

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

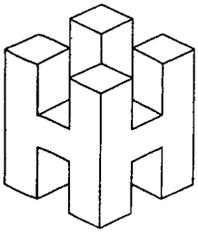
INDEPENDENT AUDITORS' REPORT

JUNE 30, 2006 AND 2005

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors
Capstone Behavioral Healthcare, Inc.
Newton, Iowa

We have audited the accompanying statements of financial position of CAPSTONE BEHAVIORAL HEALTHCARE, INC., as of June 30, 2006 and 2005, and the related statements of activities, functional expenses and cash flows for the years then ended. These financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on these 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 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 audits provide a reasonable basis for our opinion.

As more fully described in Note 3 to the financial statements, during the year ended June 30, 2005, the Organization excluded certain leased assets and lease obligations from property and debt in the accompanying statements of financial position. In our opinion, accounting principles generally accepted in the United States of America require that such obligations be included in the statements of financial position.

In our opinion, except for the effects of the matter discussed in the preceding paragraph, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of Capstone Behavioral Healthcare, Inc., as of June 30, 2006 and 2005, and the changes in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Henjes, Conner, & Williams PC
Certified Public Accountants

Sioux City, Iowa
July 28, 2006

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

STATEMENTS OF FINANCIAL POSITION

JUNE 30, 2006 AND 2005

ASSETS

	<u>2006</u>	<u>2005</u>
<u>CURRENT ASSETS</u>		
Cash and Cash Equivalents	\$ 277,305	\$ 442,344
Accounts Receivable - Trade (Net of Allowances of \$133,764 and \$148,891, for 2006 and 2005 Respectively)	258,440	189,479
Accounts Receivable - Related Party - Note 2 ..	<u>-</u>	<u>4,062</u>
Total Current Assets	\$ <u>535,745</u>	\$ <u>635,885</u>
Total Assets	\$ <u>535,745</u>	\$ <u>635,885</u>

LIABILITIES AND NET ASSETS

CURRENT LIABILITIES

Accounts Payable - Trade	\$ 3,146	\$ 15,657
Accounts Payable - ARO Adjustment	77,169	-
Accrued Vacation Payable	48,732	48,668
Accrued Wages	60,363	72,114
Payroll Taxes Payable	-	10,345
Accounts Payable - Related Party - Note 2	<u>-</u>	<u>1,000</u>
Total Current Liabilities	\$ 189,410	\$ 147,784

NET ASSETS

Unrestricted	\$ <u>346,335</u>	\$ <u>488,101</u>
Total Liabilities and Net Assets	\$ <u>535,745</u>	\$ <u>635,885</u>

See Accompanying Notes to Financial Statements

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

STATEMENTS OF ACTIVITIES

FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

<u>PUBLIC SUPPORT AND OTHER REVENUE</u>	2006 <u>Unrestricted</u>	2005 <u>Unrestricted</u>
Public Support:		
Capstone Community Foundation - Note 2	\$ 26,170	\$ 18,617
Fees from Governmental Agencies:		
Jasper County Revenue:		
Chemical Dependency	10,695	1,900
Mental Health	245,276	240,169
Community Based Services	58,848	102,908
Residential	26,996	40,864
Marion County Revenue:		
Chemical Dependency	23,000	15,879
Mental Health	41,305	52,543
Community Based Services	11,338	10,615
Other County Revenue:		
Community Based Services	6,604	3,771
Residential	14,844	12,577
Adult Rehab Option Revenue	445,863	378,330
Iowa Department of Public Health	333,224	363,949
CSP - Adult	15,407	14,985
CSP - Children	16,484	6,841
School Contracts	43,190	46,250
Patient Fees	1,242,348	1,099,761
Adjustment for Managed Care and Charity Care	(455,803)	(387,416)
Other Revenue:		
Interest Income	1,848	2,589
Dividend Income	928	2,828
Miscellaneous Revenue	<u>60,121</u>	<u>34,182</u>
Total Public Support, Fees, and Other Revenue	\$ 2,168,686	\$ 2,062,142
 <u>EXPENSES</u>		
Program Services:		
Chemical Dependency	\$ 441,551	\$ 389,597
Mental Health	855,661	809,174
Substance Abuse Prevention	97,332	127,126
Community Based Services	269,946	257,501
Residential	<u>336,017</u>	<u>340,090</u>
Total Program Services	\$ 2,000,507	\$ 1,923,488
Supporting Services:		
Management and General	<u>309,945</u>	<u>279,674</u>
Total Expenses	\$ 2,310,452	\$ 2,203,162
(Decrease) in Net Assets	\$(141,766)	\$(141,020)
Net Assets at Beginning of Year	<u>488,101</u>	<u>629,121</u>
Net Assets at End of Year	\$ <u>346,335</u>	\$ <u>488,101</u>

See Accompanying Notes to Financial Statements

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

STATEMENT OF FUNCTIONAL EXPENSES

FOR THE YEAR ENDED JUNE 30, 2006

	<u>Rehabilitation Program Services</u>			
	<u>Chemical Dependency</u>	<u>Mental Health</u>	<u>Substance Abuse Prevention</u>	<u>Community Based Services</u>
<u>SALARIES AND BENEFITS</u>				
Salaries	\$ 244,214	\$ 421,606	\$ 60,641	\$ 186,700
Payroll Taxes and Insurance	25,358	43,371	6,377	18,372
Group Benefits	20,231	29,873	8,486	21,593
Retirement Benefits	7,540	8,469	2,927	6,786
Medical Services	<u>3,331</u>	<u>130,719</u>	<u> </u>	<u> </u>
 Total Salaries and Benefits	 \$ 300,674	 \$ 634,038	 \$ 78,431	 \$ 233,451
<u>OTHER EXPENSES</u>				
Professional Fees	\$ 3,408	\$ 4,707	\$ 642	\$ 1,275
Contract Service Payments .	1,769	10,172	895	1,616
Office Supplies and Expenses	7,621	13,858	1,589	4,999
Medical Supplies and Other Costs	1,396	2,816	2,513	303
Food Supplies	3,518	4,850	484	5,708
Telephone	1,571	2,673	443	873
Postage and Shipping	5,810	10,829	2,792	5,403
Space Rent	3,925	7,566	2,058	3,700
Building and Grounds	1,062	2,049	549	982
Utilities	2,255	12,148	718	1,962
Property and Liability Insurance	3,226	4,171	2,998	4,175
Mileage	1,042	20,834	419	418
Staff Development, Training and Recruitment	57	39	23	
Meetings and Conferences .	84	178	12	29
Subscriptions and Publications	894	485	230	
Membership Dues	4,696	10,180	2,180	4,390
Equipment Rent	934	1,058	248	408
Public Relations	371	768	108	254
Bank Fees	97,162	112,242		
Bad Debts	<u>76</u>	<u> </u>	<u> </u>	<u> </u>
Miscellaneous	 Total Other Expenses	 \$ 140,877	 \$ 221,623	 \$ 18,901
	 Total Expenses ...	 \$ 441,551	 \$ 855,661	 \$ 269,946

<u>Residential Program</u>	<u>Supporting Services Management and General</u>	<u>Total Expenses</u>
\$ 249,205	\$ 202,196	\$ 1,364,562
24,512	17,477	135,467
22,878	12,916	115,977
4,836	8,275	38,833
<u>116</u>	<u>25</u>	<u>134,191</u>
\$ 301,547	\$ 240,889	\$ 1,789,030
\$ 1,776	\$ 2,865	\$ 14,673
262	3,391	18,105
1,121	12,180	41,368
1,841	78	8,947
11,825		11,825
4,186	2,503	21,249
425	1,542	7,527
3,553	10,016	38,403
837	7,310	25,396
108	1,856	6,606
1,789	7,760	26,632
4,843	1,519	20,932
226	3,565	26,504
	406	525
48	327	678
	390	1,999
1,004	5,933	28,383
249	7,084	9,981
358	40	1,899
		209,404
<u>19</u>	<u>291</u>	<u>386</u>
\$ <u>34,470</u>	\$ <u>69,056</u>	\$ <u>521,422</u>
\$ <u>336,017</u>	\$ <u>309,945</u>	\$ <u>2,310,452</u>

See Accompanying Notes to Financial Statements

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

STATEMENT OF FUNCTIONAL EXPENSES

FOR THE YEAR ENDED JUNE 30, 2005

	<u>Rehabilitation Program Services</u>			
	<u>Chemical Dependency</u>	<u>Mental Health</u>	<u>Substance Abuse Prevention</u>	<u>Community Based Services</u>
<u>SALARIES AND BENEFITS</u>				
Salaries	\$ 248,457	\$ 401,380	\$ 84,204	\$ 178,546
Payroll Taxes and Insurance	22,642	34,808	8,422	17,086
Group Benefits	18,988	32,427	10,855	19,731
Retirement Benefits	8,116	11,649	4,158	7,112
Medical Services	<u>4,474</u>	<u>205,655</u>	<u>6</u>	<u>20</u>
 Total Salaries and Benefits	 \$ 302,677	 \$ 685,919	 \$ 107,645	 \$ 222,495
<u>OTHER EXPENSES</u>				
Professional Fees	\$ 4,426	\$ 3,586	\$ 313	\$ 968
Contract Service Payments .	1,470	11,557	406	1,000
Office Supplies and Expenses	9,082	14,482	1,437	3,293
Medical Supplies and Other Costs	693	1,292	1,982	830
Food Supplies				
Telephone	3,289	4,630	619	5,982
Postage and Shipping	971	1,666	355	592
Space Rent	5,631	10,627	3,380	5,444
Building and Grounds	3,272	6,307	2,045	3,078
Utilities	918	1,793	623	882
Property and Liability Insurance	2,361	4,133	757	2,113
Mileage	1,697	1,878	3,239	4,896
Staff Development, Training and Recruitment	1,631	21,358	758	454
Meetings and Conferences .	59	63	110	11
Subscriptions and Publications	67	131		-
Membership Dues	888	393		38
Equipment Rent	4,912	10,088	2,712	4,357
Public Relations	596	635	492	379
Bank Fees	761	1,361	253	463
Bad Debts	44,146	27,202		
Miscellaneous	<u>50</u>	<u>73</u>		<u>226</u>
 Total Other Expenses	 \$ 86,920	 \$ 123,255	 \$ 19,481	 \$ 35,006
 Total Expenses ...	 \$ <u>389,597</u>	 \$ <u>809,174</u>	 \$ <u>127,126</u>	 \$ <u>257,501</u>

<u>Residential Program</u>	<u>Supporting Services Management and General</u>	<u>Total Expenses</u>
\$ 249,885	\$ 188,498	\$ 1,350,970
23,142	15,892	121,992
25,503	12,518	120,022
3,215	8,689	42,939
<u>193</u>	<u> </u>	<u>210,348</u>
\$ 301,938	\$ 225,597	\$ 1,846,271
\$ 1,083	\$ 1,527	\$ 11,903
758	1,771	16,962
3,886	10,551	42,731
1,226	10	6,033
8,547		8,547
4,651	2,744	21,915
482	955	5,021
3,589	9,755	38,426
4,824	5,663	25,189
106	1,563	5,885
2,020	6,370	17,754
4,015	1,584	17,309
609	2,554	27,364
	603	846
61	714	973
8	273	1,600
1,234	6,202	29,505
242	334	2,678
641	38	3,517
		71,348
<u>170</u>	<u>866</u>	<u>1,385</u>
\$ <u>38,152</u>	\$ <u>54,077</u>	\$ <u>356,891</u>
\$ <u>340,090</u>	\$ <u>279,674</u>	\$ <u>2,203,162</u>

See Accompanying Notes to Financial Statements

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS

	2006	2005
<u>CASH FLOWS FROM OPERATING ACTIVITIES</u>		
Cash Received from Public Support	\$ 26,170	\$ 18,617
Cash Received from Operations	1,805,316	1,988,834
Cash Paid to Employees and Suppliers	(2,059,422)	(2,112,101)
Dividend Income	928	2,828
Interest Received	1,848	2,589
Miscellaneous Receipts	<u>60,121</u>	<u>34,182</u>
Net Cash (Used) by Operating Activities	\$(<u>165,039</u>)	\$(<u>65,051</u>)
Net (Decrease) in Cash and Cash Equivalents	\$(165,039)	\$(65,051)
Cash and Cash Equivalents at Beginning of Year ...	<u>442,344</u>	<u>507,395</u>
Cash and Cash Equivalents at End of Year	\$ <u>277,305</u>	\$ <u>442,344</u>
<u>RECONCILIATION OF CHANGE IN NET ASSETS</u>		
<u>TO NET CASH (USED) BY OPERATING ACTIVITIES:</u>		
Change in Net Assets	\$(141,766)	\$(141,020)
Adjustments to Reconcile Change in Net Assets to Net Cash (Used) by Operating Activities:		
Bad Debt Expense	\$ 209,404	-
(Increase) in Accounts Receivable	(278,365)	\$(55,020)
Decrease in Accounts Receivable - Related Party	4,062	1,776
Decrease in Other Receivables	-	24,918
Decrease in Prepaid Expenses	-	13,233
(Decrease) in Accounts Payable - Trade ..	(12,511)	(27,469)
Increase in Accounts Payable - ARO Adjustment	77,169	-
Increase in Accrued Vacation Payable ..	64	5,408
Increase (Decrease) in Accrued Wages ..	(11,751)	33,132
Increase (Decrease) in Payroll Taxes Payable	(10,345)	8,643
Decrease in Related Party Payable	(<u>1,000</u>)	<u>-</u>
Total Adjustments	\$(<u>23,273</u>)	\$ <u>75,969</u>
Net Cash (Used) by Operating Activities	\$(<u>165,039</u>)	\$(<u>65,051</u>)

See Accompanying Notes to Financial Statements

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2006 AND 2005

Note 1 - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Activities

Capstone Behavioral Healthcare, Inc., a non-profit organization with offices in Newton, Pella, and Knoxville, Iowa, provides services to educate, evaluate, and treat persons who are in need of mental health care or substance abuse treatment and provides services to promote the prevention of mental illness and substance abuse.

Financial Statement Presentation

The accompanying financial statements have been prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. The Organization is required to report information regarding its financial position and activities according to three classes of net assets (unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets) based upon the existence or absence of donor-imposed restrictions. The Organization only has unrestricted net assets.

Cash and Cash Equivalents

For purposes of the statement of cash flows, the Organization considers all highly liquid debt instruments with a maturity of three months or less to be cash equivalents.

Accounts Receivable and Allowances

The Organization's receivables are trade receivables due primarily from government agencies and Medicaid payors. The receivables are uncollateralized and are due in normal 30 to 60 day billing cycles. No interest or finance charges are collected on trade receivables. Management has included allowances for doubtful accounts and managed care contract adjustments in the calculation of the allowance. The allowance account is maintained at a balance which, in the opinion of management, is adequate to reflect accounts receivable at their net realizable value.

Net Patient Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered. Charity care is provided on a sliding fee scale based on the patient's financial need.

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2006 AND 2005

Note 1 - ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
(Cont.)

Tax Status

Capstone Behavioral Healthcare, Inc. has been granted tax-exempt status under Section 501(C)(3) of the Internal Revenue Code. The Organization is exempt from the payment of Federal and state income taxes, as well as Federal unemployment taxes. The State of Iowa has determined that the Organization is exempt from Iowa corporate income tax and Iowa sales and use taxes.

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 certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

Note 2 - RELATED PARTIES

Capstone Community Foundation is a separate non-profit corporation. It leases property and equipment and contributes funding to the Organization. Following, is a summary of transaction balances at June 30, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Contributions from Capstone Community Foundation	\$ <u>26,170</u>	\$ <u>18,617</u>
Rents Paid for Property and Equipment	\$ <u>51,646</u>	\$ <u>53,117</u>
Payable to Capstone Community Foundation	<u> </u>	\$ <u>1,000</u>

Beacon Housing Corporation, a separate non-profit corporation, was incorporated November 12, 1991. It provides residential housing for individuals with disabilities through a HUD program. The two corporations are related by some common officers and trustees and operate toward a common cause. However, the members do not comprise a majority of either non-profit's board. Following is a summary of transaction balances at June 30, 2006 and 2005:

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2006 AND 2005

Note 2 - RELATED PARTIES
(Cont.)

	<u>2006</u>	<u>2005</u>
Management Fee Receivable from Beacon Housing Corporation	-	\$ <u>4,062</u>
Management Fee Revenue from Beacon Housing Corporation	\$ <u>6,405</u>	\$ <u>6,369</u>
Rents Paid to Beacon Housing Corporation	\$ <u>3,000</u>	\$ <u>3,000</u>

Management fee income is included in Miscellaneous Revenue on the Statements of Activities.

Note 3 - LEASES

Capstone Behavioral Healthcare, Inc. leases certain property and equipment from Capstone Community Foundation for use in its operations. The leases are classified as operating leases and have one-year terms renewable at the end of each year. The annual lease rate is based on Capstone Community Foundation's actual costs. During the year ended June 30, 2005, several of these leases should have been classified as capital leases. Generally accepted accounting principles require that long-term leases, containing minimum lease payments at the beginning of the lease term with a present value of 90% or more of the fair market value of the leased equipment, are more accurately stated as capital leases. The effect of this departure on the Capstone's Behavioral Healthcare, Inc.'s financial position and changes in net assets has not been determined.

The Organization also leases an apartment from Beacon Housing Corporation (a related party) for use as an office, the lease is renewed annually. The Organization also has leases which are properly classified as operating leases for office space and equipment with unrelated third parties.

Lease expense amounted to \$66,786 and \$67,931 at June 30, 2006 and 2005, respectively. These amounts are included in the statements of functional expenses in space rent and equipment rent.

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

NOTES TO FINANCIAL STATEMENTS

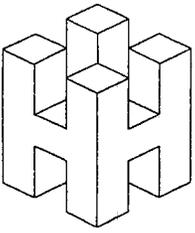
JUNE 30, 2006 AND 2005

Note 4 - OFF-BALANCE SHEET RISK

At June 30, 2006 and 2005, and at times during the years, the Organization had total bank balances greater than \$100,000 per bank. The banks have FDIC insurance that insures depositor's accounts up to \$100,000. The Organization has exposure on any amount that exceeds \$100,000, should any of these financial institutions fail.

Note 5 - ECONOMIC DEPENDENCY

The Organization receives substantially all of its revenue from contracts with Jasper and Marion Counties. The Organization's ability to continue operating in the absence of those contracts has not been determined



HENJES, CONNER &
WILLIAMS, P.C.

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To the Board of Directors and
Executive Director
Capstone Behavioral Healthcare, Inc.
Newton, Iowa

In planning and performing our audit of the financial statements of CAPSTONE BEHAVIORAL HEALTHCARE, INC. for the years ended June 30, 2006 and 2005, we considered its internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control. However, we noted certain matters involving internal control and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect Capstone Behavioral Healthcare, Inc.'s ability to initiate, record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of internal control would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we noted the following reportable condition that we believe to be a material weakness.

To the Board of Directors and
Executive Director
Capstone Behavioral Healthcare, Inc.

1. The accounting system currently in use by the Organization is not designed to record expenses under the accrual method of accounting. Under the accrual method of accounting, expenses should be recorded in the period during which the expense is incurred. Generally accepted accounting principles hold that the matching of income and expense items provides the most accurate accounting of the organization's activities.

This material weakness was considered in determining the nature, timing, and extent of the audit tests applied in our audits of the June 30, 2006 and 2005 financial statements, and this report does not affect our report on those financial statements dated July 28, 2006. We have not considered internal control since the date of our report.

This report is intended solely for the information and use of the Board of Directors, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

Henjes, Conner, + Williams, PC

Certified Public Accountants

Sioux City, Iowa
July 28, 2006