



**HARRIS COUNTY HOSPITAL DISTRICT,
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

Financial Statements

February 29, 2012

(With Independent Auditors' Report Thereon)

**HARRIS COUNTY HOSPITAL DISTRICT,
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

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KPMG LLP
811 Main Street
Houston, TX 77002

Independent Auditors' Report

The Board of Managers
Harris County Hospital District:

We have audited the accompanying balance sheet of the business-type activities and aggregate discretely presented component units of Harris County Hospital District (the District), a component unit of Harris County, Texas, as of February 29, 2012, and the related statements of revenues, expenses, and changes in net assets and cash flows for the year then ended, which collectively comprise the District's basic financial statements. These financial statements are the responsibility of the District's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of the Harris County Hospital District Foundation, a discretely presented component unit, which represent 17.7%, 25.7%, and 3.6% of the 2012 assets, net assets, and revenues of the aggregate discretely presented component units, respectively. Those financial statements were audited by other auditors whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for the Harris County Hospital District Foundation, is based solely on the report of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. 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 District'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 audit provides a reasonable basis for our opinion.

In our opinion, based on our audit, and the report of the other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the business-type activities and the aggregate discretely presented component units of Harris County Hospital District, as of February 29, 2012, and the respective changes in net assets and cash flows thereof for the year then ended, in conformity with U.S. generally accepted accounting principles.

As described in note 2(c), in 2012, the District adopted Governmental Accounting Standards Board (GASB) Statement No. 61, *The Financial Reporting Entity: Omnibus—An Amendment of GASB Statements No. 14 and 34*.

In accordance with *Government Auditing Standards*, we have also issued our report dated June 15, 2012 on our consideration of the District's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting



and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

U.S. generally accepted accounting principles require that management's discussion and analysis on pages 3 through 10 and the supplementary schedules on pages 43 through 45 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

KPMG LLP

June 15, 2012

**HARRIS COUNTY HOSPITAL DISTRICT,
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

Management's Discussion and Analysis

February 29, 2012

(Unaudited)

This section of the Harris County Hospital District's (the District) financial report presents background information and management's analysis of the District's financial results for the fiscal year ended February 29, 2012. This section should be read in conjunction with the District's financial statements, which begin on page 11.

Financial Highlights

- The District's net assets increased \$7 million or 0.9% in fiscal 2012 given the change in net assets reported for the year. Between fiscal 2010 and 2011, net assets decreased \$12 million or 1.5% as a result of the net loss reported for the year.
- Total assets increased \$40 million, or 3.0%, between fiscal 2011 and fiscal 2012. Total assets increased \$30 million, or 2.3%, between fiscal 2010 and fiscal 2011.
- Long-term debt, including current portion, decreased \$3 million, or 1.1%, between fiscal 2011 and fiscal 2012 and decreased \$17 million or 5.7% between fiscal 2010 and fiscal 2011. In August 2010, the Series 2007B variable rate bonds in the amount of \$103,525,000 were refunded by Series 2010 as tax-exempt variable rate bonds hedged by an interest rate swap effective August 16, 2010.
- Community Health Choice, Inc. experienced a 14.6% growth in membership during fiscal 2012, and 15% in fiscal 2011.
- The District experienced a 2.9% decline in the number of unduplicated patients served in fiscal 2012. Services provided on an inpatient basis decreased 4.9%, while emergency care/urgent visits decreased 2.9%. Community health center and specialty clinic visits, and other outpatient diagnostic visits increased 4.1% and 9.5%, respectively. In fiscal 2011, the District experienced a 3.7% growth in the number of unduplicated patients served. Services provided on an inpatient basis decreased 7.2% while emergency care/urgent care visits, community health center visits, and other outpatient diagnostic visits increased 5.2%, 0.6%, and 7.8%, respectively.
- The District continued its focus on access to cost effective surgical services by increasing outpatient surgery schedules in fiscal 2012. Total surgeries increased 0.6%. Outpatient cases increased 8.9% and at the same time, inpatient surgeries declined 5.5% reflecting a continuing shift from inpatient to outpatient care and delivery of care in a more cost effective manner that reduced inpatient cost and length of stay.
- During fiscal 2012, the District invested \$89 million in space/facility expansion projects, critical information technology, and medical equipment. Significant capital acquisitions and resource investments included the following:

Information Technology including a managed care claims system and remote portal and Web redesigns

Expansion of outpatient ancillary services including:

- Three outlying pediatric clinic campuses
- Radiation and diagnostic clinic tower scheduled to open in late summer 2012, at the administrative campus, and

**HARRIS COUNTY HOSPITAL DISTRICT,
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Management's Discussion and Analysis

February 29, 2012

(Unaudited)

- LBJ emergency center and specialty expansion
- The District Foundation's multiyear Capital Campaign has raised more than \$23 million in gifts and commitments.
- In fiscal 2011, the District invested \$79 million in critical projects including:
 - Information Technology including electronic order entry systems and remote portal and Web redesigns
 - Expansion of outpatient ancillary services including:
 - Parking garage located at the administrative campus
 - Initial construction of the outpatient tower for radiation and diagnostic clinics at the administrative campus, and
 - Expansion of the LBJ emergency center

Financial Statements

The District's financial statements are prepared on the accrual basis of accounting and present the District's operational activities in a manner similar to that of private sector companies. The financial statements consist of three statements: (1) balance sheet, (2) statement of revenues, expenses, and changes in net assets, and (3) statement of cash flow. The statements provide information about the activities of the District, the HCHD Foundation (the Foundation) and Community Health Choice, Inc. (the HMO). The balance sheet and the statement of revenues, expenses, and changes in net assets reflect the District's financial position at the end of the fiscal year and report the District's net assets and changes in them as a result of the District's revenues and expenses for the year. The term "net assets" represents the difference between assets, or the District's investment in resources, and liabilities, or the District's obligation to its creditors. Increases or decreases in net assets are an indicator of whether financial health is improving or deteriorating. Other nonfinancial factors should be considered, however, in evaluating financial health, such as changes in the District's patient base, changes in economic conditions, taxable property values and tax rates, and changes in government legislation. The statement of cash flows reports cash receipts, cash payments, and net changes in cash resulting from operations, investing, and noncapital/capital financing activities. The statement explains where cash came from, how it was used, and the change in cash balance during the year.

**HARRIS COUNTY HOSPITAL DISTRICT,
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Management's Discussion and Analysis

February 29, 2012

(Unaudited)

Net Assets

Table 1

Condensed Summary of Assets and Liabilities

(In millions)

	<u>2012</u>	<u>2011</u>	<u>Dollar change</u>	<u>Total percentage change</u>	<u>2010</u>	<u>Dollar change</u>	<u>Total percentage change</u>
Current and other assets	\$ 1,000	1,002	(2)	(0.2)%	\$ 1,007	(5)	(0.5)%
Capital assets	360	318	42	13.2	283	35	12.4
Total assets	<u>\$ 1,360</u>	<u>1,320</u>	<u>40</u>	<u>3.0%</u>	<u>\$ 1,290</u>	<u>30</u>	<u>2.3%</u>
Long-term debt outstanding	\$ 280	283	(3)	(1.1)%	\$ 300	(17)	(5.7)%
Other liabilities	304	268	36	13.4	209	59	28.2
Total liabilities	<u>\$ 584</u>	<u>551</u>	<u>33</u>	<u>6.0%</u>	<u>\$ 509</u>	<u>42</u>	<u>8.3%</u>
Invested in capital assets, net of related debt	\$ 99	103	(4)	(3.9)%	\$ 107	(4)	(3.7)%
Restricted net assets	27	31	(4)	(12.9)	23	8	34.8
Unrestricted net assets	650	635	15	2.4	651	(16)	(2.5)
Total net assets	<u>\$ 776</u>	<u>769</u>	<u>7</u>	<u>0.9%</u>	<u>\$ 781</u>	<u>(12)</u>	<u>(1.5)%</u>

Net assets, the difference between the assets and liabilities reported on the balance sheet, increased \$7 million in fiscal 2012. The overall increase is the result of the income reported for fiscal 2012. In fiscal 2011, net assets decreased \$12 million as a result of the loss reported for the year. The net gain/loss reported for fiscal 2012 and 2011 is discussed in detail following Table 2. Current and other assets decreased \$2 million or 0.2 % from fiscal 2011 to fiscal 2012, and decreased \$5 million or 0.5% in fiscal 2011. The fiscal years' increase and decrease is primarily related to funding estimates as of February 29, 2012 and February 28, 2011 due to the District under the DSH/UPL/1115 Waiver programs. The growth in capital assets is discussed in detail following Table 3.

In fiscal 2012 and fiscal 2011, reductions in bond-related debt reflect scheduled debt service payments. The District's net obligation for the provision of certain post-employment healthcare benefits increased approximately \$36 million during fiscal 2012 and \$36 million during fiscal 2011.

At February 28, 2010, the District recorded a \$44.2 million receivable related to the DSH/UPL programs. Related funds received in fiscal 2011 were less than estimates by \$8.9 million. As of February 28, 2011, the District received funds totaling \$66.1 million related to the state of Texas 2011 DSH/UPL programs. The District recorded a \$16.4 million receivable at February 28, 2011, related to the DSH and UPL programs. Related funding received in fiscal 2012 exceeded estimates by \$2.5 million.

In December of 2011, Texas received federal approval to redirect the funding it would have received over the next five years into a new reform plan (1115 Waiver). The District had recorded receivables of \$96.4 million at February 29, 2012 related to the DSH and 1115 Waiver programs.

**HARRIS COUNTY HOSPITAL DISTRICT,
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Management's Discussion and Analysis

February 29, 2012

(Unaudited)

Summary of Revenues, Expenses, and Changes in Net Assets

The following table summarizes the District's revenues and expenses for each of the years ended February 29, 2012 and February 28, 2011 and 2010, and the changes in net assets during each of those years:

Table 2
Condensed Summary of Revenues, Expenses, and Changes in Net Assets

(In thousands)

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Operating revenues:			
Net patient service revenue	\$ 308,624	290,309	272,362
DSH/UPL/1115 Waiver programs revenue	224,322	184,849	184,671
Other operating revenues	26,004	28,920	33,985
Total operating revenues	<u>558,950</u>	<u>504,078</u>	<u>491,018</u>
Operating expenses:			
Salaries, wages, and benefits	629,836	616,324	614,009
Purchased services, supplies, and other	401,632	368,287	376,193
Depreciation and amortization	47,064	42,624	39,831
Total operating expenses	<u>1,078,532</u>	<u>1,027,235</u>	<u>1,030,033</u>
Operating loss	<u>(519,582)</u>	<u>(523,157)</u>	<u>(539,015)</u>
Nonoperating revenues:			
Ad valorem tax revenues – net	511,593	504,496	528,613
Tobacco settlement revenues	10,753	11,153	22,613
Investment income	10,653	4,315	9,669
Other	1,435	(38)	13
Total nonoperating revenues	<u>534,434</u>	<u>519,926</u>	<u>560,908</u>
Nonoperating expenses:			
Deferred outflows – derivative financial instrument	—	(1,316)	—
Interest expense	(7,817)	(7,249)	(7,269)
Other	(95)	(606)	(579)
Total nonoperating expenses	<u>(7,912)</u>	<u>(9,171)</u>	<u>(7,848)</u>
Change in net assets	6,940	(12,402)	14,045
Total net assets – beginning of year, as restated	<u>768,761</u>	<u>781,163</u>	<u>767,118</u>
Total net assets – end of year	<u>\$ 775,701</u>	<u>768,761</u>	<u>781,163</u>

**HARRIS COUNTY HOSPITAL DISTRICT,
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February 29, 2012

(Unaudited)

Revenues

During the year ended February 29, 2012, the District's total operating revenue increased by \$55 million or 10.9%. Operating revenues increased \$13 million or 2.7% during the year ended February 28, 2011.

- Net patient service revenue increased \$18.3 million in fiscal 2012 and \$17.9 million in fiscal year 2011 due to increased service volumes and reimbursement from third-party payors and patients.
- Estimated revenues from the DSH/UPL/1115 Waiver programs increased \$39.5 million in fiscal 2012 after being relatively flat from fiscal 2010 to fiscal 2011.
- Other operating revenues decreased \$2.9 million for fiscal 2012 and \$5.1 million for fiscal 2011, primarily due to reductions in trauma care funding each year.

Operating expenses

During the year ended February 29, 2012, total operating expenses increased \$51.3 million or 5.0%.

- District salaries and wages increased \$7.1 million or 1.6%. The compensation plan remained competitive with merit increases and an average salary increase of 0.7%. Total staffing increased 0.6% with a productivity improvement of 3.8%.
- Related benefits increased 4.0% due to employee health plan expense increases.
- Purchased medical services, supplies, and other operating expenses increased 9.1%, primarily as a result of increased service volumes.

During the year ended February 28, 2011, total operating expenses decreased \$2.8 million or 0.3%.

- District salaries and wages decreased \$5 million or 1.1%. Total staffing decreased 2.4% and with increased productivity served a 3.7% increase in individuals compared to the prior year. The compensation plan remained competitive with merit increases and an average salary increase of 1.3%. Related benefits increased \$7.3 million or 4.8%, employee healthcare costs remained flat and healthcare costs for retirees increased 23.5%. Pension expenses decreased fiscal 2010 to fiscal 2011 8.4% due to higher than expected return on investments.
- Overall, purchased services and supplies decreased \$7.9 million, or 2.1%. Physician service costs decreased \$5.1 million as compared to fiscal 2010. Physician services are primarily coordinated through the Harris County collaborative discussed in further detail in note 12 to the financial statements. The District reported an overall decrease in supplies of \$2.0 million, or 1.2%.

Overall, the District's operating loss improved 0.7% from 2011 to 2012 and 2.9% in fiscal 2011 as a result of the items discussed above. The District receives property tax revenues to subsidize the cost of services provided to qualified uninsured patients. Although the costs incurred to provide these services are reflected above as operating expenses, the property tax revenues are required to be reported as nonoperating revenues.

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Management's Discussion and Analysis

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(Unaudited)

Nonoperating revenues and expenses consist of property tax revenue, investment income, tobacco settlement funds, interest expense, gains or losses on disposal of assets, and deferred outflows related to the change in value of the interest rate swap. Tax revenues, net of related expenses, increased \$7.1 million, or 1.4%, in 2012 compared to a decrease in fiscal 2011 of \$24.1 million or 4.6%. Investment income increased \$6.3 million in fiscal 2012 vs. a decrease of \$5.3 million reported for fiscal 2011 as a result of lower investment returns. In fiscal 2012, the District received approximately \$10.8 million in tobacco settlement revenue as compared to \$11.1 million in 2011 and \$22.6 million in 2010.

Capital Assets and Debt Financing

During fiscal 2012 and 2011, the District invested \$89 million and \$79 million, respectively, in information technology, equipment, facility renovation, and land acquisition. Table 3 summarizes the changes in the District's capital assets between February 29, 2012 and February 28, 2011 and between February 28, 2011 and February 28, 2010:

Table 3

Capital Assets

(In thousands)

	<u>2012</u>	<u>2011</u>	<u>Dollar change</u>	<u>Total percentage change</u>	<u>2010</u>	<u>Dollar change</u>	<u>Total percentage change</u>
Land and improvements	\$ 37,280	36,631	649	2.0%	\$ 33,917	2,714	8.0%
Buildings and fixed equipment	406,023	391,667	14,356	4.0	322,559	69,108	21.0
Major movable equipment	273,285	260,462	12,823	5.0	242,802	17,660	7.0
Subtotal	716,588	688,760	27,828	4.0	599,278	89,482	15.0
Less accumulated depreciation	(430,578)	(398,046)	(32,532)	(8.0)	(366,089)	(31,957)	(9.0)
Construction in progress	74,366	27,522	46,844	170.0	49,720	(22,198)	(45.0)
Capital assets – net	<u>\$ 360,376</u>	<u>318,236</u>	<u>42,140</u>	<u>13.0%</u>	<u>\$ 282,909</u>	<u>35,327</u>	<u>13.0%</u>

In 2008, the District embarked on a multiyear plan with an estimated cost of \$364 million in capital projects for the expansion of existing diagnostic and treatment facilities to improve access to healthcare services. As of February 29, 2012, the estimated cost of identified projects has increased to \$390 million and approximately \$144 million has been expended for these projects. It is anticipated that additional funds of \$60 million will be expended in the upcoming year.

Annually, the District conducts an assessment of its facilities, equipment, and technology to determine the priorities for replacement, repair, and any new acquisitions. The assessment and prioritization process addresses obsolescence, new technology, building safety, and code compliance requirements. As a result, the District's capital budget for fiscal year 2013 includes an investment of \$45 million in routine capital expenditures. The capital projects include \$10 million in information technology primarily dedicated to current system upgrades and technology refresh, \$9 million specific to medical capital, and \$26 million in renovations of current facilities.

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Management's Discussion and Analysis

February 29, 2012

(Unaudited)

At February 29, 2012, the District had \$276.4 million in outstanding revenue bonds, net of any discounts, premiums, and deferred refunding losses. In October 2007, the District issued Series 2007A refunding and revenue bonds to refund \$24 million in outstanding commercial paper debt, to provide funding for expansion and renovation projects totaling \$158 million and to fund the required debt service reserve fund. In October 2007, the District also refunded and refinanced the Series 2000 revenue bonds with the issuance of Series 2007B Bonds in the amount of \$103.5 million. The bonds were initially issued as 28-day taxable auction-rate paper converting to tax exempt in August of 2010. Subsequent to the 2008 fiscal year-end, the auction-rate paper was converted to taxable fixed rate bonds. In August 2010, the District refunded and refinanced the Series 2007B Bonds by issuing Series 2010 refunding and revenue bonds in the amount of \$104,435,000. The Series 2010 Bonds financed the refunding of the 2007B Bonds and costs of issuance and are tax exempt. The Series B Bonds were hedged with a forward starting swap effective upon the tax-exempt conversion of the Bonds. In order to obtain a substantially fixed rate for the 2007B debt service requirements, a Qualified Hedge Agreement was executed between the Harris County Hospital District and Siebert Brandford Shank & Co. and the Harris County Hospital District and Bank of America. The swap became effective August 16, 2010 upon issuance of the Series 2010 Refunding Bonds. On that date, the interest rate swap was redesignated to the new debt and an off market element totaling \$17,546,000 to the swap was created. In accordance with Governmental Accounting Standards Board (GASB) Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, this off-market element is recorded as a borrowing payable and is being amortized as an adjustment to interest expense over the life of the swap agreement. The 2007B Bonds were defeased through the irrevocable deposit of sufficient funds with trustees to pay the principal and interest of such bonds through maturity. Moody's and Standard & Poor's have an underlying rating of A2/A on the District's revenue bond obligations. The debt is scheduled to be repaid in 2042. The debt is issued in the name of the Harris County Hospital District. Any issuance of debt requires the approval of the District's Board of Managers and the Harris County Commissioners' Court. Table 4 below summarizes the District's debt obligations at February 29, 2012, February 28, 2011, and February 28, 2010:

**Table 4
Long-Term Debt and Other Long-Term Obligations**

(In thousands)

	<u>2012</u>	<u>2011</u>	<u>2010</u>
Series 2007 tax-exempt revenue bonds, including premium and deferred loss on refunding	\$ 193,735	196,475	298,960
Series 2010 Revenue Bonds, including deferred loss on refunding	82,659	88,294	—
Borrowing payable – interest rate swap	16,159	17,546	—
Derivative liability	10,904	—	—
Other long – term obligations	3,928	4,185	5,253
Total long-term debt and other long-term obligations	<u>307,385</u>	<u>306,500</u>	<u>304,213</u>
Less current portion	<u>(6,553)</u>	<u>(5,825)</u>	<u>(4,785)</u>
Noncurrent portion	<u>\$ 300,832</u>	<u>300,675</u>	<u>299,428</u>

**HARRIS COUNTY HOSPITAL DISTRICT,
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

Management's Discussion and Analysis

February 29, 2012

(Unaudited)

Economic Conditions and Plan for Fiscal 2013

In planning for fiscal 2013, the primary concerns were the same as prior year – the uncertain status of the economy at both the federal and state funding levels and the uncertainty of federal healthcare reform efforts and their potential financial and operational impact on the District. Issues that need to be monitored on an ongoing basis throughout the year include the following:

- The unemployment rate, the number of uninsured and working poor, and the capacity of the District's system at both a physical plant capacity level and staffing availability level
- Routine plant and equipment needs for replacement of aged equipment, and needed repairs, maintenance, and renovation
- Current and future funding available under the DSH and 1115 Waiver programs
- Property tax funding and the valuation of properties within Harris County
- Monitoring of the expansion and renovations projects under the Strategic Capital Initiatives Plan and continued development of the long-range operating, facilities, and financial plan related to these capital initiatives
- Cost savings and efficiencies available under the Harris County collaborative and development of a regional healthcare plan under the new Texas 1115 Waiver Program
- Monitoring of District's key strategic priorities of:
 - Meeting community needs through improved access to care,
 - Providing high-quality healthcare,
 - Improving patient, physician, and employee satisfaction,
 - Hiring and retaining excellent employees, and
 - Maintaining financial strength and stability.

Contacting the District's Financial Management

This financial report is designed to provide taxpayers, creditors, and patients with a general overview of the District's finances and to demonstrate the District's accountability for funds it receives. The report is available at <https://www.hchdonline.com>. If you have questions about this report or need further financial information, contact the Harris County Hospital District, 2525 Holly Hall, Houston, Texas 77054, Attention: Michael Norby, Executive Vice President and Chief Financial Officer (Michael_Norby@hchd.tmc.edu).

**HARRIS COUNTY HOSPITAL DISTRICT
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

Balance Sheet

February 29, 2012

(In thousands)

Assets and Deferred Outflows of Resources	Hospital District	Component units	
		Foundation	Community Health Choice Inc.
Current assets:			
Cash and cash equivalents	\$ 237,266	2,326	13,009
Short-term investments (notes 5 and 6)	105,368	—	38,093
Accounts receivable – net of allowance for uncollectible accounts of \$170,840 (note 10)	82,209	—	—
Current portion of ad valorem taxes receivable – net of allowance for uncollectible taxes of \$5,158	28,216	—	—
Inventories	8,355	—	—
DSH/1115 Waiver programs receivable	96,400	—	—
Prepaid expenses and other current assets	9,431	1,199	14,591
Estimated third-party payor settlements	5,809	—	—
Due from Community Health Choice, Inc.	4,063	—	—
Current portion of assets limited as to use or restricted (notes 5 and 6)	37,847	—	—
Total current assets	614,964	3,525	65,693
Assets limited as to use or restricted – net of current portion (notes 5 and 6):			
Debt service	19,743	—	—
Capital expansion	209,157	—	—
Self-insured programs and other	136,519	22,241	—
Total assets limited as to use or restricted – net	365,419	22,241	—
Capital assets (notes 7 and 11):			
Land and improvements	37,280	—	—
Buildings and fixed equipment	406,023	—	—
Major movable equipment	273,285	—	—
Less accumulated depreciation	(430,578)	—	—
Total depreciable capital assets – net	286,010	—	—
Construction in progress	74,366	—	—
Capital assets – net	360,376	—	—
Other assets and deferred outflows of resources:			
Ad valorem taxes receivable – net of current portion and allowance for uncollectible taxes of \$51,480	1,690	—	—
Net pension asset (note 9)	2,335	—	—
Long-term investments (note 6)	—	—	115,119
Deferred bond issue costs – net of accumulated amortization of \$824	4,025	—	—
Other assets	24	13,200	—
Deferred outflow – derivative financial instrument	10,904	—	—
Total other assets and deferred outflows of resources	18,978	13,200	115,119
Total assets and deferred outflows of resources	\$ 1,359,737	38,966	180,812

**HARRIS COUNTY HOSPITAL DISTRICT
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

Balance Sheet

February 29, 2012

(In thousands)

Liabilities and Net Assets	Hospital District	Component units	
		Foundation	Community Health Choice, Inc.
Current liabilities:			
Accounts payable and accrued liabilities	\$ 52,617	39	6,826
Interest payable	605	—	—
Employee compensation and related benefit liabilities (note 11)	33,524	—	—
Post employment health benefit liability (note 9)	11,600	—	—
Compensated absences	39,480	—	—
Medical claims liability (note 2)	—	—	57,414
Due to Harris County Hospital District	—	—	3,816
Estimated third-party payor settlements	3,194	—	—
Current portion of long-term debt and capital leases (note 8)	6,553	—	—
Total current liabilities	147,573	39	68,056
Other long-term liabilities:			
Postemployment health benefit liability (note 9)	135,631	—	—
Borrowing payable (note 8)	16,159	—	—
Derivative liability	10,904	—	—
Long-term debt (note 8):			
Series 2007 revenue bonds	190,855	—	—
Series 2010 revenue bonds – net of deferred loss on refunding of \$19,221	80,764	—	—
Other long-term obligations – capital leases	2,150	—	—
Total liabilities	584,036	39	68,056
Commitments and contingencies (note 11)			
Net assets:			
Invested in capital assets – net of related debt	99,027	—	—
Restricted net assets – debt service	27,407	34,956	—
Unrestricted net assets	649,267	3,971	112,756
Total net assets	775,701	38,927	112,756
Total liabilities and net assets	\$ 1,359,737	38,966	180,812

See accompanying notes to financial statements.

**HARRIS COUNTY HOSPITAL DISTRICT
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

Statement of Revenues, Expenses, and Changes in Net Assets

Year ended February 29, 2012

(In thousands)

	Hospital District	Component units	
		Foundation	Community Health Choice, Inc.
Operating revenues:			
Net patient service revenue (note 3)	\$ 308,624	—	—
DSH/UPL/1115 Waiver programs revenue (note 4)	224,322	—	—
Premium revenue	—	—	512,562
Other operating revenues	26,004	16,698	2,507
Total operating revenues	<u>558,950</u>	<u>16,698</u>	<u>515,069</u>
Operating expenses:			
Salaries, wages, and benefits	629,836	581	23,247
Pharmaceuticals and supplies	166,626	21	1,323
Physician services (note 12)	136,367	—	—
Medical claims expense	—	—	428,412
Other purchased services	98,639	3,042	23,535
Depreciation and amortization	47,064	—	—
Total operating expenses	<u>1,078,532</u>	<u>3,644</u>	<u>476,517</u>
Operating (loss) income	<u>(519,582)</u>	<u>13,054</u>	<u>38,552</u>
Nonoperating revenues (expenses):			
Ad valorem tax revenues – net	511,593	—	—
Tobacco settlement revenues	10,753	—	—
Investment income	10,653	2,598	2,372
Interest expense (note 8)	(7,817)	—	—
Other	1,340	(115)	(1,498)
Total nonoperating revenues – net	<u>526,522</u>	<u>2,483</u>	<u>874</u>
Change in net assets	6,940	15,537	39,426
Net assets – beginning of year, as restated (note 2(s))	<u>768,761</u>	<u>23,390</u>	<u>73,330</u>
Net assets – end of year	<u>\$ 775,701</u>	<u>38,927</u>	<u>112,756</u>

See accompanying notes to financial statements.

**HARRIS COUNTY HOSPITAL DISTRICT,
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

Statement of Cash Flows

Year ended February 29, 2012

(In thousands)

	<u>Hospital District</u>
Operating activities:	
Cash received from and on behalf of patients	\$ 331,373
Cash received from DSH/UPL/1115 Waiver programs	144,364
Cash payments to suppliers	(422,553)
Cash payments to employees and for employee benefits	(587,954)
Net cash used in operating activities	<u>(534,770)</u>
Noncapital financing activities:	
Receipts of restricted contributions	1,435
Ad valorem taxes received – net	516,181
Tobacco settlement received	10,753
Net cash provided by noncapital financing activities	<u>528,369</u>
Capital and related financing activities:	
Acquisitions and construction of capital assets	(75,059)
Interest paid	(14,693)
Repayment of long-term debt	(5,867)
Net cash used in capital and related financing activities	<u>(95,619)</u>
Investing activities:	
Receipts of investment income – including realized gains and losses	8,860
Increase in cash equivalents included in assets limited as to use or restricted	(15,777)
Purchases of investment securities	(943,379)
Proceeds from sale and maturities of investment securities	1,225,639
Net cash provided by investing activities	<u>275,343</u>
Net increase in cash and cash equivalents	173,323
Cash and cash equivalents – beginning of year, as restated	<u>63,943</u>
Cash and cash equivalents – end of year	<u><u>\$ 237,266</u></u>

**HARRIS COUNTY HOSPITAL DISTRICT,
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

Statement of Cash Flow

Year ended February 29, 2012

(In thousands)

Reconciliation of operating loss to net cash used in operating activities:	
Operating loss	\$ (519,582)
Adjustments to reconcile operating loss to net cash used in operating activities:	
Depreciation and amortization	47,064
Changes in operating assets and liabilities:	
Increase in accounts receivable	(7,303)
Increase in inventories	(1,025)
Increase in DSH/1115 Waiver programs receivable	(79,957)
Increase in prepaid expenses and other assets	(1,623)
Decrease in estimated third-party payor settlements	1,156
Decrease in net pension asset	52
Decrease in accounts payable and accrued liabilities	(18,274)
Increase in employee compensation and related benefit liabilities	4,029
Increase in compensated absences	1,549
Increase in estimated third-party payor settlements	2,892
Increase in postemployment health benefit liability	36,252
Total adjustments	(15,188)
Net cash used in operating activities	\$ (534,770)
Supplemental disclosures of noncash operating, financing, and investing activities:	
Unrealized gain on investments	\$ 1,558
Amounts related to acquisition of capital assets in accounts payable and accrued liabilities	16,482
Amount of interest expense capitalized	7,241

See accompanying notes to financial statements.

**HARRIS COUNTY HOSPITAL DISTRICT,
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

Notes to Financial Statements

February 29, 2012

(1) Organization and Mission

Harris County Hospital District (the District), a component unit of Harris County, Texas, was created by authorization of the legislature of the State of Texas and subsequent approval by the voters of Harris County, Texas, in November 1965. The District provides patient care to the indigent population of Harris County and receives property taxes levied by Harris County for the provision of this care. The District operates two acute care hospitals and a hospital-based skilled nursing and rehabilitation facility and psychiatric unit, with a total of 963 licensed beds. The District also operates 13 health clinics; 3 specialty clinics providing dental, dialysis, and HIV/AIDS treatment services; and 8 school-based or mobile health clinics. The District is exempt from federal income taxes.

The District is a component unit of Harris County, Texas (legally separate from Harris County, Texas) since the members of the District's governing board are appointed by the Harris County Commissioners' Court. The Harris County Commissioners' Court approves the District's tax rate and annual operating and capital budget. Harris County, Texas does not provide any funding to the District, hold title to any of the District's assets, or have any rights to any surpluses of the District.

The District's primary mission is to provide quality preventive, medical, hospital, and emergency care to the indigent and needy of Harris County and to others with the ability to pay. All activities conducted by the District are directly associated with the furtherance of this mission and are, therefore, considered to be operating activities.

The Harris County Hospital District Foundation (the Foundation), was organized in 1993. The Foundation is a nonprofit, tax-exempt corporation organized under Section 501 (c)(3) of the Internal Revenue Code whose primary purpose is to raise funds to support the operations and activities of the District. Although the District does not control the timing or amount of receipts from the Foundation, the majority of resources (or income thereon) that the Foundation holds and invests are restricted to the activities of the District by the donor. Because these restricted resources held by the Foundation can only be used by, or for the benefit of, the District, the Foundation is considered a component unit of the District and is included in the District's financial statements. The Foundation is reported as a discretely presented component unit of the District. Financial reports for the Foundation can be obtained from the Harris County Hospital Foundation, 2525 Holly Hall, Suite 292, Houston, Texas 77054. Attention: Lisa Whitaker, Executive Director (Lisa_Whitaker@hchd.tmc.edu).

Community Health Choice, Inc. (the HMO), is a Texas not-for-profit corporation incorporated on May 8, 1996, and organized under Section 501 (c)(4) of the Internal Revenue Code to operate as a health maintenance organization. The HMO was licensed by the Texas Department of Insurance on February 14, 1997. The HMO had approximately 219,200 enrollees as of December 31, 2011. The HMO offers 3 Medicaid insurance products. The HMO is reported as a discretely presented component unit of the District since the HMO's Board of Directors is appointed by the District's Board of Managers and the District can impose its will on the HMO. The differences in amounts due to the Hospital District and due from the HMO in the accompanying balance sheet are primarily due to the presentation of the HMO's financials based on its fiscal year-end of December 31. Financial reports for the HMO can be obtained from Community Health Choice, 2636 South Loop West, Ste. 700, Houston, Texas 77054, Attention: Richard Lee, Senior Vice President Finance (Richard_Lee@communityhealthchoice.org).

**HARRIS COUNTY HOSPITAL DISTRICT,
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

Notes to Financial Statements

February 29, 2012

Unless otherwise noted, the following notes do not include the Foundation or the HMO.

(2) Summary of Significant Accounting Policies

(a) Basis of Accounting

The accompanying financial statements are prepared on the accrual basis of accounting.

(b) Method of Accounting

Under the provisions of the American Institute of Certified Public Accountants' *Audit and Accounting Guide, Health Care Organizations*, the District is considered a governmental organization and is subject to the pronouncements of the Governmental Accounting Standards Board (GASB).

In accordance with GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, the District's financial statements include the balance sheet; statement of revenues, expenses, and changes in net assets; and statement of cash flow.

The balance sheet requires that total net assets be reported in three components (a) invested in capital assets, net of related debt; (b) restricted; and (c) unrestricted.

- “Invested in capital assets, net of related debt” consists of capital assets, net of accumulated depreciation, reduced by the amount outstanding for any bonds, notes, or other financing liabilities that were incurred related to the acquisition, construction, or improvement of the capital assets.
- “Restricted net assets” consists of assets that are restricted as to use by external factors, such as debt covenants, grantors, contributors, or laws or regulations of other governments or legislation.
- “Unrestricted net assets” consists of net assets that do not meet the definitions above for “invested in capital assets, net of related debt” or “restricted net assets.”

When an expense is incurred for purposes for which there are both restricted and unrestricted net assets available, it is the District's practice to apply that expense to restricted net assets to the extent such are available and then to unrestricted net assets.

The Foundation is a private not-for-profit organization that reports under Financial Accounting Standards Board pronouncements. As such, certain revenue recognition criteria and presentation features are different from that of the GASB. The Foundation's financial statement formats were modified to make them compatible with the District's financial statement formats.

The HMO is licensed only in the state of Texas and reports under the statutory accounting practices prescribed or permitted by the Texas Department of Insurance for an insurance plan. The HMO's financial statement formats were modified to make them compatible with the District's financial statement formats.

**HARRIS COUNTY HOSPITAL DISTRICT,
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

Notes to Financial Statements

February 29, 2012

(c) Principles of Reporting

The financial statements include the accounts of the District, the Foundation, and the HMO, as described in note 1. The District has implemented GASB Statement No. 61, *The Financial Reporting Entity: Omnibus—An Amendment of GASB Statements Nos. 14 and 34*. As a result, the District reported the HMO and the Foundation as discretely presented component units in its financial statements for the year ended February 29, 2012. Management of the District believes the separate presentation of the District's statements and of each discretely presented component unit to be the most reflective of the District's activities. Previously the Foundation and the HMO were presented in the District's financial statements as blended component units. See further discussion in note 1(s).

Transactions between the District and Component Units:

The District provides certain administrative services to the HMO including employment of all individuals who perform the day-to-day requirements of the business functions of the HMO. The HMO reimburses the District for such salaries, wages, and benefits and these costs are reflected as expenses of the HMO. An additional fee for indirect costs approximating \$995,000 annually is included as a revenue and expense in the District/HMO financial statements. As permitted and limited by the state of Texas laws applicable to insurance companies, the HMO's Board of Directors has approved certain agreements with the District and unrelated third parties whereby an allocation of surplus capital was committed to fund projects designed to further the HMO's mission of providing quality healthcare to the underserved population of Southeast Texas. Financial commitments to the District for these projects include initiation of a Medical Home project based in outpatient clinics and the establishment and operation of additional pediatric clinics. Funds transferred to the District under these agreements are reflected as restricted contributions (distributions) in the statement of revenues, expenses, and changes in net assets.

The District supports the Foundation with payments for goods and services, approximately \$763,000 in fiscal 2012, which are recognized in the Foundation financial data as in-kind contributions and expenses. The Foundation provided support to the District for projects and grants of \$1,996,000 in 2012.

(d) Cash, Cash Equivalents, and Short-Term Investments

Cash and cash equivalents include cash and investments that are highly liquid with maturities of less than 3 months maturities when purchased. Short-term investments are investments with maturities in excess of three months, but less than a year, when purchased.

The District's and HMO's cash, cash equivalents, and short-term investments are invested in fully collateralized time deposits, certificates of deposit, and government securities as authorized by Chapter 281 of the *Texas Health and Safety Codes* and Chapter 116 of the *Texas Local Government Code*. Such total collateralization and insurance coverage is required by the Board of Managers of the District. The Foundation's investments, however, are not subject to these laws.

Investments are reported at fair value, with realized and unrealized gains and losses included in investment income in the statement of revenues, expenses, and changes in net assets.

**HARRIS COUNTY HOSPITAL DISTRICT,
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Notes to Financial Statements

February 29, 2012

(e) Foundation Net Assets

The Foundation records contributions/pledges receivable as revenue in the period in which the promise is made and categorizes the contributions in accordance with donor-imposed restrictions, if any. When an externally imposed restriction expires or unrestricted contributions are realized, temporarily restricted net assets are reclassified to unrestricted net assets. Contributions for which restrictions are met in the same period in which the unconditional promise to give is received are recorded as unrestricted revenue. The majority of the pledges recorded are temporarily restricted to new construction of a District outpatient tower. Pledges are included in prepaid expenses and other current assets in the balance sheet.

(f) Inventories

Inventories are valued at the lower of cost, using the first-in, first-out method, or market and consist principally of pharmaceuticals.

(g) Capital Assets

Property, plant, and equipment are carried at cost or greater or fair market value at the time of donation and include expenditures for new facilities and equipment and expenditures that substantially increase the useful life of existing capital assets. Ordinary maintenance and repairs are charged to expense when incurred. Capitalization is limited to assets with a cost of \$5,000 or greater.

Capitalized interest is calculated based upon interest expense for the period, less investment income related to long-term debt for the same period.

Disposals are removed at carrying cost less accumulated depreciation, with any resulting gain or loss included in other nonoperating revenue and expenses. Depreciation is recorded on the straight-line method over the estimated useful lives of the assets. Estimated useful lives for buildings are up to 40 years and for equipment are 2 to 25 years. Equipment under capital leases is amortized on the straight-line method over the lesser of the useful life of the equipment or the lease term. Such amortization is included in depreciation and amortization in the accompanying statement of revenues, expenses, and changes in net assets.

(h) Deferred Bond Issue Costs

The costs associated with the issuance of bonds are deferred and amortized over the term of the respective bond issue using the bonds outstanding method.

**HARRIS COUNTY HOSPITAL DISTRICT,
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

Notes to Financial Statements

February 29, 2012

(i) ***Compensated Absences***

The District maintains a paid time-off plan. Under the paid time-off plan, the cost of all compensated absences is accrued at the time the benefits are earned. At the option of the employee, unused benefits may be liquidated at 50% or at the time of termination, unused benefits are payable at 75%. Changes in the District's liability for compensated absences in fiscal year 2012 are as follows (in thousands):

<u>Beginning- of-year liability</u>	<u>Current-year claims and changes in estimates</u>	<u>Claim payments</u>	<u>End-of-year liability</u>
\$ 37,930	50,550	49,000	39,480

(j) ***Classification of Revenues and Expenses***

Operating revenues include those generated from direct patient care and related support services. Nonoperating revenues consist of those revenues that are related to financing and investing types of activities and result from nonexchange transactions or investment income. Operating expenses include those related to direct patient care and related support services. Nonoperating expenses include interest expense and other expenses that are not considered operating.

(k) ***Net Patient Service Revenue and Accounts Receivable***

Net patient service revenue is reported as the estimated net realized amounts from patients, third-party payors, and others for services rendered and includes estimated retroactive revenue adjustments under reimbursement agreements with third-party payors. In recognizing net patient service revenue, estimates are used in recording allowances for contractual adjustments and noncollectible accounts. Allowances for noncollectible accounts are estimated using historical experience, current trend information, aged account balances, and a collectibility analysis. The District provides services under contract to patients covered under the Medicare and Medicaid programs. Net revenues from these programs are included in patient service revenue at estimated reimbursement based on customary billing charges, predetermined rates of reimbursement, plus certain adjustments. The amounts due to or from these programs are subject to final review and settlement by the program fiscal intermediary. Retroactive adjustments under third-party reimbursement agreements are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known. Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, it is reasonably possible that these estimates could differ from actual settlements and thus change in the near term by material amounts. During 2012, the District recognized a reduction in net patient service revenue of \$1.1 million from the differences between estimated and actual cost report settlements and appeals.

**HARRIS COUNTY HOSPITAL DISTRICT,
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

Notes to Financial Statements

February 29, 2012

(l) Charity Care Policy

The District accepts all Harris County residents as patients regardless of their ability to pay. Harris County residents may qualify for partial financial assistance, on a sliding scale. The extent to which a resident will be financially responsible is determined based upon pre-established financial criteria, which utilize family income and size as it relates to the federal poverty guidelines set by the U.S. Department of Health and Human Services. Charity services are defined as those services for which no payment is anticipated. These amounts are not reported as revenue. The District maintains records to identify and monitor the level of charity care it provides. These records include the amount of charges foregone for services and supplies furnished under the District Financial Assistance program. The following information measures the level of charity care provided during the year ended February 29, 2012.

Charges foregone, based on established rates	\$ 1,254,491,000
Cost of foregone charges, estimated	495,915,000

(m) Premium Revenue

Prepaid healthcare premiums from enrolled groups with the HMO are reported as revenue in the month in which enrollees are entitled to receive healthcare. Supplemental delivery premiums received for Medicaid-eligible births are recognized based on claims information from Texas hospitals and the state and include estimates for incurred but unreported births at year-end. Premium revenue is recognized as revenue during the coverage period of the subscriber agreement. Throughout the year, the HMO is notified of any new, removed, or revised members and the date of eligibility for coverage. The date of notification may be subsequent to the date of eligibility. The HMO believes that it has adequately recognized premium revenue for the year.

(n) Medical Claims Expense

The HMO arranges for comprehensive healthcare services to its members primarily through fee-for-service arrangements. Certain services, however, are arranged through capitation – a fixed, monthly payment made without regard to the frequency, extent, or nature of the healthcare services actually furnished. Under capitation arrangements, benefits are provided to enrolled members generally through the HMO’s contractual relationships with physician groups and hospitals. The HMO’s contracted providers may, in turn, contract with specialists or referral providers for specific services and are responsible for any related payments to those referral providers.

Medical claims expense reserves represent the estimated ultimate net cost of all reported and unreported losses incurred through the end of December and are presented on a discounted basis. The reserves for unpaid medical claims expenses are actuarially estimated based on claims experience and statistical analyses. Those estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, management believes the reserves for medical claims expenses are adequate. The estimates are continually

**HARRIS COUNTY HOSPITAL DISTRICT,
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Notes to Financial Statements

February 29, 2012

reviewed and adjusted as necessary as experience develops or new information becomes known; such adjustments are included in current operations.

Changes in the HMO's aggregate liability for medical claims in fiscal year 2012 are as follows (in thousands):

Beginning of fiscal year liability	Current-year claims and changes in estimates	Claim payments	End of fiscal year liability
\$ 43,530	428,412	414,528	57,414

In fiscal year 2012, the HMO paid \$375.3 million in claims related to the current fiscal year and \$39.2 million in claims related to the prior fiscal year.

(o) Ad Valorem Tax Revenues – Net

Ad valorem tax revenues are recorded in the year for which the taxes are levied, net of provisions for uncollectible amounts, collection expenses, and appraisal fees. Harris County Commissioners' Court levies a tax for the District as provided under state law. The taxes are collected by the Harris County Tax Assessor – Collector and are remitted to the District as received. On January 1, at the time of assessment, an enforceable lien is attached to the property for property taxes. Taxes are levied and become collectible from October 1 to January 31 of the succeeding year. Subsequent adjustments to the tax rolls, made by the County Assessor, are included in revenues in the period such adjustments are made by the County Assessor.

(p) Tobacco Settlement Revenues

In the fiscal year ended February 29, 2012, the District received a portion of the funds from the settlement between various counties and hospital districts in Texas and the tobacco industry for tobacco-related healthcare costs. Under the program guidelines, the District is free to use the funds in either the immediate or future periods without restriction. The District recognizes all funds received from the settlement as nonoperating revenue in the period funds are received.

(q) Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles (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 financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

(r) Newly Adopted Accounting Pronouncements

GASB Statement No. 59 – GASB Statement No. 59, *Financial Instruments Omnibus*. The Statement updates and improves existing standards regarding financial reporting of certain financial

**HARRIS COUNTY HOSPITAL DISTRICT,
A COMPONENT UNIT OF HARRIS COUNTY, TEXAS**

Notes to Financial Statements

February 29, 2012

instruments and external investment pools. The District has evaluated GASB Statement No. 59 and determined that the Statement had no impact on its financial position, results of operations, and cash flows and therefore is not applicable at this time.

GASB Statement No. 62 – GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 1989 FASB and AICPA Pronouncements*. The Statement objective is to incorporate pronouncements that do not contradict or conflict with GASB pronouncements. The requirements of GASB Statement No. 62 are effective for financial statements for periods beginning after December 15, 2011; however, GASB encourages early implementation and the District elected early adoption. The District determined that the Statement had no impact on the financial position, results of operations, and cash flows and that all applicable provisions have already been applied to the District's financial statements.

Pending Adoption of Recent Accounting Pronouncements

GASB Statement No. 57 – The District has not completed the process of evaluating the impact that will result from implementing GASB Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*. This Statement amends Statement No. 45, *Accounting and Financial Reporting by Employers/or Postemployment Benefits other Than Pensions*, and Statement No. 43, *Financial Reporting/or Postemployment Benefit Plans Other Than Pension Plans*. This Statement clarifies actuarially determined Other Post Employment Benefits (OPEB) measures reported by an agent multiple-employer OPEB plan and its participating employers. Those measures should be determined by a common date and at a minimum frequency to satisfy the agent multiple-employer OPEB plan's financial reporting requirement. The District is therefore unable to disclose the impact GASB Statement 57 will have on its financial position, results of operations, and cash flows when such Statement is adopted. This Statement is effective for financial statements for periods beginning after June 15, 2011.

GASB Statement No. 60 – The District has not completed the process of evaluating the impact that will result from implementing GASB Statement No. 60, *Accounting and Financial Reporting/or Service Concession Arrangements (SCA)*. The requirements of this statement will improve financial reporting by establishing recognition, measurement, and disclosure requirements for SCAs for both transferors and governmental operators, requiring governments to account for and report SCAs in the same manner, which improves the comparability of financial statements. The Statement is effective for financial statements prepared by state and local governments for periods beginning after December 15, 2011.

GASB Statement No. 63 – The District has not completed the process of evaluating the impact that will result from implementing GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. This Statement standardizes the presentation of deferred outflows of resources and deferred inflows of resources and their effects on a government's net position. The Statement is effective for financial statements for periods beginning after December 15, 2011.

GASB Statement No. 64 – The Statement objective is to clarify whether an effective hedging relationship continues after the replacement of a swap counterparty or a swap counterparty's credit

**HARRIS COUNTY HOSPITAL DISTRICT,
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February 29, 2012

support provider. The Statement is effective for financial statements for periods beginning after June 15, 2011. At this time, the District has determined that the Statement is not applicable.

GASB Statement No. 65 – The District has not completed the process of evaluating the impact that will result from implementing GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*. The Statement establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities. The Statement provisions are effective for financial statements for periods beginning after December 15, 2012.

GASB Statement No. 66 – The District has not completed the process of evaluating the impact that will result from implementing GASB Statement No. 66, *Technical Corrections – 2012, an amendment of GASB Statements No. 10 and No. 62*. The Statement amends Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues* and Statement No. 62, *Codification of Accounting and Financial reporting Guidance Contained in Pre-November 1989 FASB and AICPA Pronouncements*. The provisions of the Statement are effective for financial statements for periods beginning after December 15, 2012.

(s) ***Adoption of GASB Statement No. 61***

As discussed in note 2(c), the District adopted GASB Statement No. 61 for fiscal year 2012. Application of this standard changed the presentation of the Foundation and HMO to discretely presented component units. Previously, the Foundation and HMO were presented as blended component units. As a result, the cumulative effect of applying this Statement has been reported as a restatement of beginning net assets of the District in the accompanying financial statements as follows (in thousands):

Net assets, as of February 28, 2011 as previously reported	\$	867,968
Reduction in net assets for discrete presentation of HMO		(75,817)
Reduction in net assets for discrete presentation of Foundation		<u>(23,390)</u>
Net assets, as of February 28, 2011 as restated	\$	<u><u>768,761</u></u>

(3) Net Patient Service Revenue

Charity care provided during the year ended February 29, 2012, measured at established rates, totaled \$1,254,491,000. These charges are not included in net patient service revenue.

The District has agreements with third-party payors that provide for payments to the District at amounts different from its established rates. The amounts by which the established billing rates exceed the amounts

**HARRIS COUNTY HOSPITAL DISTRICT,
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recoverable from these programs are written off and accounted for as contractual allowances. A summary of the payment arrangements with major third-party payors follows:

Medicare – Inpatient acute care services and defined capital costs related to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical diagnostic and other factors. Medicare outpatient services are reimbursed on fee schedules and on a prospective basis through ambulatory payment classifications, which are based on clinical resources used in performing the procedures. The District's Medicare cost reports have been audited by the Medicare administrative contractor through February 28, 2010.

Medicaid – Inpatient services rendered to Medicaid program beneficiaries are paid at prospectively determined rates per discharge similar to those of the Medicare inpatient program. Medicaid outpatient beneficiaries are reimbursed under a cost reimbursement methodology. For outpatients, the District is reimbursed a preliminary rate, with final settlement determined after submission of annual cost reports by the District and reviews thereof by the Medicaid administrative contractor based on Medicare administrative contractor audits. The District's Medicaid cost reports have been settled by the Medicaid administrative contractor through February 28, 2007.

Cash received from the Medicare program accounted for approximately 26% of the District's total cash collections for net patient service revenue for the year ended February 29, 2012. Cash received from the Medicaid program (including managed Medicaid) accounted for approximately 54% of the District's total cash collections for net patient service revenue for the year ended February 29, 2012.

Compliance with laws and regulations governing the Medicare and Medicaid programs can be subject to future government review and interpretation, as well as significant regulatory action, including fines, penalties, and exclusion from the Medicare and Medicaid programs.

(4) Disproportionate Share III, Upper Payment Limit, and 1115 Waiver Programs

The Disproportionate Share III (DSH) program was created in fiscal 1992 by the state of Texas to access additional federal matching funds. These funds are distributed to selected hospitals that provide services to low-income and uninsured patients. According to the DSH program guidelines, the District may use the funds for the benefit of the indigent in either the immediate period or future periods.

The Upper Payment Limit (UPL) program was created in May 2002 with an effective date of July 2001. The UPL program uses federal matching funds to raise state Medicaid reimbursement rates to 100% of equivalent Medicare rates for certain public hospital systems.

The District recognizes all funds received under the DSH and UPL programs as operating revenues in the period applicable to the receipt of the funds. Any amounts related to that year that are not received as of fiscal year-end are recorded as receivables and reflected in other current assets in the accompanying balance sheet. These receivables can be subject to adjustments that are reflected in the period they become known. There were no adjustments recorded in fiscal 2012 for prior year programs.

**HARRIS COUNTY HOSPITAL DISTRICT,
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In December 2011, Texas received federal approval to redirect the funding it would have received under the UPL program over the next five years into a new reform plan (1115 Waiver). The 1115 Waiver allows the state to expand Medicaid managed care, improve Medicaid services, and reward performance. Federal funding that would have been received by hospitals if managed care was not expanded is to be preserved. The funding, combined with cost savings from the expansion, provides incentive payments for healthcare improvements and directs more funding to hospitals that serve large numbers of uninsured patients. The impact on the District's fiscal 2012 operating results, which includes the first five months of the waiver period, should be positive. The District had recorded a receivable of \$96.4 million at February 29, 2012 related to the DSH and 1115 Waiver programs.

(5) Assets Limited as to Use or Restricted

Assets limited as to use or restricted represent those assets whose use has been legally restricted related to the 2007 and 2010 bond issues (50% of the greatest debt service requirement scheduled to occur); funds restricted by donors; or funds designated by the board for future debt service, future capital expansion, and other uses. Investments in government securities are recorded at fair value. The carrying amount of money market government funds approximates fair value. The fair values of securities are based on quoted market prices as of February 29, 2012. The components of assets limited as to use or restricted at fair value at February 29, 2012, are as follows (in thousands):

Description of assets	Total	Restricted debt service	Restricted/ designated capital expansion	Designated		
				Legal reserves	Self-Insured programs	Other
Money market government funds	\$ 37,118	6,719	23,214	2,192	4,943	50
Government securities	366,148	18,404	197,222	—	149,684	838
	403,266	25,123	220,436	2,192	154,627	888
Less funds required for current liabilities	(37,847)	(5,380)	(11,279)	(2,192)	(18,996)	—
	<u>\$ 365,419</u>	<u>19,743</u>	<u>209,157</u>	<u>—</u>	<u>135,631</u>	<u>888</u>

Foundation – Assets limited as to use of \$22.2 million at February 29, 2012 are restricted subject to donor-imposed stipulations that will be met by actions of the Foundation or the District or the passage of time.

(6) Investment Risk

GASB Statement No. 40, *Deposit and Investment Risk Disclosures – an amendment of GASB Statement No. 3*, requires disclosures related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk associated with interest-bearing investments.

Credit Risk and Concentration of Credit Risk – Credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by a nationally recognized statistical rating organization (NRSRO). The District, the HMO, and the Foundation each have formal investment policies adopted by the Board of Managers, Board of Directors, and Board of

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Trustees, respectively, which limit investment in securities based on an NRSRO credit rating. The District's investments are also subject to the Public Funds Investment Act (the Act), Texas Administrative Code Section 2256, and the HMO's investments are also subject to regulations enumerated in Title 28, Chapter 11 of the Texas Administrative Code and Chapter 20A of the Texas Insurance Code. The Foundation's investments are not subject to these laws.

The District's investment policy is to be reviewed and approved annually by the Board of Managers and the Commissioners' Court. The investment policy includes a list of authorized investment instruments, a maximum allowable stated maturity by fund type, and the maximum weighted average maturity of the overall portfolio. Guidelines for diversification and risk tolerance are also detailed within the policy. Additionally, the policy includes specific investment strategies for fund groups that address each group's investment options and describe the priorities for suitable investments.

The District's investment policy establishes minimum acceptable credit ratings for certain investment instruments. Securities of states, agencies, counties, cities, and other political subdivisions must be rated as to investment quality by a nationally recognized investment-rating firm as AA or its equivalent. Money market mutual funds and public funds investment pools must be rated Aaa or its equivalent.

Concentration of credit risk is the risk of loss attributed to the magnitude of an investment in a single issuer. The District mitigates these risks by emphasizing the importance of a diversified portfolio. All funds must be sufficiently diversified to eliminate the risk of loss resulting from overconcentration of assets in a specific maturity, a specific issuer, or a specific class of securities. In particular, no more than 50% of the overall portfolio may be invested in time deposits, including certificates of deposit, of a single issuer. Concentration by issuer for other investment instruments is not specifically addressed in the investment policy. However, the policy does specify that acceptable investment instruments must have high-quality credit ratings.

GASB Statement No. 40 also provides that securities with split ratings, or a different rating assignment between NRSROs, are disclosed using the rating indicative of the greatest degree of risk.

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The table below indicates the fair value and maturity amount of the District's investments as of February 29, 2012 summarized by security type. The table below presents the percentage of total portfolio, the credit rating of the investment, and the modified duration in years for each summarized security type (in thousands).

Security	Fair value	Percentage of portfolio	Maturity amount	Modified duration (years)	Rating S&P/ Moody's
Commercial paper:					
TMCC	\$ 239,513	32.00%	\$ 240,838	1.000	A-1+
Other:					
Maryland State	8,862	1.00	8,820	1.000	AA+
King County Washington	11,307	2.00	10,000	17.000	AAA
San Antonio Texas					
Electric and Gas	1,303	—	1,190	20.000	AA
U.S. agency notes:					
FHLB	7,547	1.00	7,547	4.000	AAA/Aaa
FHLMC	55,014	7.00	55,000	3.000	AAA/Aaa
FNMA	147,747	20.00	147,515	4.000	AAA/Aaa
Money market mutual funds	274,607	37.00	274,607	—	AAA/Aaa
Total cash and investments	<u>\$ 745,900</u>	<u>100.00%</u>	<u>\$ 745,517</u>	1.000	

The table below indicates the fair value and maturity amount of the HMO's investments as of December 31, 2011, summarized by security type. Also demonstrated are the percentage of total portfolio and the modified duration in years for each summarized security type (in thousands).

Security	Fair value	Percentage of portfolio	Maturity amount	Modified duration (years)	Credit Rating S&P/ Moody's
Commercial paper:					
TMCC	\$ 34,770	21.00%	\$ 35,000	1.000	A-1+
Other:					
North Texas Tollway Authority	14,846	9.00	14,500	2.000	AAA
U.S. agency notes:					
FHLB	35,245	21.00	35,250	3.000	AAA/Aaa
FFCB	15,000	9.00	15,000	4.000	AAA/Aaa
FNMA	50,028	30.00	50,000	3.000	AAA/Aaa
Time deposit:					
JP Morgan Chase	3,323	2.00	3,323	—	AAA/Aaa
Money market mutual funds	13,009	8.00	13,009	—	AAA/Aaa
Total cash and investments	<u>\$ 166,221</u>	<u>100.00%</u>	<u>\$ 166,082</u>	2.000	

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The District maintained no investments in derivatives at February 29, 2012.

Custodial Credit Risk – Custodial credit risk for deposits is the risk that, in the event of failure of a depository financial institution, the District will not be able to recover its deposits or will not be able to recover collateral securities that are in the possession of an outside party. The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the District will not be able to recover the value of its investment or collateral securities that are in the possession of another party.

Chapter 2257 of the Texas Government Code is known as the Public Funds Collateral Act. This act provides guidelines for the amount of collateral that is required to secure the deposit of public funds. Federal Deposit Insurance Corporation (FDIC) insurance is available for funds deposited at any one financial institution up to a maximum of \$100,000 each for demand deposits, time, and savings deposits, and deposits pursuant to indenture. During the fourth quarter of calendar 2008, the FDIC temporarily increased basic insurance coverage from \$100,000 to \$250,000 through December 31, 2009. In May 2009, the FDIC extended their \$250,000 coverage through December 31, 2013.

The Public Funds Collateral Act requires that the deposit of public funds be collateralized in an amount not less than the total deposit, reduced by the amount of FDIC insurance available.

At February 29, 2012, the carrying amount of the HMO's demand and time deposits was \$3.3 million as was the balance per various financial institutions. The District's deposits are not exposed to custodial credit risk since all deposits are either covered by FDIC insurance or collateralized with securities held by the District or its agent in the District's name, in accordance with the Public Funds Collateral Act.

Interest Rate Risk – All investments carry the risk that changes in market interest rates will adversely affect the fair value of an investment. Generally, the longer the maturity of an investment, the greater the sensitivity of its fair value to changes in market interest rates. One of the ways that the District manages its exposure to interest rate risk is by purchasing a combination of shorter- and longer-term investments and by matching cash flows from maturities so that a portion of the portfolio is maturing evenly over time as necessary to provide the cash flow and liquidity needed for operations.

According to the District's investment policy, no more than 25% of the portfolio, excluding those investments held for future capital expenditures, debt service payments, bond fund reserve accounts, and capitalized interest funds, may be invested beyond 24 months. Additionally, at least 15% of the portfolio, with the previous exceptions, is invested in overnight instruments or in marketable securities that can be sold to raise cash within one day's notice. Overall, the average maturity of the portfolio, with the previous exceptions, shall not exceed two years. As of February 29, 2012, the District was in compliance with these guidelines.

Foreign Currency Risk – Foreign currency risk is the risk that fluctuations in the exchange rate will adversely affect the value of investments denominated in a currency other than the U.S. dollar. The District's investment policy does not list securities denominated in a foreign currency among the authorized investment instruments. Consequently, the District is not exposed to foreign currency risk.

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(7) Capital Assets

The District's investment in capital assets as of February 29, 2012, consists of the following (in thousands):

	<u>Beginning balance</u>	<u>Additions/ transfers</u>	<u>Retirements</u>	<u>Ending balance</u>
Land and improvements	\$ 36,631	654	(5)	37,280
Buildings and fixed equipment	391,667	16,405	(2,049)	406,023
Major movable equipment	<u>260,462</u>	<u>25,405</u>	<u>(12,582)</u>	<u>273,285</u>
Total at historical cost	<u>688,760</u>	<u>42,464</u>	<u>(14,636)</u>	<u>716,588</u>
Less accumulated depreciation:				
Land and improvements	(5,235)	(986)	—	(6,221)
Buildings and fixed equipment	(224,813)	(12,894)	1,965	(235,742)
Major moveable equipment	<u>(167,998)</u>	<u>(32,969)</u>	<u>12,352</u>	<u>(188,615)</u>
Total accumulated depreciation	(398,046)	(46,849)	14,317	(430,578)
Construction in progress	<u>27,522</u>	<u>46,844</u>	<u>—</u>	<u>74,366</u>
Capital assets – net	<u>\$ 318,236</u>	<u>42,459</u>	<u>(319)</u>	<u>360,376</u>

Depreciation expense for the year ended February 29, 2012 was \$46,849,000.

(8) Long-Term Debt

(a) Revenue Bonds

On October 3, 2007, the District issued two Series of Harris County Hospital District Senior Lien Refunding Revenue Bonds (the Bonds). The Series 2007A Bonds, in the amount of \$199,085,000, were sold to provide funding for expansion and renovation projects, to refund the District's outstanding commercial paper, to cash fund the Debt Service Reserve Fund, and to pay costs of issuance. The Series 2007B Bonds, in the amount of \$103,525,000, were used to refund the Series 2000 revenue bonds and to pay costs of issuance.

The Series 2007A Bonds bear interest at an effective rate of approximately 5.1% (stated rates ranging from 5% to 5.25%) and were issued as fixed rate bonds with a final maturity on February 15, 2042.

The Series 2007B Bonds Series have a final maturity date of February 1, 2042, and were initially issued as 28-day taxable auction-rate paper, convertible to tax exempt on August 16, 2010. In April 2008, these bonds were converted from auction-rate securities and reoffered as variable rate bonds bearing interest at a term rate during a term period. The 2007B Bonds Series were hedged with a forward starting swap effective upon the tax-exempt conversion of the bonds. The Series 2007

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Bonds are insured by municipal bond insurance policies and secured by a lien on the pledged revenues of the District and certain funds established pursuant to the bond order.

In August 2010, the District refunded and refinanced the Series 2007B Bonds by issuing Series 2010 Refunding and Revenue bonds in the amount of \$104,435,000. The proceeds of the Series 2010 Bonds covered costs of issuance and defeased the Harris County Hospital District Senior Lien Refunding Revenue Bonds, Series 2007B, in the principal amount of \$103,525,000 through the irrevocable deposit of sufficient funds with trustees to pay the principal and interest of such bonds through maturity. Accordingly, these trustee funds and the related defeased indebtedness are excluded from the balance sheet. The refunding resulted in a loss of \$21,531,000, which includes \$16,230,000 deferred loss on refunding related to the interest rate swap, which has been deferred and is being amortized over the life of the Series 2007B Bond issue. The remaining loss on refunding of \$5,301,000 has been deferred and is being amortized to interest expense over the life of the Series 2000 bond issue. The primary components of this loss were the write-offs of unamortized deferred financing costs and bond premiums, the net deferred amount related to the hedging derivative instrument associated with the 2007B Bonds and the difference between amounts funded for the defeasance and the principal due on the 2007B Bonds. The financial statements reflect long-term debt net of unamortized deferred amounts of \$19,221,000 at February 29, 2012. Principal amounts of total defeased indebtedness outstanding at February 29, 2012 are \$168,470,000. The bonds are secured by an irrevocable letter of credit issued by JPMorgan Chase Bank.

The Series 2010 Refunding and Revenue bonds in the amount of \$104,435,000 are variable rate demand bonds maturing through 2042. The bonds are subject to purchase on the demand of the owner at a price equal to purchase price on any given business day upon irrevocable notice by electronic means to the District's tender agent and remarketing agent.

Under an irrevocable letter of credit issued by JPMorgan Chase Bank, only the tender agent is entitled to draw an amount sufficient to pay the principal amount of the bonds when due, or to pay the portion of the purchase price corresponding to the principal amount upon certain tenders. The letter of credit is valid through August 12, 2013. Unreimbursed advances will accrue interest at the higher of (i) the Prime Rate, (ii) one-month LIBOR plus 2.5%, or (iii) 7.5% per annum. The District is also required to pay to the JPMorgan Chase Bank an annual facility fee for the letter of credit of 0.75% per annum of the outstanding principal amount of the bonds. No amounts were outstanding on the letter of credit as of February 29, 2012. In addition, the District is required to pay the remarketing agent an annual fee of \$1.00 per \$1,000 of principal amount of the bonds actually remarketed.

Compliance

The District is in compliance with its debt covenants at February 29, 2012.

(b) Interest Rate Swap

Related Bonds – On September 25, 2007, the District entered into an interest rate swap agreement in connection with its \$103,525,000 Harris County Hospital District Senior Lien Revenue and Refunding Bonds, Series 2007B with the settlement date on October 3, 2007. On August 12, 2010, when the District refunded and refinanced the Series 2007B Bonds by issuing Series 2010 Bonds, the

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interest rate swap was redesignated and associated with the new debt. The derivative contained an off market element equal to the value of the swap associated with the Series 2007B Bonds on August 12, 2010. In accordance with GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, this off-market element is recorded as a borrowing payable and is amortized as an adjustment to interest expense over the life of the swap agreement.

Objective of the Swap – The intention of the swap was to effectively reduce the impact of the District’s variable interest rate exposure on the Related Bonds to a synthetic fixed rate of 4.218%.

Swap terms:

Trade date	September 12, 2007
Effective date	August 16, 2010
Termination date	February 15, 2024
Initial notional amount	\$103,500,000
District pays fixed	4.218%
Counterparty pays floating	SIFMA Municipal Swap Index
Payment dates	Monthly on the 15th calendar day of every month

As further defined in the confirmation to the swap agreement, the District is subject to an “Annual Counterparty Ceiling” which limits the maximum payment, inclusive of collateral, made by the District in any fiscal year to \$40,000,000. Subject to cash settlement, the District has the right to terminate the agreement, in whole or in part, on the Effective Date, August 16, 2010, and on any Business Day (as observed by New York and London financial markets) thereafter.

The effectiveness of the interest rate swap has been measured using the regression analysis method. The District has concluded that the transactions are highly effective.

Fair Value – The redesignated swap that is associated with the new debt had a zero fair value at its inception date and a fair value of (\$10.9) million at February 29, 2012 and is reported as a derivative liability in the balance sheet. The fair value of the swap was determined by calculating the present value of the anticipated future cash flows for both the floating portion and the stated fixed rate portion using discount factors derived from the London Interbank Offered Rate (LIBOR) swap curve.

Interest Rate Risk – The District is exposed to interest rate risk in that as the variable rates on the swaps agreements decrease the District’s net payment in the swap agreement could increase.

Basis Risk – The District is exposed to basis risk when the variable interest rate paid to the holders of its variable rate demand obligations is not equivalent to the variable interest rate received from its counterparties on the related swap agreements. When exposed to basis risk, the net interest expense incurred on the combination of the swap agreement and the associated variable rate debt may be higher or lower than anticipated.

Collateral Posting Risk – The risk that the District will be required to secure its obligations under the swap agreement. Any securities posted as collateral would not be available for the District’s

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expenditure or reserve needs, which could adversely impact credit ratings and overall liquidity and budgetary efforts. The District was not exposed to collateral posting risk as of and for the year ended February 29, 2012.

Credit Risk – The risk of a change in the credit quality or credit rating of the District and/or its counterparty. The swap counterparty was rated A+ by Standard & Poor’s and Aa3 by Moody’s Investors Services as of February 29, 2012. In December 2011, the District received a rating downgrade to A2 from A1 by Moody’s Investors Service and at February 29, 2012 maintained a rating of A by Standard and Poor’s and A by Fitch.

Rollover Risk – The District is exposed to rollover risk only on swaps that mature or may be terminated at the counterparty’s option prior to the maturity of the associated debt. As of February 29, 2012, the District was not exposed to rollover risk.

Termination Risk – The District’s swap agreements do not contain any out-of-the-ordinary termination events that would expose it to significant termination risk. In keeping with market standards, the District or the counterparty may terminate each swap if the other party fails to perform under the terms of the contract. In addition, the swap documents allow either party to terminate in the event of a significant loss of creditworthiness. If at the time of the termination a swap has a negative value, the District would be liable to the counterparty for a payment equal to the fair value of such swap. As of February 29, 2012, termination of the original swap agreement would create a liability of \$28.6 million and would result in a reversal of the derivative liability related to the redesignated swap, the borrowing payable amount, and the deferred loss on refunding. Any resulting net change would be recorded through nonoperating expenses.

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Swap Payments – Using interest rates as of February 29, 2012, debt service requirements of the District’s outstanding fixed and variable-rate debt and net swap payments on the variable-rate debt were as follows (in thousands). As rates vary, variable rate interest rate payments on the bonds and net swap payments will change.

	<u>Principal</u>	<u>Interest</u>	<u>Swap</u>	<u>Total</u>
Years ending February:				
2013	\$ 4,775	14,305	(2,962)	16,118
2014	4,985	14,081	(2,911)	16,155
2015	5,195	13,846	(2,856)	16,185
2016	5,415	13,602	(2,800)	16,217
2017	5,635	13,347	(2,742)	16,240
2018–2022	32,120	62,518	(12,748)	81,890
2023–2027	40,330	54,201	(10,881)	83,650
2028–2032	50,965	43,519	(8,594)	85,890
2033–2037	64,355	29,929	(5,800)	88,484
2038–2042	81,840	12,501	(2,383)	91,958
Total	295,615	271,849	(54,677)	512,787
Less – unamortized deferred loss on refunding on 2010 revenue bonds	(19,221)	—	—	(19,221)
Total	\$ <u>276,394</u>	<u>271,849</u>	<u>(54,677)</u>	<u>493,566</u>

Hybrid Instrument Borrowings – The District’s interest rate swap includes fixed rates that were off market at the execution of the interest rate swap. For financial reporting purposes, the interest rate swap is considered a hybrid instrument and is bifurcated between borrowings, with an aggregate original amount of \$18 million reflecting the fair value of the instrument at its execution, and an interest rate swap with a fixed rate that was considered at the market at execution. Activity for the hybrid instrument borrowings for the year ended February 29, 2012 was as follows (in thousands):

Beginning balance	\$ 17,546
Additions	—
Reductions	(1,387)
Ending balance	\$ <u>16,159</u>

The following table sets for as of February 29, 2012, the amortization of the hybrid instrument borrowings for the next five years and thereafter (in thousands).

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Years ending February:	
2013	\$ 879
2014	863
2015	846
2016	828
2017	811
2018–2022	3,765
2023–2027	3,213
2028–2032	2,538
2033–2037	1,713
2038–2042	703
Total	\$ 16,159

(c) Other Obligations

Other long-term obligations at February 29, 2012, are as follows (in thousands):

Years ending February:	
2013	\$ 1,778
2014	1,184
2015	435
2016	346
2017	185
Total	\$ 3,928

(9) Employee Benefit Plans

The District currently maintains two benefit plans allowing employees to plan and save for retirement: a defined contribution plan and a defined benefit plan. In October 2006, the Harris County Hospital District Board of Managers amended the pension plan to freeze enrollment. The amended plan offers employees hired prior to January 1, 2007, a choice to either (1) continue with their current pension plan or (2) elect to participate in the District’s enhanced 401(k) retirement savings plan with a match, effective July 2007, of up to 5% of participant’s compensation provided by the District. All new hires and rehires after December 31, 2006, are only eligible for the District’s 401(k) retirement savings plan with a match of up to 5%. The change was designed to safeguard individuals approaching retirement, who had accumulated a large pension benefit in the current plan, while providing employees who planned to work many more years an option for better flexibility and portability in the District’s enhanced 401(k) plan.

The District administers the Harris County Hospital District Pension Plan and the Harris County Hospital District 401(k) Plan. The District issues publicly available financial reports that include financial statements and required supplementary information. The financial reports may be obtained by writing to Harris County Hospital District, Human Resources Department, 2525 Holly Hall, Houston, Texas 77054.

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(a) *Defined Contribution Plan*

The District has a defined contribution 401(k) plan (which qualifies as a tax-exempt employee benefit plan under Section 401(a) of the Internal Revenue Code) (401k Plan) open to all full-time and part-time employees of the District who meet the plan's requirements. It is a single-employer, self-administered, trustee plan to which contributions are made by participants on a biweekly basis not to exceed the statutory maximum of \$16,500 during calendar year 2011, for participants under the age of 50. Contributions to the plan cannot exceed the statutory maximum of \$22,000 for participants age 50 and older. Effective July 2007, the District enhanced the 401k Plan with an employer match up to 5% of the participant's compensation for eligible employees, which is 100% vested with three or more years of service. The 401k Plan is a governmental plan and, as such, is specifically exempt from the reporting and disclosure requirements of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Total participant contributions were \$18,787,000 and total District contributions were \$4,940,000.

(b) *Pension Plan*

The District has a noncontributory, defined benefit pension plan (the Plan). It is a single-employer, self-administered, trustee plan in which a separate stand-alone financial report is issued. The Plan is administered by an Administrative Committee appointed by the Board of Managers of the District, which is responsible for administering the Plan under the terms that are established. The Board of Managers approves amendments to the Plan. State Street Bank & Trust Co. serves as the trustee and custodian for the Plan. As a unit of local government, the Plan is not covered by ERISA. The Plan is funded through actuarially determined contributions by the District. The projected unit credit method is used to determine both the funding.

Each participant shall have a monthly benefit payable for life equal to the greater of (a) the number of years of service multiplied by 1.5% of average monthly compensation (average base compensation received in five highest consecutive calendar years out of the ten complete calendar years prior to retirement) or (b) the accrued monthly retirement benefit determined as of January 1, 1989, plus the number of years of future service earned after January 1, 1989, multiplied by 1.5% of average monthly compensation, subject to a minimum equal to the benefit earned under the Plan prior to the adoption of the 6th Amendment as of September 30, 1991 (applies to nonhighly compensated employees only). Monthly benefit payments are subject to a minimum based on the number of years of service multiplied by \$6 and a maximum provision permitted to be paid under Section 415 of the Internal Revenue Code. Participants may also elect to receive their benefits in other optional forms approved by the Administrative Committee.

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(c) *Annual Pension Cost and Net Pension Asset*

The contribution requirements for the District's fiscal year are based on an actuarial valuation as of two months before the beginning of the fiscal period, as follows:

<u>Fiscal year ended</u>	<u>Annual pension cost (APC)</u>	<u>Percentage of APC contributed</u>	<u>Net pension asset</u>
February 29, 2012	\$ 23,709,066	100%	\$ 2,335,034

The Plan is on a calendar year-end, and for the plan year ended December 31, 2011, the actuarially determined contribution requirement was approximately \$23,657,000 and intended to cover normal cost of \$13,257,000 and \$10,400,000 for amortization of the unfunded actuarial accrued liability and represented 9.8% of January 1, 2011, covered payroll.

During the year ended February 29, 2012, the District made cash contributions of \$23,657,000 to the pension trust. Pension expense recognized in the statement of revenues, expenses, and changes in net assets was \$23,709,000.

The annual pension cost equals the annual required contribution, minus one year's interest on the net pension asset, plus an adjustment for amortization of the net pension asset. The annual pension cost and net pension asset for the current year were as follows:

	<u>2012</u>
Annual required contribution	\$ 23,656,901
Interest discount on net pension asset	(190,976)
Adjustment to annual required contribution	243,141
Annual pension cost	23,709,066
Contributions made	23,656,901
Decrease in net pension asset	(52,165)
Net pension asset – beginning of year	2,387,199
Net pension asset – end of year	\$ 2,335,034

As of January 1, 2011, the most recent actuarial valuation date, the Plan was 83.0% funded. The actuarial accrued liability for benefits was \$540,947,000, and the actuarial value of assets was \$449,247,000, resulting in an unfunded actuarial accrued liability (UAAL) of \$91,700,000. The covered payroll (annual payroll of active employees covered by the Plan) was \$241,076,000, and the ratio of the UAAL to the covered payroll was 38.0%.

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The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents multiyear trend information about whether the actuarial value of plan assets are increasing or decreasing over time relative to the actuarial accrued liability for benefits.

Actuarial methods and assumptions used in the January 1, 2011 actuarial valuation are as follows:

Actuarial cost method	Projected unit credit
Equivalent single amortization period	20 years
Asset valuation method	Five-year smoothed market
Actuarial assumptions:	
Inflation	3.0%
Investment rate of return (net of expenses)	8.0%
Projected salary increases (ultimate rate)	4.0%
Mortality rates	The RP2000 Combined Mortality Tables

(d) *Deferred Compensation*

The District has a deferred compensation plan for the benefit of its eligible employees under Section 457 of the Internal Revenue Code of 1954. The assets in the Deferred Compensation Plan, which is not recorded in the accompanying balance sheet, are not subject to creditors. The Deferred Compensation Plan assets at February 29, 2012 were approximately \$72,109,000.

(e) *Post employment Benefits Other Than Pension*

In addition to providing pension benefits, the District provides certain healthcare benefits for retired employees. The District's employees may become eligible for those benefits upon completing 10 years of service. The number of retirees and beneficiaries eligible to receive the benefits was 2,219 at January 1, 2011.

Retiree medical plan participants are provided benefits under the District's self insured medical plan. The contribution/premium requirements of plan members and the District are established and may be amended by the District's Board of Managers. For fiscal year 2012, the District contributed \$15 million to the Plan for current premiums and administrative costs. Plan members receiving benefits during fiscal year 2012 contributed \$2 million, or approximately 14% of the total premiums, through their required contribution of \$54.15 per month for retiree-only coverage and \$386.60 for retiree and spouse coverage.

The District's annual OPEB cost or expense is calculated based on the annual required contribution of the District (ARC), an amount actuarially determined in accordance with GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize any unfunded actuarial liabilities, or funding excess, over a period not to exceed 30 years. The following table shows the components of the District's annual

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OPEB cost for the year 2012, the amount actually contributed to the Plan, and changes in the District's net OPEB obligation to the Plan (in thousands):

Annual required contribution	\$	49,290
Interest on net OPEB obligation		4,439
Adjustment to annual required contribution		<u>(4,621)</u>
Annual OPEB cost/expense		49,108
Contributions		<u>12,856</u>
Increase in net OPEB obligation		36,252
Net OPEB obligation – beginning of year		<u>110,979</u>
Net OPEB obligation – end of year	\$	<u><u>147,231</u></u>

The District annual OPEB cost, the percentage of annual OPEB cost contributed to the plan, and the net OPEB obligation for 2012 were as follows (in thousands):

Annual OPEB cost	Percentage of OPEB contributed	Net OPEB obligation
\$ 49,108	26%	\$ 147,231

As of the March 1, 2011 actuarial valuation, the Plan was not prefunded. Contributions made were for current-year costs incurred only. The actuarially accrued liability for benefits was \$548.8 million, and the actuarial value of assets was \$0 resulting in an unfunded actuarial accrued liability of \$548.8 million. The covered payroll (annual payroll of active employees covered by the Plan) was \$241.1 million for March 1, 2011. The ratio of the unfunded actuarial accrued liability to the covered payroll was 227.7% for March 1, 2011.

Actuarial valuations of the Plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future, such as assumptions about future employment, mortality, and the healthcare cost trend. Amounts determined regarding the annual required contributions of the District and the funded status of the Plan are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future.

In the March 1, 2011 actuarial valuation, the projected unit credit actuarial cost method was used. The actuarial assumptions included a 4% investment rate of return and an annual healthcare cost trend rate of 7.0% reduced by decrements to an ultimate rate of 4.75%, after 5 years. The initial unfunded actuarial liability was amortized over a period of 30 years based on a level percentage of payroll method.

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(10) Concentrations of Credit Risk

The District provides services to its patients, most of whom are local residents and may be insured under third-party payor agreements, in accordance with its charity care policy (see note 2). Patient service revenues (see note 3) and the related accounts receivable are reflected in the District's combined financial statements net of charges for charity care provided. The mix of net receivables from self-pay patients and third-party payors at February 29, 2012 is as follows:

	2012
Medicaid	28%
Medicare	14
Commercial	8
Self-pay patient	50
	100%

(11) Commitments and Contingencies

At February 29, 2012, the District was a defendant in certain pending civil litigation and has notice of certain claims that have been asserted against it. The District is covered under the Texas Tort Claims Act (the Claims Act). Under the Act, any claims and recoveries from pending or possible litigation due to personal injuries are limited to \$100,000 per person and \$300,000 per single occurrence of bodily injury or death. Professional liability claims have been asserted by various claimants. The claims are in various stages of processing, and some may ultimately be brought to trial. There are also other known and unknown incidents that have occurred through February 29, 2012, that may result in the assertion of additional claims. The District covers its exposure for asserted and unasserted claims through a program of self-insurance and has accrued its best estimate of these contingent losses. In the opinion of the District's management, the outcomes of these actions will not have a material adverse effect on the financial statements of the District.

The District has self-insurance programs for the payment of hospital professional and general liability claims, workers' compensation, and employee health claims. Liabilities related to these programs are accrued utilizing actuarial analyses based on historical claims experience and are undiscounted. Changes in these self-insurance programs for the year ended February 29, 2012 are as follows (in thousands):

	Beginning- of-year liability	Current-year claims and changes in estimates	Claim payments	End-of-year liability
Hospital professional and general liability	\$ 3,409	(656)	401	2,352
Workers' compensation liability	2,726	415	1,205	1,936
Employee healthcare benefits liability	7,340	70,396	70,340	7,396

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The reserve for hospital professional and general liability, including malpractice, and the reserve for workers' compensation claims are included in accounts payable and accrued liabilities in the accompanying balance sheet. The reserve for incurred but unreported employee health claims is included in employee compensation and related benefit liabilities in the accompanying balance sheet.

The District is also exposed to various risks of loss related to theft of, damage to, and destruction of assets, errors and omissions, and natural disasters. It is the District's policy to purchase commercial insurance for the risks of these losses. Settled claims have not exceeded this commercial coverage in any of the past three fiscal years.

At February 29, 2012, the District had commitments outstanding in the amount of approximately \$20.3 million related to construction of new facilities, \$30.7 million related to improvements at existing facilities, and \$5.6 million related to information technology projects.

The District had rental expenses related to its operating leases of approximately \$6,662,000 during the year ended February 29, 2012.

The District receives financial awards from federal and state agencies in the form of grants. Expenditures of funds under those programs require compliance with the grant agreements and are subject to audit. Any disallowed expenditures resulting from such audits become a liability of the district. In the opinion of management, such adjustments, if any, are not expected to materially affect the financial condition or operations of the District.

(12) Harris UPL Program

The Harris UPL Program is a collaborative established to improve the level of healthcare provided to the indigent population of Harris County by strategically allocating the available community healthcare resources and the burden of providing services. The parties to the collaborative include Harris County Hospital District and the Affiliated Hospitals – Gulf Coast Division Inc., Memorial Hermann Hospital System, CHRISTUS Health Gulf Coast, St. Joseph Medical Center, the Methodist Hospital, Texas Children's Hospital, and St. Luke's Episcopal Health System. An affiliation agreement among the parties allows the parties to improve access to healthcare for indigent persons residing in the Houston community through participation in one of the state's Medicaid supplemental payment programs for privately owned safety-net hospitals. The District provides funding for the nonfederal share of the Medicaid Supplemental Payment Program by using ad valorem tax revenues.

As part of the Harris UPL Program collaboration, the Affiliated Hospitals formed a Certified Non-Profit Health Organization, Harris County Clinical Services Inc. (HCCS), to provide physician services to the indigent in the Harris County community. HCCS has an agreement with Affiliated Medical Services (AMS), a contracting entity for Baylor College of Medicine (Baylor) and the University of Texas Health Science Center (UT), which provides for Baylor and UT to supervise and direct services of patients of the District. With the creation of the collaborative, the agreement between AMS and HCCS was created in order to provide the physician services to indigent patients who seek treatment. In addition, HCCS also entered into agreements with other healthcare service providers to extend services available. Through its

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agreements with AMS and other providers, HCCS provides approximately \$208 million of physician and other clinical services annually to the indigent in the Harris County community. Under a management agreement between HCCS and the District, the District manages the services provided by AMS and provides facilities for indigent patients to receive services.

During the fiscal year ended February 29, 2012, the District utilized \$151.8 million of tax revenues as the nonfederal share of the Harris County UPL program. The District recorded expenses of \$135.7 million in 2012 under the Harris UPL program and provider affiliation agreements. These expenses are reflected as physician services in the statement of revenues, expenses, and changes in net assets.

(13) Subsequent Events

The District evaluated subsequent events from February 29, 2012 through June 15, 2012, the date on which the financial statements were available to be issued.

On May 11, 2012, Fitch Ratings (Fitch) lowered the long-term debt and short-term debt ratings of JPMorgan Chase Bank, N.A. (The Bank), the provider of the irrevocable direct-pay letter of credit applicable to the Bonds. The Bond's long-term rating has been downgraded from "AA-" to "A+" and the short-term rating has been downgraded from "F1+" to "F1."

On May 14, 2012, the District's long-term rating on the Bonds has been downgraded from "AA+" to "AA" and the short-term rating has been downgraded from "F1+" to "F1".

**REQUIRED
SUPPLEMENTARY INFORMATION**

**HARRIS COUNTY HOSPITAL DISTRICT
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Schedule of Funding Progress of Defined Benefit Pension Plan

Three-Year Historical Trend Beginning January 1, 2009

(Unaudited)

Actuarial valuation date (1)	Actuarial value of assets (AVA) (2)	Actuarial accrued liability (AAL) (3)	Unfunded actuarial liability (UAAL) (3) – (2) (4)	Funded ratio (2)/(3) (5)	Annual covered payroll (6)	UAAL as a percentage of covered payroll (4)/(6)
January 1, 2009	\$ 371,468	490,205	118,737	75.8%	\$ 255,127	46.5%
January 1, 2010	438,597	527,930	89,333	83.1	250,454	35.7
January 1, 2011	449,247	540,947	91,700	83.0	241,076	38.0

Dollar amounts in thousands.

See accompanying independent auditors' report.

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Schedule of Actuarial Data for Defined Benefit Pension Plan

January 1, 2011

(Unaudited)

The information presented in the required supplementary information was determined as part of the actuarial valuations at the dates indicated. Additional information as of the latest actuarial valuation is as follows:

Valuation date	January 1, 2011
Actuarial cost method	Projected unit credit
Amortization method	Level dollar, open
Amortization period	20 years
Asset valuation method	Five-year smoothed market
Actuarial assumptions:	
Inflation	3.0%
Investment rate of return	8.0%
Projected salary increases (ultimate rate)	4.0%
Cost-of-living adjustments	Not applicable
Mortality rates	The RP2000 Combined Mortality Table

See accompanying independent auditors' report.

HARRIS COUNTY HOSPITAL DISTRICT
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Schedule of Funding Progress of Other Postemployment Benefit Plan
Three-Year Historical Trend Beginning March 1, 2009
(Unaudited)

Actuarial valuation date (1)	Actuarial value of assets (AVA) (2)	Actuarial accrued liability (AAL) (3)	Unfunded actuarial accrued liability (UAAL) (3) – (2) (4)	Funded ratio (2)/(3) (5)	Annual covered payroll (6)	UAAL as a percentage of covered payroll (4)/(6)
March 1, 2009	\$ —	428,843	428,843	—%	\$ 255,127	168.1%
March 1, 2010	—	540,087	540,087	—	250,454	215.6
March 1, 2011	—	548,818	548,818	—	241,076	227.7

Dollar amounts in thousands.

See accompanying independent auditors' report.