

Health & Education Services, Inc. and Affiliate

Combined Financial Statements as of and
for the Years Ended June 30, 2010 and 2009,
Supplemental Combining Information as of and
for the Year Ended June 30, 2010, and
Independent Auditors' Report

HEALTH & EDUCATION SERVICES, INC. AND AFFILIATE

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Health & Education Services, Inc.
Beverly, Massachusetts

We have audited the accompanying combined balance sheets of Health & Education Services, Inc. (an affiliate of Northeast Health System, Inc. (NHS)) and affiliate (the "Company") as of June 30, 2010 and 2009, and the related combined statements of activities, functional expenses, and cash flows for the years then ended. These combined financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these combined 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 financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such combined financial statements present fairly, in all material respects, the combined financial position of Health & Education Services, Inc. and affiliate as of June 30, 2010 and 2009, and the changes in their combined net assets and combined cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 10 to the combined financial statements, on June 28, 2010, the Company's Board of Directors approved the merger of the Company with CAB Health & Recovery Services, Inc., another affiliate of NHS. The Company expects this merger to be completed sometime during the year ending June 30, 2011.

Our audits were performed for the purpose of forming an opinion on the basic combined financial statements taken as a whole. The supplemental combining information included on pages 15 and 16 is presented for the purpose of additional analysis of the basic combined financial statements, rather than to present the financial position and changes in net assets of the individual entities, and is not a required part of the basic combined financial statements. The supplemental combining information is the responsibility of the Company's management. Such information has been subjected to the auditing procedures applied in our audit of the basic 2010 combined financial statements and, in our opinion, is fairly stated in all material respects when considered in relation to the basic combined financial statements taken as a whole.

Deloitte + Touche LLP

November 10, 2010

HEALTH & EDUCATION SERVICES, INC. AND AFFILIATE

COMBINED BALANCE SHEETS AS OF JUNE 30, 2010 AND 2009

	2010	2009
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 1,337,321	\$ 1,399,707
Accounts receivable:		
Client service fees	4,293,160	3,483,545
Contracts	1,678,640	2,801,459
Other	653,187	456,925
Due from affiliates	608,279	540,772
Less allowance for doubtful accounts and contractual adjustments	<u>(1,659,339)</u>	<u>(1,493,116)</u>
Accounts receivable — net	5,573,927	5,789,585
Prepaid expenses and other current assets	<u>912,697</u>	<u>307,027</u>
Total current assets	7,823,945	7,496,319
PROPERTY AND EQUIPMENT — Net	12,142,383	12,051,166
OTHER ASSETS	<u>205,802</u>	<u>245,682</u>
TOTAL	<u>\$20,172,130</u>	<u>\$ 19,793,167</u>
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	\$ 2,943,717	\$ 2,321,136
Accrued wages and vacation payable	3,247,397	3,063,108
Current portion of debt	158,257	179,497
Other liabilities	848,845	952,687
Due to affiliate	<u>192,371</u>	<u>310,000</u>
Total current liabilities	7,390,587	6,826,428
DUE TO AFFILIATE	2,749,169	1,600,000
OTHER LONG-TERM LIABILITIES		67,909
LONG-TERM DEBT — Net of current portion	<u>2,847,821</u>	<u>3,921,455</u>
Total liabilities	<u>12,987,577</u>	<u>12,415,792</u>
NET ASSETS:		
Unrestricted net assets	4,555,579	4,697,256
Temporarily restricted net assets	<u>2,628,974</u>	<u>2,680,119</u>
Total net assets	<u>7,184,553</u>	<u>7,377,375</u>
TOTAL	<u>\$20,172,130</u>	<u>\$ 19,793,167</u>

See notes to combined financial statements.

HEALTH & EDUCATION SERVICES, INC. AND AFFILIATE

COMBINED STATEMENTS OF ACTIVITIES FOR THE YEARS ENDED JUNE 30, 2010 AND 2009

	2010			2009		
	Unrestricted Net Assets	Temporarily Restricted Net Assets	Total Net Assets	Unrestricted Net Assets	Temporarily Restricted Net Assets	Total Net Assets
REVENUE:						
Contract revenue	\$ 35,086,500	\$ -	\$ 35,086,500	\$ 45,007,658	\$ -	\$ 45,007,658
Net patient service revenue	29,732,637		29,732,637	22,462,749		22,462,749
Other revenue	1,999,802		1,999,802	1,823,504		1,823,504
Contributions	418,382		418,382	372,183		372,183
Net assets released from restrictions for operations	18,111	(18,111)	-	16,782	(16,782)	-
Total revenue	67,255,432	(18,111)	67,237,321	69,682,876	(16,782)	69,666,094
EXPENSES:						
Salaries and wages	40,738,055		40,738,055	42,369,958		42,369,958
Fringe benefits	8,728,058		8,728,058	9,083,539		9,083,539
Professional services	6,855,978		6,855,978	6,475,723		6,475,723
Supplies and other expenses	10,152,034		10,152,034	10,928,910		10,928,910
Interest	195,685		195,685	159,672		159,672
Depreciation and amortization	796,104		796,104	770,263		770,263
Loss on disposal of fixed assets	30,296		30,296	122,954		122,954
Total expenses	67,496,210	-	67,496,210	69,911,019	-	69,911,019
LOSS FROM OPERATIONS	(240,778)	(18,111)	(258,889)	(228,143)	(16,782)	(244,925)
NONOPERATING GAINS (LOSSES):						
Investment income	1,945		1,945	4,283		4,283
Restricted gifts, pledges, and grants		223,488	223,488		410,338	410,338
Fundraising expenses	(159,366)		(159,366)	(229,106)		(229,106)
Net assets released from restrictions used for fundraising	159,366	(159,366)		229,106	(229,106)	
Net assets released from restrictions used for purchase of property and equipment	97,156	(97,156)	-	26,557	(26,557)	-
Total nonoperating gains (losses)	99,101	(33,034)	66,067	30,840	154,675	185,515
DECREASE IN NET ASSETS	(141,677)	(51,145)	(192,822)	(197,303)	137,893	(59,410)
NET ASSETS — Beginning of year	4,697,256	2,680,119	7,377,375	4,894,559	2,542,226	7,436,785
NET ASSETS — End of year	\$ 4,555,579	\$ 2,628,974	\$ 7,184,553	\$ 4,697,256	\$ 2,680,119	\$ 7,377,375

See notes to combined financial statements.

HEALTH & EDUCATION SERVICES, INC. AND AFFILIATE

COMBINED STATEMENTS OF FUNCTIONAL EXPENSES FOR THE YEARS ENDED JUNE 30, 2010 AND 2009

2010	Administration (Management and General)	Program Services	Total
EMPLOYEE COMPENSATION AND RELATED BENEFITS	\$ 2,894,739	\$ 46,813,662	\$ 49,708,401
OCCUPANCY	669,291	3,611,016	4,280,307
OTHER PROGRAM/OPERATING EXPENSES	1,646,889	8,926,723	10,573,612
SUBCONTRACT EXPENSE	34,321	230,063	264,384
ADMINISTRATIVE EXPENSE	579,199	1,294,203	1,873,402
DEPRECIATION OF PROPERTY AND EQUIPMENT	<u>110,621</u>	<u>685,483</u>	<u>796,104</u>
TOTAL	<u>\$ 5,935,060</u>	<u>\$ 61,561,150</u>	<u>\$ 67,496,210</u>
2009			
EMPLOYEE COMPENSATION AND RELATED BENEFITS	\$ 3,293,473	\$ 48,488,883	\$ 51,782,356
OCCUPANCY	497,687	3,931,633	4,429,320
OTHER PROGRAM/OPERATING EXPENSES	1,750,616	8,779,008	10,529,624
SUBCONTRACT EXPENSE	77,398	359,533	436,931
ADMINISTRATIVE EXPENSE	702,875	1,259,650	1,962,525
DEPRECIATION OF PROPERTY AND EQUIPMENT	<u>91,504</u>	<u>678,759</u>	<u>770,263</u>
TOTAL	<u>\$ 6,413,553</u>	<u>\$ 63,497,466</u>	<u>\$ 69,911,019</u>

See notes to combined financial statements.

HEALTH & EDUCATION SERVICES, INC. AND AFFILIATE

COMBINED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED JUNE 30, 2010 AND 2009

	2010	2009
CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
Decrease in net assets	\$ (192,822)	\$ (59,410)
Adjustments to reconcile decrease in net assets to net cash provided by (used in) operating activities:		
Loss on disposal of fixed assets	30,596	122,954
Noncash interest expense	18,111	
Depreciation and amortization	796,104	770,263
Restricted gifts, pledges, and grant awards	(223,488)	(410,338)
Increase (decrease) in cash as a result of the change in:		
Accounts receivable — net	201,771	(478,673)
Prepaid expenses and other current assets	(605,670)	615,709
Other assets	68,851	(27,148)
Accounts payable, accrued expenses, wages, and vacation payable	806,870	(1,355,289)
Other liabilities	<u>(171,751)</u>	<u>104,540</u>
Net cash provided by (used in) operating activities	<u>728,572</u>	<u>(717,392)</u>
CASH FLOWS USED IN INVESTING ACTIVITIES — Purchases of property and equipment		
	<u>(698,367)</u>	<u>(1,618,358)</u>
CASH FLOWS (USED IN) PROVIDED BY FINANCING ACTIVITIES:		
Due to affiliate	1,031,540	1,600,000
Line-of-credit borrowings	600,000	1,000,000
Line-of-credit repayments	(600,000)	(1,185,405)
Proceeds from issuance of new debt		1,280,000
Repayments of debt and capital leases	(1,332,535)	(192,061)
Nike project nonamortizing mortgages		18,911
Decrease in restricted cash		65,170
Restricted gifts, pledges, and grant awards	<u>208,404</u>	<u>378,618</u>
Net cash (used in) provided by financing activities	<u>(92,591)</u>	<u>2,965,233</u>
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(62,386)	629,483
CASH AND CASH EQUIVALENTS — Beginning of year	<u>1,399,707</u>	<u>770,224</u>
CASH AND CASH EQUIVALENTS — End of year	<u>\$ 1,337,321</u>	<u>\$ 1,399,707</u>
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITY — Property and equipment recorded under capital leases		
	<u>\$ 219,550</u>	<u>\$ 26,115</u>

See notes to combined financial statements.

HEALTH & EDUCATION SERVICES, INC. AND AFFILIATE

NOTES TO COMBINED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED JUNE 30, 2010 AND 2009

1. ORGANIZATION AND OPERATIONS

Health & Education Services, Inc. (HES) is a not-for-profit corporation that provides outpatient services, cross-cultural programs, community support services, youth residential services, substance abuse services, prevention services, trauma services, early childhood services, and medical services in the northeast area of Massachusetts. HES is an affiliate of Northeast Health System, Inc. Northeast Health System, Inc. and affiliates are referred to herein as NHS. NHS has historically provided financial support to HES and its affiliates and may continue to do so in the future. HES is the sole member of Health & Education Housing Services, Inc. (“Housing”).

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General — The accompanying combined financial statements include the accounts of HES and Housing (collectively, the “Company”). Intercompany balances and transactions, if any, are eliminated in combination. The assets of any member of the combined group may not be available to meet the obligations of the other member in the group.

Use of Estimates — The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) 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 combined financial statements. Estimates also affect the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Contract Revenue — The Company derives a significant amount of its contract revenue (approximately 40% and 54% in 2010 and 2009, respectively) through contracts negotiated with various agencies of the Commonwealth of Massachusetts (the “Commonwealth”). Therefore, the Company is subject to the regulations and rate formulae of the Commonwealth. Additionally, the Company derives contract revenue (approximately 8% and 5% in 2010 and 2009, respectively) from U.S. federal agencies. These federal and state contracts are generally renewable on an annual basis, and there is no assurance that such contracts will be renewed in the future. These contracts generally provide for payment to the Company based on cost reimbursement or fixed fee per unit of provided service arrangements.

Net Patient Service Revenue — The Company has entered into payment agreements with Medicare, Medicaid, and various commercial insurance carriers, health maintenance organizations, and preferred provider organizations that provide for payments to the Company at amounts different from its established rates. 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. Under the terms of various agreements, regulations, and statutes, certain elements of third-party reimbursement are subject to negotiation, audit, and/or final determination by the third-party payors. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Variances between preliminary estimates of net patient service revenue and final third-party settlements are included in the combined statements of activities in the year in which the settlement or change in estimate occurs.

Charity Care — The Company offers comprehensive mental health services with a special emphasis on those individuals who have been traditionally underinsured and those experiencing chronic mental health disabilities. The Company provides care to clients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because the Company does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. The amount of charges foregone for services and supplies furnished under the Company’s charity care policy aggregated approximately \$85,000 and \$102,000 for the years ended June 30, 2010 and 2009, respectively. The equivalent percentage of charity care to all patients served was approximately 0.3% and 0.5% in 2010 and 2009, respectively. Such amounts and percentages are determined using charges foregone based on established rates.

Combined Statements of Activities — For purposes of display, transactions deemed by management to be ongoing, major, or central to the provision of the Company’s related mission and services are reported as revenue and expenses. Peripheral or incidental transactions are reported as nonoperating gains and losses.

Cash and Cash Equivalents — Cash and cash equivalents include highly liquid investments with maturities at the date of purchase of three months or less.

Property and Equipment — Property and equipment is recorded at cost or, if received by gift, at fair market value at the date of the gift. Depreciation and amortization is provided using the straight-line method over the lesser of the estimated useful lives of the assets or the lease terms. Expenditures for maintenance and repairs are charged to operations as incurred. Property and equipment is depreciated over the useful life as follows:

Buildings	27.5–40 years
Building improvements	20 years
Leasehold improvements	lesser of 5 years or lease term
Equipment	10 years
Office furnishings	7 years
Office and other program equipment	5 years
Motor vehicles	5 years
Used motor vehicles	3 years

Costs of Borrowing — Interest costs incurred on borrowed funds during the period of construction of capital assets, net of investment income, are capitalized as a component of the cost of acquiring those assets. The amount of interest that was capitalized, net of the related interest income, totaled \$0 and \$45,045 for the years ended June 30, 2010 and 2009, respectively.

Accounting for Impairment of Long-Lived Assets — Long-lived assets to be held and used are reviewed for impairment whenever circumstances indicate that the carrying amount of an asset may not be recoverable. Long-lived assets to be disposed of are reported at the lower of carrying amount or fair value, less cost to sell. No impairment was recorded for the years ended June 30, 2010 and 2009.

Income Taxes — Both entities included in the combined financial statements have been recognized as tax-exempt organizations pursuant to Section 501(c)(3) of the Internal Revenue Code (the “Code”) and, accordingly, are exempt from federal income taxes on related income pursuant to Section 501(a) of the Code.

Contributions and Grants — Contributions and grants have been received from governmental agencies and used for property and equipment, which must be returned to the U.S. government if the Company does not continue to use the property and equipment for its intended use. Such amounts were recorded as nonoperating gains in the year received because management believes that the likelihood that the Company will not use the property and equipment for its intended purpose is remote. The aggregate net book value of such assets totaled approximately \$4,143,193 and \$4,180,892 at June 30, 2010 and 2009, respectively.

Temporarily Restricted Net Assets — Temporarily restricted net assets are those whose use by the Company has been limited by donors to a specific time period or purpose. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are classified as unrestricted net assets and reported in the combined statements of activities as net assets released from restrictions.

Promises to Give — Unconditional promises to give that are expected to be collected within one year are recorded at fair value at the date the promise is received and are included in pledges receivable. Unconditional promises to give that are expected to be collected in future years are recorded at the present value of their estimated future cash flows. The discounts on these amounts are computed using risk-free rates applicable to the years in which the promises are received. Amortization of the discounts is included in contribution revenue. Conditional promises to give are not included as support until such time as the conditions are substantially met.

Recently Issued Accounting Pronouncements — In August 2010, the FASB issued Accounting Standards Update (ASU) 2010-23, which requires health care organizations to use costs as the measurement basis for charity care disclosures and that they identify those costs as the direct and indirect costs of providing charity care. The ASU also requires the disclosure of the method used to identify the costs. This ASU is effective for fiscal years beginning after December 15, 2010. Management is evaluating the impact that this standard will have on the Company's financial statements.

In August 2010, the FASB issued ASU 2010-24, which clarifies that health care entities should not net insurance recoveries against a related claim liability. This ASU is effective for years beginning after December 15, 2010. Management is evaluating the impact that this standard will have on the Company's financial statements.

3. PLEDGES RECEIVABLE

Pledges receivable at June 30, 2010 and 2009, include unconditional promises, which are expected to be realized in the following years:

	2010	2009
In one year or less	\$ 54,021	\$ 33,486
Between one and five years	36,445	77,404
Discount	<u>(9,758)</u>	<u>(21,746)</u>
Total	<u>\$ 80,708</u>	<u>\$ 89,144</u>

These amounts are recorded in other current receivables and other assets in the accompanying combined balance sheets. There was no allowance for uncollectible pledges at June 30, 2010 and 2009.

4. PROPERTY AND EQUIPMENT

Property and equipment at June 30, 2010 and 2009, consisted of the following:

	2010	2009
Land and improvements	\$ 4,869,452	\$ 4,869,452
Buildings and improvements	9,369,617	9,150,815
Fixed equipment	5,219,364	4,725,216
Moveable equipment	<u>527,412</u>	<u>548,936</u>
Total property and equipment	19,985,845	19,294,419
Less accumulated depreciation and amortization	<u>(7,843,462)</u>	<u>(7,243,253)</u>
Property and equipment — net	<u>\$ 12,142,383</u>	<u>\$ 12,051,166</u>

Leased property under capital leases had a cost of \$1,203,398 and \$983,848 and accumulated depreciation of \$940,288 and \$829,800, at June 30, 2010 and 2009, respectively.

5. LONG-TERM DEBT

Long-term debt at June 30, 2010 and 2009, consisted of the following:

	2010	2009
Massachusetts Health and Educational Facilities Authority, payable monthly through April 2027	\$ -	\$ 1,161,795
Nike project construction financing — term note	525,343	545,408
Nike project construction financing — grant	400,000	400,000
Nike nonamortizing mortgages	251,796	233,685
HeadStart mortgage	1,556,300	1,593,839
Obligations under capital leases	<u>272,639</u>	<u>166,225</u>
Total long-term debt	3,006,078	4,100,952
Less current portion	<u>158,257</u>	<u>179,497</u>
Long-term debt net of current portion	<u>\$ 2,847,821</u>	<u>\$ 3,921,455</u>

Interest paid in fiscal years 2010 and 2009 totaled \$177,754 and \$142,800, respectively.

The fair value of the Company's debt approximates its carrying value at June 30, 2010 and 2009.

Massachusetts Health and Educational Facilities Authority — During 1996, the Company entered into a 30-year loan agreement with the Massachusetts Health and Educational Facilities Authority (MHEFA). The variable interest rate was 0% in June 2010, and 0% at June 30, 2009, and is payable monthly. NHS paid off the balance of this loan in June 2010 on behalf of the Company as a result of MHEFA closing the loan pool. As a result at June 30, 2010, \$1,129,169 is recorded as amounts due to affiliate.

Danversbank Line of Credit — The Company has a line of credit with Danversbank, collateralized by the Company's accounts receivable and equipment, under which it can borrow up to \$1,000,000. The line of credit bears interest at 5%, which is payable monthly. This line of credit was put in place in April 2008. It is subject to review by Danversbank at the beginning of each calendar year. The amount outstanding under the line of credit was \$0 at June 30, 2010 and 2009. Effective October 6, 2010 in conjunction with the new mortgage, Danversbank has frozen the line of credit.

HeadStart Mortgage — The Company received a mortgage in the amount of \$1,600,000 from Danversbank in April 2008. In 2008, an initial amount of \$320,000 was drawn on this mortgage, which, along with a \$530,000 grant from the Administration for Children and Families, was used to purchase property at 292 Cabot Street in Beverly, Massachusetts. Additional amounts were drawn during fiscal year 2009 to fund renovations to this property, which now houses the Company's HeadStart program. The mortgage bears interest at the rate of 7% for the first five years. The interest rate will be adjusted every five years based on the Federal Home Loan Bank (FHLB) Five-Year Classic Advance Rate plus 225 basis points. Payments of interest only were made until May 2009, at which time payments of principal and interest started on a 20-year amortization schedule. The borrowing is collateralized by the property at 292 Cabot Street. Danversbank required the Company to deposit \$75,000 in an account with Danversbank. The interest-only monthly loan payments were deducted from this account until the project was complete. Since the construction is complete and the loan is amortizing, this account was closed during the year ended June 30, 2010.

Nike Project Construction Financing — The Company executed a construction line of credit with BankNorth during 2004. This \$620,000 note was interest only until January 2005, at which time it converted to a 20-year term note. The interest rate is 7%. The note is collateralized by the Nike site and the assets under construction. During 2004, the Company also received a \$300,000 grant from the FHLB to fund the Nike project. Under the terms of the grant, no payments are due so long as the property continues to be used for its intended purpose and the Company does not default under any of the terms of the grant agreement for a period of 15 years. In December 2007, the grant was increased by an additional \$100,000, subject to the same terms.

In August 2007, the Company received approximately \$2,800,000 in nonamortizing interest-free mortgages from the Massachusetts Housing Partnership Fund Board and the Community Economic Development Assistance Corporation. The terms of these mortgages dictate that no interest will be charged and that the mortgages' terms may be extended indefinitely, provided that the Company does not default. Default occurs if the Company fails to continue to use the land under the Nike project for its intended use. Should this occur, the Company would be liable for the full amount of the mortgages. The Company has imputed interest on these mortgages using a rate of 7.75% and will report interest expense and contribution revenue in connection with these loans. Contribution revenue is recorded based on the difference between the fair value of the loans using the imputed interest rate of 7.75% and the stated rate of zero. As a result, the Company recorded an increase to temporarily restricted net assets of \$2,430,961 and an increase to long-term debt of \$203,499 during the year ended June 30, 2008. Each year, the Company will recognize interest expense based on the recorded loan balance and the imputed interest rate. The amount of recognized interest expense during each period will be an offsetting increase to the loan payable, a decrease to temporarily restricted net assets, and an increase to net assets released for restrictions, used for operations. During the years ended June 30, 2010 and 2009, the Company recognized interest expense and net assets released from restrictions used for operations of \$18,111 and \$16,872, respectively.

The funds received from the mortgages were used to pay off the Bank of America line of credit (\$975,550), pay project-specific invoices (\$628,000), pay NHS (\$650,000), and pay general liabilities (\$350,000).

Guarantees — The debt with the Massachusetts Health and Educational Facilities Authority was guaranteed by Northeast Health Corporation, an affiliate of NHS.

Debt Covenants and Repayment Schedule — The Company’s loan agreements provide for restrictions on, among other things, additional indebtedness, transfers between affiliates, and dispositions of property. The Nike project construction financing places limits on the net cash flow that the Company can recognize from that project. The HeadStart mortgage requires the Company to maintain a debt service coverage ratio of at least 1.3. At June 30, 2010, management believes that the Company was in compliance with the debt service coverage ratio.

Scheduled maturities of long-term debt, excluding the FHLB grant and the Nike project nonamortizing mortgages, for the years ending June 30, are as follows:

Years Ending June 30	Loans	Capital Leases
2011	\$ 62,808	\$ 102,144
2012	67,372	77,009
2013	72,267	52,586
2014	77,518	38,557
2015	83,151	14,982
Thereafter	<u>1,718,527</u>	<u> </u>
	<u>\$ 2,081,643</u>	285,278
Amounts representing interest		<u>12,639</u>
Present value of net minimum lease payments		<u>\$ 272,639</u>

6. COMMITMENTS AND CONTINGENCIES

Contingencies — The Company is a party in various legal proceedings and potential claims arising in the ordinary course of business. The health care industry, as a whole, is subject to numerous laws and regulations of federal, state, and local governments. Compliance with these laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time. Such compliance in the health care industry has recently come under increased governmental scrutiny. Management does not believe that the ultimate resolution of these regulatory matters will have a material adverse effect on the Company’s combined financial statements.

Operating Leases — The Company leases several of its facilities. These leases expire on various dates through 2021. Some operating leases contain rent escalation clauses whereby the rent payments increase over the term of the lease. Rent expense recognized in the accompanying combined statements of activities, including leases with terms of less than one year, was approximately \$2,493,000 and \$2,551,000 for the years ended June 30, 2010 and 2009, respectively.

The following is a schedule of future minimum rental payments required under operating leases that have remaining noncancelable lease terms in excess of one year:

**Years Ending
June 30**

2011	\$ 2,126,813
2012	2,058,479
2013	1,767,154
2014	1,729,641
2015	1,714,097
Thereafter	<u>5,839,107</u>
 Total	 <u>\$ 15,235,291</u>

Surplus Revenue Retention Fund (Unaudited) — The Commonwealth requires companies to segregate the operating income associated with services provided under certain contracts with the Commonwealth. Companies may retain, for future use, such income to the extent that it does not exceed 5% of the related revenue. The cumulative amount of the surplus that can be retained may not exceed 20% of the prior year's gross revenue from purchasing agencies. The surplus revenue retention fund may be used for any of the Company's charitable purposes, except for certain defined nonreimbursable costs. Under these contracts, HES had deficits of \$602,155 and \$1,050,379 for the years ended June 30, 2010 and 2009, respectively, and cumulative deficits of \$7,715,490 and \$7,113,335 for the years ended June 30, 2010 and 2009, respectively.

7. CONCENTRATIONS OF CREDIT RISK

The Company grants credit without collateral to individuals, third-party payors, and certain federal and state agencies. The mix of net client service and contract receivables from individuals, governmental agencies, and third-party payors at June 30, 2010 and 2009, was as follows:

	2010	2009
Federal and state contracts	31 %	53 %
Medicare	4	3
Medicaid	42	30
Other third-party payors	20	13
Individuals	<u>3</u>	<u>1</u>
	<u>100 %</u>	<u>100 %</u>

8. TEMPORARILY RESTRICTED NET ASSETS

Temporarily restricted net assets were available at June 30, 2010 and 2009, for the following purposes:

	2010	2009
Capital campaign	\$ 80,708	\$ 183,079
Contribution restricted to specific program	69,781	445
Time restricted related to nonamortizing interest-free mortgages	<u>2,478,485</u>	<u>2,496,595</u>
Total	<u>\$2,628,974</u>	<u>\$2,680,119</u>

9. RELATED-PARTY TRANSACTIONS

Management fees totaling \$50,100 and \$77,800 were paid to NHS during the years ended June 30, 2010 and 2009, respectively. NHS provides property, workers' compensation, and professional liability insurance coverage for its affiliates. HES's expense for this coverage for the years ended June 30, 2010 and 2009, was approximately \$471,000 and \$477,000, respectively. Amounts owed to NHS that were included in HES's accounts payable for the years ended June 30, 2010 and 2009, were approximately \$1,159,000 and \$1,090,000, respectively. In addition, the Company had borrowed \$2,859,169 from NHS as of June 30, 2010, and \$1,910,000 as of June 30, 2009. Of the amount due to affiliates at June 30, 2010, \$1,620,000 was classified as long-term because payment will not be made within one year, and \$1,129,169 has been classified as long-term because the Company has an agreement in place to refinance this debt on a long-term basis. Of the amount due to affiliates at June 30, 2009, \$1,600,000 was classified as long-term.

HES provides certain services to NHS and its affiliates. Revenues for these services totaled \$16,554,300 and \$16,025,500 during the years ended June 30, 2010 and 2009, respectively.

Rent payments totaling approximately \$103,000 and \$101,000 were paid to NHS during the years ended June 30, 2010 and 2009, respectively.

Interest expense on amounts due to affiliates totaled \$10,000 and \$14,500 during the years ended June 30, 2010 and 2009, respectively.

10. SUBSEQUENT EVENTS

On June 28, 2010, the Company's Board of Directors approved the merger of the Company with CAB Health & Recovery Services, Inc., another affiliate of NHS. The Company expects this merger to be completed sometime during the year ending June 30, 2011.

On October 6, 2010, the Company closed a mortgage loan in the amount of \$1,130,000 to reimburse NHS for debt payments made by NHS on behalf of the Company (see Note 5). The mortgage is payable over 25 years with interest at 6% for the first five years and is variable thereafter. This borrowing is collateralized by property with a net book value of \$485,952 at June 30, 2010.

The Company has evaluated subsequent events through November 10, 2010, which is the date the combined financial statements were available to be issued.

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SUPPLEMENTAL COMBINING INFORMATION

HEALTH & EDUCATION SERVICES, INC. AND AFFILIATE

SUPPLEMENTAL COMBINING BALANCE SHEET INFORMATION AS OF JUNE 30, 2010

	HES	Housing	Combined
ASSETS			
CURRENT ASSETS:			
Cash and cash equivalents	\$ 1,290,015	\$ 47,306	\$ 1,337,321
Accounts receivable:			
Client service fees	4,286,074	7,086	4,293,160
Contracts	1,678,640		1,678,640
Other	653,187		653,187
Due from affiliates	608,279		608,279
Less allowance for doubtful accounts and contractual adjustments	(1,659,339)		(1,659,339)
Accounts receivable — net	5,566,841	7,086	5,573,927
Prepaid expenses and other current assets	905,573	7,124	912,697
Total current assets	7,762,429	61,516	7,823,945
PROPERTY AND EQUIPMENT — Net	11,472,690	669,693	12,142,383
OTHER ASSETS	205,302	500	205,802
TOTAL	\$ 19,440,421	\$ 731,709	\$ 20,172,130
LIABILITIES AND NET ASSETS			
CURRENT LIABILITIES:			
Accounts payable and accrued expenses	\$ 2,927,137	\$ 16,580	\$ 2,943,717
Accrued wages and vacation payable	3,247,397		3,247,397
Current portion of debt	158,257		158,257
Other liabilities	844,933	3,912	848,845
Due to affiliate	192,371		192,371
Total current liabilities	7,370,095	20,492	7,390,587
DUE TO AFFILIATE	2,749,169		2,749,169
LONG-TERM DEBT — Net of current portion	2,847,821		2,847,821
Total liabilities	12,967,085	20,492	12,987,577
NET ASSETS:			
Unrestricted net assets	3,844,362	711,217	4,555,579
Temporarily restricted net assets	2,628,974		2,628,974
Total net assets	6,473,336	711,217	7,184,553
TOTAL	\$ 19,440,421	\$ 731,709	\$ 20,172,130

HEALTH & EDUCATION SERVICES, INC. AND AFFILIATE

SUPPLEMENTAL COMBINING STATEMENT OF ACTIVITIES INFORMATION FOR THE YEAR ENDED JUNE 30, 2010

	HES	Housing	Combined
REVENUE:			
Contract revenue	\$ 35,086,500	\$	\$ 35,086,500
Net patient service revenue	29,732,637		29,732,637
Other revenue	1,922,957	76,845	1,999,802
Contributions	418,382		418,382
Net assets released from restrictions for operations	<u>18,111</u>	<u></u>	<u>18,111</u>
Total revenue	<u>67,178,587</u>	<u>76,845</u>	<u>67,255,432</u>
EXPENSES:			
Salaries and wages	40,738,055		40,738,055
Fringe benefits	8,728,058		8,728,058
Contract services	6,855,978		6,855,978
Supplies and other expenses	10,082,425	69,609	10,152,034
Interest	195,685		195,685
Depreciation and amortization	779,603	16,501	796,104
Loss on disposal of fixed assets	<u>30,296</u>	<u></u>	<u>30,296</u>
Total expenses	<u>67,410,100</u>	<u>86,110</u>	<u>67,496,210</u>
LOSS FROM OPERATIONS	<u>(231,513)</u>	<u>(9,265)</u>	<u>(240,778)</u>
NONOPERATING GAINS:			
Investment income	1,811	134	1,945
Fundraising expenses	(159,366)		(159,366)
Net assets released from restrictions used for fundraising	159,366		159,366
Net assets released from restrictions used for purchase of property and equipment	<u>97,156</u>	<u></u>	<u>97,156</u>
Total nonoperating gains	<u>98,967</u>	<u>134</u>	<u>99,101</u>
DECREASE IN UNRESTRICTED NET ASSETS	(132,546)	(9,131)	(141,677)
UNRESTRICTED NET ASSETS — Beginning of year	<u>3,976,908</u>	<u>720,348</u>	<u>4,697,256</u>
UNRESTRICTED NET ASSETS — End of year	<u>\$ 3,844,362</u>	<u>\$ 711,217</u>	<u>\$ 4,555,579</u>