CAPSTONE BEHAVIORAL HEALTHCARE, INC.

INDEPENDENT AUDITORS' REPORT

JUNE 30, 2008 AND 2007

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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. (a nonprofit organization) as of June 30, 2008 and 2007, 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Capstone Behavioral Healthcare, Inc. as of June 30, 2008 and 2007, 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.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 7 to the financial statements, the Company has suffered recurring losses from operations and has a net assets deficit that raises substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 7. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information on page 14 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Henjes, Conner, & Williams, PC
Certified Public Accountants

Sioux City, Iowa
October 3, 2008

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

STATEMENTS OF FINANCIAL POSITION

JUNE 30, 2008 AND 2007

ASSETS

	2008	2007
CURRENT ASSETS		
Cash and Cash Equivalents	$ 37,986	$ 109,201
Accounts Receivable - Trade (Net of Allowances of $257,780 and $300,056, for 2008 and 2007 Respectively)	268,450	290,958
Accounts Receivable - Related Party - Note 2	-	886
Prepaid Expenses	7,518	400
Total Current Assets	$ 313,954	$ 401,445
Total Assets	$ 313,954	$ 401,445

LIABILITIES AND NET ASSETS

CURRENT LIABILITIES		
Accounts Payable - Trade	$ 71,470	$ 12,633
Accounts Payable - Adult Rehab Option Adjustment	-	16,162
Accounts Payable - Related Party - Note 2	351	-
Accrued Vacation Payable	56,287	50,248
Accrued Wages	59,643	43,314
Payroll Taxes Payable	-	630
Other Payable	-	6,168
Total Current Liabilities	$ 187,751	$ 129,155
LONG-TERM LIABILITIES		
Due to Related Party - Note 2	376,244	195,000
Total Liabilities	$ 563,995	$ 324,155
NET ASSETS		
Unrestricted	(250,041)	77,290
Total Liabilities and Net Assets	$ 313,954	$ 401,445

See Accompanying Notes to Financial Statements

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

STATEMENTS OF ACTIVITIES

FOR THE YEARS ENDED JUNE 30, 2008 AND 2007

PUBLIC SUPPORT, FEES, AND OTHER REVENUE	2008 Unrestricted	2007 Unrestricted
Public Support:		
Capstone Community Foundation - Note 2	$ 1,257	$ 9,321
Fees from Governmental Agencies:		
County Revenue:		
Substance Abuse Prevention	40,000	-
Chemical Dependency	32,092	23,252
Mental Health	136,328	228,695
Community Based Services	89,064	98,924
Residential	53,750	52,063
Contracted Support Service	-	2,771
Adult Rehab Option Revenue	391,172	339,017
Iowa Department of Public Health	323,009	389,079
Community Support Program - Adult	7,237	16,273
Community Support Program - Children	5,270	16,566
School Contracts	-	42,467
Patient Fees	1,027,680	1,150,409
Adjustment for Managed Care and Charity Care ..	(304,988)	(353,466)
Other Revenue:		
Miscellaneous Revenue	54,543	46,462
Total Public Support, Fees, and Other Revenue	$ 1,856,414	$ 2,061,833
EXPENSES		
Program Services:		
Chemical Dependency	$ 402,658	$ 460,096
Mental Health	836,453	876,083
Substance Abuse Prevention	95,450	101,756
Community Based Services	239,759	263,227
Residential	315,740	312,776
Total Program Services	$ 1,890,060	$ 2,013,938
Supporting Services:		
Management and General	293,685	316,940
Total Expenses	$ 2,183,745	$ 2,330,878
(Decrease) in Net Assets	$(327,331)	$(269,045)
Net Assets at Beginning of Year	77,290	346,335
Net Assets at End of Year	$(250,041)	$ 77,290

See Accompanying Notes to Financial Statements

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

STATEMENT OF FUNCTIONAL EXPENSES

FOR THE YEAR ENDED JUNE 30, 2008

	Rehabilitation Program Services			
	Chemical Dependency	Mental Health	Substance Abuse Prevention	Community Based Services
SALARIES AND BENEFITS				
Salaries	$ 252,648	$ 588,841	$ 65,372	$ 166,981
Payroll Taxes and Insurance	24,860	55,637	6,271	16,108
Group Benefits	17,619	37,587	7,221	15,526
Retirement Benefits	6,699	11,786	3,105	4,556
Medical Services	9,416	47	-	7
Total Salaries and Benefits	$ 311,242	$ 693,898	$ 81,969	$ 203,178
OTHER EXPENSES				
Professional Fees	$ 2,386	$ 3,735	$ 417	$ 1,114
Contract Service Payments	4,680	17,405	557	1,953
Office Supplies and Expenses	6,381	10,653	587	3,889
Medical Supplies and Other Costs	796	1,354	3,087	(77)
Food Supplies				
Telephone	3,739	5,494	402	5,537
Postage and Shipping	1,231	2,218	271	698
Space Rent - Note 3	7,258	12,973	1,888	4,920
Building and Grounds	4,548	7,389	878	3,507
Utilities	1,162	2,308	330	840
Property and Liability Insurance	2,685	7,417	695	1,856
Mileage	2,297	5,209	2,936	5,689
Staff Development, Training and Recruitment	1,361	7,292	290	2,333
Meetings and Conferences	13		16	
Subscriptions and Publications	105	120		
Membership Dues	1,350	387	100	38
Equipment Rent - Note 3	5,956	9,752	1,027	4,222
Public Relations	448	582		49
Bank Fees	5	5		
Bad Debts	44,719	47,964		
Miscellaneous	296	298		13
Total Other Expenses	$ 91,416	$ 142,555	$ 13,481	$ 36,581
Total Expenses	$ 402,658	$ 836,453	$ 95,450	$ 239,759

Residential Program	Supporting Services Management and General	Total Expenses
$ 222,311	$ 190,906	$ 1,487,059
22,376	26,115	151,367
16,965	18,757	113,675
6,184	8,595	40,925
82		9,552
$ 267,918	$ 244,373	$ 1,802,578
$ 1,260	$ 1,425	$ 10,337
2,001	4,109	30,705
2,537	2,764	26,811
1,166	40	6,366
12,218		12,218
4,959	2,208	22,339
587	867	5,872
7,932	6,366	41,337
1,948	3,269	21,539
823	959	6,422
2,083	6,109	20,845
5,312	2,474	23,917
1,686	8,800	21,762
	772	801
	116	341
38	30	1,943
3,272	3,647	27,876
	2,947	4,026
	31	41
		92,683
	2,379	2,986
$ 47,822	$ 49,312	$ 381,167
$ 315,740	$ 293,685	$ 2,183,745

See Accompanying Notes to Financial Statements

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

STATEMENT OF FUNCTIONAL EXPENSES

FOR THE YEAR ENDED JUNE 30, 2007

	Rehabilitation Program Services			
	Chemical Dependency	Mental Health	Substance Abuse Prevention	Community Based Services
SALARIES AND BENEFITS				
Salaries	$ 281,085	$ 551,255	$ 63,550	$ 175,886
Payroll Taxes and Insurance	27,728	40,274	6,798	18,517
Group Benefits	24,370	29,578	10,034	22,953
Retirement Benefits	8,271	16,933	3,252	4,951
Medical Services	2,854	151		35
Total Salaries and Benefits	$ 344,308	$ 638,191	$ 83,634	$ 222,342
OTHER EXPENSES				
Professional Fees	$ 4,280	$ 4,902	$ 412	$ 1,014
Contract Service Payments	4,469	10,189	1,261	2,604
Office Supplies and Expenses	7,870	11,575	1,278	4,401
Medical Supplies and Other Costs	1,268	597	2,650	903
Food Supplies				
Telephone	4,098	5,797	575	6,538
Postage and Shipping	1,543	2,472	499	971
Space Rent - Note 3	6,509	10,348	2,792	5,502
Building and Grounds	3,625	5,950	1,515	2,821
Utilities	1,205	1,978	541	1,000
Property and Liability Insurance	1,908	5,729	730	2,001
Mileage	3,327	3,926	2,723	5,602
Staff Development, Training and Recruitment	6,401	6,589	385	1,393
Meetings and Conferences	26	3	15	3
Subscriptions and Publications	44	185	9	17
Membership Dues	777	3,799	284	183
Equipment Rent - Note 3	6,506	11,499	2,268	5,228
Public Relations	989	1,412	181	695
Bank Fees	17	28	4	9
Bad Debts	60,662	150,944		
Miscellaneous	264	(30)		
Total Other Expenses	$ 115,788	$ 237,892	$ 18,122	$ 40,885
Total Expenses	$ 460,096	$ 876,083	$ 101,756	$ 263,227

Residential Program	Supporting Services Management and General	Total Expenses
$ 226,507	$ 209,691	$ 1,507,974
21,184	17,976	132,477
21,472	18,265	126,672
5,278	9,221	47,906
161	2	3,203
$ 274,602	$ 255,155	$ 1,818,232
$ 1,383	$ 1,168	$ 13,159
533	4,132	23,188
931	9,810	35,865
1,838	126	7,382
11,689		11,689
4,122	3,150	24,280
92	1,660	7,237
4,012	9,293	38,456
623	5,952	20,486
156	1,760	6,640
1,867	7,571	19,806
5,398	1,911	22,887
1,200	1,253	17,221
22	811	880
66	465	786
96	550	5,689
2,411	6,695	34,607
500	3,553	7,330
12	29	99
		211,606
1,223	1,896	3,353
$ 38,174	$ 61,785	$ 512,646
$ 312,776	$ 316,940	$ 2,330,878

See Accompanying Notes to Financial Statements

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED JUNE 30, 2008 AND 2007

INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash Received from Public Support	$ 1,257	$ 9,321
Cash Received from Operations	1,708,045	1,683,471
Cash Paid to Employees and Suppliers	(2,016,304)	(2,102,358)
Miscellaneous Receipts	54,543	46,462
Net Cash (Used) by Operating Activities	$(252,459)	$(363,104)
CASH FLOWS FROM FINANCING ACTIVITIES		
Increase in Due to Related Party	$ 181,244	$ 195,000
Net Cash Provided by Financing Activities	$ 181,244	$ 195,000
Net (Decrease) in Cash and Cash Equivalents	$(71,215)	$(168,104)
Cash and Cash Equivalents at Beginning of Year	109,201	277,305
Cash and Cash Equivalents at End of Year	$ 37,986	$ 109,201
RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH (USED) BY OPERATING ACTIVITIES:		
Change in Net Assets	$(327,331)	$(269,045)
Adjustments to Reconcile Change in Net Assets to Net Cash (Used) by Operating Activities:		
Bad Debt Expense	$ 92,683	$ 211,606
(Increase) in Accounts Receivable	(70,175)	(244,124)
(Increase) Decrease in Accounts Receivable - Related Party	886	(886)
(Increase) in Prepaid Expenses	(7,118)	(400)
Increase in Accounts Payable - Trade	58,837	9,487
(Decrease) in Accounts Payable - Adult Rehab Option Adjustment	(16,162)	(61,007)
Increase in Accounts Payable - Related Party	351	-
Increase in Accrued Vacation Payable	6,039	1,516
Increase (Decrease) in Accrued Wages	16,329	(17,049)
Increase (Decrease) in Payroll Taxes Payable	(630)	630
Increase (Decrease) in Other Payable	(6,168)	6,168
Total Adjustments	$ 74,872	$(94,059)
Net Cash (Used) by Operating Activities	$(252,459)	$(363,104)

See Accompanying Notes to Financial Statements

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 individuals, 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.

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

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, 2008 and 2007:

	2008	2007
Contributions from Capstone Community Foundation	$ 1,257	$ 9,321
Rents Paid for Property and Equipment	$ 49,281	$ 56,860
Due to Capstone Community Foundation..	$ 376,244	$ 195,000

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, 2008 and 2007:

Note 2 - RELATED PARTIES
(Cont.)

	2008	2007
Management Fee Receivable from Beacon Housing Corporation	-	$ 886
Payable to Beacon Housing Corporation.	$ 351	-
Management Fee Revenue from Beacon Housing Corporation	$ 6,171	$ 6,805
Rents Paid to Beacon Housing Corporation	$ 4,200	$ 3,500

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.

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 $69,213 and $73,063 at June 30, 2008 and 2007, respectively. These amounts are included in the statements of functional expenses in space rent and equipment rent.

Note 4 - OFF-BALANCE SHEET RISK

At June 30, 2007, and at times during the years ended June 30, 2008 and 2007, 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 and the Iowa Department of Public Health. The Organization's ability to continue operating in the absence of those contracts has not been determined.

The Organization has received substantial operating loan advances from the Capstone Community Foundation, a related party, during the years ended June 30, 2007 and 2008. The Organization's ability to continue operating in the absence of these advances, or potential future advances, have not been determined.

Note 6 - RETIREMENT PLAN

The Organization established a 403(B) Plan for all full-time employees. The Organization matches 100% of the first 5% of salary deferred by the participant. The Organization contributed $40,925 and $47,906 to the Plan in the years ended June 30, 2008 and 2007, respectively.

Note 7 - GOING CONCERN

As shown in the accompanying financial statements, the Organization has incurred recurring losses from operations and as of June 30, 2008, the Organization's total liabilities exceeded its total assets by $250,041. These factors raise substantial doubt about the Organization's ability to continue as a going concern. Management has instituted a cost reduction program which included a reduction in labor and fringe costs. In addition, the Organization has made changes to its staffing policies and has instituted more efficient management techniques. Management believes these factors will contribute towards achieving profitability. The financial statements do not include any adjustments that might be necessary if the Organization is unable to continue as a going concern.

SUPPLEMENTARY INFORMATION

CAPSTONE BEHAVIORAL HEALTHCARE, INC.

SCHEDULE I - ANALYSIS OF COUNTY REVENUE

FOR THE YEAR ENDED JUNE 30, 2008

	Jasper County	Marion County	Other Counties	Total
Substance Abuse Prevention	$ 40,000			$ 40,000
Chemical Dependency		$ 32,092		32,092
Mental Health	82,375	53,953		136,328
Community Based Services	53,480	26,490	$ 9,094	89,064
Residential	34,824	2,098	16,828	53,750
Total County Revenue	$ 210,679	$ 114,633	$ 25,922	$ 351,234

FOR THE YEAR ENDED JUNE 30, 2007

	Jasper County	Marion County	Other Counties	Total
Chemical Dependency		$ 23,252		$ 23,252
Mental Health	$ 193,812	34,883		228,695
Community Based Services	78,760	13,224	$ 6,940	98,924
Residential	31,895		20,168	52,063
Contracted Support Service		2,771		2,771
Total County Revenue	$ 304,467	$ 74,130	$ 27,108	$ 405,705

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

In planning and performing our audit of the financial statements of CAPSTONE BEHAVIORAL HEALTHCARE, INC. as of and for the years ended June 30, 2008 and 2007, in accordance with auditing standards generally accepted in the United States of America, we considered Capstone Behavioral Healthcare, Inc.'s internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Organization's internal control. Accordingly, we do not express an opinion on the effectiveness of the Organization's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or a combination of control deficiencies, that adversely affects the organization's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the organization's financial statements that is more than inconsequential will not be prevented or detected by the organization's internal control. We consider the following deficiencies to be significant deficiencies in internal control.

1. The accounts receivable balance consisted of duplicated revenue due to the method of applying a grant subsidy (125+ accounts with combined balances in excess of $74,000), credit balances outstanding for extended periods (180+ accounts with combined balances in excess of $16,500), outstanding balances needing to be written off, and multiple errors in billing rate and units, superbills, CBS reports and group sign-in sheets.

This communication is intended solely for the information and use of management, the Board of Directors, 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, P.C.
Certified Public Accountants

Sioux City, Iowa
October 3, 2008

ML08