, as defined in the operating agreement.

NNS, LLC (Company) was organized as a limited liability company and was formed in October 2008. Indiana Orthopaedic Hospital, LLC is the sole member of NNS, LLC with complete authority, power and discretion to manage and control the business affairs and properties of the Company, to make all decisions regarding those matters and to perform any and all other acts or activities customary or incident to the management of NNS, LLC's business. The Hospital holds 100 units of the Company.

## Note 4: Medical Malpractice Coverage and Claims

### *Medical Malpractice Claims*

The Hospital is a qualified health care provider under the Indiana Medical Malpractice Act and is fully insured under a claims-made policy on a fixed premium basis. The Indiana Medical Malpractice Act limits a qualified provider's liability for an occurrence to the amount of required insurance. The Indiana patient compensation fund is liable for the excess up to an overall damage cap. Accounting principles generally accepted in the United States of America require a health care provider to accrue the expense of its share of malpractice claim costs, if any, for any reported and unreported incidents of potential improper professional service occurring during the year by estimating the probable ultimate costs of the incidents. Based upon the Hospital's claim experience, no such accrual has been made. It is reasonably possible that this estimate could change materially in the near term.

## Note 5: Line of Credit

The Hospital is a party to a line of credit and equipment purchase line agreements with a bank providing up to $5,000,000 and $2,000,000 in borrowings, respectively. The line of credit agreement expires August 5, 2013, and the equipment purchase line expires August 5, 2018. Interest on the line of credit and equipment purchase line varies with the bank's prime rate. At December 31, 2012, the interest rate was 2.25% and 3.75% on the line of credit and equipment purchase line, respectively. At December 31, 2012 and 2011, no balance had been drawn on the line of credit. At December 31, 2012 and 2011, $0 and $918,058, respectively, was drawn on the equipment purchase line. The 2011 equipment purchase line converted into a note payable in 2012, which is more fully described in Note 6.

## Note 6: Long-Term Obligations

| | 2012 | 2011 |
|---|---|---|
| Capital lease obligations (A) | $ 2,576,672 | $ 3,403,728 |
| Note payable to bank (B) | 749,747 | 1,287,925 |
| Note payable to bank (C) | 1,247,208 | 1,611,929 |
| Note payable to bank (D) | 1,525,549 | 918,058 |
| Total long-term obligations | 6,099,176 | 7,221,640 |
| Less current maturities | 1,198,720 | 1,122,887 |
| | $ 4,900,456 | $ 6,098,753 |

(A) Capital lease obligation payable in monthly installments of $73,393 with an interest rate of 3.25%. The lease is governed by a master lease agreement from a leasing company and is secured by the leased equipment. The lease is scheduled to expire in 2016.

(B) A promissory note in the name of NNS, LLC, with a maturity date in July 2016; payable in monthly installments of $8,432 with a balloon payment due at maturity. The interest rate is fixed at 4.75%. The loan is secured by certain real estate.

(C) Due January 10, 2025; a promissory note in the name of NNS, LLC, payable in monthly installments of $14,427 plus variable rate interest based on a five-year treasury index plus 3%. At December 31, 2012, this rate was 5.5%. The loan is secured by certain real estate.

(D) A promissory note payable in 60 monthly installments of $15,301 plus variable rate interest of prime plus one-half percent. At December 31, 2012, this rate was 3.75%. The loan is secured by the Hospital's assets. The loan was originally a draw on the Hospital's equipment purchase line in 2011, and it converted into a promissory note in 2012.

Property and equipment include the following property under capital lease arrangements:

| | 2012 | 2011 |
|---|---|---|
| Equipment | $ 4,009,977 | $ 3,985,283 |
| Less accumulated depreciation | 1,048,845 | 489,725 |
| | $ 2,961,132 | $ 3,495,558 |

Aggregate annual payments on capital lease obligations and long-term debt at December 31, 2012, are:

| | Long-Term Debt (Excluding Capital Lease Obligations) | Capital Lease Obligations |
|---|---|---|
| 2013 | $ 318,004 | $ 880,716 |
| 2014 | 325,208 | 880,716 |
| 2015 | 332,883 | 880,716 |
| 2016 | 1,403,758 | 69,059 |
| 2017 | 129,271 | - |
| Thereafter | 1,013,380 | - |
| | $ 3,522,504 | 2,711,207 |
| Less amount representing interest | | 134,535 |
| Present value of future minimum lease payments | | 2,576,672 |
| Less current maturities | | 880,716 |
| Noncurrent portion | | $ 1,695,956 |

## Note 7: Operating Leases

Noncancellable operating leases for the primary Hospital facility, several other facilities in the greater Indianapolis area and certain diagnostic equipment expire through 2025. The facility leases generally contain renewal options for periods ranging from five to ten years and require the Hospital to pay all executory costs (property taxes, maintenance and insurance). The leases are secured by certain assets, as defined in the lease agreements.

Future minimum lease payments at December 31, 2012, were:

| | |
|---|---|
| 2013 | $ 7,794,615 |
| 2014 | 7,922,714 |
| 2015 | 7,717,171 |
| 2016 | 4,992,082 |
| 2017 | 2,504,707 |
| Later years | 19,082,524 |
| Future minimum lease payments | $ 50,013,813 |

Total lease expense was $7,727,655 and $7,673,509 for 2012 and 2011, respectively.

## Note 8: Related Party Transactions

The Hospital and Orthopaedics-Indianapolis, P.C. (Ortho Indy) are related parties through common ownership. Ortho Indy provides certain management, administrative and payroll related services for the Hospital. Reimbursed expenses to Ortho Indy amounted to $2,729,750 and $2,618,394 for the years ended December 31, 2012 and 2011, respectively. Reimbursed expenses from Ortho Indy amounted to $467,849 and $1,351,669 for the years ended December 31, 2012 and 2011. Amounts due from and to Ortho Indy are reported in the accompanying consolidated balance sheets as other current assets or liabilities.

Effective January 1, 2011, the Hospital entered into a management service agreement with OrthoIndy Enterprises, LLC (OE) to provide management services, including certain management, administrative and payroll related services for an initial period of five years, renewing automatically for one year terms unless terminated by either party. OE is a related party through common ownership. Reimbursed expenses to OE amounted to $5,869,432 and $5,287,562 for the years ended December 31, 2012 and 2011, respectively. Reimbursed expenses from OE amounted to $93,103 and $126,181 for the years ended December 31, 2012 and 2011. Amounts due from and to OE are reported in the accompanying consolidated balance sheets as other current assets or liabilities.

The Hospital subleases certain facilities from Ortho Indy on the west and south sides of Indianapolis. The west and south side leases expire in 2023 and 2025, respectively, and provide annual rental payments of approximately $2,307,000. Lease expense recognized in 2012 approximated $2,307,000.

The base annual rentals for the facilities for the west and south side leases were $32.55 and $37.51 per square foot, respectively, subject to certain yearly increases as identified in the subleases. Future minimum lease payments are included in Note 7.

During 2009, NNS, LLC, a consolidated entity of the Hospital, acquired certain property for $2,350,000. The Hospital rents the use of the property from NNS, LLC. The intercompany rent has been eliminated in the consolidated financial statements.

## Note 9: Pension Plans

In March 2007, the Hospital joined the retirement benefit plan of Ortho Indy. The plan provides for a matching component for up to 6% of the employees' salary and also allows a discretionary profit-sharing contribution from the Hospital. Substantially all of the Hospital's full-time employees are covered by the plan. Pension expense in 2012 and 2011 was $1,219,242 and $1,050,129, respectively.

## Note 10: Joint Venture Activities

In 2011, the Hospital divested its 50% ownership in the Southeast Surgery Center, LLC. The Hospital's portion of earnings prior to the divestiture totaled $809,850. The resulting loss from the divestiture was $1,491,168. Both the earnings and the resulting loss are reported as non-operating activities in the statement of income.

The original investment in the Southeast Surgery Center, LLC met the definition of a business combination, which would have required its investment to be recorded at fair value. Management elected to record the investment at book value of the net assets received, which is not in compliance with Generally Accepted Accounting Standards. The Hospital's interest in the joint venture terminated on March 15, 2011.

## Note 11: Commitments and Contingencies

### *Litigation*

In the normal course of business, the Hospital is, from time to time, subject to allegations that may or do result in litigation. Some of these allegations are in areas not covered by the Hospital's commercial insurance; for example, allegations regarding employment practices or performance of contracts. The Hospital evaluates such allegations by conducting investigations to determine the validity of each potential claim. Based upon the advice of counsel, management records an estimate of the amount of ultimate expected loss, if any, for each of these matters. Events could occur that would cause the estimate of ultimate loss to differ materially in the near term.

### *Self Insurance of Employee Health Claims*

The Hospital pools its share of health insurance claims with Ortho Indy, a related party. Any such accrual is included in the related party accrual described in Note 8.

## Note 12: Significant Estimates and Concentrations

Accounting principles generally accepted in the United States of America require disclosure of certain significant estimates and current vulnerabilities due to certain concentrations. Those matters include the following:

### *Allowance for Net Patient Service Revenue Adjustments*

Estimates of allowances for adjustments included in net patient service revenue are described in Notes 1 and 2.

### *Malpractice Claims*

Estimates related to the accrual for medical malpractice claims are described in Notes 1 and 4.

### *Admitting Physicians*

The Hospital is served by a group of admitting and surgical physicians that comprise nearly 100% of the Hospital's net patient service revenue. The physician group is a related party of the Hospital through common ownership as described in Note 8.

### *Economic and Political Conditions*

The current protracted economic decline continues to present hospitals with difficult circumstances and challenges, which in some cases have resulted in unanticipated declines in volumes, constraints on liquidity and difficulty obtaining financing. The consolidated financial statements have been prepared using values and information currently available to the Hospital.

Current economic conditions, including the rising unemployment rate, have made it difficult for certain of the Hospital's patients to pay for services rendered. As employers make adjustments to health insurance plans or more patients become unemployed, services provided to self-pay and other payers may significantly impact net patient service revenue, which could have an adverse impact on the Hospital's future operating results. Further, the effect of economic conditions on the state may have an adverse effect on cash flows related to the Medicaid program.

Given the volatility of current economic conditions, the values of assets and liabilities recorded in the consolidated financial statements could change rapidly, resulting in material future adjustments in allowances for accounts receivable or other financial statement elements.

In recent years, The United States Congress has passed legislation that affects new or expanding physician-owned specialty hospitals. In between legislative actions, Congress and the Centers for Medicare and Medicaid Services continue discussion about how legislation may affect specialty hospitals, ranging from disclosures to prohibition of new specialty hospitals. Most recently, The Affordable Care Act of 2010 contained provisions limiting the expansion of existing specialty hospitals. Management believes they are in compliance with all current laws and regulations. However, management cannot estimate the long-term impact of any future legislation on the Hospital given the uncertainty involved with the regulatory changes.

The Patient Protection and Affordable Care Act (PPACA) will substantially reform the United States health care system. The legislation impacts multiple aspects of the health care system, including many provisions that change payments from Medicare, Medicaid and insurance companies. Starting in 2014, the legislation requires the establishment of health insurance exchanges, which will provide individuals without employer provided health care coverage the opportunity to purchase insurance. It is possible that some employers currently offering insurance to employees will opt to have employees seek insurance coverage through the insurance exchanges. The reimbursement rates paid by insurers participating in the insurance exchanges may be substantially different than rates paid under current health insurance products. Another significant component of the PPACA is the expansion of the Medicaid program to a wide range of newly eligible individuals. In anticipation of this expansion, payments under certain existing programs, such as Medicare disproportionate share, will be substantially decreased. Each state's participation in an expanded Medicaid program is optional.

The PPACA is extremely complex and may be difficult for the federal government and each state to implement. While the overall impact of the PPACA cannot currently be estimated, it is reasonably possible that it will have a negative impact on the Hospital's net patient service revenue. Additionally, it is possible that the Hospital will experience payment delays and other operational challenges during PPACA's implementation.

## Note 13: Subsequent Events

Effective January 1, 2013, IOH's individual Class A and Class B members, which are more fully described in Note 3, entered into an agreement with Orthopaedic Indianapolis, Inc. (OI). The terms of the agreements provided that the Class A and Class B members exchanged their units of the Hospital for additional shares of OI, thereby, resulting in OI becoming the majority member in the Hospital. In connection with this agreement, the Hospital amended its Operating Agreement permitting the exchange of units and permitting OI to become a Class A member of the Hospital. The IOH Amended and Restated Operating Agreement also permits a new entity, APM Holdings, LLC, to become a Class A member, the previous Class D member will continue to own 20% as a Class C member (a new Class of units) and the irrevocable trust will continue to own 3.15% as a Class D member. Founding members of the Hospital will continue to hold a founding member's interest in the Hospital as Class B members as set forth in the Amended and Restated Operating Agreement.

Subsequent events have been evaluated through the date of the Independent Auditor's Report, which is the date the consolidated financial statements were issued.