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, 2011 and 2010, Additional Required Supplementary Information as of January 1, 2010 and March 1, 2010, and Independent Auditors' Report

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

TABLE OF CONTENTS

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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, 2011 and 2010, 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, 2011 and 2010, 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.

As described in Note 2 of the financial statements, in 2011, the District adopted Governmental Accounting Standards Board (GASB) Statement No. 53, Accounting and Financial Reporting for Derivative Instruments.

Management's discussion and analysis on pages 3 through 19 and the supplementary schedules on pages 52 through 55 are not a required part of the combined financial statements, but are supplementary information required by the Governmental Accounting Standards Board . 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 17, 2011, 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 17, 2011

MANAGEMENT'S DISCUSSION AND ANALYSIS
Harris County Hospital District
Year Ended February 28, 2011

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, 2011. 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 decreased $6 million, or 0.7%, given the net loss reported for the year.

- Total assets increased $29 million, or 2.0%, between fiscal 2010 and fiscal 2011.

- Long-term debt, including current portion, decreased $17 million, or 5.7%, between fiscal 2010 and fiscal 2011. In August 2010, the Series 2007B variable rate bonds in the amount of $103,525,000 were refunded by Series 2010 as tax exempt variable rate bonds hedged by an interest rate swap effective August 16, 2010.

- Community Health Choice, Inc. experienced a 15% growth in membership during the year.

- The District experienced a 3.7% growth in the number of unduplicated patients served in fiscal 2011. Services provided on an inpatient basis decreased 7.2% while emergency care/urgent visits, community health center visits, and other outpatient diagnostic visits increased 5.2%, 0.6% and 7.8% respectively.

- The District continued its focus on access to surgical services by increasing outpatient surgery schedules. Total surgeries increased 2.8%. Outpatient cases increased 20.4% and at the same time, inpatient surgeries declined 7.4% reflecting a continuing shift from inpatient to outpatient care and delivery of care in a more cost effective manner that reduced inpatient cost and length of stay.

- During the year, the District invested $79 million in critical information technology, medical equipment and space/facility expansion projects. Significant capital acquisitions and resource investments included the following:

  - Information Technology including:
    - Electronic order entry systems
    - Remote portal & web redesigns
  - Expansion of outpatient ancillary services including:
    - Parking garage located at the administrative campus
    - Radiation and diagnostic clinic scheduled to open in late summer 2012, at the administrative campus, and
    - LBJ emergency center expansion

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, 2011 and 2010 is presented in Table 1 below:

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

	2011	2010	Dollar Change	Total % Change
Current and other assets	$ 1,158	$ 1,164	$ (6)	(0.5)%
Capital assets	318	283	35	0.1
Total assets	$ 1,476	$ 1,447	$ 29	2.0 %
Long-term debt outstanding	$ 283	$ 300	$ (17)	(5.7)%
Other liabilities	325	273	52	19.0
Total liabilities	$ 608	$ 573	$ 35	6.1 %
Invested in capital assets, net of related debt	$ 103	$ 107	$ (4)	(3.7)%
Restricted net assets	51	42	9	21.4
Unrestricted net assets	714	725	(11)	(1.5)
Total net assets	$ 868	$ 874	$ (6)	(0.7)%

Net assets, the difference between the assets and liabilities reported on the balance sheet, decreased $6 million in fiscal 2011. The overall decrease is the result of the loss reported for fiscal 2011. The net loss reported is discussed in detail following Table 2. Current and other assets decreased $6 million or 0.5% from fiscal 2010 to fiscal 2011. The decrease is primarily related to funding estimates as of February 28, 2011 due to the District under the DSH/UPL program. The growth in capital assets is discussed in detail following Table 3.

Reductions in bond related debt reflect scheduled debt service payments. The District's net obligation for the provision of certain post employment health care benefits increased approximately $36 million during fiscal 2011.

At February 28, 2010, the District recorded a $44.2 million receivable related to the DSH/UPL programs. Related fundings received in fiscal 2011 were less than estimates by $8.9 million. The District is unable to estimate the continuance or amount of future funding of the UPL program. As of February 28, 2011, the District has received funds totaling $66.1 million related to the state of Texas 2011 DSH/UPL programs. The District has recorded a $16.4 million receivable at February 28, 2011, related to the DSH and UPL programs.

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, 2011 and 2010, 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)

	2011	2010
Operating revenues:		
Net patient service revenue	$ 277,274	$ 258,457
DSH/UPL programs revenue	184,849	184,671
Premium revenue	479,402	426,997
Other operating revenues	27,154	34,640
Total operating revenues	968,679	904,765
Operating expenses:		
Salaries, wages, and benefits	637,406	635,655
Purchased services, supplies, and other	391,406	395,448
Medical claims expense	416,749	374,305
Depreciation and amortization	42,624	39,831
Total operating expenses	1,488,185	1,445,239
Operating loss	(519,506)	(540,474)
Nonoperating revenues:		
Ad valorem tax revenues - net	504,496	528,613
Tobacco settlement revenues	11,154	22,613
Investment income	6,946	14,041
Total nonoperating revenues	522,596	565,267
Nonoperating expenses:		
Deferred outflows - derivative financial instrument	(1,316)	
Interest expense	(7,256)	(7,281)
Other	(606)	(579)
Total nonoperating expenses	(9,178)	(7,860)
Restricted contributions — net	(38)	13
Change in net assets	(6,126)	16,946
Total net assets — beginning of year	874,094	857,148
Total net assets — end of year	$ 867,968	$ 874,094

During the year, the District's total operating revenue increased by $63.9 million. Increased funding from third-party payors and patients of $18.8 million and an increase of $52.4 million in premium revenue were the primary drivers. Subsequent to the 2009 implementation of a new patient accounting system and other supporting software, revenue cycle management has focused on streamlining workflows and improving clinical documentation. The increase in premium revenue is driven by the increase in membership for Community Health Choice Inc. DSH/UPL program revenue reflects a 0.1% increase or $0.2 million in funding. Other operating revenues decreased $7.5 million for the year, primarily due to reduction of trauma care funding.

Operating expenses increased by $42.9 million over the prior year. District salaries and wages decreased $6.5 million, or 1.4%. Total staffing decreased 2.4% and with increased productivity served a 3.7% increase in individuals compared to prior year. The compensation plan remained competitive with merit increases and average salary increased 1.3%. Related benefits increased $8.3 million, or 5.3%. Employee healthcare costs remained flat and healthcare costs for retirees increased 24.9%. Pension expenses decreased 8.4% due to higher than expected return on investments.

Overall, purchased services and supplies decreased $4 million, or 1.0%. Physician service costs decreased $5.1 million as compared to fiscal 2010. Physician services are primarily coordinated through the Harris County collaborative discussed in further detail in Note 12 to the financial statements. The District reported an overall decrease in supplies of $1.7 million, or 1.0%. The District expended $2.8 million more than the prior year in its cost for other purchased services.

Medical claims expense associated with the HMO increased by $42.4 million or 11.3%. Membership increased from 157,845 member months in February 2010 to 181,516 in February 2011, a 15% increase. In addition, the medical loss ratio improved 9.9%.

Overall, the District's operating loss decreased $21 million, or 3.9%. 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, gains or losses on disposal of assets and deferred outflows related to the change in value of the interest rate swap. Tax revenues, net of related fees, decreased $24.1 million, or 4.6%. Investment income decreased approximately $7.1 million reflecting continued low investment returns during the past year. In fiscal 2011, the District received approximately $11.1 million in tobacco settlement revenue as compared to $22.6 million in 2010. Interest expense remained relatively constant year to year.

Capital Assets and Debt Financing

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

TABLE 3
Capital Assets
(In thousands)

	2011	2010	Dollar Change	Total % Change
Land and improvements	$ 36,631	$ 33,917	$ 2,714	8.0 %
Buildings and fixed equipment	391,667	322,559	69,108	21.4
Major movable equipment	260,462	242,802	17,660	7.3
Subtotal	688,760	599,278	89,482	14.9
Less accumulated depreciation	(398,046)	(366,089)	(31,957)	(8.7)
Construction in progress	27,522	49,720	(22,198)	(44.6)
Capital assets — net	$ 318,236	$ 282,909	$ 35,327	12.5 %

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, 2011, approximately $96 million has been expended for these projects. It is anticipated that additional funds of $60 million will be expended in the upcoming year.

For the fiscal year 2012 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 2012 includes an investment of $34 million in routine capital expenditures. The capital projects include $16 million in information technology primarily dedicated to current system upgrades and technology refresh, $9 million specific to medical capital, and $9 million in renovations of current facilities.

At February 28, 2011, the District had $284.8 million in outstanding revenue bonds, net of any discounts, premiums, and deferred refunding losses. In October 2007, the District issued Series 2007A refunding and revenue bonds to refund $24 million in outstanding commercial paper debt 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. In August 2010, the District refunded and refinanced the Series 2007B bonds by issuing Series 2010 refunding and revenue bonds in the amount of $104,435,000. The Series 2010 bonds financed the refunding of the 2007B bonds and costs of issuance and are tax exempt. The Series B Bonds were hedged with a forward starting swap effective upon the tax-exempt conversion of the Bonds. In order to obtain a substantially fixed rate for the 2007B debt service requirements, a Qualified Hedge Agreement was executed between the Harris County Hospital District and Siebert Brandford Shank & Co. and the Harris County Hospital District and Bank of America. The swap became effective August 16, 2010 upon issuance of the Series 2010 Refunding Bonds. On that date, the interest rate swap was redesignated to the new debt and an off market element totaling $17,546,000 to the swap was created. In accordance with GASB Statement No. 53, this off market element is recorded as a borrowing payable and is being amortized as an adjustment to interest expense over the life of the swap agreement. The 2007B Bonds were defeased through the irrevocable deposit of sufficient funds with trustees to pay the principal and interest of such bonds through maturity. Moody's and Standard & Poor's have maintained an underlying rating of Aa1/A on the District's revenue bond obligations. The debt is scheduled to be repaid in 2042. The debt is issued in the name of the Harris County Hospital District. Any issuance of debt requires the approval of the District's Board of Managers and the Harris County Commissioners' Court. Table 4 below summarizes the District's debt obligations at February 28, 2011 and 2010:

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

	2011	2010
Series 2007 tax-exempt revenue bonds, including premium and deferred loss on refunding	$ 196,475	$ 298,959
Series 2010 Revenue Bonds, including deferred loss on refunding	88,294	-
Borrowing payable - interest rate swap	17,546	-
Other long - term obligations	4,276	5,469
Total long-term debt and other long-term obligations	306,591	304,428
Less current portion	(5,916)	(4,910)
Noncurrent portion	$ 300,675	$ 299,518

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 2011 actual results:

TABLE 5
Budget vs. Actual
(In thousands)

	Budget 2011	Actual 2011	Favorable (Unfavorable) Variance
Revenues:			
Net patient service revenue	$ 298,805	$ 277,274	$ (21,531)
DSH/UPL programs revenue	185,165	184,849	(316)
Premium revenue	491,479	479,402	(12,077)
Other operating revenues	32,103	27,154	(4,949)
Nonoperating revenues - net of interest expense of $7,256 and $7,281, respectively	524,498	513,418	(11,080)
Total revenues	$ 1,532,050	$ 1,482,097	$ (49,953)
Operating expenses:			
Salaries, wages, and benefits	$ 641,110	$ 637,406	$ 3,704
Purchased services, supplies, and other	402,353	391,406	10,947
Medical claims expense	444,365	416,749	27,616
Depreciation and amortization	40,578	42,624	(2,046)
Total operating expenses	$ 1,528,406	$ 1,488,185	$ 40,221
Income before restricted contributions	$ 3,644	$ (6,088)	$ (9,732)
Restricted contributions — net	-	(38)	(38)
Change in net assets	$ 3,644	$ (6,126)	$ (9,770)

In comparing 2011 financial results to budget, the following items are noted.

Consolidated revenues reported for fiscal 2011 were $50.0 million below budget, and total expenses were below budget by $40.2 million creating a negative variance of $9.8 million in operating income as compared to budget. When adjusted for volume, the District provided care at 5% less than planned cost. Challenges for fiscal 2011 were experienced in all categories of funding. Reimbursement for patient services reflected the greatest shortfall on funding. Charity and self pay services exceeded budget by 3.7%. Sources of funding from other operating revenues were less than budget $4.9 million and non operating revenues fell short of budget by $11.1 million. Deficits compared to budget were experienced in both Tobacco Settlement and Trauma Fund distributions for a total of $10.1 million. Lower than expected returns on investments of $4.0 million were also experienced. Premium revenues exceeded budget, driven by growth in membership.

Economic Conditions and Plan for Fiscal 2012

In planning for fiscal 2012, the primary concerns were the same as prior year - the uncertain status of the economy at both the federal and state funding levels and the uncertainty of federal health care 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 District's key strategic priorities of:
    - Meeting community needs through improved access to care
    - Providing high quality health care
    - 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, 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	283	239	44	18.4
Total assets	$ 1,447	$ 1,434	$ 13	0.9 %
Long-term debt outstanding	$ 300	$ 303	$ (3)	(0.9)%
Other liabilities	273	274	(1)	(0.4)
Total liabilities	$ 573	$ 577	$ (4)	(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	725	704	21	3.0
Total net assets	$ 874	$ 857	$ 17	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	34,640	37,899
Total operating revenues	904,765	837,593
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	39,831	41,996
Total operating expenses	1,445,239	1,284,722
Operating loss	(540,474)	(447,129)
Nonoperating revenues:		
Ad valorem tax revenues - net	528,613	522,053
Tobacco settlement revenues	22,613	22,276
Investment income	14,041	13,570
Total nonoperating revenues	565,267	557,899
Nonoperating expenses:		
Deferred outflows - derivative financial instrument	-	-
Interest expense	(7,281)	(18,045)
Other	(579)	(122)
Total nonoperating expenses	(7,860)	(18,167)
Restricted contributions — net	13	43
Change in net assets	16,946	92,646
Total net assets — beginning of year	857,148	764,502
Total net assets — end of year	$ 874,094	$ 857,148

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	242,802	224,544	18,258	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	49,720	30,869	18,851	61.1
Capital assets — net	$ 282,909	$ 239,270	$ 43,639	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	5,469	6,042
Total long-term debt and other long-term obligations	304,428	315,270
Less current portion	(4,910)	(12,261)
Noncurrent portion	$ 299,518	$ 303,009

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	568,159	557,407	(10,752)
Total revenues	$ 1,463,621	$ 1,462,172	$ (1,449)
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	37,242	39,831	(2,589)
Total operating expenses	$ 1,412,078	$ 1,445,239	$ (33,161)
Income before restricted contributions	$ 51,543	$ 16,933	$ (34,610)
Restricted contributions — net	-	13	13
Change in net assets	$ 51,543	$ 16,946	$ (34,597)

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

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

COMBINED BALANCE SHEETS
AS OF FEBRUARY 28, 2011 AND 2010
(In thousands)

	2011	2010
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 76,624	$ 273,341
Short-term investments (Notes 5 and 6)	138,117	110,123
Accounts receivable — net of allowance for uncollectible accounts of $300,098 and $199,833 in 2011 and 2010, respectively (Note 10)	74,906	65,643
Current portion of ad valorem taxes receivable — net of allowance for uncollectible taxes of $5,087 and $5,296 in 2011 and 2010, respectively	31,641	36,418
Inventories	7,330	6,764
Prepaid expenses and other current assets	37,708	65,351
Estimated third-party payor settlements	6,965	5,434
Current portion of assets limited as to use or restricted (Notes 5 and 6)	20,828	21,319
Total current assets	394,119	584,393
ASSETS LIMITED AS TO USE OR RESTRICTED — Net of current portion (Notes 5 and 6):		
Debt service	25,293	17,714
Capital expansion	252,255	291,021
Other	132,130	93,197
Total assets limited as to use or restricted — net	409,678	401,932
CAPITAL ASSETS (Notes 7 and 11):		
Land and improvements	36,631	33,917
Buildings and fixed equipment	391,667	322,559
Major movable equipment	260,462	242,802
Less accumulated depreciation	(398,046)	(366,089)
Total depreciable capital assets — net	290,714	233,189
Construction in progress	27,522	49,720
Capital assets — net	318,236	282,909
OTHER ASSETS:		
Ad valorem taxes receivable — net of current portion and allowance for uncollectible taxes of $52,278 and $52,290 in 2011 and 2010, respectively	2,853	3,215
Net pension asset (Note 9)	2,387	2,441
Long-term investments (Note 6)	337,191	164,212
Deferred bond issue costs — net of accumulated amortization of $609 and $638 in 2011 and 2010, respectively	4,240	5,515
Derivative asset (Note 8)	5,861	-
Other assets	1,440	2,646
Total other assets	353,972	178,029
TOTAL	$ 1,476,005	$ 1,447,263

(Continued)

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

COMBINED BALANCE SHEETS
AS OF FEBRUARY 28, 2011 AND 2010
(In thousands)

LIABILITIES AND NET ASSETS	2011	2010
CURRENT LIABILITIES:		
Accounts payable and accrued liabilities	$ 70,938	$ 72,452
Interest payable	634	636
Employee compensation and related benefit liabilities (Note 11)	29,495	28,140
Compensated absences	37,931	36,771
Medical claims liability (Note 2)	51,167	54,997
Estimated third-party payor settlements	302	714
Current portion of long-term debt and capital leases (Note 8)	5,916	4,910
Total current liabilities	196,383	198,620
OTHER LONG-TERM LIABILITIES:		
Post employment health benefit liability (Note 9)	110,979	75,031
Borrowing payable (Note 8)	17,546	-
LONG-TERM DEBT (Note 8):		
Series 2007 revenue bonds — including premium of $0 and $8 in 2011 and 2010, respectively, and deferred loss on refunding of $0 in 2011 and $3,643 in 2010	193,735	295,549
Series 2010 revenue bonds — including deferred loss on refunding of $15,141	86,742	-
Other long-term obligations	2,652	3,969
Total liabilities	608,037	573,169
COMMITMENTS AND CONTINGENCIES (Note 11)		
NET ASSETS:		
Invested in capital assets — net of related debt	103,330	106,988
Restricted net assets	51,039	41,550
Unrestricted net assets	713,599	725,556
Total net assets	867,968	874,094
TOTAL	$ 1,476,005	$ 1,447,263

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, 2011 AND 2010 (In thousands)

	2011	2010
OPERATING REVENUES:		
Net patient service revenue (Note 3)	$ 277,274	$ 258,457
DSH/UPL programs revenue (Note 4)	184,849	184,671
Premium revenue	479,402	426,997
Other operating revenues	27,154	34,640
Total operating revenues	968,679	904,765
OPERATING EXPENSES:		
Salaries, wages, and benefits	637,406	635,655
Pharmaceuticals and supplies	162,304	164,008
Physician services (Note 12)	108,092	113,204
Medical claims expense	416,749	374,305
Other purchased services	121,010	118,236
Depreciation and amortization	42,624	39,831
Total operating expenses	1,488,185	1,445,239
OPERATING LOSS	(519,506)	(540,474)
NONOPERATING REVENUES (EXPENSES):		
Ad valorem tax revenues — net	504,496	528,613
Tobacco settlement revenues	11,154	22,613
Investment income	6,946	14,041
Interest expense (Note 8)	(7,256)	(7,281)
Deferred outflows — derivative financial instrument (Note 8)	(1,316)	
Other	(606)	(579)
Total nonoperating revenues (expenses) — net	513,418	557,407
(LOSS) INCOME BEFORE OTHER CHANGES IN NET ASSETS	(6,088)	16,933
RESTRICTED (DISTRIBUTIONS) CONTRIBUTIONS — Net	(38)	13
CHANGE IN NET ASSETS	(6,126)	16,946
NET ASSETS — Beginning of year	874,094	857,148
NET ASSETS — End of year	$ 867,968	$ 874,094

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, 2011 AND 2010
(In thousands)

	2011	2010
OPERATING ACTIVITIES:		
Cash received from patients and members	$ 774,070	$ 717,484
Cash received from DSH/UPL	212,641	168,729
Cash payments for medical claims	(420,579)	(398,328)
Cash payments for goods and services	(396,021)	(390,629)
Cash payments to employees	(598,889)	(600,922)
Net cash used in operating activities	(428,778)	(503,666)
NONCAPITAL FINANCING ACTIVITIES:		
(Use) receipts of restricted contributions	(38)	13
Ad valorem taxes received — net	509,635	544,977
Tobacco settlement received	11,154	22,613
Net cash provided by noncapital financing activities	520,751	567,603
CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisitions and construction of capital assets	(67,116)	(73,223)
Proceeds from Series 2010 Bonds	98,224	-
Defeasance of Series 2007 Bonds	(98,224)	-
Interest paid	(15,199)	(16,445)
Repayment of long-term debt	(5,093)	(12,283)
Net cash used in capital and related financing activities	(87,408)	(101,951)
INVESTING ACTIVITIES:		
Receipts of investment income — including realized gains and losses	9,712	14,041
Decrease in cash equivalents included in assets limited as to use or restricted	9,013	178,962
Purchases of investment securities	(1,194,430)	(737,420)
Proceeds from sale and maturities of investment securities	974,423	623,196
Net cash (used in) provided by investing activities	(201,282)	78,779
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(196,717)	40,765
CASH AND CASH EQUIVALENTS — Beginning of year	273,341	232,576
CASH AND CASH EQUIVALENTS — End of year	$ 76,624	$ 273,341

(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, 2011 AND 2010
(In thousands)

	2011	2010
RECONCILIATION OF OPERATING LOSS TO NET CASH USED IN OPERATING ACTIVITIES:		
Operating loss	$ (519,506)	$ (540,474)
Adjustments to reconcile operating loss to net cash used in operating activities:		
Depreciation and amortization expense	42,624	39,831
Changes in operating assets and liabilities:		
Increase in accounts receivable	(9,263)	(880)
Increase in inventories	(566)	(630)
Decrease (increase) in prepaid expenses and other assets	28,849	(3,566)
Increase in estimated third-party payor settlements	(1,531)	(4,696)
Decrease in net pension asset	54	54
Decrease in accounts payable and accrued liabilities	(3,660)	(4,221)
Increase in employee compensation and related benefit liabilities	1,355	3,312
Increase in compensated absences	1,160	2,787
Decrease in medical claims liability	(3,830)	(24,023)
(Decrease) increase in estimated third-party payor settlements	(412)	260
Increase in post employment health benefit liability	35,948	28,580
Total adjustments	90,728	36,808
NET CASH USED IN OPERATING ACTIVITIES	$ (428,778)	$ (503,666)
SUPPLEMENTAL DISCLOSURES OF NONCASH OPERATING, FINANCING AND INVESTING ACTIVITIES:		
Unrealized gain on investments	$ 389	$ 3,160
Amounts related to acquisition of capital assets in accounts payable and accrued liabilities	$ 11,013	$ 8,867
Amount of interest expense capitalized	$ 8,762	$ 9,591

See notes to combined financial statements. (Concluded)

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. The HMO had approximately 177,461 and 152,468 enrollees, as of February 28, 2011 and February 28, 2010, respectively. 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.

Under the provisions of the American Institute of Certified Public Accountants' *Audit and Accounting Guide, Health Care Organizations*, the District is considered a governmental organization and is subject to the pronouncements of the Governmental Accounting Standards Board (GASB). Pursuant to GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the District has elected to apply the provisions of all relevant pronouncements of the Financial Accounting Standards Board (FASB), including those issued after November 30, 1989, unless they conflict with or contradict 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 the *Texas Local Government Code*. Such total collateralization and insurance coverage is required by the Board of Managers of the District. The Foundation's investments, however, are not subject to these laws.

Investments are classified (as defined by the GASB) in three categories to indicate 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, 2011 and 2010 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. Contributions and pledges receivable are included in the prepaid expenses and other current assets in the combined balance sheets.

One year or less	$ 899,741
Between one year and three years	704,700
Total pledges receivable	1,604,441
Less present value discount	20,525
Net contributions receivable	$1,583,916

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 unused benefits may be liquidated at 50% 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 2011 and 2010, the District recognized $7.7 million and $3.9 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, 2011 and 2010. During 2011, the HMO recorded $0.5 million in decreased premium revenue, representing the difference between the estimated and actual premiums received related to 2010. 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.

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 2011 and 2010 were as follows (in thousands):

	Beginning of Fiscal Year Liability	Current-Year Claims and Changes in Estimates	Claim Payments	End of Fiscal Year Liability
2011	$ 54,997	$ 429,784	$ 433,614	$ 51,167
2010	79,020	388,210	412,233	54,997

In fiscal 2011 and 2010, the HMO paid $379.2 million and $354.8 million in claims related to the current fiscal years and $54.4 million and $57.4 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, 2011 and 2010, 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.

Correction of 2010 Financial Statement Amounts — Subsequent to the issuance of the 2010 financial statements, the District identified the following errors in the prior year presentation. These adjustments were not material overall to the combined financial statements as there was no change in the amounts previously reported for total assets, total net assets, and the subtotals relating to cash flows from operating, capital and related financing, and investing.

1) Internally designated assets totaling $75,031,000 were classified as current assets whose use is restricted or limited in 2010 and are now classified as long-term assets whose use is limited.

2) Within the consolidated cash flow statement:

    a) the net cash used in operating activities section: a $4,436,000 change in due to / due from third party settlement estimates was previously reported as cash payments for goods and services and is now classified as cash received from patients and members,

    b) the net cash used in capital and related financing activities section: $9,591,000 in capitalized interest was previously reported in acquisition/construction of capital assets and is now classified as interest paid, and,

    c) within the net cash provided by investing activities section: the change in the investment activity for the Foundation was previously reported as net in one line item, Foundation investments – net, totaling $5,061,000, which amounts are now classified separately in the following line items: purchases of investment securities ($54,787,000), cash equivalents included in assets limited as to use or restricted of ($3,097,000), and proceeds from sales/maturities of investments $52,823,000.

Newly Adopted Accounting Pronouncements:

GASB Statement No. 51 — GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, establishes accounting and financial reporting requirements for intangible assets including easements, water rights, timber rights, patents, trademarks, and computer software. This statement amends GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, paragraphs 19–21, and GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, paragraphs 9e, 16, and 18 and relates to the recognition and recording of intangible assets as capital assets in the statement of net assets. The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2009. The District completed the process of evaluating GASB Statement No. 51 and determined that the Statement had no impact on its financial position, results of operations, and cash flows and therefore is not applicable at this time.

GASB Statement No. 53 — GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, establishes accounting and financial reporting requirements for derivative instruments entered into by state and local governments. The District has completed the process of evaluating the impact that will result from implementing GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments,* and has reported the fair value of the derivative in the accompanying financial statements. GASB Statement No. 53 deals with the recognition, measurement, and disclosure of information regarding derivative instruments, and addresses hedge accounting requirements. Hedging derivative instruments are supposed to significantly reduce financial risk by substantially offsetting the associated changes in cash flows or fair values of the underlying bond portfolio. The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2009. As a result, the District reported a derivative asset, borrowing payable, and deferred outflows from derivative financial instruments of $5,861,000, $17,546,000, and $1,316,000, respectively, in its financial statements as of and for the year ended February 29, 2011, as discussed in detail in Note 8.

GASB Statement No. 58 — The District has completed the process of evaluating GASB Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies.* This Statement establishes accounting and financial reporting guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code. The District has determined that GASB Statement No. 58 will have no impact on its financial position, results of operations, and cash flows and therefore is not applicable to its operations at this time. The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2009.

Pending Adoption of Recent Accounting Pronouncements:

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 year ending February 28, 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. The District has not completed the process of evaluating the impact that will result from implementing GASB No. 54.

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

GASB Statement No. 59 — The District has not completed the process of evaluating the impact that will result from implementing GASB Statement No. 59, *Financial Instruments Omnibus*. The Statement updates and improves existing standards regarding financial reporting of certain financial instruments and external investment pools. The Statement is effective for financial statements prepared by state and local governments for periods beginning after June 15, 2010.

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

GASB Statement No. 61 — The District has not completed the process of evaluating the impact that will result from implementing GASB Statement No. 61, *The Financial Reporting Entity: Omnibus – An Amendment of GASB Statements Nos. 14 and 34.* The requirements of this Statement result in financial reporting entity's financial statements being more relevant by improving guidance for including, presenting and disclosing information about component units and equity interest transactions of a financial reporting entity. The Statement is effective for financial statements prepared by state and local governments for periods beginning after December 15, 2011.

GASB Statement No. 62 — The District has not completed the process of evaluating the impact of GASB Statement No. 62, *Codification of accounting and Financial Reporting Guidance Contained in Pre-November 1989 FASB and AICPA Pronouncements*. The Statement objective is to incorporate pronouncements that do not contradict or conflict with GASB pronouncements. This Statement is effective for financial statements for periods beginning after December 15, 2011.

3. NET PATIENT SERVICE REVENUE

Charity care provided during the years ended February 28, 2011 and 2010, measured at established rates, totaled $1,100,528,000 and $862,544,000, 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 administrative contractor through February 29, 2008.

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

Cash received from the Medicare program accounted for approximately 23% and 21% of the District's total cash collections for net patient service revenue for the years ended February 28, 2011 and 2010, respectively. Cash received from the Medicaid program (including managed Medicaid) accounted for approximately 56% of the District's total cash collections for net patient service revenue for the years ended February 28, 2011 and 2010.

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 $16.4 million and $44.2 million at February 28, 2011 and 2010, respectively, related to the DSH and UPL programs. There were no adjustments recorded in fiscal 2011 for prior year programs. Additional changes in estimates of 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 million 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 2007 and 2010 bond issues (50% of the greatest debt service requirement scheduled to occur); funds restricted by donors; or funds designated by the board for future debt service, future capital expansion, and other uses. Investments in government securities are recorded at fair value. The carrying amount of cash, time deposits, and commercial paper approximates fair value. The fair values of securities are based on quoted market prices as of February 28, 2011 and 2010. The components of assets limited as to use or restricted at fair value at February 28, 2011, are as follows (in thousands):

Description of Assets	Total	Debt Service	Capital Expansion	Legal Reserves	Self-Insured Programs	Other
Money market government funds	$ 21,340	$ 4	$ 5,467	$ 3,008	$ 12,852	$ 9
Government securities	388,863	30,221	252,336		105,467	839
Foundation investments	20,303	-	-	-	-	20,303
	430,506	30,225	257,803	3,008	118,319	21,151
Less funds required for current liabilities	(20,828)	(4,932)	(5,548)	(3,008)	(7,340)	-
	$409,678	$25,293	$252,255	$ -	$110,979	$ 21,151

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	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	17,281	-	-	-	-	17,281
	423,251	21,750	296,639	4,555	82,141	18,166
Less funds required for current liabilities	(21,319)	(4,036)	(5,618)	(4,555)	(7,110)	-
	$401,932	$17,714	$291,021	$ -	$ 75,031	$18,166

Foundation — Assets limited as to use of $20,303,000 and $17,281,000 at February 28, 2011 and 2010, 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, 2011, are as follows (in thousands):

Description of Assets	Total	Restricted Children's Health	Restricted Trauma	All Others
Investments:				
Cash, deposits, and money market funds	$ 1,423	$ 1,086	$ 35	$ 301
Equities	9,299	7,634	206	1,460
Corporate bonds	819	683	25	110
Government securities	8,762	867	85	7,811
Subtotal investments	20,303	10,270	351	9,682
Less funds required for related current liabilities	-	-	-	-
	$ 20,303	$ 10,270	$ 351	$ 9,682

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	6,909	858	25	6,026
Subtotal investments	17,281	9,309	297	7,675
Less funds required for related current liabilities	-	-	-	-
	$ 17,281	$ 9,309	$ 297	$ 7,675

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

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

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

Concentration of credit risk is the risk of loss attributed to the magnitude of an investment in a single issuer. The District mitigates these risks by emphasizing the importance of a diversified portfolio. All funds must be sufficiently diversified to eliminate the risk of loss resulting from overconcentration of assets in a specific maturity, a specific issuer, or a specific class of securities. In particular, no more than 50% of the overall portfolio may be invested in time deposits, including certificates of deposit, of a single issuer. Concentration by issuer for other investment instruments is not specifically addressed in the investment policy. However, the policy does specify that acceptable investment instruments must have high-quality credit ratings; 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, 2011 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/ Rating Moody's
Commercial paper —					
TMCC	$ 29,991	3.12 %	$ 30,000	0.118	A-1+; P-1
Other:					
Maryland State	8,798	0.92	8,820	2.510	AA/Aa1
King County Washington	10,576	1.10	10,000	17.770	AAA/Aa3
San Antonio Texas Electric & Gas	1,210	0.13	1,190	21.186	AA/Aa1
U.S. agency notes:					
FCAR	115,212	11.99	115,450	0.446	A-1+; P-1
FFCB	56,224	5.85	56,000	2.385	AAA/Aaa
FHLB	97,493	10.15	98,020	3.138	AAA/Aaa
FHLMC	336,911	35.06	337,825	2.614	AAA/Aaa
FNMA	203,867	21.22	205,000	2.941	AAA/Aaa
Time deposit —					
JP Morgan Chase	3,323	0.35	3,323	0.279	AAA/Aaa
Money market mutual funds	97,117	10.11	97,117	0.003	AAA/Aaa
Total cash and investments	$ 960,722	100.00 %	$ 962,745	2.288	

The table below indicates the fair value and maturity value of the District's investments as of February 28, 2010, 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 —					
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	249,197	26.17	249,197	0.003	AAA/Aaa
Total cash and investments	$ 952,323	100.00 %	$ 948,059	1.545	

The District maintained no investments in derivatives at February 28, 2011 and 2010, except for an interest rate swap issued in conjunction with the Series 2007B Bonds issued in October 2007, refunded and refinanced in 2010, and discussed in further detail in Note 8.

At February 28, 2011, 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/ Rating Moody's
U.S. agency notes:					
FHLMC	$ 241	7.17 %	$ 215	4.829	AAA /Aaa
Corporate bonds:					
AT&T	54	1.61	50	2.967	A1/A2
BP Capital Markets	154	4.58	150	4.592	A/A2
General Electric	81	2.41	75	1.929	AA+/Aa2
JP Morgan	29	0.86	25	8.153	A+/Aa3
Kinder Morgan Energy	110	3.27	100	10.011	BBB/Baa2
Morgan Stanley	105	3.13	100	8.573	A/A2
Novartis Securities	27	0.80	25	7.956	AA-/Aa2
SBC Communications	77	2.29	75	0.041	A-/A2
Time Warner Cable	26	0.77	25	3.929	BBB/Baa2
Verizon	80	2.38	75	0.545	A-1/Baa2
Wells Fargo & Co	77	2.29	75	0.422	A+/A2
Money market mutual funds	2,298	68.41	2,298	0.003	AAA/Aaa
Total cash and investments	$ 3,359	100.00%	$ 3,288	0.407	

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/ Rating
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	6,764	82.82	6,764	0.003	AAA
Total cash and investments	$ 8,164	100.00%	$ 8,089	0.625	

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, 2011 and 2010, the carrying amount of the District's demand and time deposits was $3.3 million. The balance per various financial institutions was $3.3 million at February 28, 2011 and February 28, 2010. 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, 2011 and 2010, the District was not in compliance with these guidelines as 60% and 35%, respectively, of unrestricted portfolio maturities extended beyond 24 months. Maturities beyond 24 months comprised 82% and 50% of the HMO's portfolio. In fiscal 2011 and 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 2014. At February 28, 2011 and 2010, approximately 10% and 15% of the District's unrestricted portfolio was invested in step-up notes with maturities beyond 24 months, respectively. As of February 28, 2011 and 2010, approximately 0% and 30%, respectively, 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, 2011 and 2010 had $583,000 and $363,000, respectively, invested in non-U.S. equities.

7. CAPITAL ASSETS

The District's investment in capital assets as of February 28, 2011, consists of the following (in thousands):

	Beginning Balance	Additions/ Transfers	Retirements	Ending Balance
Land and improvements	$ 33,917	$ 2,910	$ (196)	$ 36,631
Buildings and fixed equipment	322,559	70,165	(1,057)	391,667
Major movable equipment	242,802	28,103	(10,443)	260,462
Total at historical cost	599,278	101,178	(11,696)	688,760
Less accumulated depreciation				
Land and improvements	(4,471)	(844)	80	(5,235)
Buildings and fixed equipment	(214,757)	(10,773)	717	(224,813)
Major moveable equipment	(146,861)	(30,765)	9,628	(167,998)
Total accumulated depreciation	(366,089)	(42,382)	10,425	(398,046)
Construction in progress	49,720	(22,198)	-	27,522
Capital assets — net	$ 282,909	$ 36,598	$ (1,271)	$ 318,236

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	224,544	34,964	(16,706)	242,802
Total at historical cost	550,929	66,928	(18,579)	599,278
Less accumulated depreciation				
Land and improvements	(4,124)	(445)	98	(4,471)
Buildings and fixed equipment	(204,200)	(10,818)	261	(214,757)
Major moveable equipment	(134,204)	(28,163)	15,506	(146,861)
Total accumulated depreciation	(342,528)	(39,426)	15,865	(366,089)
Construction in progress	30,869	18,851	-	49,720
Capital assets — net	$ 239,270	$ 46,353	$ (2,714)	$ 282,909

Depreciation expense for the years ended February 28, 2011 and 2010, was $42,382,000 and $39,426,000, 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 fair value of the Series 2007A Bonds outstanding at February 28, 2011 and 2010, based on quoted market prices, is approximately $196,838,000 and $ 198,647,000, respectively.

The Series 2007B Bonds Series have a final maturity date of February 1, 2042, and were initially issued as 28-day taxable auction-rate paper, convertible to tax exempt on August 16, 2010. In April 2008, these bonds were converted from auction rate securities and reoffered as variable rate bonds bearing interest at a term rate during a term period. The 2007B Bonds Series were hedged with a forward starting swap effective upon the tax-exempt conversion of the bonds. The Series 2007 Bonds are insured by municipal bond insurance policies and secured by a lien on the pledged revenues of the District and certain funds established pursuant to the bond order.

In August 2010, the District refunded and refinanced the Series 2007B bonds by issuing Series 2010 Refunding and Revenue bonds in the amount of $104,435,000. The proceeds of the Series 2010 Bonds covered costs of issuance and defeased the Harris County Hospital District Senior Lien Refunding Revenue Bonds, Series 2007B, in the principal amount of $103,525,000 through the irrevocable deposit of sufficient funds with trustees to pay the principal and interest of such bonds through maturity. Accordingly, these trusteed funds and the related defeased indebtedness are excluded from the combined balance sheets. The refunding resulted in a loss of $15,670,000, which includes $10,369,000 deferred loss on refunding related to the interest rate swap which has been deferred and is being amortized over the life of the Series 2007B bond issue. The remaining loss on refunding of $5,301,000 has been deferred and is being amortized to interest expense over the life of the Series 2000 bond issue. The primary components of this loss were the write-offs of unamortized deferred financing costs and bond premiums, the net deferred amount related to the hedging derivative instrument associated with the 2007B bonds and the difference between amounts funded for the defeasance and the principal due on the 2007B Bonds. The combined financial statements reflect long-term debt net of unamortized deferred amounts of $15,141,000 and $3,643,000 at February 28, 2011 and 2010, respectively. Principal amounts of total defeased indebtedness outstanding at February 28, 2011 and 2010, are $186,785,000 and $100,080,000, respectively. The fair value of the 2010 Bonds outstanding at February 28, 2011, based on quoted market prices, is approximately $104,435,000. The bonds are secured by an irrevocable letter of credit issued by JPMorgan Chase Bank.

Long-term debt maturities and other obligations at February 28, 2011, are as follows (in thousands):

Years Ending February	Long-Term Debt	Other Long-Term Obligations
2012	$ 4,292	$ 1,624
2013	4,775	1,540
2014	4,985	932
2015	5,195	154
2016	5,415	26
Thereafter	275,248	-
Totals	299,910	4,276
Less — unamortized deferred loss on refunding on 2010 revenue bonds	(15,141)	-
Totals	$ 284,769	$ 4,276

Interest expense was $7,256,000 and $7,281,000 for the years ended February 28, 2011 and 2010, respectively.

Compliance — The District is in compliance with its debt covenants at February 28, 2011.

Interest Rate Swap:

Related Bonds — On September 25, 2007, the District entered into an interest rate swap agreement in connection with its $103,525,000 Harris County Hospital District Senior Lien Revenue and Refunding Bonds, Series 2007B with the settlement date on October 3, 2007. On August 12, 2010, when the District refunded and refinanced the Series 2007B Bonds by issuing Series 2010 Bonds, the interest rate swap was redesignated and associated with the new debt. The derivative also contains an off market element equal to the value of the swap associated with the Series 2007B Bonds on August 12, 2010. In accordance with GASB Statement No. 53, this off market element is recorded as a borrowing payable and is amortized as an adjustment to interest expense over the life of the swap agreement.

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

In regard to the Consistent Critical Terms method, if the critical terms of the potential hedging derivative instrument and the terms of the item it is hedging are the same, then the ending date of an interest rate swap is the same as the maturity date of the bonds. Since both are based on the Security Industry and Financial Market Association (SIFMA) Swap Index, then the potential hedging derivative instrument is presumed to be effective. Under such circumstances, any changes in the cash flows or fair value of the item being hedged is offset by changes in the cash flows or fair value of the potential hedging derivative. The District has employed this methodology for the interest rate swap and evaluated it as effective.

Fair Value —The redesignated swap which is associated with the new debt had a zero fair value at its inception date and a fair value of $5.9 million at February 28, 2011 and is reported as a derivative asset in the 2011 combined balance sheet. The fair value of the swap was determined by calculating the present value of the anticipated future cash flows for both the floating portion and the stated fixed rate portion using discount factors derived from the London Interbank Offered Rate (LIBOR) swap curve.

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 swap was determined effective as of February 28, 2011 and March 1, 2010 (date of adoption of GASB No. 53).

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 and for the year ended February 28, 2011.

Credit Risk — The risk of a change in the credit quality or credit rating of the District and/or its counterparty. The swap counterparty was rated A- and A+ by Standard & Poor's and Aa3 by Moody's Investors Services as of February 28, 2011 and March 1, 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 for the year ended February 28, 2011, 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. As of February 28, 2011, termination of the original swap agreement would create a liability of $10.1 million and would result in a reversal of the following: the derivative asset related to the redesignated swap, the borrowing payable amount, and the deferred loss on refunding. Any resulting net change would be recorded through non-operating expenses.

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) ("401k Plan") open to all full-time and part-time employees of the District who meet the Plan's requirements. It is a single-employer, self-administered, trusteed plan to which contributions are made by participants on a biweekly basis not to exceed the statutory maximum of $16,500 during calendar years 2010 and 2009, for participants under the age of 50. Contributions to the plan cannot exceed the statutory maximum of $22,000 during calendar years 2010 and 2009 for participants age 50 and older. Effective July 2007, the District enhanced the 401k Plan with an employer match up to 5% of the participant's compensation for eligible employees, which is 100% vested with three or more years of service. The 401k plan is a governmental plan and, as such, is specifically exempt from the reporting and disclosure requirements of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Total contributions made by participants and the District for the years ended December 31, 2010 and 2009, were $21,662,000 and $19,788,000, respectively.

Pension Plan — The District has a noncontributory, defined benefit pension plan (the "Plan"). It is a single-employer, self-administered, trusteed 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 Asset — The contribution requirements for the District's fiscal year are based on an actuarial valuation as of two months before the beginning of the fiscal period, as follows:

Fiscal Years Ended	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Asset
February 28, 2011	$25,272,346	100 %	$ 2,387,199
February 28, 2010	27,592,960	100	2,440,531
February 28, 2009	17,985,494	100	2,495,054

The Plan is on a calendar year-end, and for the plan year ended December 31, 2010, the actuarially determined contribution requirement was approximately $25,219,000 intended to cover normal cost of $14,926,000 and $10,293,000 for amortization of the unfunded actuarial accrued liability and represented 10.1% of January 1, 2010, covered payroll. 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.

During the years ended February 28, 2011 and 2010, the District made cash contributions of $25,219,014 and $27,538,437, respectively, to the pension trust. Pension expense recognized in the combined statements of revenue, expenses, and changes in net assets was $25,272,346 and $27,592,960 for the years ended February 28, 2011 and 2010, respectively.

In April 2010, all participants receiving monthly pension, death, or disability benefits under the Plan received a supplemental benefit payment under the Plan for 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, minus one year's interest on the net pension asset, plus an adjustment for amortization of the net pension asset. The annual pension cost and net pension asset for the current year were as follows:

Annual required contribution	$25,219,014
Interest discount on net pension asset	(195,242)
Adjustment to annual required contribution	248,574
Annual pension cost	25,272,346
Contributions made	25,219,014
Decrease in net pension asset	(53,332)
Net pension asset — beginning of year	2,440,531
Net pension asset — end of year	$ 2,387,199

As of January 1, 2010, the most recent actuarial valuation date, the Plan was 83.1% funded. The actuarial accrued liability for benefits was $527,930,000, and the actuarial value of assets was $438,597,000, resulting in an unfunded actuarial accrued liability (UAAL) of $89,333,000. The covered payroll (annual payroll of active employees covered by the Plan) was $250,454,000, and the ratio of the UAAL to the covered payroll was 35.7%.

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, 2010 actuarial valuation are as follows:

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

Deferred Compensation — The District has a deferred compensation plan for the benefit of its eligible employees under Section 457 of the Internal Revenue Code of 1954. The assets in the Deferred Compensation Plan, which are not recorded in the accompanying combined balance sheets, are not subject to creditors. The Deferred Compensation Plan assets at February 28, 2011 and 2010, were approximately $66,415,000 and $55,718,000, respectively. A corresponding liability to the participants of an equal amount exists at February 28, 2011 and 2010.

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 2,124 and 2,023 at January 1, 2010, and 2009, respectively.

Effective March 1, 2010, retiree medical plan participants are provided benefits under the District's self insured medical plan. Previously, retiree medical plan participants age 65 and older were provided benefits through a private fee for service plan, a Medicare Advantage Plan, that incorporated a Medicare Part D drug benefit. Retiree covered/eligible dependents younger than age 65 were provided benefits under the District's current 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 2011, the District contributed $14 million to the Plan for current premiums and administrative costs. Plan members receiving benefits contributed $2 million, or approximately 14% of the total premiums, through their required contribution of $53.57 per month for retiree-only coverage and $382.74 for retiree and spouse coverage.

The District's annual OPEB cost or expense is calculated based on the annual required contribution of the District (ARC), an amount actuarially determined in accordance with GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize any unfunded actuarial liabilities, or funding excess, over a period not to exceed 30 years. The following table shows the components of the District's annual OPEB cost for the years 2011 and 2010, the amount actually contributed to the Plan, and changes in the District's net OPEB obligation to the Plan (in thousands):

	2011	**2010**
Annual required contribution	$ 48,029	$ 38,418
Interest on net OPEB obligation	3,001	1,858
Adjustment to annual required contribution	(3,124)	(1,934)
Annual OPEB cost/expense	47,906	38,342
Contributions	11,958	9,762
Increase in net OPEB obligation	35,948	28,580
Net OPEB obligation — beginning of year	75,031	46,451
Net OPEB obligation — end of year	$ 110,979	$ 75,031

The District annual OPEB cost, the percentage of annual OPEB cost contributed to the plan, and the net OPEB obligation for 2011 and 2010 were as follows (in thousands):

Fiscal Year Ended	**Annual OPEB Cost**	**Percentage of OPEB Contributed**	**Net OPEB Obligation**
February 28, 2011	$ 47,906	25 %	$ 110,979
February 28, 2010	38,342	25	75,031

As of March 1, 2010 and 2009 actuarial valuations, the Plan was not prefunded. Contributions made were for current-year costs incurred only. The actuarially accrued liability for benefits was $540.1 million, and the actuarial value of assets was $0 resulting in an unfunded actuarial accrued liability of $540.1 million. The covered payroll (annual payroll of active employees covered by the Plan) was $250.5 million and $255.1 million for March 1, 2010 and 2009, respectively. The ratio of the unfunded actuarial accrued liability to the covered payroll was 215.6% and 168.1% for March 1, 2010 and 2009, 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, 2010 and 2009 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 7.5% and 8%, respectively, reduced by decrements to an ultimate rate of 4.75%, 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, 2011 and 2010, is as follows:

	2011	2010
Medicaid	60 %	42 %
Medicare	18	20
Commercial and self-pay patients	22	38
	100 %	100 %

11. COMMITMENTS AND CONTINGENCIES

At February 28, 2011, 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. There are also other known and unknown incidents that have occurred through February 28, 2011, 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 Department Health and Human Services (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 $114,968 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, 2011, the District had commitments outstanding in the amount of approximately $53,748,000 related to construction of new facilities, $20,616,000 related to improvements at existing facilities, and $4,629,000 related to information technology projects.

The District had rental expenses related to its operating leases of approximately $9,111,000 and $8,254,000 during the years ended February 28, 2011 and 2010, 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, 2011 and 2010, 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:				
2011	$ 7,110	$ 63,241	$ 63,011	$ 7,340
2010	6,734	61,336	60,960	7,110
Workers' compensation liability:				
2011	$ 3,317	$ 1,082	$ 1,673	$ 2,726
2010	4,479	(484)	1,646	3,317

Accounts payable and accrued liabilities in the accompanying combined balance sheet includes a reserve for workers' compensation claims in the amount of $2,726,000 and $3,317,000 at February 28, 2011 and 2010, 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 $7,340,000 and $7,110,000 at February 28, 2011 and 2010, 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 $194 million of physician and other clinical services annually to the indigent in the Harris County community. Under a management agreement between HCCS and the District, the District manages the services provided by AMS and provides facilities for indigent patients to receive services.

During the fiscal years ended February 28, 2011 and 2010, the District utilized $102.4 million and $103.5 million, respectively, of tax revenues as the nonfederal share of the Harris County UPL program. The District recorded expenses of $107.3 million and $112.1 million in 2011 and 2010, 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.

13. SUBSEQUENT EVENTS

The District evaluated subsequent events from February 28, 2011 through June 17, 2011, the date on which the financial statements were available to be issued. On April 19, 2011, the Foundation entered into a grant agreement with the Lester and Sue Smith Foundation to receive a $15 million pledge restricted to the construction of the new outpatient clinic at Holly Hall.

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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, 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)
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
January 1, 2010	438,597	527,930	(89,333)	83.1	250,454	35.7

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 AS OF JANUARY 1, 2010

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, 2010
Actuarial cost method	Projected unit credit
Amortization method	Level dollar, open
Amortization period	20 years
Asset valuation method	Five-year smoothed market
Actuarial assumptions:	
Inflation	3.0%
Investment rate of return	8.0%
Projected salary increases (ultimate rate)	4.0%
Cost-of-living adjustments	Not applicable
Mortality rates	The RP2000 Combined Mortality Table

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	$ -	$ 395,201	$ (395,201)	- %	$ 257,521	153.4 %
March 1, 2009	-	428,843	(428,843)	-	255,127	168.1
March 1, 2010	-	540,087	(540,087)	-	250,454	215.6

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).*