

Harris County Hospital District and Affiliates, a Component Unit of Harris County, Texas

Combined Financial Statements as of and for the Years Ended
February 28, 2010 and 2009, Additional Required
Supplementary Information as of January 1, 2009, and
Independent Auditors' Report

HARRIS COUNTY HOSPITAL DISTRICT AND AFFILIATES, A COMPONENT UNIT OF HARRIS COUNTY, TEXAS

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INDEPENDENT AUDITORS' REPORT

To the Board of Managers of
Harris County Hospital District:

We have audited the accompanying combined balance sheets of the Harris County Hospital District and affiliates (the "District"), a component unit of Harris County, Texas, as of February 28, 2010 and 2009, and the related combined statements of revenues, expenses, and changes in net assets and cash flows for the years then ended. These combined financial statements are the responsibility of the District's management. Our responsibility is to express an opinion on these combined financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America 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 combined 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 combined financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such combined financial statements present fairly, in all material respects, the combined financial position of the District as of February 28, 2010 and 2009, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Management's discussion and analysis on pages 3 through 19 and the supplementary schedules on pages 52 through 54 are not a required part of the combined financial statements, but are supplementary information required by the Governmental Accounting Standards Board (GASB). This supplementary information is the responsibility of the District's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated June 1, 2010, on our consideration of the District's internal control over financial reporting and 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.

Deloitte & Touche LLP

June 1, 2010

MANAGEMENT'S DISCUSSION AND ANALYSIS

Harris County Hospital District

Year Ended February 28, 2010

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 28, 2010. This section should be read in conjunction with the District's combined financial statements, which begin on page 20.

Financial Highlights

- The District's net assets increased \$17 million, or 2.0%, given the income reported for the year.
- Total assets increased \$13 million, or 0.9%, between fiscal 2009 and fiscal 2010.
- Long-term debt, including current portion, decreased \$10.7 million, or 3.4%, between fiscal 2009 and fiscal 2010. In April 2008, the Series 2007B bonds in the amount of \$103,525,000 were converted from auction rate securities and reoffered as variable rate bonds bearing interest at a term rate during a term rate period. The initial term rate period ends August 16, 2010.
- Community Health Choice, Inc. experienced a 9.3% growth in membership during the year.
- The District increased access to surgical services by increasing outpatient surgery schedules 30%. At the same time, inpatient surgeries declined 7% reflecting a shift from inpatient to outpatient care. Thus surgeries were performed in a more cost effective manner that reduced inpatient cost and length of stay.
- The Riverside Dialysis Unit became operational and alleviated overcrowding in the emergency room. Emergency room patient satisfaction scores were greatly improved and, with other operational improvements, fewer patients left without being treated.
- Expansion of current community health centers and the opening of an additional clinic has allowed space for additional providers and the ability to provide more primary care services. Total outpatient visits increased by 11.2% over prior year.
- During the year, the District invested \$86 million in critical information technology, medical equipment and space/facility expansion projects. Significant capital acquisitions and resource investments included the following:
 - Information Technology including:
 - Financial decision support software
 - EPIC clinical care systems
 - EPIC business systems
 - PeopleSoft ERP software enhancements, and
 - Enterprise monitoring and event management system
 - Renovation projects including:
 - Quentin Mease to provide enhanced outpatient rehabilitation services
 - Existing community health clinics
 - Old Ben Taub tower renovation architectural and engineering services, and
 - Dialysis

- Expansion of community health clinics and outpatient ancillary services including:
 - Land acquisition
 - Construction services for the replacement of an existing clinic opening in May 2010 and the addition of a new site in west Harris County that opened in November 2009
 - Parking garage located at the administrative campus to accommodate a new radiation and diagnostic clinic scheduled to open in late summer 2012, and
 - LBJ emergency center expansion
- Medical equipment including:
 - Automated digital cell morphology for hematology
 - Mammography units
 - Beds and stretchers
 - Ultrasonic scan systems
 - Physiological monitoring system, and
 - Video Endoscopy scopes

Combined Financial Statements

The District's combined 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) combined balance sheets, (2) combined statements of revenues, expenses, and changes in net assets, and (3) combined statements of cash flows. The statements provide information about the combined activities of the District, the HCHD Foundation (the "Foundation") and Community Health Choice, Inc. (the "HMO"). The combined balance sheets and the combined statements of revenues, expenses, and changes in net assets reflect the District's combined 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 combined statements of cash flows report 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.

Net Assets

A summary of the District's assets and liabilities as of February 28, 2010 and 2009, is presented in Table 1 below:

TABLE 1
Condensed Summary of Assets and Liabilities
(In millions)

	2010	2009	Dollar Change	Total % Change
Current and other assets	\$ 1,164	\$ 1,195	\$ (31)	(2.6)%
Capital assets	<u>283</u>	<u>239</u>	<u>44</u>	18.4
Total assets	<u>\$ 1,447</u>	<u>\$ 1,434</u>	<u>\$ 13</u>	0.9 %
Long-term debt outstanding	\$ 300	\$ 303	\$ (3)	(0.9)%
Other liabilities	<u>273</u>	<u>274</u>	<u>(1)</u>	(0.4)
Total liabilities	<u>\$ 573</u>	<u>\$ 577</u>	<u>\$ (4)</u>	(0.7)%
Invested in capital assets, net of related debt	\$ 107	\$ 93	\$ 14	15.1 %
Restricted net assets	42	60	(18)	(30.0)
Unrestricted net assets	<u>725</u>	<u>704</u>	<u>21</u>	3.0
Total net assets	<u>\$ 874</u>	<u>\$ 857</u>	<u>\$ 17</u>	2.0 %

Net assets, the difference between the assets and liabilities reported on the balance sheet, increased \$17 million in fiscal 2010. The overall increase is the result of the income reported for fiscal 2010. The income reported is discussed in detail following Table 2. Current and other assets decreased \$31 million or 2.6% from fiscal 2009 to fiscal 2010 as a result of expenditures by Community Health Choice, Inc for increased claims adjudication and reduction in year end reserves. The growth in capital assets is discussed in detail following Table 3.

Reductions in bond related debt reflect scheduled debt service payments. The outstanding principal amount of the Series 1990 Bonds in the amount of \$11 million was paid in February of 2010. The first scheduled payments of principal of the Series 2007 Bonds totaling \$3.4 million are due in February of 2011. The District's net obligation for the provision of certain post employment health care benefits increased approximately \$29 million during fiscal 2010. During the same period, Community Health Choice, Inc. reflected a \$24 million reduction in reserves for incurred but unreported claims.

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 28, 2010 and 2009, and the changes in net assets during each of those years:

TABLE 2
Condensed Statements of Revenues, Expenses, and Changes in Net Assets
(In thousands)

	2010	2009
Operating revenues:		
Net patient service revenue	\$ 258,457	\$ 226,358
DSH/UPL programs revenue	184,671	179,721
Premium revenue	426,997	393,615
Other operating revenues	<u>34,640</u>	<u>37,899</u>
Total operating revenues	<u>904,765</u>	<u>837,593</u>
Operating expenses:		
Salaries, wages, and benefits	635,655	572,894
Purchased services, supplies, and other	395,448	350,670
Medical claims expense	374,305	319,162
Depreciation and amortization	<u>39,831</u>	<u>41,996</u>
Total operating expenses	<u>1,445,239</u>	<u>1,284,722</u>
Operating loss	(540,474)	(447,129)
Total nonoperating revenues — net	557,407	539,732
Restricted contributions — net	<u>13</u>	<u>43</u>
Change in net assets	16,946	92,646
Total net assets — beginning of year	<u>857,148</u>	<u>764,502</u>
Total net assets — end of year	<u>\$ 874,094</u>	<u>\$ 857,148</u>

During the year, the District's total operating revenue increased by \$67.2 million. Increased funding from third-party payors and patients of \$32.1 million and an increase of \$33.4 million in premium revenue were the primary drivers. The final implementation of new patient accounting software District wide was accomplished mid summer 2009. The implementation coupled with the redesign of business systems and processes facilitated increased reimbursement from third party payors. The District has better clinical documentation and revenue cycle tools available through the patient accounting system and other supporting software. As a result, revenue cycle management has been able to streamline work flows and improve accuracy. During fiscal 2010 reimbursement was received in the amount of \$5.6 million related to care provided to individuals evacuated to Houston after Hurricane Katrina. The increase in premium revenue is related to the increase in membership for Community Health Choice Inc. DSH/UPL program revenue reflects a 2.8% increase or \$5 million in funding. Other operating revenues decreased \$3.3 million for the year. An increase in other funding sources for the District of \$4.1 million, primarily trauma care funding, was offset by \$7.2 million decreased contributions to the Harris County Hospital District Foundation.

Current year DSH/UPL revenues include (\$5.4) million for a period prior to fiscal 2010. At February 28, 2009, the District recorded a \$28.3 million receivable related to the DSH/UPL programs. Revenues in fiscal 2010 for the state's fiscal 2009 program exceeded estimates by \$6.6 million. The District is unable to estimate the continuance or amount of future funding of the UPL program. As of February 28, 2010, the District has received funds totaling \$54.5 million related to the state of Texas 2010 DSH/UPL programs. The District has recorded a \$44.2 million receivable at February 28, 2010, related to the DSH and UPL programs.

Operating expenses increased by \$160.5 million over the prior year. Salaries and wages increased \$34.2 million, or 7.7%. Merit increases and changes in the compensation plan to reflect market adjustments has enabled the District to retain current staff and recruit additional needed staff to address increased patient volumes. The number of individuals served during fiscal 2010 increased 9.8% compared to prior year. Related benefits increased \$28.6 million, or 22.3%. Employee healthcare costs increased 23.1%. Pension expenses increased 53.4% due to lower return on investments.

Overall, purchased services and supplies increased \$44.8 million, or 12.8%. Physician service costs increased \$32.9 million as compared to fiscal 2009. 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 increase in supplies of \$14.0 million, or 9.3%. Increased supply expenditures were reflected in most categories including pharmaceutical costs of \$6.8 million and patient device costs of \$1.9 million. The District expended \$2.1 million less than the prior year in its cost for other purchased services.

Medical claims expense associated with the HMO increased by \$55.1 million or 17.3%. Membership increased from 154,081 member months in February 2009 to 157,845 in February 2010, a 2.4% increase. In addition, the medical loss ratio increased 16.7%.

Overall, the District's operating loss increased \$93.3 million, or 20.9%. 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.

Nonoperating revenues and expenses consist of property tax revenue, investment income, tobacco settlement monies, interest expense, and gains or losses on disposal of assets. Tax revenues, net of related fees, increased \$6.6 million, or 1.3%. Investment income increased approximately \$0.5 million reflecting continued low investment returns during the past year. In fiscal 2010, the District received approximately \$22.6 million in tobacco settlement revenue as compared to \$22.3 million in 2009. Interest expense decreased \$10.8 million year over year with the capitalization of interest costs related to the Series 2007 Bond funded projects.

Capital Assets and Debt Financing

During fiscal 2010, the District has invested \$86 million in information technology, equipment, facility renovation and land acquisition. Table 3 summarizes the changes in the District's capital assets between February 28, 2010 and 2009:

TABLE 3
Capital Assets
(In thousands)

	2010	2009	Dollar Change	Total % Change
Land and improvements	\$ 33,917	\$ 28,078	\$ 5,839	20.8 %
Buildings and fixed equipment	322,559	298,307	24,252	8.1
Major movable equipment	<u>242,802</u>	<u>224,544</u>	<u>18,258</u>	8.1
Subtotal	599,278	550,929	48,349	8.8
Less accumulated depreciation	(366,089)	(342,528)	(23,561)	(6.9)
Construction in progress	<u>49,720</u>	<u>30,869</u>	<u>18,851</u>	61.1
Capital assets — net	<u>\$ 282,909</u>	<u>\$ 239,270</u>	<u>\$ 43,639</u>	18.2 %

For the fiscal year 2011 capital budget, the District conducted an assessment of its facilities, equipment and technology to determine the priorities for replacement, repair and any new acquisitions. The assessment and prioritization process addressed obsolescence, new technology, building safety and code compliance requirements. As a result, the District's capital budget for fiscal year 2011 includes an investment of \$37 million in routine capital expenditures. The capital projects include \$17 million in information technology primarily dedicated to current system upgrades and technology refresh, \$9 million specific to medical capital, and \$11 million in renovations of current facilities.

In 2008, the District embarked on a multi-year plan with an estimated cost of \$364 million in capital projects for the expansion of existing diagnostic and treatment facilities to improve access to health care services. As of February 28, 2010, approximately \$55 million has been expended for these projects. It is anticipated that additional funds of \$60 million will be expended in the upcoming year.

At February 28, 2010, the District had \$299.0 million in outstanding revenue bonds, net of any discounts, premiums, and deferred refunding losses. The refunding revenue bonds issued in 1990 for facility expansions were refinanced in 2000. The proceeds of the 2000 bonds were used to defease approximately 54% of the 1990 bonds and to increase the debt service reserve funds. The final maturity and payment of the 1990 bonds was February 2010. In October 2007 the District issued Series 2007A refunding and revenue bonds to refund \$24 million in outstanding commercial paper debt and 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. Moody's and Standard & Poor's have maintained an underlying rating of A1/A on the District's revenue bond obligations. The debt was insured by MBIA Insurance Corporation and, as such, was designed to carry Aaa/AAA ratings by both Moody's and Standard & Poor's. Since that time both Moody's and Standard & Poor's have downgraded MBIA Insurance Corporation to B3/BBB ratings. 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 28, 2010 and 2009:

TABLE 4
Long-Term Debt and Other Long-Term Obligations
(In thousands)

	2010	2009
Series 1990 tax-exempt revenue bonds, net of discount	\$	\$ 10,880
Series 2007 tax-exempt revenue bonds, including premium and deferred loss on refunding	298,959	298,348
Other long - term obligations	<u>5,469</u>	<u>6,042</u>
Total long-term debt and other long-term obligations	304,428	315,270
Less current portion	<u>(4,910)</u>	<u>(12,261)</u>
Noncurrent portion	<u>\$ 299,518</u>	<u>\$ 303,009</u>

Current Budget

Annually, the District prepares an operating and capital budget for approval by the District's Board of Managers and for submission to the Harris County Commissioners' Court for approval prior to the beginning of the operating year. Table 5 presents the approved budget as compared to fiscal 2010 actual results:

TABLE 5
Budget vs. Actual
(In thousands)

	Budget 2010	Actual 2010	Favorable (Unfavorable) Variance
Revenues:			
Net patient service revenue	\$ 258,065	\$ 258,457	\$ 392
DSH/UPL programs revenue	174,747	184,671	9,924
Premium revenue	423,937	426,997	3,060
Other operating revenues	38,713	34,640	(4,073)
Nonoperating revenues	<u>568,159</u>	<u>557,407</u>	<u>(10,752)</u>
Total revenues	<u>\$ 1,463,621</u>	<u>\$ 1,462,172</u>	<u>\$ (1,449)</u>
Operating expenses:			
Salaries, wages, and benefits	\$ 620,266	\$ 635,655	\$ (15,389)
Purchased services, supplies, and other	380,162	395,448	(15,286)
Medical claims expense	374,408	374,305	103
Depreciation and amortization	<u>37,242</u>	<u>39,831</u>	<u>(2,589)</u>
Total operating expenses	<u>\$ 1,412,078</u>	<u>\$ 1,445,239</u>	<u>\$ (33,161)</u>
Income before restricted contributions	\$ 51,543	\$ 16,933	\$ (34,610)
Restricted contributions — net	<u> </u>	<u>13</u>	<u>13</u>
Change in net assets	<u>\$ 51,543</u>	<u>\$ 16,946</u>	<u>\$ (34,597)</u>

In comparing 2010 financial results to budget, the following items are noted.

Consolidated revenues reported for fiscal 2010 were \$1.4 million below budget, and total expenses exceeded budget \$33.2 million creating a negative variance of \$35 million in operating income as compared to budget. When adjusted for volume, the District provided care within 0.4% of planned cost. The challenges for cost containment were experienced in the supplies expense category. A review of funding sources indicates estimated reimbursement for services exceeded budget. However, the sources of funding from non operating revenues fell short of budget by \$10.8 million. The effect of the national economic downturn and increase in the unemployment rate was reflected in a lower tax base than budgeted which resulted in a \$9.7 million deficit in projected net ad valorem taxes. Lower than expected returns on investments of \$14.0 million were also experienced. These deficits were partially offset by \$9.9 million increased funding recognized for the state of Texas DSH/UPL programs. Premium revenues exceeded budget, however, the medical loss ratio exceeded budget resulting in approximately \$11 million in excess claims expenses. The Board of Managers has designated 75% of the District's fiscal 2010 income for use in the facilities expansion program.

Economic Conditions and Plan for Fiscal 2011

In planning for fiscal 2011, of primary concern was the uncertain status of the economy at both the federal and state funding levels and the uncertainty of federal health reform efforts and their potential financial and operational impact on the District. Issues that need to be addressed on an ongoing basis throughout the year include the following:

- Medicaid cuts
- Increased 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
- Future funding available under the DSH and UPL programs
- Uncertain property tax funding due to home foreclosures and rising unemployment
- 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
- Future cost savings and efficiencies available under the Harris County collaborative
- Management of the EPIC clinical and business systems implementation and subsequent process related changes and maximization of efficiencies
- Monitoring of new payment methodology for physician services
- 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

MANAGEMENT'S DISCUSSION AND ANALYSIS

Harris County Hospital District

Year Ended February 28, 2009

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 28, 2009. This section should be read in conjunction with the District's combined financial statements, which begin on page 20.

Financial Highlights

- The District's net assets increased \$92 million, or 12%, given the income reported for the year.
- Total assets increased \$92 million, or 6.9%, between fiscal 2008 and fiscal 2009.
- Long-term debt decreased \$6 million, or 1.9%, between fiscal 2008 and fiscal 2009. In October of 2007, the District issued \$302,610,000 in refunding and revenue bonds. In April 2008, the Series 2007B bonds in the amount of \$103,525,000 were converted from auction rate securities and reoffered as variable rate bonds bearing interest at a term rate during a term rate period. The initial term rate period ends August 16, 2010.
- Community Health Choice, Inc. experienced a 22.1% growth in membership during the year.
- During the year, the District invested \$80 million in critical information technology, medical equipment and space/facility expansion projects. Significant capital acquisitions and resource investments included the following:
 - Coordinated EPIC clinical care systems implementation
 - EPIC patient accounting and business systems implementation
 - Renovation projects including:
 - LBJ imaging areas
 - Existing community health clinics
 - Ben Taub imaging areas, and
 - Dialysis
 - Expansion of community health clinics and outpatient ancillary services including:
 - LBJ site located specialty clinics
 - Construction services for the replacement of an existing clinic and the addition of a new site in west Harris County
 - Architectural services for a new radiation therapy and diagnostic clinic to be located at the administrative campus, and
 - LBJ emergency center expansion
 - Medical equipment including:
 - Automated dispensing units
 - Patient monitoring systems, and
 - Beds and stretchers

Combined Financial Statements

The District's combined 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) combined balance sheets, (2) combined statements of revenues, expenses, and changes in net assets, and (3) combined statements of cash flows. The statements provide information about the combined activities of the District, the HCHD Foundation (the "Foundation") and Community Health Choice, Inc. (the "HMO"). The combined balance sheets and the combined statements of revenues, expenses, and changes in net assets reflect the District's combined 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 combined statements of cash flows report 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.

Net Assets

A summary of the District's assets and liabilities as of February 28, 2009 and February 29, 2008, is presented in Table 6 below:

TABLE 6
Condensed Summary of Assets and Liabilities
(In millions)

	2009	2008	Dollar Change	Total % Change
Current and other assets	\$ 1,195	\$ 1,138	\$ 57	5.0 %
Capital assets	<u>239</u>	<u>204</u>	<u>35</u>	17.2
Total assets	<u>\$ 1,434</u>	<u>\$ 1,342</u>	<u>\$ 92</u>	6.9 %
Long-term debt outstanding	\$ 303	\$ 309	\$ (6)	(1.9)%
Other liabilities	<u>274</u>	<u>268</u>	<u>6</u>	2.2
Total liabilities	<u>\$ 577</u>	<u>\$ 577</u>	<u>\$ -</u>	- %
Invested in capital assets, net of related debt	\$ 93	\$ 69	\$ 24	34.8 %
Restricted net assets	60	61	(1)	(1.6)
Unrestricted net assets	<u>704</u>	<u>635</u>	<u>69</u>	10.9
Total net assets	<u>\$ 857</u>	<u>\$ 765</u>	<u>\$ 92</u>	12.0 %

Net assets, the difference between the assets and liabilities reported on the balance sheet, increased \$92 million in fiscal 2009. The overall increase is the result of the income reported for fiscal 2009. The income reported is discussed in detail following Table 7; however, the change in net assets is primarily the result of increased nonoperating revenues including net ad valorem taxes of \$42 million and tobacco settlement revenues of \$2 million. Current and other assets increased \$57 million or 5% from fiscal 2008 to fiscal 2009 as a result of increased cash and investments generated by the year's income.

Reductions in bond related debt reflect scheduled debt service payments. Such reductions in liabilities were offset by an increase in operational liabilities as of year end.

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 28, 2009 and February 29, 2008, and the changes in net assets during each of those years:

TABLE 7
Condensed Statements of Revenues, Expenses, and Changes in Net Assets
(In thousands)

	2009	2008
Operating revenues:		
Net patient service revenue	\$ 226,358	\$ 258,428
DSH/UPL programs revenue	179,721	165,161
Premium revenue	393,615	345,280
Other operating revenues	<u>37,899</u>	<u>23,906</u>
Total operating revenues	<u>837,593</u>	<u>792,775</u>
Operating expenses:		
Salaries, wages, and benefits	572,894	525,385
Purchased services, supplies, and other	350,670	324,487
Medical claims expense	319,162	299,069
Depreciation and amortization	<u>41,996</u>	<u>32,360</u>
Total operating expenses	<u>1,284,722</u>	<u>1,181,301</u>
Operating loss	(447,129)	(388,526)
Total nonoperating revenues (expenses) — net	539,732	521,091
Restricted contributions — net	<u>43</u>	<u>(48)</u>
Change in net assets	92,646	132,517
Total net assets — beginning of year	<u>764,502</u>	<u>631,985</u>
Total net assets — end of year	<u>\$ 857,148</u>	<u>\$ 764,502</u>

During the year, the District's total operating revenue increased \$44.8 million while operating expenses increased \$103.4 million over the prior year. Decreased funding from third-party payors and patients of \$32.1 million was partially offset by \$14.6 million in increased funding by the Disproportionate Share (DSH) and Upper Payment Limit (UPL) programs. Other operating revenues increased \$14.0 million over the prior year, including \$5.9 million in additional trauma funds received and \$8 million in contributions to the District Foundation. Premium revenue in fiscal 2009 was 14.0%, or \$48.3 million, greater than the prior year.

Current year DSH/UPL revenues include \$5.5 million for a period prior to fiscal 2009. At February 29, 2008, the District had recorded a \$22.5 million receivable related to the DSH/UPL programs. Revenues in fiscal 2009 for the state's fiscal 2008 program exceeded estimates by \$2.0 million. The District is unable to estimate the continuance or amount of future funding of the UPL program. As of February 28, 2009, the District has received funds totaling \$56.5 million related to the state of Texas September 2008-August 2009 DSH/UPL programs. The District has recorded a \$28.2 million receivable at February 28, 2009, related to the DSH and UPL programs.

Salaries and wages increased \$44.9 million, or 11.2%. Merit increases and changes in the compensation plan to reflect market adjustments has enabled the District to retain current staff and recruit additional needed staff to address unserved patient volumes. Related benefits increased \$2.9 million, or 2.3%.

Overall, purchased services and supplies increased \$26.2 million, or 8.1%. As a result of the Harris County collaborative discussed in further detail in Note 12 to the financial statements, the District was able to achieve cost savings in physician service costs of \$5.3 million as compared to fiscal 2008. The District reported an overall increase in supplies of \$13.8 million, or 10.1%. Increased supply expenditures were reflected in several categories including: minor medical and information technology equipment purchases of \$3.7 million, pharmaceutical costs of \$2.2 million, blood and plasma expenses of \$1.3 million, and patient device costs of \$1.4 million. The District expended \$17.7 million over the prior year in its cost for other purchased services. Increases were experienced in facilities, maintenance and utilities costs of approximately \$3.8 million, \$2.0 million in premium taxes incurred by the HMO, \$4.7 million in contracted non-clinical costs, and \$2.6 million in legal fees.

Medical claims expense associated with the HMO increased by \$20.1 million or 6.7%. Although membership increased from 126,220 member months in February 2008 to 154,081 in February 2009, a 22.1% increase, a favorable claims experience was realized.

Overall, the District's operating loss increased \$58.6 million, or 15.1%. 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.

Nonoperating revenues consist of property tax revenue, investment income, tobacco settlement monies, and gains or losses on disposal of assets. Tax revenues increased \$41.5 million, or 8.6%, as a result of increased property values and a reduction in collection fees. Investment income decreased approximately \$19.9 million reflecting declining investment returns during the past year as well as a decline in the fair value of investments. In fiscal 2009, the District received approximately \$22.3 million in tobacco settlement revenue as compared to \$20 million in 2008.

Capital Assets and Debt Financing

During fiscal 2009, the District has invested \$80 million in information technology, facility renovation and land acquisition. Table 8 summarizes the changes in the District's capital assets between February 28, 2009 and February 29, 2008:

TABLE 8
Capital Assets
(In thousands)

	2009	2008	Dollar Change	Total % Change
Land and improvements	\$ 28,078	\$ 28,030	\$ 48	0.2 %
Buildings and fixed equipment	298,307	291,409	6,898	3.7
Major movable equipment	<u>224,544</u>	<u>199,389</u>	<u>25,155</u>	1.3
Subtotal	550,929	518,828	32,101	6.2
Less accumulated depreciation	(342,528)	(323,275)	(19,253)	6.0
Construction in progress	<u>30,869</u>	<u>8,169</u>	<u>22,700</u>	277.9
Capital assets — net	<u>\$ 239,270</u>	<u>\$ 203,722</u>	<u>\$ 35,548</u>	17.4 %

For the fiscal year 2010 capital budget, the District conducted an assessment of its facilities, equipment and technology to determine the priorities for replacement, repair and any new acquisitions. The assessment and prioritization process addressed obsolescence, new technology, building safety and code compliance requirements. As a result, the District's capital budget for fiscal year 2010 includes an investment of \$36 million in routine capital expenditures. The capital projects include \$12 million in information technology primarily dedicated to current system upgrades and technology refresh, \$15 million specific to medical capital, and \$9 million in renovations of current facilities.

In 2008, the District embarked on a multi-year plan with an estimated cost of \$364 million in capital projects for the expansion of existing diagnostic and treatment facilities to improve access to health care services. As of February 28, 2009 approximately \$19.4 million has been expended for these projects. It is anticipated that additional funds of \$48.3 million will be expended in the upcoming year.

At February 28, 2009, the District had \$309.2 million in outstanding revenue bonds, net of any discounts, premiums, and deferred refunding losses. The refunding revenue bonds were issued in 1990 for facility expansions and were refinanced in 2000. The proceeds of the 2000 bonds were used to defease approximately 54% of the 1990 bonds and to increase the debt service reserve funds. The final maturity of the 1990 bonds is February 2010. In October 2007 the District issued Series 2007A refunding and revenue bonds to refund \$24 million in outstanding commercial paper debt and 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. Moody's and Standard & Poor's have maintained an underlying rating of A1/A on the District's revenue bond obligations. The debt was insured by MBIA Insurance Corporation and, as such, was designed to carry Aaa/AAA ratings by both Moody's and Standard & Poor's. Since that time both Moody's and Standard & Poor's have downgraded MBIA Insurance Corporation to

B3/BBB ratings. 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 9 below summarizes the District's debt obligations at February 28, 2009 and February 29, 2008:

TABLE 9
Long-Term Debt and Other Long-Term Obligations
(In thousands)

	2009	2008
Series 1990 tax-exempt revenue bonds, net of discount	\$ 10,880	\$ 19,329
Series 2007 tax-exempt revenue bonds, including premium and deferred loss on refunding	298,348	297,737
Other long term obligations	<u>6,042</u>	<u>845</u>
Total long-term debt and other long-term obligations	315,270	317,911
Less current portion	<u>(12,261)</u>	<u>(9,000)</u>
Noncurrent portion	<u>\$ 303,009</u>	<u>\$ 308,911</u>

Current Budget

Annually, the District prepares an operating and capital budget for approval by the District's Board of Managers and for submission to the Harris County Commissioners' Court for approval prior to the beginning of the operating year. Table 10 presents the approved budget as compared to fiscal 2009 actual results:

TABLE 10
Budget vs. Actual
(In thousands)

	Budget 2009	Actual 2009	Favorable (Unfavorable) Variance
Revenues:			
Net patient service revenue	\$ 272,519	\$ 226,358	\$ (46,161)
DSH/UPL programs revenue	165,542	179,721	14,179
Premium revenue	437,822	393,615	(44,207)
Other operating revenues	24,969	37,899	12,930
Nonoperating revenues	<u>525,420</u>	<u>539,732</u>	<u>14,312</u>
Total revenues	<u>\$ 1,426,272</u>	<u>\$ 1,377,325</u>	<u>\$ (48,947)</u>
Operating expenses:			
Salaries, wages, and benefits	\$ 581,345	\$ 572,894	\$ 8,451
Purchased services, supplies, and other	358,079	350,670	7,409
Medical claims expense	382,565	319,162	63,403
Depreciation and amortization	<u>34,404</u>	<u>41,996</u>	<u>(7,592)</u>
Total operating expenses	<u>\$ 1,356,393</u>	<u>\$ 1,284,722</u>	<u>\$ 71,671</u>
Income before restricted contributions	\$ 69,879	\$ 92,603	\$ 22,724
Restricted distributions — net	<u> </u>	<u>43</u>	<u>43</u>
Change in net assets	<u>\$ 69,879</u>	<u>\$ 92,646</u>	<u>\$ 22,767</u>

In comparing 2009 financial results to budget, the following items are noted.

Although revenues reported for fiscal 2009 were \$48.9 million below budget, by managing expenses the District, the Foundation, and the HMO combined generated \$22.8 million net income in excess of plan.

Net patient service revenue and premium revenues were below budget, \$46.2 million and \$44.2 million respectively. The deficit in net patient service revenues reflected lower than anticipated reimbursement rates as the payor mix included a 6.3% increase over plan of clients with limited or no ability to pay for services. Although both inpatient and outpatient volumes were below plan, 3.6% and 2.8% respectively, the acuity of the clients served was 4.1% greater than plan. Although the HMO's membership increased 22.1% during the year, the membership level was approximately 1% below plan and the premium risk group mix was approximately 6% below plan. Revenues from the DSH/UPL programs exceeded budget \$14.2 million, and funding from other operating revenue sources such as grants exceeded budget \$12.9 million. Non operating revenue exceeded budget \$14.3 million. Although investment income fell short of plan \$20.2 million, net ad valorem tax revenues exceeded budget \$34.7 million.

Operating costs were maintained below plan in all categories excluding depreciation and amortization costs. Total operating expenses were \$71.7 million less than budget. As a result of cost management, the District was able to achieve income before restricted contributions/distributions \$22.8 million greater than planned. The Board of Managers has designated 75% of the District's fiscal 2009 income for use in the facilities expansion program.

Economic Conditions and Plan for Fiscal 2010

In planning for fiscal 2010, of primary concern was the uncertain status of the economy at both the federal and state funding levels. Issues that need to be addressed on an ongoing basis throughout the year include the following:

- Medicaid cuts
- Downsizing of the University of Texas Medical Branch at Galveston after Hurricane Ike and the closure of two community hospitals
- 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
- Plant and equipment needs for replacement of aged equipment, and needed repairs, maintenance, and renovation
- Financial planning for the District's Strategic Capital Initiatives Plan and continued development of the long-range operating, facilities, and financial plan related to these capital initiatives
- Future funding available under the DSH and UPL programs
- Future property tax funding due to home foreclosures and rising unemployment
- Monitoring of the expansion and renovations projects under the Strategic Capital Initiatives Plan
- Future cost savings and efficiencies available under the Harris County collaborative
- Management of the EPIC clinical and business systems implementation and subsequent process related changes
- Implementation and monitoring of new payment methodology for physician services

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

**COMBINED BALANCE SHEETS
AS OF FEBRUARY 28, 2010 AND 2009
(In thousands)**

	2010	2009
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 273,341	\$ 232,576
Short-term investments (Notes 5 and 6)	110,123	219,125
Accounts receivable — net of allowance for uncollectible accounts of \$199,833 and \$157,736 in 2010 and 2009, respectively (Note 10)	65,643	64,763
Current portion of ad valorem taxes receivable — net of allowance for uncollectible taxes of \$5,296 and \$5,234 in 2010 and 2009, respectively	36,418	52,222
Inventories	6,764	6,134
Prepaid expenses and other current assets	65,351	61,203
Estimated third-party payor settlements	5,434	738
Current portion of assets limited as to use or restricted (Notes 5 and 6)	<u>96,350</u>	<u>71,916</u>
Total current assets	<u>659,424</u>	<u>708,677</u>
ASSETS LIMITED AS TO USE OR RESTRICTED — Net of current portion (Notes 5 and 6):		
Debt service	17,714	31,798
Capital expansion	291,021	316,385
Other	<u>18,166</u>	<u>93,112</u>
Total assets limited as to use or restricted — net	<u>326,901</u>	<u>441,295</u>
CAPITAL ASSETS (Notes 7 and 11):		
Land and improvements	33,917	28,078
Buildings and fixed equipment	322,559	298,307
Major movable equipment	242,802	224,544
Less accumulated depreciation	<u>(366,089)</u>	<u>(342,528)</u>
Total depreciable capital assets — net	233,189	208,401
Construction in progress	<u>49,720</u>	<u>30,869</u>
Capital assets — net	<u>282,909</u>	<u>239,270</u>
OTHER ASSETS:		
Ad valorem taxes receivable — net of current portion and allowance for uncollectible taxes of \$52,290 and \$50,328 in 2010 and 2009, respectively	3,215	3,775
Net pension asset (Note 9)	2,441	2,495
Long-term investments	164,212	29,988
Deferred bond issue costs — net of accumulated amortization of \$638 and \$6,840 in 2010 and 2009, respectively	5,515	5,920
Other assets	<u>2,646</u>	<u>3,228</u>
Total other assets	<u>178,029</u>	<u>45,406</u>
TOTAL	<u>\$ 1,447,263</u>	<u>\$ 1,434,648</u>

(Continued)

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

**COMBINED BALANCE SHEETS
AS OF FEBRUARY 28, 2010 AND 2009
(In thousands)**

	2010	2009
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES:		
Accounts payable and accrued liabilities	\$ 72,452	\$ 76,674
Interest payable	636	819
Employee compensation and related benefit liabilities	28,140	24,828
Compensated absences	36,771	33,984
Medical claims liability (Note 2)	54,997	79,020
Estimated third-party payor settlements — net	714	454
Current portion of long-term debt and capital leases (Note 8)	<u>4,910</u>	<u>12,261</u>
Total current liabilities	<u>198,620</u>	<u>228,040</u>
OTHER LONG-TERM LIABILITIES — Post employment health benefit liability (Note 9)	<u>75,031</u>	<u>46,451</u>
LONG-TERM DEBT (Note 8):		
Series 2007 revenue bonds — including premium of \$8 and \$8 in 2010 and 2009, respectively, and deferred loss on refunding of \$3,643 in 2010 and \$4,254 in 2009	295,549	298,348
Other long-term obligations	<u>3,969</u>	<u>4,661</u>
Total liabilities	<u>573,169</u>	<u>577,500</u>
COMMITMENTS AND CONTINGENCIES (Note 11)		
NET ASSETS:		
Invested in capital assets — net of related debt	106,988	92,439
Restricted net assets	41,550	60,437
Unrestricted net assets	<u>725,556</u>	<u>704,272</u>
Total net assets	<u>874,094</u>	<u>857,148</u>
TOTAL	<u>\$ 1,447,263</u>	<u>\$ 1,434,648</u>

See notes to combined financial statements.

(Concluded)

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

**COMBINED STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED FEBRUARY 28, 2010 AND 2009
(In thousands)**

	2010	2009
OPERATING REVENUES:		
Net patient service revenue (Note 3)	\$ 258,457	\$ 226,358
DSH/UPL programs revenue (Notes 4 and 12)	184,671	179,721
Premium revenue	426,997	393,615
Other operating revenues	<u>34,640</u>	<u>37,899</u>
Total operating revenues	<u>904,765</u>	<u>837,593</u>
OPERATING EXPENSES:		
Salaries, wages, and benefits	635,655	572,894
Pharmaceuticals and supplies	164,008	149,995
Physician services	113,204	80,318
Medical claims expense	374,305	319,162
Other purchased services	118,236	120,357
Depreciation and amortization	<u>39,831</u>	<u>41,996</u>
Total operating expenses	<u>1,445,239</u>	<u>1,284,722</u>
OPERATING LOSS	<u>(540,474)</u>	<u>(447,129)</u>
NONOPERATING REVENUES (EXPENSES):		
Ad valorem tax revenues — net	528,613	522,053
Tobacco settlement revenues	22,613	22,276
Investment income	14,041	13,570
Interest expense (Note 8)	(7,281)	(18,045)
Other	<u>(579)</u>	<u>(122)</u>
Total nonoperating revenues — net	<u>557,407</u>	<u>539,732</u>
INCOME BEFORE OTHER CHANGES IN NET ASSETS	16,933	92,603
RESTRICTED CONTRIBUTIONS — Net	<u>13</u>	<u>43</u>
CHANGE IN NET ASSETS	16,946	92,646
NET ASSETS — Beginning of year	<u>857,148</u>	<u>764,502</u>
NET ASSETS — End of year	<u>\$ 874,094</u>	<u>\$ 857,148</u>

See notes to combined financial statements.

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

**COMBINED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED FEBRUARY 28, 2010 AND 2009
(In thousands)**

	2010	2009
OPERATING ACTIVITIES:		
Cash received from patients and members	\$ 721,920	\$ 650,423
Cash received from DSH/UPL	168,729	173,978
Cash payments for medical claims	(398,328)	(326,733)
Cash payments for goods and services	(395,065)	(366,359)
Cash payments to employees	<u>(600,922)</u>	<u>(546,877)</u>
Net cash used in operating activities	<u>(503,666)</u>	<u>(415,568)</u>
NONCAPITAL FINANCING ACTIVITIES:		
Receipts of restricted contributions — net	13	43
Ad valorem taxes received — net	544,977	505,920
Tobacco settlement received	<u>22,613</u>	<u>22,276</u>
Net cash provided by noncapital financing activities	<u>567,603</u>	<u>528,239</u>
CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisitions and construction of capital assets — net of deletions	(82,814)	(71,240)
Proceeds from Series 2007 Bonds		(442)
Interest paid	(6,854)	(17,082)
Repayment of long-term debt	<u>(12,283)</u>	<u>(9,720)</u>
Net cash used in capital and related financing activities	<u>(101,951)</u>	<u>(98,484)</u>
INVESTING ACTIVITIES:		
Receipts of investment income — including realized gains and losses	14,041	13,570
Foundation purchase of investments — net	(5,061)	400
Increase (Decrease) in cash equivalents included in assets limited as to use or restricted — net	182,059	(138,679)
Purchases of investment securities	(682,633)	(750,936)
Proceeds from sale and maturities of investment securities	<u>570,373</u>	<u>958,098</u>
Net cash provided by investing activities	<u>78,779</u>	<u>82,453</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS	40,765	96,640
CASH AND CASH EQUIVALENTS — Beginning of year	<u>232,576</u>	<u>135,936</u>
CASH AND CASH EQUIVALENTS — End of year	<u>\$ 273,341</u>	<u>\$ 232,576</u>

(Continued)

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

**COMBINED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED FEBRUARY 28, 2010 AND 2009
(In thousands)**

	2010	2009
RECONCILIATION OF OPERATING LOSS TO NET CASH USED IN OPERATING ACTIVITIES:		
Operating loss	<u>\$ (540,474)</u>	<u>\$ (447,129)</u>
Adjustments to reconcile operating loss to net cash used in operating activities:		
Depreciation and amortization expense	39,831	41,996
Changes in operating assets and liabilities:		
Increase in accounts receivable	(880)	(1,837)
Increase in inventories	(630)	(126)
Increase in prepaid expenses and other assets	(3,566)	(12,034)
(Increase) decrease in estimated third-party payor settlements	(4,696)	727
Decrease in net pension asset	54	185
Decrease in accounts payable and accrued liabilities	(4,221)	(15,524)
Increase in employee compensation and related benefit liabilities	3,312	954
Increase in compensated absences	2,787	2,582
Decrease in medical claims liability	(24,023)	(7,571)
Increase (decrease) in estimated third-party payor settlements	260	(87)
Increase in post employment health benefit liability	<u>28,580</u>	<u>22,296</u>
Total adjustments	<u>36,808</u>	<u>31,561</u>
NET CASH USED IN OPERATING ACTIVITIES	<u>\$ (503,666)</u>	<u>\$ (415,568)</u>
See notes to combined financial statements.		(Concluded)

HARRIS COUNTY HOSPITAL DISTRICT AND AFFILIATES, A COMPONENT UNIT OF HARRIS COUNTY, TEXAS

NOTES TO COMBINED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED FEBRUARY 28, 2010 AND 2009

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 12 health clinics; three specialty clinics providing dental, dialysis, and HIV/AIDS treatment services; and nine school-based or mobile health clinics. The District is exempt from federal income taxes.

The District is presented as a discrete 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.

Harris County Hospital District Foundation (the "Foundation"), a blended component unit of the District, is a not-for-profit corporation incorporated on March 2, 1992, and organized under Section 501(c)(3) of the Internal Revenue Code to support the operations and activities of the District.

Community Health Choice, Inc. (the "HMO"), a blended component unit of the District, 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. As of February 28, 2010, the HMO had approximately 152,468 enrollees. The HMO offers three Medicaid insurance products.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting — The accompanying combined financial statements are prepared on the accrual basis of accounting.

Method of Accounting — The District's accounting policy is to apply all Financial Accounting Standards Board (FASB) statements and interpretations issued after November 30, 1989, except for those that would conflict with or contradict Governmental Accounting Standards Board (GASB) pronouncements.

In accordance with GASB Statement No. 34, *Basic Financial Statements — and Management’s Discussion and Analysis — for State and Local Governments*, the District’s combined financial statements include combined balance sheets; combined statements of revenues, expenses, and changes in net assets; and combined statements of cash flows.

The combined balance sheets require 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, including restricted 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.”

Principles of Combination — The combined financial statements include the accounts of the District, the Foundation, and the HMO, as described in Note 1. Management of the District believes the combined financial statements, presented on a comparative basis, to be the most reflective of the District’s activities. All intraentity accounts and transactions have been eliminated.

Cash, Cash Equivalents, and Short-Term Investments — The District defines cash and cash equivalents as cash and investments that are highly liquid with less than three-month 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 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 Texas Local Government Code*. The Foundation’s investments, however, are not subject to these laws. Such total collateralization and insurance coverage is required by the Board of Managers of the District.

Investments are classified (as defined by the GASB) in three categories to give an indication of the level of risk assumed by the entity at year-end. Category 1 includes investments that are insured or registered or for which the securities are held by the District or its agent in the District’s name. Category 2 includes uninsured and unregistered investments for which the securities are held by the broker’s or dealer’s trust department or agent in the District’s name. Category 3 includes uninsured and unregistered investments for which the securities are held by the broker or dealer or by its trust department or agent but not in the District’s name. Investments at February 28, 2010 and 2009, are primarily classified as Category 1 and are reported at fair value, with realized and unrealized gains and losses included in investment income in the combined statements of revenues, expenses, and changes in net assets.

Contributions and Pledges Receivable — 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. Contributions receivable are recorded at the present value of expected future cash flows discounted at 3.0%. The majority of the pledges recorded are temporarily restricted to new construction of a District outpatient tower. At this time, the Foundation deems these pledges and other contributions to be realized in the following periods.

One year or less	\$ 1,116,085
Between one year and three years	<u>2,019,517</u>
Total pledges receivable	3,135,602
Less present value discount	<u>(105,102)</u>
Net contributions receivable	<u>\$ 3,030,500</u>

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

Capital Assets — Property, plant, and equipment are carried at cost of \$5,000 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.

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 combined statements of revenues, expenses, and changes in net assets.

Deferred Bond Issue Costs — The costs associated with the issuance of bonds are being amortized over the term of the respective bond issue, using the bonds outstanding method.

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 or at the time of termination, unused benefits are payable at 75%.

Combined Statements of Revenues, Expenses, and Changes in Net Assets — For purposes of display, transactions deemed by management to be ongoing, major, or central to the provision of health care services are reported as 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. 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.

Net Patient Service Revenue — 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 2010 and 2009, the District recognized \$3.9 million and \$3.6 million, respectively, in additional net patient service revenue from the differences between estimated and actual cost report settlements and appeals.

Charity Care Policy — The District accepts all Harris County residents as patients regardless of their ability to pay. A patient is classified as a charity patient by reference to certain established eligibility policies of the District. These policies define charity services as those services for which no payment is anticipated. These amounts are not reported as revenue. In assessing a patient's ability to pay, the District utilizes the federal poverty income guidelines set by the U.S. Department of Health and Human Services (HHS) and considers the size of the patient's family unit and place of primary residence.

Premium Revenue — Prepaid health care premiums from enrolled groups are reported as revenue in the month in which enrollees are entitled to receive health care. 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 years ended February 28, 2010 and 2009. During 2010, the HMO recorded \$0.1 million in decreased premium revenue, representing the difference between the estimated and actual premiums received related to 2009. During 2009, the HMO recorded \$1 million in decreased premium revenue, representing the difference between the estimated and actual premiums received related to 2008.

Medical Claims Expense — The HMO arranges for comprehensive health care 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 health care 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 February. 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 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 2010 and 2009 were as follows (in thousands):

	Beginning of Fiscal Year Liability	Current-Year Claims and Changes in Estimates	Claim Payments	End of Fiscal Year Liability
2010	\$ 79,020	\$ 388,210	\$ 412,233	\$ 54,997
2009	86,591	330,256	337,827	79,020

In fiscal 2010 and 2009, the HMO paid \$354.8 million and \$270.4 million in claims related to the current fiscal years and \$57.4 million and \$67.4 million in claims related to the prior fiscal years, respectively.

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. 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.

Tobacco Settlement Revenues — In the fiscal years ended February 28, 2010 and 2009, 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 health care 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.

Use of Estimates — The preparation of combined financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

Newly Adopted Accounting Pronouncements:

GASB Statement No. 49 — *GASB Statement No. 49, Accounting and Financial Reporting for Pollution Remediation Obligations*, was adopted by the District for the year ended February 28, 2009. The GASB Statement established standards for the accounting and reporting of obligations incurred to address current or potential detrimental effects of existing pollution. A framework for identifying and measuring the component activities and liabilities was also established. Implementation had no impact on the District's combined financial position, the results of its operations, the changes in its net assets, or its cash flows.

GASB Statement No. 50 — The notes to combined financial statements reflect the adoption of GASB Statement No. 50, *Pension Disclosures — an amendment of GASB Statements No. 25 and No. 27*, which required additional disclosure information of the funded status of the plan as of the most recent valuation date, including actuarial valuation date, the actuarial value of assets, the actuarial accrued liability, the total unfunded actuarial accrued liability, the actuarial value of assets as a percentage of the actuarial

accrued liability (funded ratio), the annual covered payroll, and the ratio of the unfunded actuarial liability to annual covered payroll. The disclosure requirements of this statement were adopted by the District for the year ended February 28, 2009, and are presented in Note 9.

GASB Statement Nos. 55 and 56 — In March 2009, the GASB issued GASB Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, and GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, which were effective upon issuance. The intent of these two Statements was to bring existing accounting guidance contained in the American Institute of Certified Public Accountants (AICPA) auditing literature without substantive changes into the GASB's body of standards, to the extent that the guidance is appropriate in a governmental environment. GASB Statement No. 55 incorporates the hierarchy of GAAP for state and local governments into the GASB's authoritative literature. GASB Statement No. 56 includes guidance on related-party transactions, subsequent events, and going-concern considerations. These statements have been evaluated, and implementation had no impact on the District's combined financial position, the results of its operations, the changes in its net assets, or its cash flows.

ASC 820 — ASC 820, *Fair Value Measurements and Disclosures*, was adopted by the District in fiscal year 2009. ASC 820 was intended to increase consistency and comparability in fair value measurements by defining fair value, establishing a framework for measuring fair value, and expanding disclosures about fair value measurements. The statement applies to other accounting pronouncements that require or permit fair value measurements. In November 2007, the FASB deferred for one year the application of the fair value measurement requirements to nonfinancial assets and liabilities that are not required or permitted to be measured at fair value. ASC 820 established a three-level fair value hierarchy for fair value to be measured based on the observability of the inputs utilized in the valuation. The levels are: Level 1 — inputs from quoted prices in an active market, Level 2 — inputs other than a quoted price market that are directly or indirectly observable through market corroborated inputs, and Level 3 — inputs that are unobservable and require assumptions about pricing by market participants. Beginning fiscal 2009, the District adopted the provisions related to financial assets and liabilities and to nonfinancial assets and liabilities currently measured at fair value. The adoption of these provisions did not have a material impact on the District's combined financial position, the results of its operations, the changes in its net assets, or its cash flows. Beginning fiscal 2010, the District adopted the provisions for nonfinancial assets and liabilities that are not required to be or are permitted to be at fair value and adoption of these provisions had no impact on the District's combined financial position or results of its operations.

In October 2008, the FASB issued FASB Staff Position (FSP) No. 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*, which clarified the application of FASB Statement No. 157 in an inactive market and demonstrated how the fair value of a financial asset is determined when the market for that financial asset is inactive. FSP FASB Statement 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. The adoption of FSP SFAS 157-3 did not have an effect on the District's combined financial position or results of operations since it did not have any financial assets in inactive markets.

ASC No's 805, 810, 815 and 944 — *ASC 805, Business Combinations*; *ASC 810, Noncontrolling Interests in Consolidated Financial Statements — an amendment of ARB No. 51*; *ASC 815, Disclosures about Derivative Instruments and Hedging Activities — an amendment of FASB Statement No. 133*; and *ASC 944, Accounting for Financial Guarantee Insurance Contracts — an interpretation of ASC 810*, is already effective for the District's fiscal year 2010. Under *ASC 805*, an entity is required to recognize the assets acquired, liabilities assumed, contractual contingencies, and contingent consideration at their fair value on the acquisition date. It further requires that acquisition-related costs and restructuring costs

be recognized separately and expensed. ASC 815 required additional quantitative and qualitative disclosures for derivative instruments, including how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows, and the objectives and strategies for using derivative instruments. ASC 944 applies to financial guarantee insurance contracts issued by insurance enterprises, including the recognition and measurement of premium revenue and claim liabilities. The District's adoption of these statements did not have an effect on the District's combined financial position, results of its operations, the changes in its net assets, or its cash flows.

During May 2009, the FASB issued ASC 855, *Subsequent Events*. ASC 855 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Specifically, this standard sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. The District has adopted this standard during the fiscal period ended February 28, 2010 and has evaluated any subsequent events through June 1, 2010 as disclosed in note 13. During the period subsequent to February 28, 2010, the District did not have any material recognizable subsequent events.

Pending Adoption of Recent Accounting Pronouncements:

GASB Statement Nos. 51 and 53 — GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, and GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, will be applicable in the fiscal year ending February 28, 2011. Statement No. 51 required that all intangible assets not specifically excluded by the provisions of the statement be classified as capital assets. In addition, the statement established a specified-conditions approach to recognizing intangible assets that are internally generated, such as internally generated computer software. Statement No. 53 addressed derivative instruments, which are often complex financial arrangements used to manage specific risks or to make investments or to lower the costs of borrowings. This statement addresses the recognition, measurement, and disclosure of information regarding derivative instruments. The District is in the process of evaluating the impact that these pronouncements will have on its combined financial position, the results of its operations, the changes in the net assets, or its cash flows in the fiscal year 2011.

GASB Statement No. 52 — GASB Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*, will be applicable to the District for the year ending February 28, 2011. Previously, accounting standards required permanent and term endowments to report land and other real estate held as investments at their cost while other entities that existed for similar purposes were required to report such investments at their fair value. This statement established consistent standards by requiring endowments to report land and other real estate investments at fair value. It is anticipated that the District's adoption of this statement will not have an effect on the combined financial position, results of its operation, the changes in its net assets, or its cash flows. The District will continue to monitor the impact of the application of this pronouncement.

GASB Statement No. 54 — GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, was issued in February of 2009 and will be applicable to the District for fiscal 2012. The Statement was designed to improve the usefulness of fund balance information reported by establishing a hierarchy of classifications for reporting an entity's fund balance that is based primarily on the extent to which the government entity is bound to observe spending constraints that control how specific amounts can be spent. It is anticipated that the District's adoption of this statement will not have an effect on the District's combined financial position or results of its operations.

3. NET PATIENT SERVICE REVENUE

Charity care provided during the years ended February 28, 2010 and 2009, measured at established rates, totaled \$862,544,000 and \$927,957,000, respectively. 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 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 fiscal intermediary through February 28, 2007.

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 fiscal intermediary based on Medicare fiscal intermediary audits. The District's Medicaid cost reports have been settled by the Medicaid fiscal intermediary through February 28, 2006.

Cash received from the Medicare program accounted for approximately 21% and 22% of the District's total cash collections for net patient service revenue for the years ended February 28, 2010 and 2009, respectively. Cash received from the Medicaid program (including managed Medicaid) accounted for approximately 56% and 52% of the District's total cash collections for net patient service revenue for the years ended February 28, 2010 and 2009, respectively.

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 AND UPPER PAYMENT LIMIT 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 combined balance sheets. These receivables can be subject to adjustments that are reflected in the period they become known. The District has recorded receivables of \$44.2 million and \$28.2 million at February 28, 2010 and 2009, respectively, related to the DSH and UPL programs.

Additional revenues recorded in fiscal 2010 related to the estimated programs for DSH and UPL for the State's 2009 program and prior years were \$6.6 and \$(5.4) million, respectively. These amounts represent the difference between the estimated and actual funds received related to these program periods. There is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

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 1990 and 2007 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 cash, time deposits, and commercial paper approximates fair value. The fair values of securities are based on quoted market prices as of February 28, 2010 and 2009. The components of assets limited as to use or restricted at fair value at February 28, 2010, are as follows (in thousands):

Description of Assets	Total	Debt Service	Capital Expansion	Harris UPL Program	Legal Reserves	Self-Insured Programs	Other
Cash and time deposits	\$ 671	\$ 659	\$ -	\$ -	\$ -	\$ -	\$ 12
Money market government funds	15,427		567		4,555	10,305	
Government securities	389,872	21,091	296,072			71,836	873
Foundation investments	<u>17,281</u>						<u>17,281</u>
	423,251	21,750	296,639	-	4,555	82,141	18,166
Less funds required for current liabilities	<u>(96,350)</u>	<u>(4,036)</u>	<u>(5,618)</u>		<u>(4,555)</u>	<u>(82,141)</u>	
	<u>\$326,901</u>	<u>\$17,714</u>	<u>\$291,021</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$18,166</u>

The components of assets limited as to use or restricted at fair value at February 28, 2009, are as follows (in thousands):

Description of Assets	Total	Debt Service	Capital Expansion	Harris UPL Program	Legal Reserves	Self-Insured Programs	Other
Cash and time deposits	\$ 13,339	\$ 10,156	\$ 3,183	\$ -	\$ -	\$ -	\$ -
Money market government funds	186,668		46,335	80,021	7,127	53,185	
Government securities	300,985	33,246	266,867				872
Foundation investments	<u>12,219</u>						<u>12,219</u>
	513,211	43,402	316,385	80,021	7,127	53,185	13,091
Less funds required for current liabilities	<u>(71,916)</u>	<u>(11,604)</u>			<u>(7,127)</u>	<u>(53,185)</u>	
	<u>\$441,295</u>	<u>\$ 31,798</u>	<u>\$316,385</u>	<u>\$80,021</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$13,091</u>

Foundation — Assets limited as to use of \$17,281,000 and \$12,219,000 at February 28, 2010 and 2009, respectively, are restricted subject to donor-imposed stipulations that will be met by actions of the Foundation or the District or the passage of time. Foundation investments are included as part of the “other” category in consolidation and separately listed in the tables above. The components of assets limited as to use at fair value at February 28, 2010, are as follows (in thousands):

Description of Assets	Total	Restricted Children’s Health	Restricted Trauma	All Others
Investments:				
Cash, deposits, and money market funds	\$ 5,424	\$4,220	\$ 113	\$ 1,091
Equities	3,988	3,380	159	449
Corporate bonds	960	851		109
Government securities	<u>6,909</u>	<u>858</u>	<u>25</u>	<u>6,026</u>
Subtotal investments	17,281	9,309	297	7,675
Less funds required for related current liabilities				
	<u>\$ 17,281</u>	<u>\$ 9,309</u>	<u>\$ 297</u>	<u>\$ 7,675</u>

The components of assets limited as to use at fair value at February 28, 2009, are as follows (in thousands):

Description of Assets	Total	Restricted Children’s Health	Restricted Trauma	All Others
Investments:				
Cash, deposits, and money market funds	\$ 2,327	\$ 378	\$ 92	\$ 1,857
Equities	5,324	4,740	77	507
Equity mutual funds	300	280		20
Corporate bonds	614	614		
Government securities	<u>3,654</u>	<u>1,025</u>	<u>28</u>	<u>2,601</u>
Subtotal investments	12,219	7,037	197	4,985
Less funds required for related current liabilities				
	<u>\$ 12,219</u>	<u>\$ 7,037</u>	<u>\$ 197</u>	<u>\$ 4,985</u>

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 Trustees, respectively, that 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 the 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 by Moody's Investors Service.

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; consequently, risk is minimal.

Per GASB Statement No. 40, unless there is information to the contrary, obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not require disclosure of credit quality. 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.

The table below indicates the fair value and maturity value of the District's investments as of February 28, 2010, summarized by security type. As discussed above, the table does not include obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government, since they are not required to be disclosed under GASB Statement No. 40. Also demonstrated are the percentage of total portfolio and the weighted-average maturity 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	\$ 24,996	2.62 %	\$ 25,000	0.082	A-1+; P-1
Other:					
Connecticut State	10,234	1.07	10,000	0.756	AA/Aa3
King County Washington	10,855	1.14	10,000	18.770	AAA/Aa3
Mississippi State	6,155	0.65	5,990	0.756	AA/Aa2
U.S. agency notes:					
FAMCA	10,384	1.09	10,000	0.877	AAA
FCAR	131,794	13.84	132,000	0.467	A-1+; P-1
FFCB	51,144	5.37	50,000	2.070	AAA/Aaa
FHLB	199,255	20.92	198,785	2.431	AAA/Aaa
FHLMC	156,577	16.44	155,600	2.833	AAA/Aaa
FNMA	98,409	10.33	98,164	1.662	AAA/Aaa
Time deposit — JP Morgan Chase	3,323	0.35	3,323	0.279	AAA/Aaa
Money market mutual funds	<u>249,197</u>	<u>26.17</u>	<u>249,197</u>	0.003	AAA/Aaa
Total cash and investments	<u>\$ 952,323</u>	<u>100.00 %</u>	<u>\$ 948,059</u>	1.545	

The table below indicates the fair value and maturity value of the District's investments as of February 28, 2009, summarized by security type. Also demonstrated are the percentage of total portfolio and the weighted-average maturity in years for each summarized security type (in thousands).

Security	Fair Value	Percentage of Portfolio	Maturity Amount	Modified Duration (Years)	Credit Rating S&P/ Rating Moody's
Commercial paper —					
America General Finance Corp	\$ 10,323	1.05 %	\$ 10,333	0.033	A-1; P-1
Other:					
Connecticut State	19,149	1.95	18,700	1.291	AAA/aaa
King County Washington	10,220	1.04	10,000	19.770	AAA/aaa
Mississippi State	12,043	1.23	11,670	1.269	AAA/aaa
New Jersey	8,934	0.91	8,730	0.674	AAA/aaa
U.S. agency notes:					
FAMCA	10,366	1.06	10,000	1.877	AAA/aaa
FFCB	41,844	4.26	40,334	2.042	AAA/aaa
FHLB	185,963	18.94	185,880	0.837	AAA/aaa
FHLMC	153,668	15.65	152,891	1.333	AAA/aaa
FNMA	86,892	8.85	86,062	0.282	AAA/aaa
Time deposit —					
JP Morgan Chase	1,356	0.14	1,356	0.282	AAA/Aaa
Money market mutual funds	<u>441,101</u>	<u>44.93</u>	<u>441,101</u>	0.003	AAA/Aaa
Total cash and investments	<u>\$981,859</u>	<u>100.00 %</u>	<u>\$977,057</u>		

The District maintained no investments in derivatives at February 28, 2010 and 2009, except for an interest rate swap issued in conjunction with the auction rate security bonds issued in October 2007 and discussed in further detail in Note 8.

At February 28, 2010, the Foundation had the following investments in interest bearing securities. As noted above, the table does not include obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government, since they are not required to be disclosed under GASB Statement No. 40 (in thousands).

Security	Fair Value	Percentage of Portfolio	Maturity Amount	Modified Duration (Years)	Credit Rating S&P/ Moody's
U.S. agency notes:					
FHLMC	\$ 371	4.55 %	\$ 345	3.967	AAA
FNMA	58	0.71	55	0.926	A
Corporate bonds:					
AT&T	54	0.66	50	3.967	A
Citigroup	78	0.96	75	0.888	A
General Electric	80	0.99	75	2.929	AA+
Goldman Sachs	79	0.97	75	0.879	A
JP Morgan Chase	79	0.97	75	0.926	A
JP Morgan Chase	28	0.34	25	9.153	A+
Kinder Morgan Energy	105	1.29	100	11.011	BBB
Morgan Stanley	99	1.21	100	9.573	A
Novartis Securities	26	0.32	25	8.956	AA-
SBC Communications	79	0.97	75	1.041	A
Target Corp	79	0.97	75	0.879	A+
Time Warner Cable	25	0.31	25	4.929	BBB
Verizon	80	0.98	75	1.545	A+
Wells Fargo & Co	80	0.98	75	1.422	A+
Money market mutual funds	<u>6,764</u>	<u>82.82</u>	<u>6,764</u>	0.003	AAA
Total cash and investments	<u>\$ 8,164</u>	<u>100.00%</u>	<u>\$ 8,089</u>	0.625	

At February 28, 2009 the Foundation had the following investments in interest bearing securities. As noted above, the table does not include obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government, since they are not required to be disclosed under GASB Statement No. 40 (in thousands).

Security	Fair Value	Percentage of Portfolio	Maturity Amount	Modified Duration (Years)	Credit Rating S&P/ Moody's
U.S. agency notes:					
FHLMC	\$ 427	3.27 %	\$ 393	5.088	AAA
FNMA	69	0.53	851	0.174	AAA
Corporate bonds:					
General Electric	74	0.56	75	3.852	AA2
Goldman Sachs	77	0.59	75	1.921	A1
JP Morgan Chase	77	0.59	75	1.978	A1
SBC Communications	80	0.62	75	2.186	A2
Target Corp	80	0.61	75	2.004	A2
Citigroup	71	0.55	75	1.794	A3
Verizon	79	0.61	75	2.692	Baa2
Wells Fargo & Co	76	0.58	75	2.444	A2
Money market mutual funds	<u>3,258</u>	<u>24.77</u>	<u>3,258</u>	0.003	AAA
Total cash and investments	<u>\$4,368</u>	<u>33.21 %</u>	<u>\$5,102</u>		

Foundation investments at fair value are summarized by security type in Note 5.

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 28, 2010 and 2009, the carrying amount of the District's demand and time deposits was \$3.3 million and \$1.4 million, respectively. The balance per various financial institutions was \$3.3 million and \$1.4 million, respectively. 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 28, 2009, the District was in compliance with all of these guidelines to manage interest rate risk. As of February 28, 2010 the District was not in compliance as 35% of unrestricted portfolio maturities extended beyond 24 months. Maturities beyond 24 months comprised 50% of the HMO’s portfolio. In fiscal 2010 investments were placed in multi-coupon U.S. agency notes issued as callable bonds. If not called and held to maturity, the step-up notes have various maturity dates extending through 2015. At February 28, 2010 approximately 15% of the District’s unrestricted portfolio was invested in step-up notes with maturities beyond 24 months. As February 28, 2010, approximately 30% of the HMO’s portfolio was similarly invested.

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. The Foundation, however, does not have such a restriction and at February 28, 2010 had \$363,000 invested in non-U.S. equities.

7. CAPITAL ASSETS

The District’s investment in capital assets as of February 28, 2010, consists of the following (in thousands):

	Beginning Balance	Additions/ Transfers	Retirements	Ending Balance
Land and improvements	\$ 28,078	\$ 6,061	\$ (222)	\$ 33,917
Buildings and fixed equipment	298,307	25,903	(1,651)	322,559
Major movable equipment	<u>224,544</u>	<u>34,964</u>	<u>(16,706)</u>	<u>242,802</u>
Total at historical cost	550,929	66,928	(18,579)	599,278
Less accumulated depreciation	(342,528)	(39,426)	15,865	(366,089)
Construction in progress	<u>30,869</u>	<u>18,851</u>	<u> </u>	<u>49,720</u>
Capital assets — net	<u>\$ 239,270</u>	<u>\$ 46,353</u>	<u>\$ (2,714)</u>	<u>\$ 282,909</u>

The District's investment in capital assets as of February 28, 2009, consists of the following (in thousands):

	Beginning Balance	Additions/ Transfers	Retirements	Ending Balance
Land and improvements	\$ 28,030	\$ 48	\$ -	\$ 28,078
Buildings and fixed equipment	291,409	7,642	(744)	298,307
Major movable equipment	<u>199,389</u>	<u>48,714</u>	<u>(23,559)</u>	<u>224,544</u>
Total at historical cost	518,828	56,404	(24,303)	550,929
Less accumulated depreciation	(323,275)	(41,481)	22,228	(342,528)
Construction in progress	<u>8,169</u>	<u>22,700</u>	<u> </u>	<u>30,869</u>
Capital assets — net	<u>\$ 203,722</u>	<u>\$ 37,623</u>	<u>\$ (2,075)</u>	<u>\$ 239,270</u>

Depreciation expense for the years ended February 28, 2010 and 2009, was \$39,426,000 and \$41,481,000, respectively.

8. LONG-TERM DEBT

Revenue Bonds — On October 3, 2007, the District issued two series of Harris County Hospital District Senior Lien Refunding Revenue 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 bonds are payable in annual installments beginning February 15, 2011. The Series 2007A Bonds proceeds also refunded notes outstanding under the District's commercial paper program in the amount of \$24,251,000. The Series 2007B Bonds have a final maturity date of February 1, 2042, and were initially issued as 28-day taxable auction-rate paper, which converts to tax exempt on August 16, 2010. The 2007B Bonds have been hedged with a forward starting swap effective upon the tax-exempt conversion of the bonds. The proceeds of the Series 2007B Bonds defeased the Harris County Hospital District Refunding Revenue Bonds, Series 2000, in the principal amount of \$100,080,000 through the irrevocable deposit of sufficient funds with trustees to pay the principal and interest of such bonds through maturity. Accordingly, these trusteed funds and the related defeased indebtedness are excluded from the combined balance sheets. The refunding increased debt maturities from 2016 through 2042 and increased debt service requirements by \$506,000,000. The refunding resulted in a loss of \$5,112,000, which has been deferred and is being amortized to interest expense over the life of the old bond issue. The primary components of this loss were the write-offs of unamortized deferred financing costs and bond premiums and the difference between amounts funded for the defeasance and the principal due on the 2007B Bonds. 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 combined financial statements reflect long-term debt net of deferred amounts of \$3,643,000 and \$4,254,000 at February 28, 2010 and 2009, respectively. Principal amounts of total defeased indebtedness outstanding at February 28, 2010 and 2009, are \$100,080,000 and \$101,400,000, respectively. The final maturity of the Series 1990 Bonds of \$10,880,000 was paid in February of 2010. The fair value of the 1990 and 2007A Bonds outstanding at February 28, 2010 and 2009, based on quoted market prices, is approximately \$198,647,305 and \$193,661,000, respectively. The fair value of

the Series 2007B Bonds at February 28, 2010, based on quoted market prices, is approximately \$103,525,000. The fair value of the Series 2007B Bonds at February 28, 2009, based on quoted market prices, is approximately \$103,525,000.

The 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.

Long-term debt maturities and other obligations at February 28, 2010, are as follows (in thousands):

Years Ending February	Long-Term Debt	Other Long-Term Obligations
2011	\$ 3,410	\$ 1,500
2012	4,115	1,520
2013	4,655	1,483
2014	4,875	873
2015	5,100	93
Thereafter	<u>280,455</u>	<u> </u>
Totals	302,610	5,469
Less — unamortized premium and deferred loss on refunding on Series 2007A and 2007B revenue bonds — net	<u>(3,651)</u>	<u> </u>
Totals	<u>\$ 298,959</u>	<u>\$ 5,469</u>

Interest expense was \$7,281,000 and \$18,045,000 for the years ended February 28, 2010 and 2009, respectively.

Compliance — The District is in compliance with its debt covenants at February 28, 2010.

Interest Rate Swap:

Related Bonds — On September 25, 2007, the District entered into an interest rate swap 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.

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 percent.

Swap Terms:

Trade date	September 12, 2007
Effective date	August 16, 2010
Termination date	February 15, 2042
Initial notional amount	\$103,500,000
District pays fixed	4.218 percent
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 and on any Business Day thereafter.

Fair Value — Because interest rates have declined since the execution of the swap, the swap has a negative fair value of \$7.8 million as of February 28, 2010 and negative \$7.4 million as of February 28, 2009. 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.

Basis Risk — The risk of a mismatch between the variable rate payable on the Related Bonds and the variable rate receivable under the swap. The District was not exposed to basis risk as of February 28, 2010 or February 28, 2009, as the swap was not effective.

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 expenditure or reserve fund balance needs, which could adversely impact credit ratings and overall liquidity and budgetary efforts. The District was not exposed to collateral posting risk as of February 28, 2010 or February 28, 2009.

Credit Risk — The risk of a change in the credit quality or credit rating of the District and/or its counterparty. As of February 28, 2010 and 2009, the District was not exposed to credit risk because the swap had a negative fair value. The swap counterparty was rated A+ by Standard & Poor’s and Aa3 by Moody’s Investors Services as of February 28, 2010.

Market Access Risk — The District has not been exposed to market access risk because entering the credit markets has not been necessary in order to achieve the objective of the swap.

Rollover Risk — Caused by a mismatch in the maturity of the swap and the maturity of the Related Bonds, it is the risk that the swap contract is not coterminous with the Related Bonds. The District was not exposed to rollover risk as of February 28, 2010 or February 28, 2009, because the term of the swap matches the term of the Related Bonds.

Termination Risk — The risk that the swap is terminated prior to its stated final cash flow date for reasons including deterioration of the District’s credit or the counterparty’s credit. In such a circumstance, the District would owe, or be owed, a termination payment and consequently, the Related Bonds would no longer carry a synthetic fixed rate. The District was not exposed to termination risk as of February 28, 2010 or February 28, 2009, because the swap was not yet effective.

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, will only be 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, TX 77054.

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) 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 employees only on a biweekly basis not to exceed the statutory maximum of \$16,500 and \$15,500 during calendar years 2009 and 2008 respectively, for participants under the age of 50. Contributions to the plan cannot exceed the statutory maximum of \$22,000 and \$20,500 during calendar years 2009 and 2008 respectively for participants age 50 and older. The 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 contributions made by participants and the District for the years ended December 31, 2009 and 2008, were \$19,788,000 and \$17,925,000, respectively.

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 District's 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 and the pension benefit obligation.

The Plan is maintained on the full accrual basis of accounting. The Plan applies the GASB pronouncements applicable to benefit plan accounting and reporting.

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 10 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 non-highly 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.

Annual Pension Cost and Net Pension Obligation — 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:

Fiscal Years Ended	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Asset
February 28, 2010	\$ 27,592,960	100 %	\$ (2,440,531)
February 28, 2009	17,985,494	100	(2,495,054)
February 29, 2008	18,431,770	100	(2,680,057)

The Plan is on a calendar year-end, and for the plan year ended December 31, 2009, the actuarially determined contribution requirement was approximately \$27,538,000 intended to cover normal cost of \$14,301,000 and \$13,238,000 for amortization of the unfunded actuarial accrued liability and represented 10.8% of January 1, 2009, covered payroll. For the plan year ended December 31, 2008, the actuarially determined contribution requirement was approximately \$17,800,000 intended to cover normal cost of \$13,931,000 and \$3,869,000 for amortization of the unfunded actuarial accrued liability and represented 6.9% of January 1, 2008, covered payroll.

During the years ended February 28, 2010 and 2009, the District made cash contributions of \$27,538,437 and \$17,800,491, respectively, to the pension trust. Pension expense recognized in the combined statements of revenue, expenses, and changes in net assets was \$27,592,960 and \$17,985,494 for the years ended February 28, 2010 and 2009, respectively.

In April 2009 and 2010, all participants receiving monthly pension, death, or disability benefits under the Plan received a supplemental benefit payment under the Plan for 2009 and 2010. The payment was equal to the amount of the monthly benefit payment the participant was entitled to receive under the Plan in March of the year of payment.

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

Annual required contribution	\$ 27,538,437
Interest discount on net pension (asset) obligation	(199,604)
Adjustment to annual required contribution	<u>254,127</u>
Annual pension cost	27,592,960
Contributions made	<u>27,538,437</u>
Decrease in net pension asset	(54,523)
Net pension asset — beginning of year	<u>2,495,054</u>
Net pension asset — end of year	<u>\$ 2,440,531</u>

As of January 1, 2009, the most recent actuarial valuation date, the Plan was 75.8% funded. The actuarial accrued liability for benefits was \$490,205,000, and the actuarial value of assets was \$371,468,000, resulting in an unfunded actuarial accrued liability (UAAL) of \$118,737,000. The covered payroll (annual payroll of active employees covered by the Plan) was \$255,127,000, and the ratio of the UAAL to the covered payroll was 46.5%.

The schedule of funding progress, presented as Required Supplementary Information following the notes to the combined 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, 2009, 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	3.50%
Investment rate of return (net of expenses)	8
Projected salary increases (ultimate rate)	4

In April 2009, the District changed two actuarial assumptions for the January 1, 2009, valuation. The amortization period was changed to 20 years, from 10 years, and resulted in a \$5.6 million decrease in the annual required contribution. The asset valuation method was changed from a three year smoothing period to a five year smoothing period with no impact to the required contribution.

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 Plan, which are not recorded in the accompanying combined balance sheets, are not subject to creditors. The Plan assets at February 28, 2010 and 2009, were approximately \$55,718,000 and \$40,717,000, respectively. A corresponding liability to the participants of an equal amount exists at February 28, 2010 and 2009.

Post Employment Benefits Other Than Pension — In addition to providing pension benefits, the District provides certain health care 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 2,023 and 1,939 at January 1, 2009, and 2008, respectively.

Retiree medical plan participants age 65 and older are provided benefits through a private fee for service plan, a Medicare Advantage Plan, that incorporates a Medicare Part D drug benefit. Retiree covered/eligible dependents younger than age 65 are provided benefits under the District's current self insured medical plan. Effective March 1, 2010, the participants age 65 and older will move from the Medicare Advantage Plan and be provided benefits under the District's self insured medical plan. The contribution requirements of plan members and the District are established and may be amended by the District's Board of Managers. For fiscal year 2010, the District contributed \$11.5 million to the Plan for current premiums and administrative costs. Plan members receiving benefits contributed \$1.7 million, or approximately 15% of the total premiums, through their required contribution of \$48.70 per month for retiree-only coverage and \$347.94 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. 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 OPEB cost for the years 2010 and 2009, the amount actually contributed to the Plan, and changes in the District's net OPEB obligation to the Plan (in thousands):

	2010	2009
Annual required contribution	\$ 38,418	\$ 34,452
Interest on net OPEB obligation	347	320
Annual OPEB cost/expense	38,342	34,412
Contributions	11,490	13,650
Increase in net OPEB obligation	28,580	22,296
Net OPEB obligation — beginning of year	46,451	24,155
Net OPEB obligation — end of year	75,031	46,451

The District annual OPEB cost, the percentage of annual OPEB cost contributed to the plan, and the net OPEB obligation for 2010 and 2009 were as follows (in thousands):

Fiscal Year Ended	Annual OPEB Cost	Percentage of OPEB Contributed	Net OPEB Obligation
February 28, 2010	\$ 38,342	30 %	\$ 75,031
February 28, 2009	34,412	39.70	46,451

As of March 1, 2009 and 2008 actuarial valuations, the Plan was not prefunded. Contributions made were for current-year costs incurred only. The actuarially accrued liability for benefits was \$428.8 million, and the actuarial value of assets was \$0 resulting in an unfunded actuarial accrued liability of \$428.8 million. The covered payroll (annual payroll of active employees covered by the Plan) was \$255.1 million and \$257.5 million for March 1, 2009 and 2008, respectively. The ratio of the unfunded actuarial accrued liability to the covered payroll was 168.1% and 153.4% for March 1, 2009 and 2008, respectively.

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 health care 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, 2009 and 2008 actuarial valuations, the projected unit credit actuarial cost method was used. The actuarial assumptions included a 4% investment rate of return, which is a blended rate of the District's expected investment returns on current investments, and an annual health care cost trend rate of 8%, reduced by decrements to an ultimate rate of 4.75% and 4.5%, respectively, after 10 years. The initial unfunded actuarial liability was amortized over a period of 30 years based on a level percentage of payroll method.

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 28, 2010 and 2009, is as follows:

	2010	2009
Medicaid	42 %	26 %
Medicare	20	15
Commercial and self-pay patients	<u>38</u>	<u>59</u>
	<u>100 %</u>	<u>100 %</u>

11. COMMITMENTS AND CONTINGENCIES

At February 28, 2010, 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 "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. At February 28, 2010, the HMO was one of nineteen defendants named in a civil rights and wrongful death claim. The case is in early stages of litigation and will be vigorously contested. There are also other known and unknown incidents that have occurred through February 28, 2010, 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 combined financial statements of the District.

The District had been the subject of an ongoing investigation and discussion with the Office of the Inspector General (OIG) of the HHS relating to the District's compliance with certain regulations. Without admitting liability on any of the assertions or claims raised by the OIG and HHS, the District agreed under a civil settlement to pay an amount of \$14,950,000, plus \$114,967.93 in expenses, attorney's fees, and costs. The obligations were paid during the fiscal year ended February 29, 2008. The District also entered into a three-year Certification of Compliance Agreement with the OIG.

At February 28, 2009, the HMO was a defendant in certain litigation alleging the underpayment or denial of claims to certain non network providers in the HMO's primary service area. In May 2009, the HMO, without admitting or denying fault, and the plaintiffs mutually agreed on a final settlement. The resolution of this litigation did not have a material impact on the District's combined financial statements.

At February 28, 2010, the District had commitments outstanding in the amount of approximately \$14,649,000 related to construction of new facilities, \$31,590,000 related to improvements at existing facilities, and \$362,000 related to information technology projects.

The District had rental expenses related to its operating leases of approximately \$8,254,000 and \$6,760,000 during the years ended February 28, 2010 and 2009, respectively.

The District has self-insurance programs for the payment of workers' compensation and employee health claims. Liabilities related to these programs are accrued utilizing actuarial analyses based on historical claims experience. Changes in these self-insurance programs for the years ended February 28, 2010 and 2009, were as follows (in thousands):

	Beginning- of-Year Liability	Current-Year Claims and Changes in Estimates	Claim Payments	End-of-Year Liability
Employee health care benefit liability:				
2010	\$ 6,734	\$ 61,336	\$ 60,960	\$ 7,110
2009	7,136	51,511	51,913	6,734
Workers' compensation liability:				
2010	\$ 4,479	\$ (484)	\$ 1,646	\$ 3,317
2009	6,149	(523)	1,147	4,479

Accounts payable and accrued liabilities in the accompanying combined balance sheet includes a reserve for workers' compensation claims in the amount of \$3,317,000 and \$4,479,000 at February 28, 2010 and 2009, respectively. Employee compensation and related benefit liabilities in the accompanying combined balance sheet includes a reserve for incurred but unreported employee health claims in the amount of \$7,110,000 and \$6,734,000 at February 28, 2010 and 2009, respectively.

12. HARRIS UPL PROGRAM

The Harris UPL Program is a collaborative established to improve the level of health care provided to the indigent population of Harris County by strategically allocating the available community health care 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, and CHRISTUS Health Gulf Coast. An affiliation agreement among the parties allows the parties to improve access to health care 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. In September 2009, the District also entered into a separate indigent care affiliation agreement with St. Joseph Medical Center. 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, in fiscal 2010 HCCS entered into agreements with other healthcare service providers to extend services available. Through its agreements with AMS and other providers, HCCS provides approximately \$174 million of physician 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 years ended February 28, 2010 and 2009, the District utilized \$103.5 million and \$115.7 million, respectively, of tax revenues as the nonfederal share of the Harris County UPL program. The District recorded expenses of \$112.1 million and \$78.1 million in 2010 and 2009, respectively, under the Harris UPL and provider affiliation agreements. These expenses are reflected as physician services in the combined statements of revenues, expenses, and changes in net assets. At February 28, 2010 and 2009, the District had deposits of \$0 and \$80 million respectively, in board designated funds for funding of the collaborative program. These funds are reflected in the combined balance sheets as assets limited to use with an offsetting liability included under accounts payable and accrued liabilities.

13. SUBSEQUENT EVENTS

No events have occurred after February 28, 2010, but before June 1, 2010, the date the financial statements were available to be issued, that require consideration as adjustments to or disclosures in the financial statements.

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**ADDITIONAL REQUIRED
SUPPLEMENTARY INFORMATION**

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

**SCHEDULE OF FUNDING PROGRESS FOR PENSION PLAN
AS OF JANUARY 1, 2009**

Valuation Date (1)	Actuarial Value of Assets (AVA) (2)	Actuarial Accrued Liability (AAL) (3)	Overfunded (Unfunded) Actuarial Accrued Liability (OAAL) (2) – (3) (4)	Funded Ratio (2) (3) (5)	Annual Covered Payroll (6)	UAAL as a % of Covered Payroll (4) (6)
January 1, 2007	\$ 396,186	\$ 417,651	\$ (21,465)	94.9 %	\$ 246,400	8.7 %
January 1, 2008	434,264	452,750	(18,486)	95.9	257,521	7.2
January 1, 2009	371,468	490,205	(118,737)	75.8	255,127	46.5

Note 1: Dollar amounts in thousands.

Note 2: All required supplementary information has been prepared in accordance with Governmental Accounting Standards Board Statement No. 50, *Pension Disclosures — an amendment of GASB Statements*, Nos. 25 and 27, for *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contributions Plans* and *Accounting for Pensions by State and Local Government Employers*, respectively.

HARRIS COUNTY HOSPITAL DISTRICT AND AFFILIATES, A COMPONENT UNIT OF HARRIS COUNTY, TEXAS

SCHEDULE OF ACTUARIAL DATA FOR PENSION PLAN

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, 2009
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	3.50%
Investment rate of return	8%
Projected salary increases (ultimate rate)	4%
Cost-of-living adjustments	Not applicable
Mortality rates	The RP2000 Combined Mortality Table

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

**SCHEDULE OF FUNDING PROGRESS FOR OTHER POSTEMPLOYMENT BENEFIT PLAN
AS OF MARCH 1, 2010**

Valuation Date (1)	Actuarial Value of Assets (AVA) (2)	Actuarial Accrued Liability (AAL) (3)	Overfunded (Unfunded) Actuarial Accrued Liability (OAAL) (2) – (3) (4)	Funded Ratio (2) (3) (5)	Annual Covered Payroll (6)	UAAL as a % of Covered Payroll (4) (6)
March 1, 2008	\$ 0	\$ 395,201	\$ (395,201)	0 %	\$ 257,521	153.4 %
March 1, 2009	0	428,843	(428,843)	0	255,127	168.1

Note 1: Dollar amounts in thousands.

Note 2: All required supplementary information has been prepared in accordance with Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions (OPEB)*.