

**PINE REST CHRISTIAN MENTAL
HEALTH SERVICES**

CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2007 and 2006

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
Grand Rapids, Michigan

CONSOLIDATED FINANCIAL STATEMENTS
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Crowe Chizek and Company LLC
Member Horwath International

REPORT OF INDEPENDENT AUDITORS

Board of Directors
Pine Rest Christian Mental Health Services
Grand Rapids, Michigan

We have audited the accompanying consolidated balance sheet of Pine Rest Christian Mental Health Services (the Association) as of June 30, 2007, and the related consolidated statements of operations and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The financial statements of Pine Rest Christian Mental Health Services as of June 30, 2006, prior to the restatement described in Note 13, were audited by other auditors whose report dated August 18, 2006 expressed an unqualified opinion on those statements.

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 presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2007 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pine Rest Christian Mental Health Services as of June 30, 2007 and the changes in its net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We also audited the adjustments described in Note 13 that were applied to restate the June 30, 2006 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

Crowe Chizek and Company LLC

Crowe Chizek and Company LLC

Grand Rapids, Michigan
November 15, 2007

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
CONSOLIDATED BALANCE SHEETS
June 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
ASSETS		
Current assets		
Cash and cash equivalents	\$ 2,381,632	\$ 893,930
Accounts receivables, less allowance for doubtful accounts of \$759,000 and \$587,000 in 2007 and 2006, respectively	5,703,253	5,361,202
Amounts receivable from third party payors	-	71,000
Contributions receivable from Foundation	932,833	867,768
Other receivables and prepaid expenses	<u>1,792,582</u>	<u>2,001,724</u>
Total current assets	10,810,300	9,195,624
Assets whose use is limited (Note 2)		
By Board for funded depreciation	31,706,368	28,622,715
By Board for self-insurance	1,956,041	1,757,665
By Donor restricted funds	5,927,077	5,890,563
Unexpended bond proceeds	<u>3,914,608</u>	-
	43,504,094	36,270,943
Property and equipment		
Land and improvements	1,607,544	1,371,832
Buildings and improvements	38,258,568	32,037,249
Equipment	8,834,531	7,729,267
Construction in progress (Note 1)	<u>1,151,946</u>	<u>1,279,760</u>
	49,852,589	42,418,108
Less accumulated depreciation	<u>27,281,302</u>	<u>25,201,769</u>
	22,571,287	17,216,339
Other assets		
Unamortized debt issue costs, less accumulated amortization of \$197,000 and \$165,000 in 2007 and 2006, respectively	233,096	63,073
Pledges receivable (Note 3)	693,516	912,800
Beneficial interest in net assets of the Foundation (Note 1)	21,310,875	18,731,245
Fair value of interest rate swap (Note 4)	12,218	30,354
Other assets	-	53,500
	<u>22,249,705</u>	<u>19,790,972</u>
	<u>\$ 99,135,386</u>	<u>\$ 82,473,878</u>
LIABILITIES AND NET ASSETS		
Current liabilities		
Accounts payable and other accrued liabilities	\$ 1,187,728	\$ 862,903
Current portion of long-term debt (Note 4)	1,135,000	1,985,976
Salaries, wages, and related liabilities	2,940,285	2,791,802
Amounts payable to third party payors	220,150	-
Accrued interest	46,830	18,426
Due to Affiliates (Note 5)	<u>492,811</u>	<u>337,360</u>
Total current liabilities	6,022,804	5,996,467
Deferred revenue	26,872	12,992
Long term debt (Note 4)	<u>13,944,325</u>	<u>5,049,325</u>
	<u>13,971,197</u>	<u>5,062,317</u>
Total liabilities	19,994,001	11,058,784
Net assets		
Unrestricted	65,990,538	60,824,542
Temporarily restricted (Note 10)	9,601,577	7,400,011
Permanently restricted (Note 10)	<u>3,549,270</u>	<u>3,190,541</u>
	<u>79,141,385</u>	<u>71,415,094</u>
	<u>\$ 99,135,386</u>	<u>\$ 82,473,878</u>

See accompanying notes to consolidated financial statements.

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS
Years ended June 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Changes in unrestricted net assets		
Unrestricted revenues, gains and other support		
Net patient service revenue		
Inpatient	\$ 13,615,163	\$ 13,584,170
Partial hospitalization	265,389	288,373
Outpatient	18,406,054	15,851,255
Residential	12,102,457	9,922,779
Other		
Contract services income	12,344,219	11,127,037
Realized investment return (Note 2)	3,804,895	3,542,101
Unrestricted contributions	47,000	50,000
Residual interest from joint operating agreement	1,660,354	1,633,191
Miscellaneous revenue	886,960	972,014
Change in beneficial interest in unrestricted net assets of the Foundation (Note 1)	1,525,507	583,352
Net assets released from restriction	<u>1,680,616</u>	<u>3,111,805</u>
Total revenues, gains and other support	<u>66,338,614</u>	<u>60,666,077</u>
Expenses		
Salaries	38,590,171	33,850,901
Employee benefits	8,159,769	7,366,354
Supplies and other	9,944,246	9,029,126
Depreciation and amortization	2,081,100	1,959,816
Interest and bank fees	616,938	356,584
Bad debts	245,300	724,296
Patient assistance	1,235,840	1,158,387
Self-insurance and malpractice costs	686,390	676,452
Contracted services	<u>1,234,197</u>	<u>1,157,420</u>
Total expenses	<u>62,793,951</u>	<u>56,279,336</u>
Excess of revenues over expenses	3,544,663	4,386,741
Other changes in net assets		
Net unrealized (depreciation) appreciation in investments	1,683,952	(1,034,990)
Changes in fair value interest rate swap (Note 4)	(18,136)	65,305
Unrealized loss on equity investment	(384,600)	-
Net assets released from restriction	<u>340,117</u>	<u>347,762</u>
	<u>1,621,333</u>	<u>(621,923)</u>
Changes in unrestricted net assets	5,165,996	3,764,818
Changes in temporarily restricted net assets		
Contributions restricted by donors as to use	3,526,905	5,321,059
Change in beneficial interest in temporarily restricted net assets of the Foundation (Note 1)	695,394	258,849
Net assets released from restriction	<u>(2,020,733)</u>	<u>(3,459,567)</u>
Change in temporarily restricted net assets	2,201,566	2,120,341
Changes in permanently restricted net assets		
Change in beneficial interest in permanently restricted net assets of the Foundation (Note 1)	<u>358,729</u>	<u>112,352</u>
Change in permanently restricted net assets	358,729	112,352
Change in net assets	7,726,291	5,997,511
Net assets, beginning of year, as previously reported	71,415,094	47,640,891
Prior period adjustment (Note 13)	<u>-</u>	<u>17,776,692</u>
Net assets at beginning of year (restated)	<u>71,415,094</u>	<u>65,417,583</u>
Net assets, end of year	<u>\$ 79,141,385</u>	<u>\$ 71,415,094</u>

See accompanying notes to consolidated financial statements.

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended June 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Operating activities		
Change in net assets	\$ 7,726,291	\$ 5,997,511
Adjustments to reconcile change in net assets to net cash from operating activities		
Net unrealized depreciation (appreciation) in investments	(1,683,952)	1,034,990
Depreciation and amortization	2,113,095	1,987,310
Unrealized loss on equity investment	384,600	-
Change in beneficial interest in net assets of the Foundation	(2,579,630)	(954,553)
Change in fair value of interest rate swap	18,136	(65,305)
Restricted contributions	(997,361)	(2,244,323)
Loss on sale of property and equipment	-	122,136
Changes in operating assets and liabilities		
Accounts receivable and amounts payable to third party payors	(50,901)	(2,074,544)
Other current assets	(206,339)	(425,685)
Pledges receivable	(150,397)	252,940
Accounts payable	(6,275)	(407,931)
Other liabilities	<u>346,218</u>	<u>(528,307)</u>
Net cash from operating activities	4,913,485	2,694,239
Investing activities		
Purchases of property and equipment	(7,436,048)	(2,791,069)
Proceeds from sale of property and equipment	-	354,318
Purchase of investments	(34,906,741)	(30,843,079)
Proceeds from sale and maturities of investments	29,357,542	28,563,758
Other	-	<u>14,200</u>
Net cash from investing activities	(12,985,247)	(4,701,872)
Financing activities		
Payments of long-term debt	(1,985,976)	(1,072,316)
Borrowings of long-term debt	10,030,000	-
Debt acquisition costs	(202,018)	-
Proceeds from restricted contributions	<u>1,717,458</u>	<u>1,477,085</u>
Net cash from financing activities	<u>9,559,464</u>	<u>404,769</u>
Change in cash and cash equivalents	1,487,702	(1,602,864)
Cash and cash equivalents, beginning of year	<u>893,930</u>	<u>2,496,794</u>
Cash and cash equivalents, end of year	<u>\$ 2,381,632</u>	<u>\$ 893,930</u>
Supplemental disclosure of cash flow information		
Cash paid for interest	\$ 449,884	\$ 220,000

See accompanying notes to consolidated financial statements.

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2007 and 2006

NOTE 1 - ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Business: Pine Rest Christian Mental Health Services (the Association) provides mental health and addiction services primarily to residents in the greater West Michigan Area and central Iowa. Pine Rest is accredited by the Joint Commission on Accreditation of Healthcare Organizations (JCAHO).

In September of 2006, the Association separately incorporated Pine Rest Christian Addiction Services as a sole member nonprofit corporation. This organization incorporates all of Pine Rest's addiction service programs and is separately accredited by the Council on Accreditation of Rehabilitation Facilities (CARF).

In addition, the Association has a beneficial interest in the net assets of the Pine Rest Foundation (the Foundation), which operates exclusively for the benefit of the Association.

Basis of Consolidation: These consolidated financial statements include the financial position and the results of operations of Pine Rest Christian Mental Health Services and Pine Rest Christian Addiction Services. All significant intercompany accounts and transactions have been eliminated.

Donor-Restricted Contributions: Unconditional promises to give cash or other assets to the Association are reported as fair value at the date received or pledged. Conditional promises to give and indications of intention to give are reported as fair value at the date the gift is received. Gifts are reported in the following net asset classifications:

Unrestricted Net Assets - Reflect unrestricted and board-designated resources available to the Association.

Temporarily Restricted Net Assets - Reflect contributed assets whose use by the Association has been limited by donors. The principal and income are transferred to and available for use as unrestricted net assets when used for the purpose designated by the donor.

Permanently Restricted Net Assets - Reflect contributed net assets that have been restricted as to use by donors and are to be preserved to provide a permanent source of income. Income generated from these contributions is not restricted.

Cash and Cash Equivalents: Cash and cash equivalents includes deposits in financial institutions and short-term investments with original maturities of 90 days or less. Deposits in financial institutions may, at times, exceed federally-insured limits.

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2007 and 2006

NOTE 1 - ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)

Assets Whose Use Is Limited: Assets whose use is limited include designated assets set aside by the Board of Directors for funded depreciation and self-insurance as well as designated assets set aside for donor restrictions and for unexpended bond proceeds.

Investments: Investments in equity and debt securities are measured at fair value based on quoted market prices.

Revenue Recognition and Contractual Allowances: Revenues are recognized at the time services are provided. Contractual allowances are recorded to reduce related billings, as necessary, to the estimated amount to be paid by each third party payor. Laws and regulations governing the Medicare program are complex and subject to interpretation. The Association believes it is in compliance with all applicable laws and regulations, however, there is at least a reasonable possibility that recorded amounts will change materially in the near term. Retroactive revenue adjustments based upon audits, reviews, and adjustments by Medicare are recognized on an estimated basis in the period such adjustments become known or as years are no longer subject to such audits, reviews or adjustments. Such adjustments of recorded amounts relating to prior-year settlement estimates decreased net assets by \$13,000 in 2007 and \$59,000 in 2006. Management believes adequate provision for anticipated settlement adjustments has been made in the financial statements.

Allowance for Doubtful Accounts: The Association evaluates the allowance for bad debts based on a review of current payor status and historical collection experience.

Property, Plant, and Equipment: Property and equipment are stated at cost, if purchased, or at fair market value on date of acquisition, if donated. Depreciation is provided by use of the straight-line method over the estimated useful lives of the assets ranging from 3 to 40 years. When properties are retired or otherwise disposed of, the appropriate accounts are relieved of cost and accumulated depreciation, and any resulting gain or loss is recognized.

At June 30, 2007, construction in progress includes costs to date incurred to construct a new Chapel Conference Center. The project is expected to be completed during November 2007 at a total cost of approximately \$3,680,000.

Beneficial Interest in Net Assets of the Foundation: The Foundation was formed for charitable purposes to hold and manage the endowment and other funds exclusively for the benefit of the Association. Accordingly, the Association is required to present its beneficial interest in the net assets of the Foundation, adjusted annually for the change in those net assets. The changes in net assets are primarily due to contributions and investment returns.

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007 and 2006

NOTE 1 - ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)

Charity Care and Community Benefit: It is the policy of the Association to recognize that all patients are not equally capable of withstanding the burden of payment for health care services, either by themselves or through a third-party insurance carrier. Those patients who do not have the ability to pay for services are eligible for benevolent care.

Patients are considered eligible for charity care if they cannot meet the agreed payment schedule and/or are denied Medicaid coverage, and provide documented evidence for such inability to pay for services. Eligibility is based on federal poverty income guidelines, which are reviewed annually. The Association provided benevolent or uncompensated care as follows:

	<u>2007</u>	<u>2006</u>
Normal charges forgiven	\$ 389,580	\$ 187,637
Charges paid by contributions	<u>1,235,840</u>	<u>1,158,387</u>
	<u>\$ 1,625,420</u>	<u>\$ 1,346,024</u>

Debt Issuance Costs: Costs incurred in connection with the issuance of debt are amortized using the bonds outstanding method over the term of the related debt.

Income Taxes: The Association is a not-for-profit corporation pursuant to Section 501(c)(3) of the Internal Revenue Code and is exempt from income taxes on related income pursuant to Section 501(a).

Use of Estimates: The preparation of consolidated 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.

Excess of Revenues over Expenses: The statements of operations and changes in net assets includes excess of revenues over expenses. Changes in unrestricted net assets excluded from excess or revenues over expenses, consistent with industry practice, include unrealized gains and losses on investments, changes in financial instrument fair value for cash flow hedges deemed effective, unrealized gains and losses on equity investments and uses of donor-restricted contributions related to capital expenditures.

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2007 and 2006

NOTE 1 - ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES (Continued)

Financial Instruments: The Association's carrying amount for its financial instruments, which include cash, accounts receivable, accounts payable, assets associated with the interest rate swap, and long-term debt at June 30, 2007 and 2006 are carried at their estimated fair values. The estimated fair value amounts have been determined by the Association using available market information and appropriate valuation methodologies. Considerable judgment is required in interpreting market data and developing these estimates.

The Association utilizes an interest rate swap agreement to manage the volatility associated with interest rate fluctuations in the normal course of business, which has been designated as a cash flow hedge. The fair value of the interest rate swap agreement is recorded on the balance sheet and represents the estimated receipts or payments that would be required to terminate the agreement. Changes in fair value are included in other changes in net assets.

If in the future, the interest rate swap agreement was determined to be an ineffective hedge or terminated before its contractual termination date, the Association would be required to reclassify into the excess or deficit of revenues over expenses all or a portion of the unrealized amounts related to the cash flow hedge that is currently included in other changes in net assets.

Concentrations: The Association had the following inpatient and outpatient revenue and accounts receivable concentrations as of and for the year ending June 30, 2007:

	<u>2007</u>	
	<u>Percent of Patient Revenue</u>	<u>Percent of Accounts Receivable</u>
Medicare	16.5 %	15.1 %
Medicaid	23.5 %	10.8 %
Managed care, commercial and other	37.4 %	16.2 %
Blue Cross/Blue Shield	14.7 %	13.4 %
Self pay	7.9 %	44.5 %

Prior Period Adjustment: During 2007, management restated its 2006 financial statements to conform them with accounting principles generally accepted in the United States of America. Previously, the Association excluded its beneficial interest in the net assets of the Foundation from its statement of financial position and the change in the Foundation's net assets from its statement of operations. The effects of the change in its accounting method on the net assets, and changes in net assets of the Association for 2006 is summarized in Note 13.

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007 and 2006

NOTE 2 - INVESTMENTS WHOSE USE IS LIMITED

Investments whose use is limited consist of the following and are stated at fair value:

	<u>2007</u>	<u>2006</u>
By Board for funded depreciation:		
Government and agency securities	\$ 2,140,023	\$ 2,813,205
Corporate bonds	4,544,660	3,234,042
Equity securities	24,874,277	22,472,447
Accrued interest	<u>147,408</u>	<u>103,021</u>
	31,706,368	28,622,715
By Board for self-insurance:		
Government and agency securities	1,956,041	1,757,665
Donor-restricted funds:		
Money market funds	1,428,981	3,123,972
Government and agency securities	<u>4,498,096</u>	<u>2,766,591</u>
	5,927,077	5,890,563
Unexpended bond proceeds:		
Money market funds	1,004,642	-
Government agency securities	1,241,746	-
Corporate bonds	1,663,526	-
Accrued interest	<u>4,694</u>	<u>-</u>
	<u>3,914,608</u>	<u>-</u>
	<u>\$ 43,504,094</u>	<u>\$ 36,270,943</u>

Realized investment return, as reported in the statements of operations and changes in net assets, consists of the following:

	<u>2007</u>	<u>2006</u>
Investment income	\$ 1,439,594	\$ 1,047,636
Realized gains	2,656,095	2,788,525
Investment management fees	<u>(290,794)</u>	<u>(294,060)</u>
Realized investment return	<u>\$ 3,804,895</u>	<u>\$ 3,542,101</u>

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007 and 2006

NOTE 3 - PLEDGES RECEIVABLE

The Association has unconditional promises receivable from various contributors at June 30 as follows:

Management feels that the pledges are fully collectible, and thus no allowance for uncollectible pledges is deemed necessary.

	<u>2007</u>	<u>2006</u>
Amounts receivable in:		
Less than one year	\$ 711,077	\$ 1,126,500
One to three years	<u>724,500</u>	<u>1,050,300</u>
Total amounts receivable	1,435,577	2,176,800
Less: Discounting of future pledges	<u>(30,984)</u>	<u>(137,500)</u>
 Net pledges receivable	 <u>\$ 1,404,593</u>	 <u>\$ 2,039,300</u>

An unconditional promise represents a promise made by a contributor to give a specified amount to the Association in the future, which is not contingent on the Association performing any specific action such as raising matching amount or completing a service.

NOTE 4 - LONG-TERM DEBT

Long-term debt consists of the following:

	<u>2007</u>	<u>2006</u>
Kent Hospital Finance Authority, Variable Rate Demand Limited Obligation Revenue Refunding Bonds, Series 2001	\$ 4,860,000	\$ 5,945,000
Kent Hospital Finance Authority, Variable Rate Demand Limited Obligation Revenue Refunding Bonds, Series 2006	10,030,000	-
Mortgages payable	<u>189,325</u>	<u>1,090,301</u>
	15,079,325	7,035,301
Less current portion of long-term debt	<u>1,135,000</u>	<u>1,985,976</u>
	<u>\$ 13,944,325</u>	<u>\$ 5,049,325</u>

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2007 and 2006

NOTE 4 - LONG-TERM DEBT (Continued)

Scheduled maturities of long-term debt are as follows:

2008	\$ 1,135,000
2009	1,185,000
2010	1,240,000
2011	1,300,000
2012	2,005,000
Thereafter	<u>8,214,325</u>
	<u>\$ 15,079,325</u>

At June 30, 2007, the Association had an available line of credit of \$2,000,000. There were no borrowings on the line of credit as of June 30, 2007 and 2006. Interest is payable at the bank prime rate less 0.5% (7.75% at June 30, 2007). The line expires November 1, 2008.

The Kent Hospital Finance Authority issued Variable Rate Demand Limited Obligation Revenue Refunding Bonds, Series 2006 on behalf of the Association. The Series 2006 bonds were issued under a master trust indenture by the Kent Hospital Finance Authority. The bonds were issued at a variable rate and are remarketed weekly with the option of converting to a fixed rate at allowable conversion dates and mature on October 1, 2031. Monthly interest payments are required (3.77% at June 30, 2007). The bonds are secured by an unused letter of credit for \$10,153,658 that is scheduled to expire on October 5, 2011. The master-trust indenture requires the Association to meet certain financial covenants. As of June 30, 2007, the Association is in compliance with its covenants for the bonds.

The Kent Hospital Finance Authority issued Variable Rate Demand Limited Obligation Revenue Refunding Bonds, Series 2001 on behalf of the Association. The Series 2001 bonds were issued under a master trust indenture by the Kent Hospital Finance Authority. The bonds are issued at a variable rate and are remarketed weekly with the option of converting to a fixed rate at allowable conversion dates and mature on November 1, 2010. Monthly interest payments are required (3.79% at June 30, 2007). The bonds are secured by an unused letter of credit for \$4,919,918 that is scheduled to expire on November 16, 2010. The master-trust indenture requires the Association to meet certain financial covenants. As of June 30, 2007, the Association is in compliance with its covenants for the bonds.

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2007 and 2006

NOTE 4 - LONG-TERM DEBT (Continued)

The Association has an interest rate swap agreement with a notional amount of \$2,430,000, which converts the variable interest rate on a portion of the Series 2001 bonds to a fixed rate. In accordance with the terms of the agreement, the Association pays a fixed rate of 3.41% and receives a variable (prime) rate on the notional amount of the swap. Interest rate differentials to be paid or received as a result of the interest rate swap are recognized as an adjustment of interest expense. The swap expires November 1, 2010. The Association is exposed to loss for the potential settlement of amounts due by the counter-party under the agreement. At June 30, 2007, the fair value of the estimated future payments required to settle the interest rate swap agreement represented an asset of \$12,218.

Included in mortgages payable at June 30, 2006 was a mortgage note payable for \$901,000 which was assumed in the acquisitions described in Note 9. This note payable was paid in full during 2007. The other mortgage note payable matures on December 3, 2022.

NOTE 5 - JOINT OPERATING AGREEMENT

The Association's Board of Directors entered into a Joint Operating Agreement ("Agreement") effective July 1, 1998 with St. Mary's Health Services and Metropolitan Hospital to manage the financial and clinical aspects of inpatient and partial hospitalization behavioral health services in the greater West Michigan area. The Agreement combines the inpatient and partial hospitalization mental health services of all three organizations under common management and operations. No initial capital contributions were required as part of the venture and none have been made since inception. The initial term of the Agreement is ten years, with automatic renewals of successive ten-year terms absent the notification of termination by any party. The parties to the Agreement also entered into a series of contractual agreements to provide specific clinical, financial, or support services. The Association has a 58% beneficial interest in the venture, with St. Mary's Health Services having 40%, and Metropolitan Hospital having 2%. All residual profits and losses are allocated in accordance with each entity's beneficial interest. At June 30, 2007 and 2006, the Association has recorded amounts due to the members of the Agreement of \$492,811 and \$337,360, respectively.

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007 and 2006

NOTE 5 - JOINT OPERATING AGREEMENT (Continued)

A summary of operations of the inpatient and partial hospitalization under the Agreement is as follows:

	Years Ended June 30	
	<u>2007</u>	<u>2006</u>
Net patient service revenues:		
Inpatient	\$ 34,507,000	\$ 32,192,000
Partial hospitalization	1,156,000	1,097,000
Professional	217,000	196,000
Other	<u>98,000</u>	<u>105,000</u>
	35,978,000	33,590,000
Expenses:		
Inpatient - direct patient care	12,958,822	11,674,000
Partial hospitalization - direct patient care	488,000	380,000
Hospital psychiatry	4,366,000	3,724,000
Hospital services	3,722,178	3,718,000
Contractual services	4,643,000	4,267,000
Support services	5,148,000	4,839,000
Depreciation	876,000	913,000
Self-insurance	<u>865,000</u>	<u>942,000</u>
	<u>33,067,000</u>	<u>30,457,000</u>
Excess of revenues over expenses	<u>\$ 2,911,000</u>	<u>\$ 3,133,000</u>
Pine Rest Christian Mental Health Services	\$ 1,688,000	\$ 1,817,000
St. Mary's Health Services	\$ 1,165,000	\$ 1,253,000
Metropolitan Hospital	\$ 58,000	\$ 63,000

NOTE 6 - BENEFIT PLAN

The Association has a voluntary tax-sheltered retirement program, which covers substantially all employees. Matching contributions to the retirement program were \$268,000 in 2007 and \$245,000 in 2006, based upon the provisions of the plan. In addition, the Association made discretionary contributions of \$295,000 in 2007 and \$363,000 in 2006.

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
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NOTE 7 - CONTINGENT LIABILITIES

The Association has established a program for professional liability risks that provides full coverage by Michigan Professional Insurance Exchange (MPIE) up to \$500,000 per claim, effective October 1, 2002. The Association is self-insured for the next \$1,500,000 per claim, at which point a general liability umbrella policy with MPIE will cover the next \$5,000,000 on an occurrence basis. Amounts exceeding MPIE umbrella coverage would be the responsibility of the Association.

The Association's policy is to provide for estimated losses incurred in connection with malpractice claims and known incidents for which an amount of loss can be reasonably estimated. The Association is aware of certain incidents that may result in the assertion of claims, and other claims may be asserted in the future arising from services provided to patients or other incidents. Management believes, after considering legal counsels' evaluations of all actions and claims, that insurance coverage is adequate to cover expected settlements and no accrual has been recorded as of year end.

NOTE 8 - OPERATING LEASE COMMITMENTS

The Association leases various facilities and equipment under noncancelable operating leases, which expire through April 2016. Terms of the leases provide for various amounts of monthly rent, some of which include taxes, insurance, and maintenance costs associated with each facility.

Minimum lease commitments under noncancelable operating leases as of June 30, 2007 are as follows:

2008	\$ 942,841
2009	916,172
2010	714,234
2011	380,877
2012	160,196
Thereafter	<u>230,643</u>
	<u>\$ 3,344,963</u>

Total rent expense for 2007 and 2006 was \$1,054,081 and \$863,800, respectively.

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
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NOTE 9 - RELATED PARTY TRANSACTIONS

The Association has a 20% interest in Care Resources, a tax exempt entity established to provide care to individuals in lieu of their Medicare benefits. Each of the members is a 20% guarantor of a line of credit with Care Resources. Accordingly, at June 30, 2007, the Association has recorded a liability of \$331,000 related to its guarantee.

NOTE 10 - RESTRICTED NET ASSETS

Temporarily restricted net assets are available for the following purposes at June 30:

	<u>2007</u>	<u>2006</u>
Capital projects	\$ 7,471,227	\$ 5,061,927
Programs and services	1,568,742	1,739,872
Financial assistance to patients	537,023	596,362
Other	<u>24,585</u>	<u>1,850</u>
	<u>\$ 9,601,577</u>	<u>\$ 7,400,011</u>

Permanently restricted net assets are invested in perpetuity with the income used for its intended purpose.

NOTE 11 - ACQUISITIONS

On December 31, 2005, Pine Rest acquired Child Guidance, Inc., a mental health treatment clinic that provides services in northern Michigan, for \$1 under the terms of an asset purchase agreement. The acquisition was accounted for as net assets contributed. Contributions of net assets between the two not-for-profit organizations included assets, primarily fixed assets, of \$1,800,000 and liabilities, including primarily mortgage obligations and accounts payable, of \$1,033,000. Under the terms of the agreement, the excess net assets over the purchase price of \$767,000 on the acquisition date represent a temporarily restricted contribution to be used for future programs, operational deficits, indigent care, medical staffing costs and other expenditures related to treatment services in the service area. At June 30, 2007, unexpended temporarily restricted contributions are \$477,108.

PINE REST CHRISTIAN MENTAL HEALTH SERVICES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007 and 2006

NOTE 11 - ACQUISITIONS (Continued)

On May 31, 2005, the Association acquired Pathfinder Resources, Inc. and Pathfinder Properties, Inc., a treatment center for drug and alcohol addictions, for \$1 under the terms of an asset purchase agreement. The acquisition was accounted for as net assets contributed. Contributions of net assets between two not-for-profit organizations included assets, including primarily fixed assets and accounts receivable, of \$2,779,000 and liabilities, including primarily mortgage obligations and accounts payable of \$1,754,000. Under the terms of the agreement, the excess net assets over the purchase price of \$1,025,000 on the acquisition date represent a temporarily restricted contribution to be utilized over the next five years to fund future programs, operational deficits, indigent care, and capital expenditure related to treatment services. At June 30, 2007, unexpended temporarily restricted contributions are \$450,908.

NOTE 12 - FUNCTIONAL EXPENSES

The Association provides mental health care services to patients in Western Michigan and Central Iowa. The expenses related to providing these mental health services were \$52,267,368 and \$46,765,564 at June 30, 2007 and 2006, respectively, and general and administrative expense (principally related to support services, administrative, and other expenses) were \$9,861,180 and \$8,989,649 in 2007 and 2006. Fundraising expenses amounted to \$665,403 and \$524,123 for the years ended June 30, 2007 and 2006.

NOTE 13 - PRIOR PERIOD ADJUSTMENT

Accounting principles generally accepted in the United States of America require the Association to record its beneficial interest in the net assets of the Foundation in its statement of financial position and the changes in its beneficial interest in the net assets of the Foundation in the statement of operations because the Foundation exists solely to support the Association. During 2007, the Association changed its method of accounting for its beneficial interest in the Foundation and restated unrestricted, temporarily restricted, and permanently restricted net assets at July 1, 2005 to conform with accounting principles generally accepted in the United States of America. This change resulted in the following increase in net assets of the Association:

	As Previously <u>Reported</u>	Prior Period <u>Adjustment</u>	<u>As Restated</u>
Net assets at July 1, 2005			
Unrestricted	\$ 42,744,052	\$ 14,315,672	\$ 57,059,724
Temporarily restricted	4,896,839	382,831	5,279,670
Permanently restricted	<u>-</u>	<u>3,078,189</u>	<u>3,078,189</u>
	<u>\$ 47,640,891</u>	<u>\$ 17,776,692</u>	<u>\$ 65,417,583</u>