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Louisiana State University School of Medicine in New Orleans Faculty Group Practice d/b/a LSU Healthcare Network and Subsidiaries

Consolidated Financial Statements as of and for the Years Ended June 30, 2004 and 2003 and Independent Auditors' Report

Under provisions of state law this report is a public document. A copy of the report has been submitted to the entity and other appropriate public officials. The report is available for public inspection at the Baton Rouge office of the Legislative Auditor and, where appropriate, at the office of the parish clerk of court.

Release Date 2-16-05

LSU HEALTHCARE NETWORK AND SUBSIDIARIES

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MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the Louisiana State University School of Medicine in New Orleans Faculty Group Practice d/b/a LSU Healthcare Network's ("LSUHN") annual financial report presents management's discussion and analysis of financial performance during the fiscal year ended June 30, 2004. It should be read in conjunction with the consolidated financial statements in this report.

FINANCIAL HIGHLIGHTS

General

LSUHN reflected revenues in excess of expenses of $704,000 for the year ended June 30, 2004, compared to an excess of revenues over expenses of over $2 million for the year ended June 30, 2003.

- Patient service revenue net of contractual adjustments and allowances and bad debt was about $4.3 million higher in fiscal year 2004, than fiscal year 2003.
- Net increase of $1 million in capitated revenue in excess of claims paid.
- Personnel expense increased $1 million for the year.
- Physician compensation and enhancement fund expenses increased over $3.6 million.
- An increase of $1.6 million in general and administrative expenses.
- An increase in medical supplies of $293,000 and a decrease in interest income of $119,000 accounts for most of the remaining year-to-year variance.

Total assets at June 30, 2004 increased $3.8 million from June 30, 2003. Most of the increase is attributable to an increase in cash and cash equivalents of $3.1 million. Current assets exceed current liabilities by $8.4 million and the company has a current ratio of 1.63:1.

IDX Partnership

On March 22, 2004 LSUHN entered into a ten year agreement with IDX Information Systems Corporation ("IDX"), headquartered in Burlington, Vermont. Under the agreement, IDX will provide LSUHN all of the functionality of its Flowcast software, the Allscripts hand-held charge capture and coding software, full back-office staffing and management as well as other onsite training and support and IT support and hosting. After an initial planning period, the contract commenced on June 1, 2004. The commencement of the agreement triggered a reduction in LSUHN's workforce of 95 employees as well as a reduction in employees leased from LSU Health Sciences Center of 25.

The contract provides LSUHN with the opportunity to elevate the quality of its business office operations, improving the non-medical aspects of the patient care encounter. It also allows IDX to expand its service offerings and assist clients in achieving the maximum benefit from the deployment of their products.

OVERVIEW OF THE FINANCIAL STATEMENTS

This annual report consists of four components – the Management's Discussion and Analysis of Financial Condition and Operating Results (this section), the Independent Auditors' Report, the Consolidated Financial Statements, and the Auditors' Report on Compliance and on Internal Control over Financial Reporting.

The *Consolidated Financial Statements* of LSU Healthcare Network and Subsidiaries report the consolidated financial position of LSUHN and the consolidated results of its operations and its cash flows. The consolidated financial statements are prepared on the accrual basis of accounting. These statements offer short-term and long-term financial information about LSUHN's activities.

The *Consolidated Balance Sheets* include all of LSUHN's and its Subsidiaries' assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to LSUHN's creditors (liabilities) for both the current year and the prior year. They also provide the basis for evaluating the capital structure of LSUHN and assessing the liquidity and financial flexibility of LSUHN.

All of the current and prior year's revenues and expenses are accounted for in the *Consolidated Statements of Operations and Changes in Net Assets*. These statements measure the performance of LSUHN's operations over the past two years and can be used to determine whether LSUHN has been able to recover all of its costs through its patient service revenue and other revenue sources.

The primary purpose of the *Consolidated Statements of Cash Flows* is to provide information about LSUHN's cash from operations, investing, and financing activities. The cash flow statement outlines where the cash comes from, what the cash is used for, and the change in the cash balance during the reporting period.

The annual report also includes *Notes to the Consolidated Financial Statements* that are essential to gain a full understanding of the data provided in the consolidated financial statements. The notes to the consolidated financial statements can be found immediately following the basic financial statements in this report.

FINANCIAL ANALYSIS OF THE HEALTHCARE NETWORK

The consolidated balance sheets and the consolidated statements of operations and changes in net assets report information about the practice's activities. These two statements report the net assets of LSUHN and the changes in them. Increases or improvements, as well as decreases or declines in the net assets, are one indicator of the financial state of the practice. Other non-financial factors that should also be considered include changes in economic conditions, changes in population patterns (including uninsured and working poor) and new or changed government legislation.

Net Assets

Condensed Consolidated Balance Sheets
(In Thousands)

	Fiscal Year 2004	Fiscal Year 2003	Dollar Change	Total % Change
Current and other assets	$ 22,049	$ 18,316	$ 3,733	20 %
Capital Assets	1,321	1,212	109	9 %
Total Assets	23,370	19,528	3,842	20 %
Debt outstanding	358	186	172	92 %
Other liabilities	12,981	10,015	2,966	30 %
Total liabilities	$ 13,339	$ 10,201	$ 3,138	31 %
Invested in capital assets, net of related debt	$ 1,263	$ 1,026	$ 237	23 %
Unrestricted	8,768	8,301	467	6 %
Total net assets	$ 10,031	$ 9,327	$ 704	8 %

Net assets increased by $704,000 during the fiscal year ending June 30, 2004. Net income from operations increased $693,000 over the prior fiscal year partially offsetting an increase in other non-operating net revenue and expense of $2 million consisting primarily of increased enhancement fund expense. The improved operating income reflects increases in patient service revenue and capitation and reductions in bad debt partially offset by increases in leased faculty employees, personnel, general and administrative expenses medical supplies and medical claims.

The increase in total assets is attributable to larger cash reserves and an increase in accounts receivable. Accounts receivable increased as a result of holding self-pay balances longer to be worked in-house and an aging of Medicaid balances due to delays caused by documentation requirement from referring physicians in the Community Care program. Total liabilities increased primarily due to an increase in due to LSU Health Sciences Center and the Line of Credit payable by LSUHN Surgery Center to Chase (formerly Bank One) of $300,000.

Summary of Operations and Changes in Net Assets

The following table presents a summary of the practice's historical revenues and expenses for each of the fiscal years ended June 30, 2004 and 2003:

Condensed Statement of Operations and Changes in Net Assets
(In Thousands)

	Fiscal Year 2004	Fiscal Year 2003
Net patient service revenue	$ 64,599	$ 63,975
Capitation revenue	8,861	7,264
Total operating revenues	73,460	71,239
Operating and administrative	38,194	33,601
Medical claims paid	7,048	6,463
Bad debts	16,373	20,098
Depreciation	582	508
Total operating expenses	62,197	60,670
Operating net income	11,263	10,569
Non-operating revenues (expenses):		
Medical school enhancement fund	(10,679)	(8,830)
Interest income, interest expense, other—net	120	272
Changes in net assets	704	2,011
Total net assets—beginning of year	9,327	7,316
Total net assets—end of year	$ 10,031	$ 9,327

During fiscal year 2004, the practice generated 88% of its total revenues from patient care with the other 12% being derived from capitation revenue from LSUHN's wholly owned subsidiary, University Medical Group, LLC.

LSUHN provides care to patients in the Louisiana public hospital system (Medical Center of Louisiana or "MCL") without regard to their ability to pay for those services. Because of the cost involved, LSUHN generally does not capture the charges that result from providing care to patients that are determined to qualify for charity care and as a result LSUHN cannot fully report the amount of charity care provided to the uninsured and working poor. However, in certain areas, the billing process requires that some free care charges be entered into the system before they are adjusted out of revenues. During the year ended June 30, 2004, charity charges entered into the billing system and adjusted off totaled over $30 million compared to $26 million during the year ended June 30, 2003. This increase in free care is due to additional anesthesia free care entered into the billing system in order to calculate concurrency and self-pay charges from the Medical Center of Louisiana locations which are now being identified as self-pay rather than bad debt.

The following table represents the relative percentage of gross charges billed for patient services by payor for the years ended June 30, 2004 and 2003:

	Fiscal Year 2004	**Fiscal Year 2003**
Medicare	14 %	18 %
Medicaid	25 %	28 %
HMO/PPO	20 %	19 %
Commercial	5 %	7 %
Contract	1 %	1 %
Self-pay	9 %	9 %
Radiology & Pathology (PBO)	14 %	4 %
LSUHN Surgery Center LLC	1 %	0 %
Free care/indigent	11 %	14 %
Total gross charges	100 %	100 %

OPERATING AND FINANCIAL PERFORMANCE

The following summarizes the practice's Statements of Operations and Changes in Net Assets between 2004 and 2003:

- Revenue from patient services net of contractual allowances, adjustments and bad debt increased nearly 10% from 2003 to 2004.
  - Increases in Family Medicine, Ophthalmology, Orthopaedics, Pediatrics, Urology and the Surgery Center offset declines in Anesthesiology, Dermatology and Medicine.
  - The estimate of unbilled gross revenues increased $4.65 million as the practice transitioned its billing operations to IDX.
  - Reduction in bad debt of $3.7 million due to:
    - Identification of Medical Center of Louisiana ("MCL") self-pay as free care rather than bad debt
    - Reduced Medicare and Medicaid denials
    - *Sent fewer self-pay accounts to collections; these accounts were worked in-house*

- Total ambulatory visits were down about 8% for the year primarily because of declines at the Medical Center of Louisiana, New Orleans. Visits at the practice's main location on Gravier St. increased 4% in 2004. A summary of visits by location follows:

Patient Visits by Location

Location:	2004	2003	Change	% Change
Gravier	81,233	78,121	3,112	4 %
Children's uptown	18,314	19,822	(1,508)	(8)%
Kenner	11,452	9,274	2,178	23 %
Touro	10,131	9,008	1,123	12 %
Mercy	9,776	10,225	(449)	(4)%
Memorial (1)	9,561	8,598	963	11 %
Baton Rouge	4,858	6,166	(1,308)	(21)%
St. Charles General	3,240	2,453	787	32 %
Children's Metairie	2,873	3,002	(129)	(4)%
Hammond	1,748	2,564	(816)	(32)%
Other	252	336	(84)	(25)%
Westbank (2)	85	1,305	(1,220)	(93)%
Total private visits	153,523	150,874	2,649	2 %
Medical Center of LA	157,876	188,315	(30,439)	(16)%
Total ambulatory visits	311,399	339,189	(27,790)	(8)%

(1) Dermatology office closed in FY 2003.
(2) Dermatology and Cardiothoracic Surgery offices closed in FY 2003.

- A 14.7% increase in inpatient revenue from private hospital locations offset a 2.0% decrease at MCL locations for fiscal year 2004.
- Operating expenses for leased employees – non faculty and personnel declined $171,000 in fiscal year 2004.
- Personnel expense increased $1,179,000.
  - Market competitive merit raises of $255,000.
  - Addition of a Director of Human Resources; budgeted positions in clinic and ambulatory surgery center operations, filling vacant positions from prior fiscal year increased personnel expense by about $563,000.
  - Severance expense related to the IDX project of $349,000.
  - Increases in workers compensation insurance, other payroll benefits and overtime contributed $201,000 to the increase.
  - Partially offsetting other personnel increases was a $210,000 reduction in group insurance expense that resulted from changing from self-insured to fully-insured.
- General and administrative expenses increased by $1,581,000 in 2004 compared to 2003. The primary factors contributing to the increase include:
  - Increased rent from new practice sites.
  - Computer and billing software expense increased as the result of writing-off previously capitalized IDX software and license fees in conjunction with the commencement of the project in June 2004.
  - Legal expenses were higher by in 2004 due to expenses relating to compliance issues and negotiations with our hospital partner.

- Billing and collection expenses increased because in June the company paid the final expenses for the billing unit as well as the first month of IDX fees.
- The practice offered valet parking for the first time in January of 2004. LSUHN switched vendors in July 2004 which will result in a lower monthly cost in fiscal year 2005.
- Popularity of the faculty lounge has increased usage resulting in an increase in expense.
- Partially offsetting the increases were reduced collection expenses, laundry expenses and telephone charges.

* Medical supplies/drugs expense increased primarily due to an increase in LSUHN's oncology practice.
* Medical claims paid increased proportionately with capitation revenue from the Tenet Choices 65, Healthcare Select and New Orleans Choice programs that LSUHN participates in through its subsidiary University Medical Group, LLC.

After considering other net revenues and expenses, the practice generated $0.7 million in revenues over expenses in 2004 compared to an increase of $2 million in 2003.

PERFORMANCE AGAINST BUDGET

In comparing actual versus budgeted fiscal year 2004 results, the following is noted:

	FY 2004 Actual	FY 2004 Budget	Variance Favorable (Unfavorable)
Revenues:			
Net patient service revenue	$ 64,599	$ 61,065	$ 3,534
Capitation revenue	8,861	6,000	2,861
Total revenues	73,460	67,065	6,395
Operating Expenses:			
Leased employees—faculty	14,592	14,936	344
Leased employees—non faculty	2,398	2,542	144
Personnel—salaries and benefits	10,311	9,831	(480)
General and administrative	7,368	5,350	(2,018)
Bad debt expense	16,373	16,888	515
Medical supplies and drugs	3,525	3,630	105
Medical claims paid	7,048	5,520	(1,528)
Depreciation	582	571	(11)
Total operating expenses	62,197	59,268	(2,929)
Operating income	11,263	7,797	3,466
Other revenues (expenses)—net	(10,559)	(7,797)	(2,762)
Change in net assets	$ 704	$ -	$ 704

* Overall patient service revenue net of contractual adjustments, allowances and bad debt expense exceeded the budget by 9% in 2004.

- Positive budget variances in certain departments resulted from:
  - Developing practices for new Family Medicine, Orthopaedics and Urology physicians
  - Increased oncology infusion activity
  - Increased neonatology activity
  - Increased neurology and psychiatry patient volume
  - Addition of retina physician and increased activity for neuro-ophthalmologist, pediatric ophthalmologist and optometrist
  - Increased activity in Lafayette
- These positive variances were partially offset by the following factors that created negative variances from budget:
  - Faculty turnover in medicine including the loss of radiation oncology practice
  - Decline in dermatology visits
  - Fewer deliveries in Baton Rouge
- Personnel expenses exceeded budget due to severance pay in June 2004 related to the IDX transition. Also negatively impacting personnel expense was an increase in temporary personnel expense and higher than expected enrollment in the employee group insurance plan.
- Unfavorable budget variances in rent and occupancy from new practice sites at Memorial, Lindy Boggs and Piety Street, billing and collections, computer and billing software, legal fees, maintenance & repairs, membership dues in CHN, office, other professional fees, printing/postage, faculty lounge, uniforms, and valet parking were partially offset by positive variances in advertising, laundry, equipment rental resulting in a net unfavorable variance in general and administrative expenses.
- Decreased expense for tissue implants and the establishment of inventory on medical supplies for LSUHN Surgery Center LLC resulted in lower expense for medical supplies than budgeted.
- Activity in LSUHN's UMG subsidiary was higher than expected resulting in higher capitation revenue and higher medical claims paid.
- An unfavorable variance in enhancement fund expense was partially offset by a favorable variance in expenses for leased faculty employees. The liability due to LSU Health Sciences Center for leased faculty compensation and enhancement fund is determined by requests from Departments within the School of Medicine. Actual payments are made based upon each Department's level of available cash.

CAPITAL ASSETS

Capital Assets Summary
(In Thousands)

	Fiscal Year 2004	Fiscal Year 2003	Dollar Change	Total % Change
Office furniture and fixtures	$ 1,070	$ 967	$ 103	11 %
Computers and related equipment	1,191	1,266	(75)	(6)%
Medical equipment	1,153	635	518	82 %
Leasehold improvements	129	129	-	- %
Subtotal	3,543	2,997	546	18 %
Less accumulated depreciation	(2,222)	(1,785)	(437)	24 %
Net capital assets	$ 1,321	$ 1,212	$ 109	9 %

LSUHN's primary capital purchase in 2004 was a "C" arm for the surgery center.

A practice improvement fund of $765,000 has been established for fiscal year 2005. Proposed projects include:

- Maintenance and improvement of clinic areas
- Start-up cost and moving expenses related to relocation of certain clinical service lines
- Maintenance of information systems and phone infrastructure

SHORT-TERM DEBT

LSUHN's only short-term debt is a note payable to Chase (formerly Bank One) used by its wholly owned subsidiary LSUHN Surgery center for working capital purposes. The note expired July 14, 2004, but was subsequently renewed through June 30, 2005.

ECONOMIC FACTORS AND NEXT YEAR'S BUDGET

LSUHN's Board and senior management considered many factors while developing the fiscal year 2005 budget. One of the most important factors taken into consideration while planning the budget is the status of the economy which takes into account market forces and environmental factors such as:

- The success of the IDX project
- Strategic relationships with our hospital partners
- Government regulations, including HIPAA
- Potential changes in oncology drug reimbursements
- Cost of drugs and supplies
- Turnover in University faculty
- Cost of technology
- Maintaining a qualified workforce

Significant uncertainties remain surrounding the physical location of LSUHN's ambulatory clinics. Negotiations continue with our hospital partners with the possibility of developing a medical office building near or adjacent to one of hospital sites. Space considerations on the LSU Health Sciences Center campus may force the practice to move to a new location or consider other options such as consolidating in one or more of our existing satellite offices in the near future. Any such move will result in a temporary increase in practice expenses and may cause some short-term disruption of practice patterns. Because of the uncertainty involved, the fiscal year 2005 budget as approved does not yet reflect the potential impact of these scenarios.

CONTACTING THE PRACTICE'S FINANCIAL MANAGER

This financial report is designed to provide our customers and creditors with a general overview of LSUHN's finances. If you have questions about this report or need additional financial information, please contact the Chief Financial Officer, LSU Healthcare Network, 2020 Gravier St., Suite C, New Orleans, LA 70112.

REPORT OF MANAGEMENT'S RESPONSIBILITY

The management of LSUHN is responsible for the preparation and integrity of the financial information presented in this report. The basic financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America as promulgated by the Governmental Accounting Standards Board and the Financial Accounting Standards Board and include amounts based on judgments and estimates made by management. Management also prepares the other information included in the report and is responsible for its accuracy and consistency with the consolidated financial statements.

The consolidated financial statements have been audited by the independent accounting firm of Deloitte & Touche LLP, who was given unrestricted access to all financial records and related data, including the minutes of all meetings of the Board of Directors. The Board of Directors, through its Finance Committee (the "Committee"), provides oversight to the financial reporting process. Integral to this process is the Committee's review and discussion with management of the monthly financial statements and the external auditors for the annual consolidated financial statements.

LSUHN maintains a system of internal control over financial reporting, which is designed to provide reasonable assurance that transactions are executed as authorized and accurately recorded and that assets are properly safeguarded, and also provide reasonable assurance to our management and the Board of Directors regarding the reliability of our consolidated financial statements. The internal control system includes:

- A documented organizational structure and division of responsibility.
- Established policies and procedures that are regularly communicated and that demand highly ethical conduct from all employees.

LSUHN's Executive Committee and Finance Committee monitor the operations and internal control system and report findings and recommendations to management and the Board of Directors as appropriate. Corrective actions are taken to address control deficiencies and other opportunities for improvement as they are identified.

Louisiana State University School of Medicine in New Orleans Faculty Group Practice (d.b.a. LSU Healthcare Network)

Signed
Chief Executive Officer

Signed
Chief Financial Officer

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Louisiana State University School of Medicine
in New Orleans Faculty Group Practice:

We have audited the accompanying consolidated balance sheets of the Louisiana State University School of Medicine in New Orleans Faculty Group Practice d/b/a LSU Healthcare Network and subsidiaries (a Louisiana non-profit corporation) ("LSUHN") as of June 30, 2004 and 2003, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the LSUHN's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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 consolidated financial statements present fairly, in all material respects, the financial position of LSUHN as of June 30, 2004 and 2003, and the consolidated results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Management's discussion and analysis on pages 1 through 9 is not a required part of the basic consolidated financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 5, 2004, on our consideration of LSUHN's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

September 5, 2004

Member of
Deloitte Touche Tohmatsu

LSU HEALTHCARE NETWORK AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
JUNE 30, 2004 AND 2003

ASSETS	2004	2003
CURRENT ASSETS:		
Cash and cash equivalents	$ 11,195,258	$ 8,065,554
Accounts receivable (net of contractual allowances and doubtful accounts of $43,190,000 in 2004 and $38,088,000 in 2003)	10,227,279	9,549,909
Prepaid expenses	65,082	123,016
Inventory of drugs and medical supplies	269,648	175,453
Total current assets	21,757,267	17,913,932
CAPITAL ASSETS—net	1,320,898	1,211,702
OTHER ASSETS	291,725	401,894
TOTAL ASSETS	$ 23,369,890	$ 19,527,528

LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES:		
Accounts payable and accrued liabilities	$ 1,399,937	$ 1,292,964
Liability for medical claims payable	1,513,140	1,207,690
Notes payable—current portion	300,000	61,208
Leases payable—current portion	32,195	66,944
Due to LSU Health Sciences Center	10,068,163	7,513,800
Total current liabilities	13,313,435	10,142,606
NOTES PAYABLE—less current portion		658
LEASES PAYABLE—less current portion	25,670	57,336
Total liabilities	13,339,105	10,200,600
NET ASSETS:		
Invested in capital assets—net of related debt	1,263,033	1,025,556
Unrestricted	8,767,752	8,301,372
Total net assets	10,030,785	9,326,928
TOTAL LIABILITIES AND NET ASSETS	$ 23,369,890	$ 19,527,528

See notes to consolidated financial statements.

LSU HEALTHCARE NETWORK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS YEARS ENDED JUNE 30, 2004 AND 2003

	2004	2003
REVENUES:		
Patient service revenue—net of contractual adjustments and allowances	$ 64,598,676	$63,975,313
Capitation revenue	8,860,539	7,264,184
Total revenues	73,459,215	71,239,497
OPERATING EXPENSES:		
Leased employees—faculty	14,591,639	12,880,860
Leased employees—non faculty	2,398,345	2,569,729
Personnel - salaries and benefits	10,310,304	9,131,346
General and administrative	7,368,368	5,787,620
Bad debt expense	16,372,963	20,097,799
Medical supplies	3,524,700	3,232,066
Medical claims expense	7,047,900	6,462,796
Depreciation	582,314	507,619
Total operating expenses	62,196,533	60,669,835
INCOME FROM OPERATIONS	11,262,682	10,569,662
OTHER REVENUES (EXPENSES):		
Medical school enhancement fund	(10,678,982)	(8,830,528)
Contributions	30,000	51,000
Interest income and other income	111,963	261,191
Interest expense	(21,806)	(39,929)
Total other revenues (expenses)	(10,558,825)	(8,558,266)
EXCESS OF REVENUES OVER EXPENSES	703,857	2,011,396
NET ASSETS—Beginning of period	9,326,928	7,315,532
NET ASSETS—End of period	$ 10,030,785	$ 9,326,928

See notes to consolidated financial statements.

LSU HEALTHCARE NETWORK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2004 AND 2003

	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash received from clinic operations	$ 47,578,423	$ 43,986,491
Cash received from capitation revenue	8,830,459	7,285,555
Cash payments for personnel	(12,839,298)	(11,684,116)
Cash payments for leased faculty	(13,335,716)	(13,998,220)
Cash payments for supplies and general and administrative	(10,716,883)	(9,606,986)
Cash payments for medical claims	(6,742,450)	(6,338,691)
Net cash provided by operating activities	12,774,535	9,644,033
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Cash payments for enhancement fund	(9,122,977)	(8,754,606)
Contributions received	30,000	51,000
Net cash used in noncapital financing activities	(9,092,977)	(8,703,606)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Increase in notes and leases payable	300,000	
Payments on notes and leases payable	(138,781)	(157,879)
Purchase of capital assets	(803,230)	(613,901)
Interest payments	(21,806)	(39,929)
Net cash used in capital and relating financing activities	(663,817)	(811,709)
CASH FLOWS FROM INVESTING ACTIVITIES—Interest received	111,963	261,191
NET INCREASE IN CASH AND CASH EQUIVALENTS	3,129,704	389,909
CASH AND CASH EQUIVALENTS—Beginning of year	8,065,554	7,675,645
CASH AND CASH EQUIVALENTS—End of year	$ 11,195,258	$ 8,065,554
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Income from operations	$ 11,262,682	$ 10,569,662
Adjustments to reconcile income from operations to net cash provided by operating activities:		
Depreciation	582,314	507,619
Loss on disposal of fixed assets	122,220	3,417
Loss on write-off of software licenses	115,662	
Change in assets and liabilities:		
(Increase) decrease in accounts receivable	(677,370)	130,348
Decrease (increase) in prepaid expenses and other assets	52,441	(1,794)
Increase in inventory of drugs and medical supplies	(94,195)	(175,453)
Increase (decrease) in accounts payable and other liabilities	412,423	(272,406)
Increase (decrease) in due to LSU Health Sciences Center—personnel costs	998,358	(1,117,360)
Net cash provided by operating activities	$ 12,774,535	$ 9,644,033

SUPPLEMENTAL SCHEDULE OF NONCASH CAPITAL AND RELATED FINANCING ACTIVITIES—During 2004, LSUHN entered into a capital lease obligation for $10,500 of optical equipment.

The notes to financial statements are an integral part of this statement.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity—Louisiana State University School of Medicine in New Orleans Faculty Group Practice d/b/a LSU Healthcare Network and Subsidiaries ("LSUHN"), a Louisiana non-profit corporation, assists the LSU Health Sciences Center ("LSUHSC") in carrying out its medical, educational, and research functions. LSUHN provides health care to the general public including, but not limited to, the delivery of physician medical services and other health care services to individuals. LSUHN receives compensation for these services from the Medicare and Medicaid programs, certain commercial insurance carriers, health maintenance organizations, preferred provider organizations and directly from patients.

LSUHN's activities include services provided in both the public hospitals and the private clinics serviced by LSUHSC. LSUHN and LSUHSC (through the Board of Supervisors of Louisiana State University and Agricultural and Mechanical College) have entered into Cooperative Endeavor and Operating Agreements that provide the two entities to work together on a mutually beneficial basis. The agreements delineate the obligations and responsibilities of both LSUHN and LSUHSC. Both parties have the right to terminate the Cooperative Endeavor Agreement with or without cause upon 60 days written notice. The agreements expire October 31, 2005.

Basis of Accounting—The financial statements of LSUHN have been prepared using the proprietary fund method of accounting whereby revenue and expenses are recognized on the accrual basis of accounting and, accordingly, reflect all significant receivables, payables and other liabilities.

Consolidation—the activity of the following entities that are controlled by LSUHN is included in these financial statements on a consolidated basis:

University Medical Group, LLC

LSUHN is the sole member of University Medical Group, LLC ("UMG"). UMG indirectly contracts with health maintenance organizations and other third party payors under capitated arrangements to provide physician health care services to members who select UMG primary care physicians. UMG operates exclusively in the New Orleans, Louisiana metropolitan area.

The purpose of UMG is to pursue risk contracts in which providers accept capitated payments for health care services. UMG has two primary goals: (1) to gain and protect market share for its providers, and (2) to generate and distribute surpluses in the event that capitation payments received exceed the cost of health care services provided.

University Technology Group, LLC

LSUHN is the only member of University Technology Group, LLC ("UTG"). UTG was formed to participate in technology ventures that will assist LSUHN in the delivery of health care services or any other activities that will enhance LSUHSC's ability to carry out its medical, educational or research missions.

University Radiation Oncology Group

LSUHN is the sole member of University Radiation Oncology Group ("UROG"), a Louisiana non-profit corporation. UROG was formed to administer the billing and collection efforts of LSUHN's radiation oncology practice. This practice ceased operations in November 2002 and was liquidated in 2004.

LSUHN Surgery Center LLC

LSUHN is the sole member of LSUHN Surgery Center LLC ("LSUHN SC"). LSUHN SC was formed to manage the day-to-day operations, including the billing and collection efforts, of the surgery center located at 2020 Gravier Street in New Orleans, Louisiana. This entity began operations as of September 1, 2003.

Use of Estimates—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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. Estimates which are significant for LSUHN include contractual and bad debt allowances. Accordingly, actual results could differ from those estimates.

Cash and Cash Equivalents—LSUHN considers all highly liquid investments in money market funds and investments available for current use with an initial maturity of three months or less to be cash equivalents. Amounts are recorded at fair value.

Inventory of Drugs and Medical Supplies—During 2003, LSUHN performed a physical inventory of its drugs and medical supplies at year-end for the first time due to its increasing significance and capitalized the balance on hand at year-end. During 2004, additional inventories were included as a result of the opening of the Surgery Center. Inventory is stated at lower of cost, determined by the first-in, first-out method, or market.

Capital Assets—Capital assets are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line basis over the estimated useful life of the asset, which ranges from 3-5 years. Assets held under capital lease obligations are recorded at the present value of the minimum lease payments and are included in equipment. Amortization of leased assets is included in depreciation and amortization expense.

Liability for Medical Claims Payable—The unpaid medical claims liability represents management's best estimate of the ultimate net cost of all reported and unreported claims incurred during the reporting period, including out-of-network claims. The estimate is based on actuarial projections of the historical development of claims incurred but not reported and case-basis estimates of claims reported prior to the end of the reporting period.

The estimate of the unpaid medical claims liability was based on the best data available to LSUHN; however, because of the limited number of members covered by LSUHN, the estimates are subject to a significant degree of inherent variability. The estimates are continually reviewed and adjusted as necessary as experience develops or new information becomes known; such adjustments are included in current operations.

Although management believes the estimate of the unpaid medical claims liability is reasonable under the circumstances, it is possible that LSUHN's actual incurred claims expense will not conform to the assumptions inherent in the determination of the liability; accordingly, the ultimate settlement of the claims may vary significantly from the estimate included in the accompanying financial statements.

Patient Service Revenue Net of Contractual Adjustments and Allowances—LSUHN has agreements with third parties that provide for payments at amounts different from its established rates. Net patient service revenue is reported in the financial statements at the estimated net amounts realizable from patients, third party payors, and others for services rendered. Major third party payor arrangements include the Medicaid and Medicare programs.

LSUHN has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payments to LSUHN under these agreements includes prospectively determined rates per office visit and discounts from established charges.

Charity Care—LSUHN provides care to patients in the Louisiana public hospital system without regard to their ability to pay for those services. LSUHN does not pursue collection of charges generated from providing services to patients that are determined to qualify for charity care and as a result these charges are not reported as revenue. Because of the cost involved, LSUHN generally does not capture charges generated by free care activity in its billing system. However, in certain areas, the billing process requires that some free care charges be entered into the system before they are adjusted out of revenues. During the years ended June 30, 2004 and 2003, charity charges entered into the billing system and adjusted off were approximately $29,975,000 and $26,029,000, respectively.

Capitation Revenue—LSUHN receives capitated payments as compensation for a commitment to provide health care services to covered members. Capitation payments are recognized as revenue during the period in which LSUHN is obligated to provide health care services to these members.

Medical Claims Expense—LSUHN contracts with various physicians, physician groups, and other ancillary providers under the terms of Primary/Specialty Care Physician Agreements or other ancillary agreements for the purpose of providing health care services on behalf of LSUHN.

Based on the nature of the agreements, medical expense is recognized either during the period in which LSUHN is obligated to provide medical services for members or during the period in which medical services are incurred by members.

LSUHN participates in a catastrophic reserve pool with the other IPAs in the Network to provide shared-risk insurance coverage on physician charges between $10,000 and $12,500 per member per year. LSUHN has stop-loss insurance coverage with an unrelated insurer for charges in excess of $12,500 per member per year up to a maximum of $1,000,000 per member per year.

Income Taxes—LSUHN is a not-profit corporation organized under the laws of the State of Louisiana. It is exempt from Federal income tax under Section 501(c) (3) of the Internal Revenue Code of 1986, and qualifies as a support organization, as defined in Section 501(a) of the Code.

New Accounting Pronouncement—Effective July 1, 2002, LSUHN adopted Governmental Accounting Standards Board Statement (GASBS) No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*. GASBS No. 34 established standards for external financial reporting for all state and local governmental entities. It requires the classification of net assets into three components – invested in capital assets, net of related debt; restricted; and unrestricted. These classifications are defined as follows:

- *Invested in capital assets, net of related debt*—This component of net assets consists of capital assets, including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets.

- *Restricted*—This component of net assets consists of constraints placed on net asset use through external constraints imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.

- *Unrestricted*—This component of net assets consists of net assets that do not meet the definition of "restricted" or "invested in capital assets, net of related debt."

2. RELATED PARTY TRANSACTIONS

LSUHSC provides certain clinical and administrative services as well as building space to LSUHN. Amounts paid for services provided under this arrangement were $16,432,313 and $18,354,706 during the years ended June 30, 2004 and 2003, respectively. $5,455,575 and $4,457,217 was owed to LSUHSC for physician and non-physician services, including amounts accrued relating to accounts receivable, as of June 30, 2004 and 2003, respectively.

LSUHN's affiliation agreement with LSUHSC requires LSUHN to pay at least ten percent (10%) of its annual gross cash receipts to LSUHSC, through the Medical School Enhancement Fund ("MSEF") to support the clinical, academic and research missions of LSUHSC. Cash payments totaling $9,122,977 and $8,754,606 were made to the MSEF during the fiscal years ended June 30, 2004 and 2003, respectively. As of June 30, 2004 and 2003, approximately $4,612,588 and $3,056,583, respectively, was due to LSUHSC for MSEF payments, including amounts accrued relating to accounts receivable.

During the years ended June 30, 2004 and 2003, the LSUHSC Foundation made donations totaling $30,000 and $51,000, respectively, to LSUHN.

3. CAPITAL ASSETS

Capital asset activity for the fiscal years ended June 30, 2004 and 2003 was as follows:

	Balance June 30, 2003	Additions	Deletions	Balance June 30, 2004
Office furniture and fixtures	$ 967,004	$ 148,851	$ (45,694)	$ 1,070,161
Computers and related equipment	1,266,446	146,325	(221,524)	1,191,247
Medical equipment	634,539	518,554		1,153,093
Leasehold improvements	128,840			128,840
Total at historical cost	2,996,829	813,730	(267,218)	3,543,341
Less accumulated depreciation	(1,785,127)	(582,314)	144,998	(2,222,443)
Capital assets—net	$ 1,211,702	$ 231,416	$ (122,220)	$ 1,320,898

	Balance June 30, 2002	Additions	Deletions	Balance June 30, 2003
Office furniture and fixtures	$ 943,570	$ 23,434	$ -	$ 967,004
Computers and related equipment	705,280	566,166	(5,000)	1,266,446
Medical equipment	610,238	24,301		634,539
Leasehold improvements	128,840			128,840
Total at historical cost	2,387,928	613,901	(5,000)	2,996,829
Less accumulated depreciation	(1,279,091)	(507,619)	1,583	(1,785,127)
Capital assets—net	$ 1,108,837	$ 106,282	$ (3,417)	$ 1,211,702

4. OTHER ASSETS

UMG (see Note 1) invested $275,000 in New Orleans Regional Physician Hospital Organization, Inc. ("NORPHO") during the year ended June 30, 2000. NORPHO is responsible for pursuing contracts and third-party payors and for management functions such as financial services, medical management, claims management, member services, and provider relations for its hospital and independent physician association members, including UMG. UMG holds an approximate 7% interest in NORPHO and accounts for the investment under the cost method.

5. COMMITMENTS

LSUHN leases office space and equipment under operating leases that expire at various dates through 2009. Certain of the lease agreements provide for escalations based on cost of operations. Total rent expense for the years ended June 30, 2004 and 2003 was $1,002,758 and $754,937, respectively.

Minimum annual lease payments are as follows:

2005	$ 332,002
2006	72,250
2007	66,750
2008	66,750
2009	55,625
Total	$ 593,377

LSUHN leases certain medical equipment under three to five year capital lease agreements that include varying interest rates (9.625% - 12.5%) and bargain purchase options. Future minimum lease payments under capital leases, together with the present value of net minimum lease payments as of June 30, 2004 are as follows:

Year Ending June 30	
2005	$ 36,807
2006	21,251
2007	2,820
2008	2,820
2009	1,066
Total minimum lease payments	64,764
Less amount representing interest	(6,899)
Present value of net minimum lease payments	57,865
Less current maturities	(32,195)
Leases payable—less current portion	$ 25,670

6. NOTES PAYABLE

Notes payable at June 30, 2004 and 2003 are as follows:

	2004	2003
Borrowings against revolving credit facility (Note 7)	$ 300,000	$ -
Notes payable to a telephone equipment vendor with interest at 10.5%, payable in monthly installments of $15,476 through December 31, 2003, including interest, collateralized by telephone equipment with a depreciated cost of $80,938		61,866
Less current maturities	(300,000)	(61,208)
Notes payable—less current portion	$ -	$ 658

7. CREDIT FACILITIES

On September 1, 2003 LSUHN SC entered into a $300,000 revolving credit facility with Chase (formerly Bank One) secured by LHSHN SC's accounts receivable. Interest is payable monthly at 3%. $300,000 has been drawn as of June 30, 2004.

8. 401(k) PLAN

In December 1997, LSUHN established a 401(k) plan for the benefit of its employees. The plan permits employees to contribute up to 15% of their compensation to the plan, subject to certain limitations. At its discretion, LSUHN may make contributions to the 401(k) plan for the benefit of participating employees. For the years ended June 30, 2004 and 2003, 401(k) plan expenses were $362,854 and $325,217, respectively.

9. CONCENTRATIONS OF CREDIT RISK

LSUHN provides services in New Orleans, Baton Rouge and Lafayette. LSUHN grants credit to its patients, some of whom are insured under third-party payor agreements. LSUHN routinely obtains assignment of, or is otherwise entitled to receive patients' benefits from, Medicare, Medicaid and other third-party payors. The mix of receivables from its patients and third party payors at June 30, 2004 and 2003, was as follows:

	2004	2003
Medicaid	35.7 %	31.2 %
Medicare	11.5 %	14.5 %
Commercial	9.1 %	10.1 %
HMO/PPO	13.5 %	13.7 %
Self Pay	30.2 %	30.5 %
	100.0 %	100.0 %

LSUHN routinely invests available operating funds in highly liquid U.S. Government and agency obligations and money market mutual funds that generally invest in highly liquid U.S. Government and agency obligations. Investments in money market funds are not insured or guaranteed by the U.S. Government; however, management believes the credit risk related to these investments is minimal.

10. INSURANCE COVERAGE

Malpractice Insurance—The physicians leased to LSUHN by LSUHSC are provided professional liability coverage in accordance with the provisions of LA. R.S. 40:1299.39 et seq. for the services provided under the Cooperative Endeavor and Operating Agreements. These provisions provide the physician with coverage on malpractice claims up to $500,000 per occurrence, which is the limit on medical malpractice claims under current state law.

Self-insurance—LSUHN was primarily self-insured for employee health insurance through April 30, 2003. Estimated amounts for claims incurred but not reported are calculated based on claims experience. Amounts recorded under this self-insured liability totaled $20,000 and $90,000 at June 30, 2004 and 2003, respectively, and are included in the liability for medical claims payable on the consolidated balance sheets.

Changes in the self insurance health claims payable liability for the years ended June 30, 2004 and 2003 were as follows:

	2004	2003
Self insurance health claims payable—beginning of year	$ 90,000	$ 125,000
Add (deduct) claims and changes in estimates	(10,000)	1,048,360
Deduct claims payments	(60,000)	(1,083,360)
Self insurance health claims payable—end of year	$ 20,000	$ 90,000

11. CONTINGENT LIABILITIES

LSUHN is a defendant in two lawsuits filed in the Civil District Court for Parish of Orleans, the State court trial bench in New Orleans, alleging employment discrimination against LSUHN. LSUHN intends to vigorously defend itself and its representatives against these actions. At this time management is unable to determine with any certainty the settlement prospects or probability of success in either of these cases.

12. GOVERNMENT REGULATIONS

The healthcare industry is subject to numerous laws and regulations of Federal, state and local governments. These laws and regulations include, but are not limited to, matters such as licensure, accreditation, and government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Recently, government oversight has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by healthcare providers. Violations of these laws and regulations could result in expulsion from government healthcare programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. The office of the Inspector General of the Department of Health and Human Services has undertaken a project to audit Medicare billings of certain academic medical institutions. The government has stated that it believes that a significant amount of Medicare claims filed by teaching physicians are not properly documented as required by current interpretations of Medicare standards. If a provider is found to be in violation of these documentation standards, the government may require repayment of any overcharges and may impose a penalty of treble damages plus up to $10,000 per false claim. Management believes that LSUHN is in compliance with the fraud and abuse regulations as well as other applicable government laws and regulations, and with the Medicare documentation standards. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time.

Legislation and regulation at all levels of government have affected and are likely to continue to affect the operations of LSUHN. Federal healthcare reform legislation proposals debated in Congress in recent years have included proposals for the imposition of price controls and/or healthcare spending budgets or targets, significant reductions in Medicare and Medicaid program reimbursement to healthcare providers and the promotion of a restructured delivery and payment system focusing on competition among providers based on price and quality, managed care, and steep discounting or capitated payment arrangements with many, if not all, of LSUHN's principal payors. It is not possible at this time to determine the impact on LSUHN of government plans to reduce Medicare and Medicaid spending, government implementation of national and state healthcare reform or market-initiated delivery system and/or payment methodology changes. However, such changes could have an adverse impact on operating results and cash flows of LSUHN in future years.

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

The Board of Directors
of Louisiana State University
School of Medicine in New Orleans
Faculty Group Practice:

We have audited the financial statements of the Louisiana State University School of Medicine in New Orleans Faculty Group Practice, d/b/a LSU Healthcare Network and subsidiaries (a Louisiana non-profit corporation) ("LSUHN") as of and for the year ended June 30, 2004, and have issued our report thereon dated September 5, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether LSUHN'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 herein under *Government Auditing Standards*.

Internal Control over Financial Reporting

In planning and performing our audit, we considered LSUHN'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 Directors, management and the Louisiana Legislative Auditor and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche LLP

September 5, 2004