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Slidell Memorial Hospital and Medical Center

September 30, 1996

Consolidated Financial Statements

Report of Independent Auditors on the Internal Control Structure

Report of Independent Auditors on Compliance with Laws and Regulations, Contracts and Grants

Consolidated Financial Statements

Slidell Memorial Hospital and Medical Center

Years ended September 30, 1996 and 1995
with Report of Independent Auditors

Slidell Memorial Hospital and Medical Center

Consolidated Financial Statements

Years ended September 30, 1996 and 1995

Contents

ERNST & YOUNG LLP

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Report of Independent Auditors

The Board of Commissioners
St. Tammany Parish Hospital Service District No. 2

We have audited the accompanying consolidated balance sheets of St. Tammany Parish Hospital Service District No. 2 (d/b/a Slidell Memorial Hospital and Medical Center) as of September 30, 1996 and 1995, and the related consolidated statements of revenue, expenses and fund balance and cash flows for the years then ended. These financial statements are the responsibility of the Hospital's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of St. Tammany Parish Hospital Service District No. 2 at September 30, 1996 and 1995, and its consolidated results of operations and changes in its financial position for the years then ended in conformity with generally accepted accounting principles.

Ernst & Young LLP

December 12, 1996

Slidell Memorial Hospital and Medical Center

Consolidated Balance Sheets

	September 30 1996	1995
Assets		
Current assets:		
Cash and cash equivalents	**$ 2,988,059**	$ 2,071,032
Patient accounts receivable, less allowances for uncollectible accounts of $2,039,017 in 1996 and $3,519,348 in 1995	**11,162,379**	11,924,541
Amounts due from medicaid	**-**	534,608
Assets whose use is limited and required for current debt service	**2,088,710**	2,026,630
Inventories	**1,478,844**	1,428,733
Prepaid expenses and other receivables	**894,033**	853,536
Total current assets	**18,612,025**	18,839,080
Assets whose use is limited or restricted, less current portion:		
By board or under indenture agreement for capital improvements and debt service	**24,083,284**	23,544,752
Other assets:		
Investment in health maintenance organization	**1,003,985**	1,000,323
Preopening costs, net of accumulated amortization of $36,981 in 1996 and $26,956 in 1995	**15,596**	22,055
Bond issuance costs, net of accumulated amortization of $215,064 in 1996 and $126,072 in 1995	**1,564,822**	1,653,814
Intangible assets, net of accumulated amortization of $70,439 in 1996	**166,773**	-
	2,751,176	2,676,192
Land, buildings and equipment:		
Land and land improvements	**4,340,007**	4,295,002
Buildings	**40,922,801**	36,303,104
Equipment	**30,173,627**	27,632,937
Less accumulated depreciation and amortization	**(31,779,899)**	(27,279,420)
Construction in progress	**439,406**	2,077,292
	44,095,942	43,028,915
	$ 89,542,427	$ 88,088,939

	September 30 1996	1995
Liabilities and fund balance		
Current liabilities:		
Trade accounts payable	**$ 2,051,171**	$ 1,994,502
Salaries, wages and benefits payable	**824,896**	579,871
Accrued vacation payable	**983,734**	880,225
Accrued interest and other expenses	**2,698,842**	2,829,902
Amounts due to medicare	**791,571**	1,665,672
Amounts due within one year on capital lease obligations and long-term debt	**2,538,380**	2,472,211
Total current liabilities	**9,888,594**	10,422,383
Capital lease obligations, less amounts due within one year	**2,160,009**	2,495,063
Long-term debt, less amounts due within one year	**33,156,695**	34,348,461
Fund balance	**44,337,129**	40,823,032
	$ 89,542,427	$ 88,088,939

See accompanying notes.

Slidell Memorial Hospital and Medical Center

Consolidated Statements of Revenue, Expenses and Fund Balance

	Year ended September 30	
	1996	**1995**
Net patient service revenue	**$ 73,965,247**	$ 75,507,754
Other revenue	**3,698,840**	3,622,960
Total revenue	**77,664,087**	79,130,714
Expenses:		
Salaries and wages	**30,037,412**	29,944,273
Employee benefits	**7,111,084**	7,412,761
Supplies and materials	**10,651,939**	10,266,180
Other direct expenses	**7,055,543**	6,813,582
Professional fees	**3,726,767**	4,511,024
Purchased services	**3,734,102**	4,067,202
Provision for bad debts	**4,719,480**	5,321,223
Depreciation and amortization	**4,981,797**	4,496,512
Interest	**2,131,866**	2,395,115
Total expenses	**74,149,990**	75,227,872
Revenue in excess of expenses	**3,514,097**	3,902,842
Fund balance at beginning of year	**40,823,032**	36,920,190
Fund balance at end of year	**$ 44,337,129**	$ 40,823,032

See accompanying notes.

Slidell Memorial Hospital and Medical Center

Consolidated Statements of Cash Flows

	Year ended September 30	
	1996	**1995**
Operating activities		
Revenue in excess of expenses	**$ 3,514,097**	$ 3,902,842
Adjustments to reconcile revenue in excess of expenses to net cash provided by operating activities:		
Depreciation and amortization	**4,981,797**	4,496,512
Changes in operating assets and liabilities:		
Patient accounts receivable, net	**762,162**	357,669
Inventories and other operating assets	**151,942**	342,738
Accounts payable and other accrued expenses	**(45,947)**	721,860
Items whose cash flows are capital and related financing activities:		
Interest expense	**2,141,024**	2,422,250
Items whose cash flows are investing activities:		
Interest income	**(1,536,140)**	(1,550,087)
Net cash provided by operating activities	**9,968,935**	10,693,784
Capital and related financing activities		
(Increase) decrease in assets whose use is limited, net of transfers from investments	**(600,612)**	2,147,879
Payments for intangible assets and preopening costs	**(240,779)**	–
Payments for acquisitions of land, buildings and equipment	**(4,618,914)**	(9,357,518)
Principal paid on capital leases and long-term debt	**(2,533,573)**	(2,164,137)
Interest paid on capital leases and long-term debt	**(2,354,701)**	(2,635,155)
Other	**6,743**	22,283
Net cash used in capital and related financing activities	**(10,341,836)**	(11,986,648)
Investing activities		
Receipts of interest earned	**1,293,590**	1,053,973
Increase in investment in health maintenance organization	**(3,662)**	(750,323)
Net cash provided by investing activities	**1,289,928**	303,650
Net increase (decrease) in cash and cash equivalents	**917,027**	(989,214)
Cash and cash equivalents at beginning of year	**2,071,032**	3,060,246
Cash and cash equivalents at end of year	**$ 2,988,059**	$ 2,071,032

See accompanying notes.

Slidell Memorial Hospital and Medical Center

Notes to Consolidated Financial Statements

September 30, 1996

1. Organization and Significant Accounting Policies

St. Tammany Parish Hospital Service District No. 2 (the District), d/b/a Slidell Memorial Hospital and Medical Center (the Hospital), is a nonprofit corporation organized as a political subdivision of the State of Louisiana. The governing authority of the District is the St. Tammany Parish Police Jury, which is the governing authority of St. Tammany Parish, Louisiana. The governing authority appoints members of the St. Tammany Parish Hospital Service District No. 2 Board of Commissioners (the Board) to oversee and govern the operations of the Hospital.

The consolidated financial statements include the accounts and transactions of the Hospital and its member organizations, Camellia Leasing Corporation (Camellia), Slidell Memorial Health Foundation, Inc. (SMH Foundation) and SMH Physician Practice Services, Inc. All material intercompany accounts and transactions have been eliminated in consolidation.

The Hospital utilizes the accrual basis of accounting for proprietary funds. Under Governmental Accounting Standards Board (GASB) Statement No. 20, the Hospital has elected not to apply Financial Accounting Standards Board (FASB) Statements issued after November 30, 1989.

The Hospital is exempt from federal income tax under Section 115 of the Internal Revenue Code as a governmental entity and under Section 501(a) as a hospital organization as described in Section 501(c)(3). The exemption from federal income taxes also extends to state income taxes. SMH Foundation has been designated as a not-for-profit organization described in Internal Revenue Code Section 501(c)(3) and is exempt from federal income taxation under Internal Revenue Code Section 501(a). Camellia and Physician Practice Services are taxable not-for-profit corporations.

Net patient service revenue and the related accounts receivable are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered. The Hospital provides care to patients even though they may lack adequate insurance or may be covered under contractual arrangements that do not pay full charges. As a result, the Hospital is exposed to certain credit risks. The Hospital manages such risk by regularly reviewing its accounts and contracts, and provides appropriate allowances.

The Hospital is reimbursed under the medicare Prospective Payment System (PPS) for inpatient services provided to medicare beneficiaries and is paid a predetermined amount for these services based, for the most part, on the Diagnosis Related Group (DRG) assigned to the patient. In addition, the Hospital is paid prospectively for medicare

1. Organization and Significant Accounting Policies (continued)

inpatient capital costs based on the federal specific rate. The Hospital qualifies as a disproportionate share provider under the medicare regulations. As such, the Hospital receives an additional payment for medicare inpatients served. Except for medicare disproportionate share reimbursement and medicare bad debts, there is no retroactive settlement for inpatient costs under the medicare inpatient prospective payment methodology.

The Hospital is paid a prospective per diem rate for medicaid inpatients. The per diem rate is based on a peer grouping methodology which assigns a per diem rate to each hospital in the peer group.

The following are reimbursed on a cost basis, subject to certain limitations imposed by governmental authorities: medicare rehabilitation, skilled nursing, and home health services. Medicare outpatient (excluding ambulatory surgery, clinical lab and radiology diagnostic procedures), medicaid outpatient (excluding ambulatory surgery and clinical lab), and medicare bad debts are reimbursed on a cost basis. Outpatient ambulatory surgery, radiology and other diagnostic services rendered to medicare beneficiaries are reimbursed based on a blend of costs, published facility fees and prevailing charges. Medicare and medicaid outpatient clinical lab and medicaid ambulatory surgery are reimbursed based upon the respective fee schedules.

Retroactive cost settlements based upon annual cost reports are estimated for those programs subject to retroactive settlement and recorded in the financial statements. Final determination of retroactive cost settlements to be received under the medicare and medicaid regulations is subject to review by program representatives. The difference between a final settlement and an estimated settlement in any year is reported as an adjustment of net patient service revenue in the year the final settlement is made.

Cash equivalents and investments are recorded at cost which approximates market value. The Hospital reports short-term, highly liquid investments (that are both readily convertible to known amounts of cash and mature within three months or less from date of purchase) as cash equivalents, excluding amounts classified as assets whose use is limited or restricted on the balance sheet. The Hospital's cash, cash equivalents and certificates of deposit were entirely insured or collateralized with securities held by its agent in the Hospital's name.

1. Organization and Significant Accounting Policies (continued)

Inventories are valued at the lower of cost (first-in, first-out method) or market.

Land, buildings and equipment acquisitions are recorded at cost except for assets donated to the Hospital. Donated assets are recorded at the fair value of the assets at the date of donation. Depreciation of buildings and equipment is computed using the straight-line method in amounts sufficient to amortize the cost of these assets over their estimated useful lives.

Equipment held under capital lease obligations has been recorded at the present value of the minimum lease payments. Amortization of leased assets is included in depreciation and amortization expense.

The Hospital has deferred the costs incurred in connection with the issuance of its 1994 Revenue Bonds (see Note 6). These costs are being amortized over the life of the bond issue. The amortization is included in depreciation and amortization expense.

The Hospital is self-insured for hospitalization and workers' compensation claims. Estimated amounts for claims incurred but not reported are calculated based on claims experience and, together with unpaid claims, are included in accrued interest and other expenses on the consolidated balance sheets.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

2. Assets Whose Use Is Limited

The terms of the Hospital's 1994 Revenue Bonds require certain funds to be maintained on deposit with the trustee. The funds on deposit with the trustee and funds designated by the Board for capital improvements as of September 30, 1996 and 1995 were as follows:

	1996	1995
Current assets:		
Under bond indenture:		
Bond debt service account	**$ 2,088,710**	$ 2,026,630
Noncurrent assets:		
Under bond indenture:		
Capital improvement account	**$ 4,281,924**	$ 6,545,210
Debt service reserve account	**3,296,115**	3,297,107
	7,578,039	9,842,317
By board:		
Designated for capital improvements	**16,466,426**	13,665,355
Other	**38,819**	37,080
	$ 24,083,284	$ 23,544,752

Statutes authorize the Hospital to invest in direct obligations of the U. S. Government, certificates of deposit of state banks and national banks having their principal office in the State of Louisiana, and any other federally insured investments, guaranteed investment contracts issued by a financial institution having one of the two highest rating categories published by Standard & Poor's or Moody's, and mutual or trust fund institutions registered with the Securities and Exchange Commission (provided the underlying investments of these funds meet certain restrictions). The Hospital's funds were invested in certificates of deposit and U. S. Government obligations carried at cost with a market value at September 30, 1996 and 1995 of $26,028,988 and $25,387,000, respectively.

3. Third-Party Payor Arrangements

The Hospital participates in the medicare and medicaid programs as a provider of medical services to program beneficiaries. During the years ended September 30, 1996 and 1995, approximately 56% and 57%, respectively, of the Hospital's gross patient service charges were derived from services provided to medicare and medicaid program beneficiaries. Revenue derived from the medicare program is subject to audit and adjustment by the

3. Third-Party Payor Arrangements (continued)

fiscal intermediary and must be accepted by the United States Department of Health and Human Services before settlement amounts become final. Revenue derived from the medicaid program is subject to audit and adjustment and must be accepted by the State of Louisiana, Department of Health and Hospitals before the settlement amounts become final. The fiscal intermediary has completed its review of estimated settlements for fiscal years ended through September 30, 1994. Annually, management evaluates the recorded estimated settlements and adjusts these balances based upon the results of the intermediary's audit of filed cost reports and additional information becoming available. During fiscal years 1996 and 1995, the Hospital increased net patient service revenue by $572,000 and $671,000, respectively, as a result of such changes in estimate. Although the fiscal intermediary has not completed its audits of the estimated settlements for fiscal years ended 1995 and 1996, the Hospital does not anticipate adverse adjustments to the recorded settlements for those years.

The Hospital has also entered into payment agreements with certain commercial insurance carriers and managed care organizations. The basis for payment to the Hospital under these agreements includes prospectively determined daily rates and discounts from established charges.

During fiscal years 1992 and 1993, the Hospital recorded (based upon published regulations) approximately $650,000 of revenue related to services provided to medicaid beneficiaries under the age of one year old. During fiscal year 1995, the Hospital received notice that the Health Care Financing Administration (HCFA) is challenging the Louisiana Department of Health and Hospitals' (DHH) method for reimbursing hospitals in the State of Louisiana for the cost of services provided to medicaid beneficiaries under the age of one year old. The Hospital has been informed by officials of DHH that DHH is trying to resolve the issues raised by HCFA and maintain the proposed reimbursement methodology for the period July 1, 1992 through June 30, 1994. The outcome of this matter and the impact on the Hospital's financial statements cannot be determined at this time.

4. Community Benefits

As a community health care provider, the Hospital's stated mission is "to meet the needs of the community by providing quality medical and health education services in a compassionate and cost-effective manner." As such, total revenue includes that generated from direct patient care, rentals from various medical office buildings, interest income, and sundry revenue related to the operation of the Hospital and its member organizations.

4. Community Benefits (continued)

The Hospital provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because the Hospital does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. Charity care provided in 1996 and 1995, measured at established rates, approximated $3,990,105 and $3,799,750, respectively.

In addition, the Hospital sponsors or participates in numerous activities to benefit the community. Many of these activities are sponsored with the knowledge that they will not be self supporting or financially viable. In 1995, the Hospital conducted a Community Health Assessment to identify health risks in the community. Through this research, the Hospital can develop wellness and prevention programs that target these high-risk areas for a healthier community.

Annually, the Hospital sponsors several health fairs and programs regarding such issues as diabetes, breast cancer, prostate cancer, smoke stoppers, nutrition, exercise, cardiology, women's health, parenting skills, developmental topics, etc., to provide access to the community on health-related information. Also, the Hospital provides health screening at no cost or a reduced cost to the community. Some health screenings include prostate cancer, cholesterol, colorectal, skin cancer, glucose and thyroid screenings.

The Hospital also donates employees' time and encourages its employees to volunteer for charitable organizations and to participate in fund-raising activities. In addition, the Hospital aided various community service organizations through donations and sponsorships.

5. Leases

The Hospital leases medical and administrative equipment under operating leases with terms that vary from month-to-month to five years. Total rental expense included in other direct expenses on the consolidated statements of revenue, expenses and fund balance was $733,719 in 1996 and $743,861 in 1995.

The Hospital also leases medical equipment under lease agreements accounted for as capital lease obligations in accordance with Financial Accounting Standards Board Statement No. 13. These capital lease obligations expire at various dates through 2001. Upon expiration, the Hospital has the option to either renew the capital lease obligation or

5. Leases (continued)

purchase the related equipment. The land, buildings and equipment balances on the consolidated balance sheets include equipment under capital lease obligations of \$7,129,317 and \$6,751,408, less accumulated amortization of \$2,930,499 and \$2,311,016 in 1996 and 1995, respectively.

The Hospital acquired equipment of approximately \$1,072,921 in 1996 and \$1,690,657 in 1995, which was financed through long-term capital lease obligations.

The future minimum lease payments at September 30, 1996 for noncancelable leases are as follows:

	Operating Leases	Capital Leases
1997	\$ 99,315	\$ 1,541,322
1998	81,065	917,204
1999	23,065	803,341
2000	928	485,062
2001 and thereafter	–	173,198
	\$ 204,373	3,920,127
Amounts representing imputed interest		(413,504)
Present value of capital lease obligations (including \$1,346,614 classified as amounts due within one year)		\$ 3,506,623

The Hospital and its subsidiary, Camellia, lease space to physicians through a combination of cancelable and noncancelable lease agreements. Rental income earned under these agreements was \$808,578 in 1996 and \$767,178 in 1995.

5. Leases (continued)

The future minimum lease payments to be received from noncancelable lease agreements at September 30, 1996 are as follows:

	Operating Leases
1997	$ 547,044
1998	455,820
1999	243,833
2000	135,163
2001	–
	$ 1,381,860

6. Long-Term Debt

The details and balances of long-term debt are presented below:

	1996	1995
Hospital Revenue Bonds, Series 1994, described in detail below ($1,030,000 due in 1997)	**$ 33,290,000**	$ 34,285,000
Certificates of Indebtedness, Series 1995, described in detail below ($147,945 due in 1997)	**1,012,051**	1,147,981
Note payable to physician, 8%, due October 1, 1999, with monthly principal and interest payments of $1,420 ($13,821 due in 1997), collateralized by land and building with a net book value of $130,000	**46,410**	59,172
	34,348,461	35,492,153
Less amounts due within one year	**1,191,766**	1,143,692
	$ 33,156,695	$ 34,348,461

6. Long-Term Debt (continued)

Hospital Revenue Bonds

On May 5, 1994, the Hospital issued $35 million of Hospital Revenue Bonds, Series 1994 (the 1994 Revenue Bonds) to finance the cost of constructing improvements to the Hospital and to defease or liquidate outstanding debt. The bonds are collateralized by a pledge of all future operating revenue of the Hospital. Proceeds from the 1994 Revenue Bonds were deposited with a trustee and restricted for the purpose described in the Trust Indenture.

At September 30, 1996, the 1994 Revenue Bonds consisted of: (1) $14,860,000 of serial bonds with interest rates ranging from 4.6% to 6.0%, payable in annual installments of $1,030,000 to $1,750,000 from October 1, 1996 to 2006; (2) $5,905,000 of 6.125% term bonds due October 1, 2009, with mandatory sinking fund requirements of $1,855,000 to $2,085,000 from October 1, 2007 to 2009; (3) $4,565,000 of 6.125% term bonds due October 1, 2011, with mandatory sinking fund requirements of $2,215,000 and $2,350,000 on October 1, 2010 and 2011; and (4) $7,960,000 of 6.25% term bonds due October 1, 2014, with mandatory sinking fund requirements ranging from $2,495,000 to $2,815,000 from October 1, 2012 to 2014. The bonds are subject to redemption prior to maturity, at the option of the District, on or after October 1, 2004, in whole or part with premiums of up to 2% of the principal balance.

In connection with the 1994 Revenue Bonds, the Hospital purchased a bond insurance policy issued by Connie Lee Insurance Company which guarantees the scheduled payment of principal and interest on the 1994 Revenue Bonds. Also, the Hospital entered into a Trust Indenture with First National Bank of Commerce which stipulates the terms and covenants with which the Hospital must comply. The Trust Indenture requires the Hospital to meet certain financial covenants, such as the maintenance of a debt service reserve fund of at least $2,993,788, a consolidated debt service coverage ratio (as defined) of at least 1.1 to 1 and days cash on hand (as defined) of at least 30. The Hospital was in compliance with these covenants as of September 30, 1996.

On May 5, 1994, the Hospital defeased the 1988 Revenue Bonds outstanding with a portion of the proceeds from the 1994 Revenue Bonds. The Hospital created an irrevocable trust to provide for the payment and retirement of the outstanding 1988 Revenue Bonds. The Hospital deposited U. S. Government Securities with a net carrying value of $10,259,635 into the trust from the proceeds of the 1994 Revenue Bonds together with

6. Long-Term Debt (continued)

other funds provided by the Hospital. Securities deposited in the trust fund, together with interest earned, are sufficient to provide for the payment of principal and interest on the defeased 1988 Revenue Bonds on the respective maturity dates. The unpaid principal balance of the 1988 Revenue Bonds was $8,770,000 at September 30, 1996.

During 1966 and 1975, the Hospital issued Revenue Bonds of $625,000 and $2,500,000, respectively, to expand and improve Hospital facilities. On October 11, 1988, these bonds were defeased with the proceeds of the 1988 Revenue Bonds. The Hospital created an irrevocable trust to provide for the payment and retirement of its outstanding 1966 and 1975 Revenue Bonds. Proceeds from the 1988 Revenue Bonds were used to purchase U. S. Government securities that were deposited in the irrevocable trust. The U. S. Government securities, together with interest earned, are sufficient to provide for the payment of principal and interest on the defeased Revenue Bonds on the respective maturity dates. These bonds had unpaid principal balances of $155,000 and $770,000, respectively, at September 30, 1996.

Certificates of Indebtedness

On April 20, 1995, the Hospital issued $1,203,000 in Certificates of Indebtedness, Series 1995 (the Certificates) to refinance two promissory notes due in April 1995. Principal is payable in monthly installments commencing on May 20, 1995 and maturing in 2002. The unpaid principal of the Certificates bear interest at a rate of 8.5% which is payable monthly. The Certificates are secured by and payable solely from the Hospital's excess annual revenues. The Hospital is required to comply with certain covenants, including the establishment of a Reserve Fund and maintenance of a minimum level of investments maturing two years or less. The Hospital was in compliance with those provisions as of September 30, 1996.

The combined aggregate amount of maturities and sinking fund requirements of long-term debt for the next five years are: $1,191,766 in 1997; $1,255,990 in 1998; $1,321,466 in 1999; $1,382,156 in 2000; and $1,457,606 in 2001.

7. Employee Benefits

The Hospital has a qualified noncontributory defined contribution pension plan which provides pension benefits for eligible employees. Employees are eligible to participate in the plan when they have a minimum of one year of continuous service. The plan agreement requires the Hospital to contribute a percentage of the first $17,500 of compensation, plus another percentage for the portion of compensation in excess of $17,500. The percentages to be applied are based on years of continuous service and range from .8% to 8%. Participating employees become fully vested immediately in Hospital contributions and the interest allocated to their accounts.

The Hospital's total payroll in 1996 was $29,924,453, and its contributions were determined based on covered salaries of $19,840,050. During 1996 and 1995, the Hospital made required contributions to the plan of $792,916 (4% of covered payroll) and $827,544 (4.4% of covered payroll), respectively.

8. Risk Management

The Hospital is involved in litigation arising in the ordinary course of business. Claims alleging malpractice have been asserted against the Hospital and are currently in various stages of litigation. The Hospital participates in the Louisiana Hospital Association Trust Fund and the Louisiana Patients' Compensation Fund for insurance coverage on medical malpractice claims. As a participant, the Hospital has a statutory limitation of liability which provides that no award can be rendered against it in excess of $500,000, plus interest and costs. The Trust Fund provides malpractice coverage for claims up to $100,000 and the Compensation Fund provides an additional $400,000 of coverage. These funds provide the Hospital with malpractice coverage on an occurrence basis up to the $500,000 statutory limitation. Hospital management has no reason to believe that the Hospital will be prevented from continuing its participation in the Fund. Additional claims may be asserted against the Hospital arising from services provided to patients through September 30, 1996. The Hospital is unable to determine the ultimate cost of the resolution of such potential claims and, accordingly, no accrual has been made for them.

The Hospital is self-insured for workers' compensation up to $275,000 per claim, and employee health up to $100,000 per claim. A liability is recorded when it is probable that a loss has been incurred and the amount of that loss can be reasonably estimated. Liabilities for claims incurred are reevaluated periodically to take into consideration recently settled claims, frequency of claims and other economic and social factors. The Hospital purchased commercial insurance which provides coverages for workers' compensation and employee health claims in excess of the self-insured limits.

8. Risk Management (continued)

Changes in the Hospital's aggregate claims liability in fiscal year 1996 and 1995 were as follows:

Year Ended September 30	Beginning of Fiscal Year Liability	Current Year Claims and Changes in Estimates	Claim Payments	Balance at Fiscal Year End
1996	**$ 846,468**	**$ 4,439,716**	**$ (4,407,836)**	**$ 878,348**
1995	$ 900,173	$ 4,796,276	$ (4,849,981)	$ 846,468

9. Hill-Burton Grants

The Hospital received grants for equipment and improvements under the federal Hill-Burton Act. The grants are subject to an agreement with the United States that if, during a 20-year period, there is an unapproved change in ownership, or the Hospital ceases to be a tax-exempt entity, the grants will have to be repaid. The acceptance of these grants requires the Hospital to provide a certain amount of free or below-cost care to indigent patients. The Hill-Burton obligation is scheduled to expire in 1998; however, the Hospital has satisfied the uncompensated services commitment and has no further commitment to provide uncompensated services in accordance with the requirements of the grant.

10. Commitments

The Hospital has several major construction projects planned or in process, funded by the issuance of the 1994 Revenue Bonds including an expansion of the operating room and ambulatory surgery facilities and construction of a second medical office building and other miscellaneous projects. The total costs incurred on these projects during fiscal year 1996 were $2,269,186 with remaining estimated costs to be incurred related to these projects of approximately $4,300,000. These projects are expected to be completed in fiscal year 1997. The amount of interest capitalized related to these projects during fiscal year 1996 is immaterial to the consolidated financial statements.

10. Commitments (continued)

At September 30, 1996, the Hospital had commitments to acquire $540,000 of equipment which it plans to purchase with working capital in fiscal year 1997.

As of September 30, 1996, the Hospital had invested $1,004,000 to acquire part ownership in a health maintenance organization (HMO) joint venture. The HMO began operations in January 1995. At September 30, 1996, the Hospital had outstanding commitments of $1,000,000 to provide additional working capital funds to the HMO. The amount is to be paid by December 31, 1997.

11. Subsequent Events

On October 7, 1996, the Hospital issued $8 million of Hospital Revenue Bonds, Series 1996 (the 1996 Revenue Bonds) to finance the cost of constructing improvements to the Hospital. Concurrent with the Bond issuance, the First Supplemental Trust Indenture was executed which allowed the 1996 Revenue Bonds to be issued as Additional Bonds on a parity with the outstanding 1994 Revenue Bonds (see Note 6).

Slidell Memorial Hospital and Medical Center

Board of Commissioners' Fees (Unaudited)

Commissioner	Meetings Attended	Amount
Emily Cote	23	$ 1,725
Mary Ann Dutton	25	1,875
David Fargo	24	1,800
Gus Fritchie	18	1,350
Thomas Hall	25	1,875
Albert Hamauei	22	1,650
Mark Hines	23	1,725
Janie McKenzie	27	2,025
John Pasqua	25	1,875
Steve Stefancik	25	1,875
Total		$17,775

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Report of Independent Auditors on the Internal Control Structure

The Board of Commissioners
St. Tammany Parish Hospital Service District No. 2

We have audited the consolidated financial statements of St. Tammany Parish Hospital Service District No. 2 (d/b/a Slidell Memorial Hospital and Medical Center) as of and for the year ended September 30, 1996, and have issued our report thereon dated December 12, 1996.

We conducted our audit in accordance with generally accepted auditing standards and *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 consolidated financial statements are free of material misstatement.

The management of Slidell Memorial Hospital and Medical Center is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of consolidated financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the internal control structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the consolidated financial statements of Slidell Memorial Hospital and Medical Center for the year ended September 30, 1996, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the consolidated financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

This report is intended for the information of the board of commissioners, management, and the Office of Legislative Auditor, State of Louisiana, and the cognizant and other federal agencies. However, this report is a matter of public record and its distribution is not limited.

Ernst + Young LLP

December 12, 1996

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Report of Independent Auditors on Compliance With Laws and Regulations, Contracts and Grants

The Board of Commissioners
St. Tammany Parish Hospital Service District No. 2

We have audited the consolidated financial statements of St. Tammany Parish Hospital Service District No. 2 (d/b/a Slidell Memorial Hospital and Medical Center) as of and for the year ended September 30, 1996, and have issued our report thereon dated December 12, 1996.

We conducted our audit in accordance with generally accepted auditing standards and *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 consolidated financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to Slidell Memorial Hospital and Medical Center is the responsibility of Slidell Memorial Hospital and Medical Center's management. As part of obtaining reasonable assurance about whether the consolidated financial statements are free of material misstatement, we performed tests of Slidell Memorial Hospital and Medical Center's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the consolidated financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.

This report is intended for the information of the board of commissioners, management, the Office of Legislative Auditor, State of Louisiana, and the cognizant and other federal agencies. However, this report is a matter of public record and its distribution is not limited.

Ernst + Young LLP

December 12, 1996