

FINANCIAL STATEMENTS

Holmes Regional Medical Center, Inc.

Year Ended September 30, 2008

With Report of Independent Certified Public Accountants

Holmes Regional Medical Center, Inc.

Financial Statements

Year Ended September 30, 2008

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Report of Independent Certified Public Accountants

The Board of Directors
Holmes Regional Medical Center, Inc.

We have audited the accompanying balance sheet of Holmes Regional Medical Center, Inc. (the Company) as of September 30, 2008, and the related statements of operations and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in 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. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Holmes Regional Medical Center, Inc. at September 30, 2008, and the results of its operations, the changes in its net assets, and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

December 19, 2008

Holmes Regional Medical Center, Inc.

Balance Sheet

September 30, 2008

(In Thousands)

Assets

Current assets:

Cash and cash equivalents	\$	—
Investments		84,433
Current portion of assets limited as to use		6,499
Accounts receivable, less allowance for uncollectible accounts of \$25,130		61,363
Inventories		9,154
Prepaid expenses and other current assets		6,498
Total current assets		<u>167,947</u>

Assets limited as to use, less current portion		841
Other assets		10,541
Property and equipment, net		321,274
Total assets	\$	<u><u>500,603</u></u>

Liabilities and net assets

Current liabilities:

Accounts payable and accrued liabilities	\$	39,169
Current portion of long-term debt		7,056
Due to related parties		54,757
Total current liabilities		<u>100,982</u>

Long-term debt, less current portion		209,430
Other noncurrent liabilities		1,249
Total liabilities		<u>311,661</u>

Net assets:

Unrestricted		183,800
Temporarily restricted		5,142
Total net assets		<u>188,942</u>
Total liabilities and net assets	\$	<u><u>500,603</u></u>

See accompanying notes.

Holmes Regional Medical Center, Inc.

Statement of Operations and Changes in Net Assets

Year Ended September 30, 2008

(In Thousands)

Unrestricted revenues, gains, and other support:	
Net patient service revenue, excluding charity care of \$77,300	\$ 462,823
Capitated fees	6,838
Investment income	3,226
Income from joint ventures	1,252
Other revenue	17,250
Net assets released from restrictions used for operations	1,042
Total unrestricted revenues, gains, and other support	<u>492,431</u>
Expenses and losses:	
Salaries and benefits	228,309
Supplies and other expenses	181,062
Depreciation and amortization	34,254
Provision for bad debts	33,638
Interest	10,041
Total expenses and losses	<u>487,304</u>
Excess of revenues, gains, and other support over expenses and losses	5,127

Continued on next page.

Holmes Regional Medical Center, Inc.

Statement of Operations and Changes in Net Assets (continued)

Year Ended September 30, 2008
(In Thousands)

Unrestricted net assets:

Excess of revenues, gains, and other support over expenses and losses	\$ 5,127
Transfers to the Parent	(11,732)
Other changes in unrestricted net assets	<u>(48)</u>
Decrease in unrestricted net assets	(6,653)

Temporarily restricted net assets:

Change in interest in net assets of Health First Foundation, Inc.	689
Investment income	30
Net assets released from restrictions for operations and purchases of property and equipment	<u>(1,042)</u>
Decrease in temporarily restricted net assets	<u>(323)</u>

Decrease in net assets	(6,976)
Net assets, beginning of year	<u>195,918</u>
Net assets, end of year	<u><u>\$ 188,942</u></u>

See accompanying notes.

Holmes Regional Medical Center, Inc.

Statement of Cash Flows

Year Ended September 30, 2008

(In Thousands)

Operating activities

Decrease in net assets	\$ (6,976)
Adjustments to reconcile increase in net assets to net cash provided by operating activities:	
Depreciation and amortization	34,254
Loss on disposal of property and equipment	
Amortization of bond discount	189
Provision for bad debts	33,638
Income from joint ventures	(1,252)
Transfers to the Parent	11,732
Change in interest in net assets of Health First Foundation, Inc.	(689)
Changes in operating assets and liabilities:	
Accounts receivable, net	(19,744)
Inventory	(332)
Other operating assets	(949)
Accounts payable and accrued liabilities	(336)
Due to related parties	2,184
Other operating liabilities	(80)
Net cash provided by operating activities	<u>51,639</u>

Investing activities

Increase in investments	(1,536)
Joint venture distributions	716
Increase in assets limited as to use	(16)
Purchases of property and equipment	(65,186)
Net cash used in investing activities	<u>(66,022)</u>

Financing activities

Proceeds from issuance of long-term debt, net of discount	30,404
Repayments of long-term debt	(5,130)
Transfers to the Parent	(11,732)
Cash transfer from Health First Foundation, Inc.	841
Net cash provided by financing activities	<u>14,383</u>
Change in cash and cash equivalents	—
Cash and cash equivalents, beginning of year	—
Cash and cash equivalents, end of year	<u>\$ —</u>

See accompanying notes.

Holmes Regional Medical Center, Inc.

Notes to Financial Statements

September 30, 2008

(In Thousands)

1. Reporting Entity

Holmes Regional Medical Center, Inc. (the Company) operates a 514-bed, general acute care hospital in Melbourne, Florida; a 60-bed general acute care hospital in Palm Bay, Florida, known as Palm Bay Hospital; a family pharmacy; and four state-of-the-art health and fitness centers in Merritt Island, Florida, Melbourne, Florida, Viera, Florida, and Palm Bay, Florida, known as Pro Health and Fitness. The Company is a not-for-profit corporation recognized as tax-exempt pursuant to Section 501(a), as an organization described in Section 501(c)(3), of the Internal Revenue Code and Section 220.13 of the Florida statutes. The Company is a part of a multi-entity, integrated health care system that includes three acute care hospitals, a home health agency, a health maintenance organization, a system of primary care centers, a hospice, a foundation, and various other health care entities. The Company is controlled by Health First, Inc. (the Parent). The Company is required to make an annual contribution to the Parent of the greater of 50% of excess of revenues, gains, and other support over expenses and losses plus extraordinary items or 6% of unrestricted net assets. For the year ended September 30, 2008, the total required contribution to the Parent was \$11,732, which is included as a reduction of unrestricted net assets in the accompanying statement of operations and changes in net assets.

2. Significant Accounting Policies

Use of Estimates

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

Financial Statement Presentation

The Company conforms to the requirements of Statement of Financial Accounting Standards (SFAS) No. 117, *Financial Statements of Not-for-Profit Organizations*. SFAS No. 117 establishes standards for external financial reporting by not-for-profit organizations and requires that resources be classified for accounting and reporting purposes into three net asset categories (unrestricted, temporarily restricted, and permanently restricted) according to externally (donor) imposed restrictions.

Holmes Regional Medical Center, Inc.

Notes to Financial Statements (continued)

2. Significant Accounting Policies (continued)

Cash and Cash Equivalents

The Company classifies all highly liquid investments with an original maturity of 90 days or less when purchased as cash equivalents, excluding amounts limited as to use by Board designation or other arrangements under trust agreements. Cash deposits are federally insured in limited amounts.

Investments and Investment Income

The Company conforms to the requirements of SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*. In accordance with SFAS No. 124, investments in equity securities with readily determinable fair values and all investments in debt securities are stated at fair value in the balance sheet. Investment income or loss, including realized gains and losses on investments, and interest and dividends are included in the deficiency of revenues, gains, and other support over expenses and losses, unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the deficiency of revenues, gains, and other support over expenses and losses, unless the investments are trading securities. Other-than-temporary impairment of investments represents losses on debt and equity securities for which the decline in the fair value below the cost basis was determined to be other-than-temporary. The Company did not incur losses due to other-than-temporary impairment of investments during the year ended September 30, 2008.

The Company participates in an investment program with the Parent and other affiliates whereby excess cash management deposits with the Parent are periodically exchanged for a demand note receivable. The demand note receivable is included in short-term investments (see Note 4). The Company receives interest on the demand note receivable based on the 30-day commercial paper rate reported on the final business day of the month in *The Wall Street Journal*. This interest is included in investment income.

Assets Limited as to Use

Assets limited as to use primarily include assets held by trustees under bond indenture agreements and designated assets set aside by the Board for future capital investments, over which the Board retains control and may, at its discretion, subsequently use for other purposes. Amounts required to meet current liabilities of the Company are reported as current assets.

Holmes Regional Medical Center, Inc.

Notes to Financial Statements (continued)

2. Significant Accounting Policies (continued)

Inventories

Inventories, consisting primarily of medical supplies and pharmaceuticals, are stated at the lower of cost (first-in, first-out) or market value.

Property and Equipment

Property and equipment are stated at cost or, if donated, at fair value at the date of the gift. Expenditures that materially increase values, change capacities, or extend useful lives are capitalized, as are interest costs during the period of construction for such expenditures. Depreciation is computed utilizing the straight-line method at rates estimated by management to amortize the cost of the various assets within the periods of expected use.

Interest in Net Assets of Health First Foundation, Inc.

The Company records its interest in the net assets of the Health First Foundation, Inc. (the Foundation) in accordance with SFAS No. 136, *Transfer of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, which requires that a specified beneficiary recognize its rights to the assets held by the recipient organization as an asset, unless the donor has explicitly granted the recipient organization variance power. Interest in net assets of the Foundation represents contributions received on behalf of the Company by the Foundation and is included in other assets in the balance sheet.

Contributions

The Company records contributions in accordance with SFAS No. 116, *Accounting for Contributions Received and Contributions Made*. SFAS No. 116 established accounting standards for contributions for donees (and donors) and generally requires unconditional promises to give cash and other assets (including multiyear promises) to be recognized at fair value as revenue and expenses in the period made.

Holmes Regional Medical Center, Inc.

Notes to Financial Statements (continued)

2. Significant Accounting Policies (continued)

Noncash contributions are valued at fair market value on the date of the gift. Contributions are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statement of operations and changes in net assets as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reflected as unrestricted contributions in the accompanying financial statements. At September 30, 2008, temporarily restricted net assets are primarily restricted for the purchase of property and equipment.

Excess of Revenues, Gains, and Other Support Over Expenses and Losses

The statement of operations and changes in net assets includes excess of revenues, gains, and other support over expenses and losses. Changes in unrestricted net assets that are excluded from excess of revenues, gains, and other support over expenses and losses include changes in unrealized gains and losses on other-than-trading investments, permanent transfers of assets to and from related organizations for other than goods or services, and contributions of long-lived assets, including assets acquired using contributions which by donor restrictions were to be used for the purpose of acquiring such assets.

Net Patient Service Revenue, Accounts Receivable, and Allowance for Uncollectible Accounts

Net patient service revenue and accounts receivable are reported at the estimated net realizable amounts due from patients, third-party payors, and others for services rendered. The Company is subject to retroactive revenue adjustments due to audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, and investigations. Adjustments to revenue related to prior periods, as a result of settled cost reports and changes in estimates, decreased patient service revenue by approximately \$5,125 for the year ended September 30, 2008.

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. However, management is not aware of any matters that could have a material effect on recorded estimates.

Holmes Regional Medical Center, Inc.

Notes to Financial Statements (continued)

2. Significant Accounting Policies (continued)

Revenue from the Medicare program and contracts with other third parties represented approximately 28% and 62%, respectively, of net patient service revenue for the year ended September 30, 2008. The Company grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor arrangements. Significant concentrations of patient accounts receivable due from third-party payors at September 30, 2008, include 15% from the Medicare program and 49% from contracts with other third parties.

The provision for bad debts and allowance for uncollectible accounts are based upon management's assessment of historical and expected net collections and historical write-off experience by payor and aging category, considering the business and economic conditions, trends in health care coverage, and other collection indicators. Accounts written off as uncollectible are deducted from the allowance and subsequent recoveries are added.

Charity Care

The Company provides care without charge or at amounts less than its established rates to patients who meet certain criteria under its charity care policy. Because the Company does not pursue collection of amounts determined to qualify as charity care, these amounts are not included in patient service revenue. Charity care is measured based on established charges.

Functional Expenses

The Company does not present expense information by functional classification because its resources and activities are primarily related to providing health care services. Further, since the Company receives substantially all of its resources from providing health care services in a manner similar to a business enterprise, other indicators contained in the financial statements are considered important in evaluating how well management has discharged its stewardship responsibilities.

3. Income Taxes

The Company is exempt from federal and state income taxes under Section 501(a), as an organization described in Section 501(c)(3), of the Internal Revenue Code and Section 220.13 of the Florida statutes.

Holmes Regional Medical Center, Inc.

Notes to Financial Statements (continued)

3. Income Taxes (continued)

In June 2006, the Financial Accounting Standards Board (the FASB) issued FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income tax positions recognized in financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Effective October 1, 2007, the Company adopted FIN 48. The adoption of FIN 48 did not have a material impact on the Company's financial position or results of operations.

4. Investments and Assets Limited as to Use

The composition of investments and assets limited as to use at September 30, 2008, is presented below:

	Investments	Board- Designated Funds	Held by Trustee
Demand note receivable from the Parent	\$ 84,433	\$ 841	\$ —
Cash and cash equivalents	—	—	6,499
	84,433	841	6,499
Less current portion	(84,433)	—	(6,499)
	<u>\$ —</u>	<u>\$ 841</u>	<u>\$ —</u>

Investment income from assets limited as to use and investments for the year ended September 30, 2008, from interest was \$3,226.

Holmes Regional Medical Center, Inc.

Notes to Financial Statements (continued)

5. Other Assets

The composition of other assets at September 30, 2008, is as follows:

Investment in joint ventures	\$ 7,555
Interest in net assets of Health First Foundation, Inc.	931
Deferred financing cost	2,045
Other	10
	<u>\$ 10,541</u>

The Company accounts for its investments in joint ventures in accordance with Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. In accordance with APB Opinion No. 18, the Company records an investment in the net assets of the joint venture at cost, and adjusts the carrying amount of the investment to recognize the Company's share of the income or losses of the joint venture after the date of acquisition. The Company's share of income from joint ventures for the year ended September 30, 2008, was \$1,252.

6. Property and Equipment

A summary of property and equipment at September 30, 2008, is as follows:

Land and improvements	\$ 29,619
Buildings and improvements	278,488
Fixed equipment and major movable equipment	238,691
	<u>546,798</u>
Less allowance for depreciation and amortization	(272,508)
	<u>274,290</u>
Construction in progress	46,984
	<u>\$ 321,274</u>

Construction in progress at September 30, 2008, represents costs incurred to date related to construction and renovation projects expected to be completed over the next five years. At September 30, 2008, the estimated cost to complete construction and renovation projects in progress is approximately \$38,460, which will be funded principally from assets limited as to use and operations.

Holmes Regional Medical Center, Inc.

Notes to Financial Statements (continued)

7. Long-Term Debt

Long-term debt at September 30, 2008, is as follows:

Health Facilities Revenue Bonds, Series 2005, recorded net of a discount of \$1,458	\$ 132,121
Health Facilities Refunding Revenue Bonds, Series 2003, recorded net of a discount of \$13	12,315
Health Facilities Revenue Bonds, Series 2001, recorded net of a discount of \$842	33,017
Hospital Revenue Bonds, Series 1996, recorded net of a discount of \$557	39,033
	<hr/> 216,486
Less current maturities	(7,056)
	<hr/> <u>\$ 209,430</u>

Maturities of long-term debt consist of the following:

Year ending:	
2009	\$ 7,056
2010	7,411
2011	7,775
2012	8,164
2013	7,059
Thereafter	181,899

A Master Trust Indenture, dated May 15, 2001, and modified December 2005, covers all bonds issued and outstanding by the Company, Cape Canaveral Hospital, Inc., and the Parent (collectively, the Obligated Group) at September 30, 2008. Under the Master Trust Indenture, all members of the Obligated Group are jointly and severally liable for the obligation covered by the Master Trust Indenture. The Company has executed a mortgage on a portion of the Company's property in favor of the Master Trustee. The mortgaged property has a carrying value of \$216,527 to secure the Obligated Group's repayment obligation under the Master Trust Indenture. In addition, all revenues of the Company and Cape Canaveral Hospital, Inc. are pledged as security for the payment of the obligations outstanding under the Master Trust Indenture. At September 30, 2008, total debt outstanding related to the Master Trust Indenture is approximately \$330,815.

The Master Trust Indenture provides for specific restrictive covenants, including a debt service coverage requirement. The Corporation was in compliance with all such restrictive covenants at September 30, 2008.

Holmes Regional Medical Center, Inc.

Notes to Financial Statements (continued)

8. Employee Benefit Plans

Retirement Plan

The Parent has a defined contribution plan covering substantially all employees. Under the plan, the Company contributes 2% of the eligible employees' gross wages to the plan. Eligible employees are allowed to contribute up to 100% of the eligible employees' gross wages not to exceed the maximum permissible standard deferral amount. This is in addition to any catch-up deferral amount for qualifying individuals. In addition to the 2% previously noted, the Company will match up to 8% of the employees' contribution at a 50% rate. As a result, a maximum 6% contribution may be made by the Company. Retirement plan expense was \$6,736 for the year ended September 30, 2008.

Employee Health Plan

Employee health benefits are self-funded by the Company. Employee health benefits expense was \$14,532 for the year ended September 30, 2008.

9. Malpractice Insurance Plan

The Parent assumes the risk for medical malpractice liability. The Parent has allocated a share of the cost to the Company for this coverage on an annual basis. Medical malpractice expense of \$4,388 is included in supplies and other expenses in the accompanying statement of operations and changes in net assets.

10. Commitments and Contingencies

Litigation

The Corporation is involved in litigation arising in the ordinary course of business. After consultation with legal counsel, management believes that these matters will be resolved without material adverse effect on the Corporation's future financial position or results of operations.

Holmes Regional Medical Center, Inc.

Notes to Financial Statements (continued)

10. Commitments and Contingencies (continued)

On May 23, 2007, Wuesthoff Health System, Inc. (Wuesthoff) filed a lawsuit (the Complaint) in the Circuit Court for the Eighteenth Judicial Circuit in and for Brevard County, Florida (the Court), alleging seven counts of various antitrust violations by Health First, Inc., the Company, Cape Canaveral Hospital, Inc., Health First Physicians, Inc. and Health First Health Plans, Inc., (hereinafter collectively referred to as the Health First Group). Wuesthoff alleges, among other things, that the Health First Group has “impermissibly obtained market power in the general acute care in-patient hospital market, and managed care markets” in the central and south portion of Brevard County (the Market Area) as a result of the merger between the Company and Cape Canaveral Hospital, Inc. in 1995 in violation of Section 7 of the Clayton Antitrust Act.

On May 15, 2007, Richard Hynes, M.D. and Brevard Orthopaedic, Spine & Pain Clinic, Inc. (Hynes) filed a lawsuit (the Complaint) in the Court, alleging twelve counts of various antitrust and other violations by the Health First Group. Hynes is alleging almost identical acts as Wuesthoff does in its May 23, 2007 Complaint.

On February 21, 2008, the Health First Group filed its Answer and Affirmative Defenses with the Court and will continue to vigorously contest the allegations contained in the Complaints.

Although it is premature to assess the likely course or outcome of the litigation discussed above, if the outcome of the litigation is adverse to the Health First Group, the Health First Group could incur material liabilities for damages or other adverse financial consequences.

Leases

Operating lease expense was \$5,662 for the year ended September 30, 2008, and is included in supplies and other expenses in the accompanying statement of operations and changes in net assets.

Holmes Regional Medical Center, Inc.

Notes to Financial Statements (continued)

11. Related-Party Transactions

Amounts due to related parties included in current liabilities in the accompanying balance sheet at September 30, 2008, are as follows:

Parent	\$ 52,051
Cape Canaveral Hospital, Inc. and subsidiary	326
Other	2,380
	<u>\$ 54,757</u>

Expenses charged to the Company by the Parent for support services provided by the Parent for the year ended September 30, 2008, are included in the accompanying statement of operations and changes in net assets as follows:

Salaries and benefits expense	\$ 38,212
Supplies and other expenses	22,794
Depreciation and amortization expense	9,567
Interest expense	1,066
	<u>\$ 71,639</u>

The Company has a fee-for-service agreement with Health First Health Plans, Inc. to provide medical services to subscribing participants. The fee-for-service agreement provides for reimbursement based on a percentage of the Company's charges. Payments received from Health First Health Plans, Inc. for services provided to Health First Health Plans, Inc. members employed by the Company under the fee-for-service agreement amounted to \$80,178, and are included within net patient service revenue in the accompanying statement of operations and changes in net assets.

Interest earned on the demand note receivable from the Parent, included in investment income, totaled \$3,274.

12. Fair Value of Financial Instruments

The following methods and assumptions were used by the Company in estimating the fair value of its financial instruments:

Investments and assets limited as to use: These assets are reported at quoted market prices if available, or estimated using quoted market prices for similar securities.

Holmes Regional Medical Center, Inc.

Notes to Financial Statements (continued)

12. Fair Value of Financial Instruments (continued)

Long-term debt: The carrying value of the Company's variable rate obligation (consisting of Health Facilities Refunding Bonds, Series 2003) approximate their fair value. The fair value of the Company's fixed-rate obligations is determined using market rates. Market rates are estimated based on the quoted market prices for the outstanding debt. The carrying value and fair value of long-term debt at September 30, 2008 are \$216,486 and \$200,406, respectively.