SLIDELL MEMORIAL HOSPITAL AND MEDICAL CENTER

Consolidated Financial Statements as of December 31, 1998 and 1997 and for the Years Then Ended and Independent Auditors' Report

SLIDELL MEMORIAL HOSPITAL AND MEDICAL CENTER

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INDEPENDENT AUDITORS' REPORT

Members of the Board of Commissioners
St. Tammany Parish Hospital Service
District No. 2:

We have audited the accompanying consolidated balance sheet of St. Tammany Parish Hospital Service District No. 2 (d/b/a Slidell Memorial Hospital and Medical Center) as of December 31, 1998, and the related consolidated statements of revenue, expenses and changes in fund balance and cash flows for the year then ended. These financial statements are the responsibility of Slidell Memorial Hospital and Medical Center's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Slidell Memorial Hospital and Medical Center for the year ended December 31, 1997 were audited by other auditors whose report, dated February 27, 1998, expressed an unqualified opinion on those statements.

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 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 audit provides a reasonable basis for our opinion.

In our opinion, such consolidated 1998 financial statements present fairly, in all material respects, the consolidated financial position of Slidell Memorial Hospital and Medical Center at December 31, 1998, and the consolidated results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

The year 2000 supplementary information on page 14 is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because of the unprecedented nature of the year 2000 issue and its effects, and the fact that authoritative measurement criteria regarding the status of remediation efforts have not been established. In addition, we do not provide assurance that Slidell Memorial Hospital and Medical Center is or will become year 2000 compliant, that Slidell Memorial Hospital and Medical Center's year 2000 remediation efforts will be successful in whole or in part, or that parties with which Slidell Memorial Hospital and Medical Center does business are or will become year 2000 compliant.

In accordance with *Government Auditing Standards*, we have also issued a report dated March 31, 1999 on our consideration of Slidell Memorial Hospital and Medical Center's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants.

Deloitte & Touche LLP

March 31, 1999

Deloitte Touche
Tohmatsu

SLIDELL MEMORIAL HOSPITAL AND MEDICAL CENTER

CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 1998 AND 1997

ASSETS	1998	1997
CURRENT ASSETS:		
Cash and cash equivalents	$ 4,104,724	$ 3,501,369
Patient accounts receivable, net of allowance for uncollectible accounts of $4,476,792 in 1998 and $3,373,635 in 1997, respectively	17,862,565	15,318,004
Assets whose use is limited - required for current liabilities (Note 2)	841,150	885,257
Inventories	1,700,585	1,549,480
Prepaid expenses and other receivables	2,055,124	988,907
Total current assets	26,564,148	22,243,017
ASSETS WHOSE USE IS LIMITED OR RESTRICTED:		
By board or under indenture agreement for capital improvements and debt service (Note 2)	20,374,277	31,185,778
LAND, BUILDINGS AND EQUIPMENT (Note 9):		
Land and improvements	4,601,711	4,466,386
Buildings	49,889,925	45,409,237
Equipment	39,219,534	32,420,813
Less accumulated depreciation and amortization	(43,450,887)	(38,017,583)
Construction in progress	1,517,330	1,873,903
Total land, buildings and equipment	51,777,613	46,152,756
OTHER ASSETS:		
Investment in affiliated organizations	2,600,155	1,275,599
Bond issuance costs, net of accumulated amortization of $428,067 in 1998 and $333,399 in 1997, respectively	1,407,822	1,502,490
Intangible assets, net of accumulated amortization of $3,089 in 1998 and $171,003 in 1997, respectively	479	69,777
Total other assets	4,008,456	2,847,866
TOTAL	$102,724,494	$102,429,417

LIABILITIES AND FUND BALANCE

CURRENT LIABILITIES:		
Trade accounts payable	$ 3,730,997	$ 2,459,156
Salaries, wages and benefits payable	1,820,148	2,469,585
Accrued vacation payable	1,215,724	1,134,164
Accrued interest and other expenses (Note 8)	1,695,125	3,354,952
Amounts due to third-party payors (Note 3)	154,028	1,419,961
Amounts due within one year on capital lease obligations and long-term debt (Notes 5 and 6)	3,062,176	2,680,212
Total current liabilities	11,678,198	13,518,030
CAPITAL LEASE OBLIGATIONS, less amounts due within one year (Note 5)	1,788,576	1,214,126
LONG-TERM DEBT, less amounts due within one year (Note 6)	35,275,095	37,348,469
FUND BALANCE	53,982,625	50,348,792
TOTAL	$102,724,494	$102,429,417

See notes to consolidated financial statements.

SLIDELL MEMORIAL HOSPITAL AND MEDICAL CENTER

CONSOLIDATED STATEMENTS OF REVENUE, EXPENSES AND CHANGES IN FUND BALANCE
YEARS ENDED DECEMBER 31, 1998 AND 1997

	1998	1997
REVENUE:		
Net patient service revenue (Note 3)	$83,954,410	$82,898,844
Other revenue	3,645,394	4,568,034
Total revenue	87,599,804	87,466,878
EXPENSES:		
Salaries and wages (Note 7)	34,159,723	33,594,298
Employee benefits (Note 7)	9,159,145	8,795,829
Supplies and materials	13,038,013	11,541,767
Other direct expenses	7,644,564	7,411,134
Professional fees	3,413,215	4,134,190
Purchased services	3,878,796	3,458,257
Provision for bad debts	4,509,753	5,582,171
Depreciation and amortization	5,841,605	5,653,318
Interest	2,321,157	2,499,657
Total expenses	83,965,971	82,670,621
REVENUE IN EXCESS OF EXPENSES	3,633,833	4,796,257
TRANSFER OF HOSPICE FOUNDATION ASSETS TO SMH FOUNDATION	-	220,048
FUND BALANCE AT BEGINNING OF YEAR	50,348,792	45,332,487
FUND BALANCE AT END OF YEAR	$53,982,625	$50,348,792

See notes to consolidated financial statements.

SLIDELL MEMORIAL HOSPITAL AND MEDICAL CENTER

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 1998 AND 1997

	1998	1997
OPERATING ACTIVITIES:		
Revenue in excess of expenses	$ 3,633,833	$ 4,796,257
Adjustments to reconcile revenue in excess of expenses to net cash provided by operating activities:		
Depreciation and amortization	5,841,605	5,653,318
Changes in operating assets and liabilities:		
Patient accounts receivable, net	(2,544,561)	(3,811,502)
Inventories and other operating assets	(1,185,346)	(160,358)
Accounts payable and other accrued expenses	(2,183,794)	3,787,167
Interest expense	2,321,157	2,499,657
Loss on sale of capital assets	108,912	85,956
Interest income	(1,909,480)	(1,901,065)
Net cash provided by operating activities	4,082,326	10,949,430
CAPITAL AND RELATED FINANCING ACTIVITIES:		
Receipts from sale of capital assets	51,395	16,108
Payments for acquisitions of land, buildings and equipment	(9,791,269)	(8,104,538)
Principal paid on capital lease obligations and long-term debt	(2,717,558)	(3,119,461)
Interest paid on capital lease obligations and long-term debt	(2,430,095)	(2,675,130)
Net cash used in capital and related financing activities	(14,887,527)	(13,883,021)
INVESTING ACTIVITIES:		
Decrease in assets whose use is limited or restricted	10,855,608	1,334,675
Receipts of interest earned	1,877,504	1,937,913
Investments in affiliated organizations	(1,324,556)	(267,019)
Net cash provided by investing activities	11,408,556	3,005,569
INCREASE IN CASH AND CASH EQUIVALENTS	603,355	71,978
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	3,501,369	3,429,391
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 4,104,724	$ 3,501,369
NON-CASH TRANSACTIONS		
Increase in capitalized lease obligation and equipment	$ 1,600,598	$ -

See notes to consolidated financial statements.

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Organization - 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.

Principles of Consolidation - 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. (Physician Practice Services). All material intercompany accounts and transactions have been eliminated in consolidation.

Basis of Accounting - The Hospital utilizes the accrual basis of accounting for proprietary funds. Under Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Activities That Use Proprietary Fund Accounting*, the Hospital has elected not to apply Financial Accounting Standards Board (FASB) pronouncements issued after November 30, 1989.

Income Tax Status - The Hospital is exempt from federal income tax under both Section 115 of the Internal Revenue Code as a governmental entity and 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 Related Receivables - 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 by providing appropriate allowances.

Premium Revenue - The Hospital has agreements with health maintenance organizations (HMOs) to provide medical services to subscribing participants. Under such agreements, the Hospital receives monthly capitation payments based on the number of the HMO participants, regardless of services actually performed by the Hospital. Under this agreement, the Hospital is liable for payments to outside medical providers for hospital services rendered. Capitation payments received net of payments to outside medical providers approximated $750,000 in 1998, and is included in net patient service revenue. Capitation payments received in 1997 were not significant.

Medicare and Medicaid Reimbursement Programs - The Hospital is reimbursed under the Medicare Prospective Payment System (PPS) for acute care 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 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.

Medicare rehabilitation, skilled nursing, and home health services are reimbursed on a cost basis, subject to certain limitations imposed by governmental authorities. Medicare outpatient services (excluding ambulatory surgery, clinical lab and radiology diagnostic procedures), Medicaid outpatient services (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 and Cash Equivalents and Assets Whose Use is Limited or Restricted - Cash equivalents and assets whose use is limited or restricted are recorded at fair 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. As of December 31, 1998 and 1997, 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.

Effective January 1, 1998, the Hospital adopted the provisions of the Governmental Accounting Standards Board Statement (GASBS) No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. GASBS No. 31 requires that all investments be reported at fair value with gains and losses included in the statements of revenues and expenses. The effect of adopting this statement at January 1, 1998 was not material to the financial statements.

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

Land, Buildings and Equipment - 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.

Investment in Affiliated Organizations - The Hospital has two investments in affiliated organizations which are accounted for under the cost and equity methods. The investment accounted for under the cost method is a 17% interest in Southeast Medical Alliance, Inc. This investment is recorded at approximately $2,590,000 and $1,126,000 at December 31, 1998 and 1997, respectively.

Unamortized Bond Issuance Costs - The costs incurred in connection with the issuance of the Hospital's revenue bonds have been deferred and are being amortized over the life of the bond issues. Amortization is included in depreciation and amortization expense.

Employee Health and Workers' Compensation Insurance - 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 sheet.

Use of Estimates - The preparation of financial statements in conformity with generally accepted accounting principles 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. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. ASSETS WHOSE USE IS LIMITED OR RESTRICTED

The terms of the Hospital's revenue bond issues 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 December 31, 1998 and 1997 were as follows:

	1998	1997
Current assets:		
Under bond indenture:		
Bond debt service account	$ 841,150	$ 885,257
Noncurrent assets:		
Under bond indenture:		
Capital improvement account	$ 4,351,007	$ 7,530,998
Debt service reserve account	4,465,670	4,389,787
	8,816,677	11,920,785
By board:		
Designated for capital improvements	11,169,971	18,959,582
Other	387,629	305,411
	$20,374,277	$31,185,778

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 fair value at December 31, 1998 and 1997.

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 December 31, 1998 and 1997, approximately 41% and 45%, respectively, of the Hospital's gross patient service charges were derived from services provided to Medicare and Medicaid program beneficiaries. Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The Hospital believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. While no such regulatory inquiries have been made, compliance with such laws and regulations 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.

Revenue derived from the Medicare program is subject to audit and adjustment by the 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 Medicare and Medicaid settlements for fiscal years ended through September 30, 1996. 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. Although the fiscal intermediary has not completed its audits of the estimated settlements for the three-month period ended December 31, 1996, the year ended December 31, 1997, and the year ended December 31, 1998, the Hospital does not anticipate significant 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 arrangements includes prospectively determined daily rates, discounts from established charges and monthly capitation payments.

4. COMMUNITY BENEFITS

As a community health care provider, the Hospital's stated mission is "to meet the needs of our customer by providing excellence in health maintenance and 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.

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 during the years December 31, 1998 and 1997, measured at established rates, totaled $5,328,439 and $4,667,957, 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. The Hospital has conducted a Community Health Assessment to identify health risks in the community. Through this research, the Hospital has developed 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, development topics, etc., to provide the community access to 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 changes in fund balance was $762,743 and $801,117 for the years ended December 31, 1998 and 1997, respectively.

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 2003. The land, buildings and equipment balances on the consolidated balance sheet include equipment under capital lease obligations of $5,300,032 and $5,253,091, less accumulated amortization of $2,324,803 and $2,613,296 at December 31, 1998 and 1997, respectively.

The future minimum lease payments at December 31, 1998 for noncancelable leases are as follows:

	Operating Leases	Capital Leases
1999	$236,510	$1,132,483
2000	176,964	774,305
2001	49,250	471,795
2002	547	360,691
2003	-	330,634
	$463,271	3,069,908
Amounts representing imputed interest		278,842
Present value of capital lease obligations (including $1,002,490 classified as amounts due within one year)		$2,791,066

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 $948,749 and $858,323 for the years ended December 31, 1998 and 1997.

The future minimum lease payments to be received from noncancelable lease agreements at December 31, 1998 are as follows:

	Operating Leases
1999	$ 461,939
2000	345,547
2001	258,849
2002	259,887
2003	122,299
	$1,448,521

6. LONG-TERM DEBT

The details and balances of long-term debt at December 31, 1998 and 1997 are presented below:

	1998	1997
Hospital Revenue Bonds, Series 1994, described in detail below ($1,190,000 due in 1999)	$30,050,000	$31,180,000
Hospital Revenue Bonds, Series 1996, described in detail below ($690,680 due in 1999)	6,624,129	7,276,630
Certificate of Indebtedness, Series 1995, described in detail below ($179,006 due in 1999)	660,652	825,120
Note payable to physician, 8% paid in full during 1998	-	28,958
	37,334,781	39,310,708
Less amounts due within one year	2,059,686	1,962,239
	$35,275,095	$37,348,469

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 the Hospital's revenue. Proceeds from the 1994 Revenue Bonds were deposited with a trustee and restricted for the purpose described in the Trust Indenture.

At December 31, 1998, the 1994 Revenue Bonds consisted of: (1) $11,620,000 of serial bonds with interest rates ranging from 5.2% to 6%, payable in annual installments of $1,190,000 to $1,750,000 from October 1, 1999 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 Hospital, on or after October 1, 2004, in whole or in 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 Ambac Assurance Corporation (formerly 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 (now Bank One) which stipulates certain terms and covenants, for example debt service ratios, with which the Hospital must comply. The Hospital was in compliance with these covenants as of December 31, 1998.

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. The 1996 Revenue Bonds bear interest at 5.7% and are payable monthly in equal installments of principal and interest totaling $87,533. The 1996 Revenue Bonds are subject to the 1994 Trust Indenture and have been issued on a parity with the outstanding 1994 Revenue Bonds. The 1996 Revenue Bonds are subject to redemption prior to maturity, at the option of the Hospital, at any time, in whole or in part with a defined prepayment penalty. Essentially, the prepayment penalty is equal to the economic difference, if any, to the original purchaser of the bonds, of obtaining an equivalent loan at the time of the redemption.

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 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 $7,440,000 at December 31, 1998.

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 $95,000 and $415,000, respectively, at December 31, 1998.

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 balances 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 was in compliance with all covenants associated with the Certificates as of December 31, 1998.

The combined aggregate amount of maturities and sinking fund requirements of long-term debt for the next five years are:

1999	$ 2,059,686
2000	2,175,923
2001	2,310,922
2002	2,298,924
2003	2,347,086
Thereafter	26,142,240
	$37,334,781

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 an additional 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 for the years ended December 31, 1998 and 1997 was $34,159,723 and $33,594,298, respectively, and its contributions were determined based on covered salaries of $22,895,401 and $21,662,559. During the years ended December 31, 1998 and 1997, the Hospital made required contributions to the Plan of $1,002,640 and $901,119, respectively (approximately 4% of covered payroll for the years ended December 31, 1998 and 1997).

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 December 31, 1998. 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 $300,000 per claim, and employee health up to $120,000 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 carries commercial insurance which provides coverages for workers' compensation and employee health claims in excess of the self-insured limits.

Changes in the Hospital's aggregate claims liability for workers' compensation and employee health for the years ended December 31, 1998 and 1997 were as follows:

Year Ended December 31	Beginning of year Liability	Current Year Claims and Changes in Estimates	Claim Payments	Balance at Year End
1998	$1,443,765	$ 5,598,134	$ 6,512,677	$ 529,222
1997	$ 849,451	$ 5,616,073	$ 5,021,759	$ 1,443,765

9. COMMITMENTS

The Hospital has several major construction projects planned or in process, funded by the issuance of its revenue bonds. The remaining estimated costs to be incurred related to these projects is approximately $6,342,000 as of December 31, 1998. The amount of interest capitalized related to these projects during the years ended December 31, 1998 and 1997 is immaterial to the consolidated financial statements.

At December 31, 1998, the Hospital had commitments to acquire $634,158 of equipment which it plans to purchase with working capital in 1999.

10. SUBSEQUENT EVENT

On March 1, 1999, the Hospital acquired all the membership rights of Slidell Radiation Center (SRC), a non-profit membership corporation. The Hospital issued $1.7 million in certificates of indebtedness which bear an annual interest rate of 7% and are payable in annual installments of principal and interest of approximately $242,000 over a period of ten years.

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SLIDELL MEMORIAL HOSPITAL AND MEDICAL CENTER

SUPPLEMENTAL SCHEDULE - YEAR 2000 INFORMATION (UNAUDITED)
DECEMBER 31, 1998

The year 2000 issue is the result of computer programs being written using two digits rather than four to define the applicable year. The Hospital's computer programs and certain computer-aided medical equipment that have time-sensitive software may recognize a date using '00' as the year 1900 rather than the year 2000. This could result in system failures or miscalculations causing disruption of operations or medical equipment malfunctions that could affect patient diagnosis and treatment. The Hospital believes that with modifications to existing software and conversions to new software, the year 2000 issue will not pose significant operational problems for its computer systems. However, if such modifications and conversions are not made, or are not completed timely, the year 2000 issue could have a material impact on the operations of the Hospital.

The Hospital has initiated the process of preparing its computer systems and applications for the year 2000. An inventory of computer systems and other electronic equipment that may be affected by the year 2000 issue has been completed. The Hospital is currently in the remediation stage as plans are under way to upgrade existing software or replace noncompliant software and equipment. Testing and validation of the systems will be completed after installation.

The Hospital expects to incur internal staff costs as well as external consulting and other expenses approximating $1,400,000 to prepare the systems for the year 2000. However, there can be no assurance that the systems of other companies, on which the Hospital's systems rely, will be timely converted or that any such failure to convert by another company (such as third-party payors) would not have an adverse effect on the Hospital's systems.

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INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED UPON THE AUDIT OF THE FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

Slidell Memorial Hospital
New Orleans, Louisiana

We have audited the financial statements of St. Tammany Parish Hospital Service District No. 2 (d/b/a Slidell Memorial Hospital and Medical Center) (the "Hospital"), as of and for the year ended December 31, 1998, and have issued our report thereon dated March 31, 1999. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Hospital's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Hospital's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the 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 over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the Board of Commissioners and management and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche LLP

March 31, 1999

Deloitte & Touche

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March 31, 1999

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

Dear Members of the Board of Commissioners:

In planning and performing our audit of the financial statements of St. Tammany Parish Hospital Service District No. 2 (d/b/a Slidell Memorial Hospital and Medical Center) (the "Hospital") for the year ended December 31, 1998 (on which we have issued our report dated March 31, 1999), we developed the following recommendations concerning certain matters related to the Hospital's internal control and certain observations and recommendations on other accounting, administrative, and operating matters. Our comments are presented in Exhibit I and are listed in the table of contents thereto.

This report is intended solely for the information and use of the Board of Commissioners, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

We will be pleased to discuss these comments with you and, if desired, to assist you in implementing any of the suggestions.

Yours truly,

Deloitte & Touche LLP

SLIDELL MEMORIAL HOSPITAL AND MEDICAL CENTER

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MONITORING OF MANAGED CARE CONTRACTS

Observation

While the Hospital's performance on specific contracts is critically reviewed when contracts are up for renewal, it does not appear that performance on such contracts is being routinely monitored during the year to identify the need for remedial action. As managed care and higher risk capitated contracts now represent approximately 37% of the net patient revenues derived by the hospital (and approximately 40% of the gross charges), the risk of loss for the hospital substantially increases.

During 1998, the Hospital received approximately $750,000 in capitated revenue, net of withhold payments for other third parties for which the Hospital is responsible. The Hospital, however, incurred charges in excess of $5 million related to these capitated arrangements. We also noted that no individual has been assigned the task of reviewing the need for accruing a liability associated with the capitated agreements for services performed by outside providers. Such amounts are often not known by hospital personnel until such claims are processed by the managed care company.

Management provides an allowance each month for 20-30% of outpatient managed care accounts and 23% of outpatient Blue Cross accounts. The allowance serves as an estimate of charges which are reduced under the various contracts once the payment on the patient's account is received in full. As the number of managed care plans has expanded over the years the average recovery to the Hospital has decreased indicating that an allowance rate of 40-45% may be more accurate for the full blend of inpatient and outpaitent services. The methodology used to develop such allowance estimates should be refined to track actual experience.

Recommendation

A knowledgeable individual should be reviewing gross charges, contractual allowances and net charges for each significant managed care contract on a monthly basis. Such a procedure would provide a valuable check on the accuracy of contractual allowances and identify "problem contracts" for corrective action.

AGING OF MANAGED CARE ACCOUNTS

Observation

Management currently receives a report on the aging of accounts receivable by financial class; however, a report is not produced which gives further detail of the aging of the managed care financial class by individual payor.

Recommendation

Management should obtain each month an aging of the managed care financial class by individual payor. This report could help identify problem payors as well as provide a negotiating tool when contracts are up for renewal.

BUSINESS CONTINUITY PLAN

Observation

SMH does not have a business continuity plan in place to minimize the risks associated with computer system and facility downtime. Limited steps have been taken to recover information systems should a disruption in data processing occur. These include the backup of production data and programs. Additionally, a business continuity plan that includes user procedures for capturing information, manual processing of critical transactions, future system entry of transactions, and the balancing and verifying of information once the system in back on-line, has not been documented. This is a key time for SMH to re-evaluate business continuity needs as it is undergoing significant system changes.

Business Insight

Critical clinical and business functions are directly dependent upon computer processing throughout the hospital. While making regular system backups is a proactive measure to mitigate potential outages, backups alone are not sufficient recovery plans. A contingency plan needs to reasonably ensure that data processing services could be efficiently and effectively resumed within an acceptable period of time following a disaster. Without the implementation of a comprehensive business continuity plan for both information technology and user groups to enact in the event of a processing disruption, the risk of invalid and/or lost information is significantly increased.

AS SMH is undergoing major system changes, this is an opportunity to develop a thorough business continuity plan along with the new system implementations. It is critical to ensure all aspects of business processes are included within the plan.

Recommendation

SMH should determine a strategy for business continuity planning throughout the hospital. The business continuity plan should include the following considerations:

- A risk assessment in order to prioritize processing of key applications,
- Identification of critical data files and software,
- Identification of critical hardware and telecommunications equipment,
- Documentation of backup processing facilities and any specific agreements concerning such,
- Assignment of specific responsibilities to users and data processing personnel, as well as a process to identify change within the organization and make updates to ensure the plan remains current,
- Interim procedures to ensure data is captured and maintained in order to be entered at the time the system is available again,
- Off-site storage of documentation, procedure manuals, and operation schedules, and
- Procedures for recovery and restart of processing

Disaster recovery test should be planned and conducted that involve Information Systems professionals as well as end users. The tests should be comprehensive enough to verify SMH's ability to bring up critical systems and network connectivity in a capacity that an end user could access critical applications and process transactions from his designated recovery location. Information Systems and business/clinical partners should work together to ensure that, in the event of a disaster or disruption in computer system availability, both data processing and business functions could be recovered with minimal loss of time and information.

SECURITY MONITORING AND REVIEW

Observation

Security review and monitoring of platform access, application access, remote access (including internet connectivity) and vendor access is not performed on a regular basis, increasing the risk that unauthorized access to information is not being detected in a timely manner.

We noted that the Novell environment contained unnecessary user Ids and that the user restrictions such as passwords were not consistently established among all users.

Business Insight

Security review and monitoring provide an important mechanism in the effort to secure computer environments. This process includes the review of items such as:

- Periodic review of users' access privileges to ensure that the assignment of access privileges is appropriate for the users' job functions and terminated users have been removed form the system,
- Daily or weekly review of security violation logs to detect any unauthorized access attempts at both the system and application level,
- Periodic review of system parameters to detect any unauthorized changes to critical system settings, and
- Daily review of remote access to the computer environments to detect any unauthorized access attempts committed by intruders.

These types of reviews will help ensure segregation of duties are maintained, terminated users are completely removed from all systems, and intruders are detected early to minimize potential damage that may be done.

Recommendation

SMH should assign the responsibility of security monitoring and review to key information system professionals. Further, policies and procedures regarding security monitoring and review should be documented as part of the hospital's policies.

OFFSITE ROTATION

Observation

Currently, backup tapes are stored in the data center. There are plans to obtain a fire proof safe for tape storage. Additionally, there are plans for the information systems department to move to a new building, which could be an alternate site for tape storage.

Business Insight

In the event of a disaster, the backup tapes could be destroyed along with the production systems. This would make the system restoration process extremely difficult, if not impossible. By taking tapes to an offsite facility such as another SMH location or bank lock box, the ability to recover after a disaster is improved.

Recommendation

We recommend that backup tapes be rotated on a regular basis to an offsite storage location. The tapes should be in an environmentally controlled area or container to help ensure their protection.

POLICIES AND PROCEDURES

Observation

We noted that comprehensive policies and procedures have not been developed for all IS functions. Specifically we noted that the following areas could be enhanced with policies and procedures:

- Remote access policy that states what type of users can obtain remote access and what the access can be used for.
- Internet usage policy defining whom can have Internet access and what the proper uses of access are.
- Program change control procedures that explain who can make program changes and how those changes are implemented into the production environment.

Business Insight

Policies and procedures are important to ensure that common processes are followed for all systems and users regarding system access and setup. Without established policies and procedures access to system resources may not be consistently controlled and contribute to a less secure environment. They also aid in employee training and transitioning job functions when personnel leave. Documentation will provide basic guidelines for users and IT personnel as they transition into their job position. Additionally, policies and procedures set a common standard and provide guidelines that users can be held accountable to. If users are not aware of indented or acceptable usage of resources they cannot be held to any standard.

Recommendation

We recommend that policies and procedures be developed for all areas of information systems. Areas of high risk such as program change should be addressed as soon as possible.

SMH
Slidell Memorial Hospital
and Medical Center

Slidell Memorial Hospital
Management Letter Responses
Information System

Business Continuity Plan

Management is addressing the development of a business continuity plan as part of the SMS and year 2000 readiness projects. Critical systems, files, hardware and documentation will be addressed. Alternative sites for the processing of critical systems that still operate on the AS/400 will be contracted and tests on loading and operating at the alternative site will be completed.

User departments already have downtime procedures for continuing their operations and entering data into the systems when available. System downtime is a regular occurrence during nightly processing, system backups and application system upgrades. The Information Systems Department shall formalize and become the keeper of the documentation of all the user departments' procedures.

Implementation of offsite storage of backup tapes and operating manuals has been implemented.

Security monitoring and Review

SMH has an assigned systems security officer who is assigned the responsibility of determining with the application managers the proper user access levels. The systems security officer maintains or oversees the assigning of all security codes and departmental managers are responsible, when the user security access needs change, to notify the security officer.

The Information Systems Department will write and implement additional polices and procedures to monitor for unauthorized system access, insure that users accesses are appropriate and that users are deleted timely from the systems.

Offsite Rotation

Implementation of offsite storage of backup tapes has been implemented.

Policies and Procedures

The hospital information systems have been undergoing rapid transition during the past year. Policies and procedures are being developed to cover such things as remote system access and user access to the Internet.

The hospital has already installed internet firewall software with internet access control abilities and the network analyst reviews the reports daily.

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SMH
Slidell Memorial Hospital
and Medical Center

MANAGEMENT'S RESPONSES TO MANAGEMENT LETTER COMMENTS

MONITORING OF MANAGED CARE CONTRACTS/ALLOWANCE FOR UNCONTRACTUALIZED ACCOUNTS

During 1997, Hospital management determined that there was a need for computer software to assist in evaluating the performance on specific managed care contracts and at that time began the process to evaluate the available software packages. The TSI system, which includes cost accounting, contract management and clinical decision support, was chosen and the process of implementing that system was begun in early 1998.

A system of this complexity typically takes from 12 to 18 months to fully implement. At this time, the system is approximately 80% complete and management has already begun to extract useful information from the system. Once fully implemented, the system will be used for various purposes, including the evaluation of the performance of each managed care contract, the calculation of contractual allowances and decision support.

Management expects to have this system fully implemented by June 30, 1999.

AGING OF MANAGED CARE ACCOUNTS

Currently there is no report available from the Hospital's information system which summarizes the accounts receivable aging by individual payor although queries have been generated for some of the larger payors which show total accounts receivable. Because the Hospital is planning to convert to a new Information System later this year, management has not devoted the time to develop such reports on the existing system.

This has been identified as an important need of the Hospital's information system and will be taken into consideration when building the new information system.

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