

Lee Memorial Health System

**Consolidated Financial Statements and
Supplemental Consolidating Information
September 30, 2008 and 2007**

Lee Memorial Health System

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September 30, 2008 and 2007

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Lee Memorial Health System

Management's Discussion and Analysis (Unaudited)

September 30, 2008 and 2007

(in thousands of dollars)

Introduction

This section of Lee Memorial Health System's (the "System") annual financial report presents management's discussion and analysis of the financial position and performance of the System for the years ended September 30, 2008 and 2007. This discussion has been prepared along with the consolidated financial statements, and related footnote disclosures, and they should be read in conjunction therewith. This discussion, the consolidated financial statements and footnotes are the responsibility of management.

The System is governed by a ten-member, publicly elected Board of Directors (the "Board"). Each Board member can be elected to an unlimited number of four-year terms with six members being up-for-election normally in the presidential election year and four in the non-presidential election. This assists in providing leadership continuity among the Board members.

The System is an integrated health care provider which consists of 1,606 acute care hospital beds located at five campuses, which includes a designated children's hospital, a 60-bed rehabilitation hospital, a 112-bed skilled nursing facility, a home health agency, outpatient treatment and diagnostic centers, and physician offices. For further detail on these entities, refer to Note 1 of the consolidated financial statements.

The Florida Legislature established a special trauma district for the System during the 2003 session. The purpose of the trauma district is to financially support the provision of trauma services through the Lee Memorial Level II Trauma Center. The System's Board has governance responsibility for the district while operations are included in the consolidated financial statements. Operations of the district began on October 1, 2003.

The Board's vision is to be recognized as the best patient centered healthcare system in the State of Florida through the balancing of quality, access and cost. To achieve this vision, the Board works within a strategic plan and evaluates existing and new service offerings based upon community need and economic viability.

The Board's strategic initiatives are to improve and strengthen services to meet the needs of the community, to pursue continuous improvement in quality and safety, to improve financial performance and to be the community's healthcare provider of choice. Achieving these goals requires development and implementation of an effective integrated delivery system (with physician input), creation of information systems that support an integrated delivery system and streamlined business systems and improved care delivery processes, the implementation of recruitment and retention strategies to attract and retain a quality workforce, and the continued improvement of facilities that support the strategic initiatives of the System.

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(in thousands of dollars)

Overview of the Financial Statements

Our annual report consists of a series of consolidated financial statements prepared in accordance with accounting standards generally accepted in the United States of America.

On August 31, 2006, the System's Board of Directors approved the purchase of the HCA facilities, located in Lee County (the "Transaction"), for \$277.8 million. See Note 13 for a summary of assets acquired and the liabilities assumed. The purchase included:

- Southwest Florida Regional Medical Center ("SWR")
- Gulf Coast Hospital ("GCH")
- All other related businesses, land, and subsidiaries located within Lee County, and
- The rights to proceed with the construction of the new hospital facility adjacent to Gulf Coast Hospital at Daniels Parkway and Metro Parkway (the "Project")

The Project will consist of 420,000 square feet of new construction and 20,000 square feet of renovation to GCH. The new hospital will feature 349 private patient rooms, a 43-bed emergency department that is double the current capacity, 22 large operating rooms, and a structure built for future growth to 565 beds. Physician offices will also be located in and around the facility to offer patients ease in scheduling procedures and office visits. The new facility will replace the SWR. Cost of construction for the Project is estimated to be \$265 million. The Project is being funded through cash flow from operations. The project will be completed in fiscal year 2009 with an anticipated opening date of March 2009.

In this document the term "Original Group" is hereby defined to be Lee Memorial Health System prior to the acquisition of the HCA facilities. The Original Group consists of Lee Memorial Hospital, HealthPark Medical Center, Cape Coral Hospital, HealthPark Care Center, Lee County Trauma Services, the Foundation and other subsidiaries and subagencies.

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September 30, 2008

Consolidated Statements of Operations and Changes in Net Assets

For the Year Ended September 30, 2008

A summary of the System's Consolidated Statements of Operations and Changes in Net Assets is presented below.

	2008	2007
Operating revenues	\$ 955,531	\$ 923,607
Operating expenses	<u>934,202</u>	<u>874,460</u>
Operating income	<u>21,329</u>	<u>49,147</u>
Nonoperating items	(55,453)	31,252
Contributions and grants	<u>1,667</u>	<u>3,416</u>
Total nonoperating (loss) income	<u>(53,786)</u>	<u>34,668</u>
(Decrease) increase in net assets	<u>\$ (32,457)</u>	<u>\$ 83,815</u>

Net assets decreased \$32.5 million during fiscal year 2008. This net asset decrease consisted of \$21.3 million of income from operations, and \$53.8 million of losses from nonoperating sources. Nonoperating loss consisted of interest income of \$50.5 million, unrealized investment losses of \$88.3 million, other income of \$2.3 million, and interest expense of \$18.3 million.

Admissions were 1.5% lower than the previous year. This consisted of a 1.4% decline in adult admissions, a 5.1% decline in pediatrics, and a 5.8% decline in neonatal cases. The drop in volume was offset slightly by a 6.5% increase in post acute admissions. Patient days were .3% lower than the prior year with overall average length of stay increasing slightly from 5.18 to 5.24.

The System's adjusted admissions increased 1.7% from fiscal year 2007 to fiscal year 2008. Net patient revenue per adjusted admissions increased 1.5%. Total operating revenues increased from \$923.6 million in fiscal year 2007 to \$955.5 million in fiscal year 2008. The \$31.9 million increase consisted of \$29.7 million from the patient revenue growth and \$2.2 million from other revenue.

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A summary of the System's key operating ratios is presented below. All ratios are expressed as a percentage of total net operating revenue.

	2008	2007	% Variance
Salaries, wages and benefits	52.9%	51.0%	-3.7%
Supplies and other services	29.3%	29.5%	0.7%
Purchased services	9.6%	8.8%	-9.1%
Capital costs (depreciation, amortization and interest expense)	7.9%	7.9%	0.0%

Total operating expense increased from fiscal year 2007 to fiscal year 2008 by \$59.7 million.

Salaries, wages and benefits increased \$35.1 million, or 7.5%. A portion of this increase is attributable to the increase in adjusted admits. The remainder of the increase is the result of the annual merit increases for staff, salary adjustments to remain market competitive, staffing adjustments in certain clinical areas to improve employee retention and quality, and increases in employee benefit costs. These factors increased the overall average wage rate for the System by 2.5%.

Benefit costs increased by \$14.4 million, or 24.3%, due to increased employee health insurance costs, the implementation of GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, (Note 10) and the overall increase in salaries and wages which increased certain benefit costs. Benefit costs as a percent of salaries, wages and benefits were 12.7% for fiscal year 2007 and 14.7% for fiscal year 2008. Salaries, wages and benefits as a percent of total net operating revenues increased from 51.0% in fiscal year 2007 to 52.9% in fiscal year 2008.

Supplies and other services increased 2.9%, or \$7.8 million, from fiscal year 2007 to fiscal year 2008. Within this expense category, other services decreased \$0.5 million while supplies increased \$8.3 million. This increase is primarily due to volume increases and supply cost inflation. Supplies and other services decreased as a percentage of net operating revenues from 29.5% in fiscal year 2007 to 29.3% for fiscal year 2008. Significant non-supply cost increases in this category include recruiting costs, equipment leasing costs, utility costs and property insurance expenses.

The increase in purchased services for fiscal year 2008 amounted to 12.6%, or \$10.2 million. The primary drivers of this increase include radiologist billing service payments, discontinuation of the System's central business office allocation and increases in information technology contract services and associated fees.

Net patient service revenue is reduced by the provision for bad debts in the consolidated statements of operations. The provision for bad debts decreased from fiscal year 2007 to fiscal year 2008 when viewed as a percent of gross patient revenue. For fiscal year 2008, this provision was 3.7% of gross patient service revenue while in fiscal year 2007 it was 4.2%. This decrease in the provision for bad debts is due to a new self-pay discount policy implemented at the beginning of the fiscal year. This new policy allows a discount of 20% for patients without insurance.

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Capital costs, which include depreciation, amortization and interest expense, increased from \$72.7 million in fiscal year 2007 to \$75.1 million in fiscal year 2008. This \$2.4 million net increase is primarily due to the depreciation expense related to new equipment and projects that came online during the fiscal year. Interest expense decreased from \$22.5 million in fiscal year 2007 to \$18.3 million in fiscal year 2008. Capital costs, expressed as a percentage of total operating revenues remained flat at 7.9% for both fiscal year 2007 and 2008.

Operating income was \$21.3 million in fiscal year 2008 compared to \$49.1 million in fiscal year 2007. The resulting operating margin (net of interest expense) was 0.3% versus 2.9% the prior year. The operating margin declined by 88.9% over the prior year.

Below is a table outlining our Board defined and monitored operating ratios. These ratios are compared with Moody's A rated hospitals.

	2007 Moody's Median	FYE 2007	FYE 2008	
Profitability Ratios				
Operating margin (%)	2.6%	2.9%	0.3%	+
Excess margin (%)	5.6%	8.3%	-3.7%	+
EBITDA margin (%)	9.5%	10.8%	8.2%	+
Liquidity Ratios				
Days cash on hand (net of VRDB)	180.0	134.6	98.1	+
Cushion ratio	17.1	11.4	9.8	+
Cash-to-debt (%)	133.9%	74.0%	63.6%	+
Capitalization Ratios				
Debt to capitalization (%) - (net of VRDB)	35.3%	46.1%	47.4%	-
Annual debt service coverage	4.9	3.5	4.4	+
Debt to cash flow (net of VRDB)	3.2	5.2	4.4	-

* Operating margin is calculated as operating income less interest expense divided by total operating revenues.

* Excess margin is calculated as the increase in net assets divided by total operating revenues plus nonoperating revenues.

* EBITDA margin is calculated as operating income plus depreciation and amortization divided by total operating revenues.

* VRDB = Variable Rated Demand Bond

Annually, the Board establishes targets for these key ratios and then monitors these ratios each month to ensure that the System remains an A-rated organization. The operating margin, days cash on hand, cash-to-debt, debt to capitalization, annual debt service coverage, and debt to cash flow ratios fall outside the range of the Moody's 2007 Medians. This is due to the Transaction and the construction of the Project and the decline in the investment portfolio.

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Net days in accounts receivable increased in fiscal year 2008 compared to fiscal year 2007 to 56.3 from prior year 55.4 primarily due to greater Medicaid utilization. The cash to debt ratio decreased from 74.0% in fiscal year 2007 to 63.6% in fiscal year 2008. Most of this reduction is related to the funding of the Project and unrealized losses incurred in the investment portfolio.

Cash Flows

Cash and cash equivalents increased \$2.9 million in fiscal year 2008. Cash flows from operating activities and investing activities were used to fund the cash outflows from capital and related financing activities during the year.

Net cash provided by operating activities was approximately \$80.3 million for fiscal year 2008 and approximately \$89.0 million for the prior year. The main factors contributing to the \$8.7 million decrease in operating cash flow during fiscal year 2008 as compared to fiscal year 2007 are as follows:

- \$40.6 million in additional cash received from patient care services, offset by
- \$51.5 million in additional cash payments made to employees and suppliers.

Net cash provided in non-capital financing activities was \$6.1 million for fiscal year 2008 versus \$2.9 million used in fiscal year 2007. The majority of this activity is the result of the investment of restricted contributions made to Lee Memorial Health System Foundation, Inc. (the "Foundation").

Net cash used in capital and related financing activities was approximately \$128.7 million in fiscal year 2008 and \$169.5 million in fiscal year 2007. This decrease in the use of cash is primarily the result of \$140.3 million used for the purchase of capital assets and construction of the Project during fiscal year 2007 compared to \$87.9 million during fiscal year 2008.

Net cash provided by investing activities was \$45.1 million for fiscal year 2008 versus \$89.8 million in investing activities in the prior year. For fiscal year 2008, \$53.7 million was received in investment income, offset with an increase in investments held in the portfolio of \$8.5 million.

General Trends

As reflected in the revenue table below, the System is dependent on the State and Federal governments for the majority of its revenues with 61.2% of the System revenue being derived from the Medicare and Medicaid programs. Over the past several years, the Medicare rate increases have not kept pace with overall medical expense increases. Management expects these trends to continue. This will put continued pressure on already thin operating margins necessitating continued efforts to enhance operating efficiencies. The System has created a department with highly trained Lear/Sigma personnel and is an industry leader in process standardization and waste elimination through the use of Lear/Sigma methodologies.

	2008	2007
Medicare	48.4%	47.8%
Medicaid	12.8%	12.3%
Commercial	27.7%	29.3%
Other	11.1%	10.6%
	<u>100.00%</u>	<u>100.00%</u>

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Capital Assets

At September 30, 2008, the System had \$628.9 million invested in net capital assets. (A breakdown of these assets can be found in Note 6 to the consolidated financial statements.) This represents an increase of \$47.3 million from September 30, 2007.

The System expects to make total capital expenditures of approximately \$144 million in fiscal year 2009 primarily to complete the Project, facility upgrades, information systems and patient care equipment. These capital purchases will be funded directly from operations.

Debt Outstanding

As of September 30, 2008, the System had approximately \$662.1 million in debt (bonds, notes, etc.) outstanding compared to approximately \$665.3 million the previous year. The long-term debt is comprised of a number of bond issues, described in more detail in Note 8 to the consolidated financial statements. Approximately 72% of the System's debt is fixed while 28% is variable. All of the fixed rate bonds are insured with the exception of the 2007 Series A bonds. The 2005 Series A bonds and the 1997 Series B bonds are insured by MBIA and carry an A2 rating as of September 30, 2008. The 2002 Series A bonds are insured by FSA and carry a AAA rating as of September 30, 2008. The remaining bonds are variable rate bonds and carry an A2/A rating from Moody's and S&P, respectively.

The Series 1985 C and D, 1992 Series B, 1995 Series A and 1997 Series B bonds are collateralized by a line of credit in an aggregate amount not to exceed \$185.2 million. Effective August 8, 2007, the System amended the existing liquidity facility which was scheduled to mature on June 24, 2008 by extending the maturity date to June 24, 2010. The bonds are subject to mandatory tender for purchase by the System within 180 days should this line of credit expire and the System not obtain an acceptable alternative line of credit or liquidity facility. Therefore, the bonds are classified as long-term in accordance with the repayment schedule. The System is required to pay an annual facility fee equal to 0.25% of the available amount under the line of credit facility. The credit facility contains certain financial covenants and restrictions including minimum debt service coverage and long-term debt to capital ratios along with unrestricted cash and investments limitations. As of September 30, 2008, the System was in compliance with all such covenants. Amounts were borrowed under the credit facility during fiscal year 2008. Outstanding balances on the liquidity facility at September 30, 2008 were \$101 million.

Community Benefits

As a special purpose unit of government, the System is committed to meeting the needs and improving the health status of the people of Southwest Florida. The essential services that are provided throughout the health system were created from our commitment to the community and not because of an economic opportunity. Therefore, the System regularly assesses the needs of the community so that even the most vulnerable of its citizens are provided care even though a particular service might generate a low or negative margin.

The entire cost of providing care to low income citizens or to fund unprofitable services is subsidized through our tax exempt status. Therefore, the System regularly estimates the benefit of its tax exempt status as compared to the "community benefits" that are provided to the citizens as well as identifying the types of services that are provided often at significant financial loss to meet the needs of the community.

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The analysis of the community benefit reveals that the System financial benefit of its tax exempt status was approximately \$41.7 million for fiscal year 2008 and \$42.9 million for fiscal year 2007. This includes the savings that are derived from not having to pay certain state and federal taxes, real estate taxes, sales and intangible taxes as well as lower malpractice costs due to sovereign immunity as a governmental entity, and lower cost of capital due to the use of tax-exempt financing.

The System estimates the benefits of the services provided to the community exceeded \$173.8 million in fiscal year 2008 and \$160.0 million in fiscal year 2007. This community benefit consists of charity care provided to patients whom might not have access to health care; low income services that are provided at less than cost (e.g., Medicaid); necessary services that are provided at a loss such as Trauma services and other community wellness and health education programs.

The System's commitment to the community is summarized into the following community benefit categories:

	2008	2007
Cost of charity care for low income patients	\$ 39.9	\$ 33.3
Cost of community outreach and educational programs and one-of-a-kind medical services	6.4	10.1
Cost of unpaid Medicaid services	14.0	19.1
Cost of unpaid Medicare and other government programs	113.5	97.5

In summary, the System continues to provide benefits to the community well in excess of the value of its tax exempt status. The System continues to be focused on the provision of essential services to all of its citizens and uses its financial surplus to further its charitable purpose.

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(in thousands of dollars)

September 30, 2007

Consolidated Statements of Operations and Changes in Net Assets

For the Year Ended September 30, 2007

A summary of the System's Consolidated Statements of Operations and Changes in Net Assets is presented below.

	2007	2006
Operating revenues	\$ 923,607	\$ 632,268
Operating expenses	<u>874,460</u>	<u>601,221</u>
Operating income	<u>49,147</u>	<u>31,047</u>
Nonoperating items	31,252	10,245
Contributions and grants	<u>3,416</u>	<u>2,990</u>
Total nonoperating income	<u>34,668</u>	<u>13,235</u>
Increase in net assets	<u>\$ 83,815</u>	<u>\$ 44,282</u>

Net assets increased \$83.8 million during fiscal year 2007. This net asset increase consisted of \$49.1 million of income from operations, and \$34.7 million from nonoperating sources. Nonoperating income consisted of interest income of \$37.7 million, unrealized investment gains of \$9.5 million, and other of \$9.9 million, offset by interest expense of \$22.5 million.

Admissions were 44.5% greater than the previous year, while acute care inpatient market share increased from 67.0% in fiscal year 2006 to 95.6% in fiscal year 2007. The increase was due primarily to the acquisition of SWR and GCH. Patient days were 35.7% greater than the prior year with overall average length of stay decreasing from 5.5 to 5.2.

The System's adjusted admissions were up 41.5% from fiscal year 2006 to fiscal year 2007. For the Original Group, adjusted admits increased 6.3%. Net revenue per adjusted admission increased 4.0% resulting from third-party payer payment increases.

Total operating revenues increased from \$632.3 million in fiscal year 2006 to \$923.6 million in fiscal year 2007. The \$291.3 million increase consisted of \$237.7 million related to revenue from the hospitals that were acquired in the Transaction and \$53.6 million from the revenue growth in the Original Group.

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(in thousands of dollars)

A summary of the System's key operating ratios is presented below. All ratios are expressed as a percentage of total net operating revenue.

	2007	2006	% Variance
Salaries, wages and benefits	51.0%	54.5%	6.4%
Supplies and other services	29.5%	27.2%	-8.5%
Purchased services	8.8%	7.8%	-12.8%
Capital costs (depreciation, amortization and interest expense)	7.9%	7.4%	-6.8%

Total operating expense increased from fiscal year 2006 to fiscal year 2007 by \$273.2 million. The portion of this expense increase associated with the Original Group is \$41.2 million.

Salaries, wages and benefits increased \$126.2 million, or 36.6%. For the Original Group, these same expenses increased by \$22.3 million or 6.5%. A portion of this increase is attributable to the increase in volumes. The remainder of the increase for the Original Group is the result of the annual merit increases for staff; salary adjustments to remain market competitive; staffing adjustments in certain clinical areas to improve employee retention and quality; and the use of premium labor (contract and overtime) to staff core vacancies resulting from the nationwide nursing shortage. These factors increased the overall average wage rate for the System by 7.5%.

Benefit costs increased by \$11.6 million or 24.1% due to the Transaction. However, benefit costs as a percent of salaries, wages and benefits were 14.0% for fiscal year 2006 and 12.7% for fiscal year 2007. Salaries, wages and benefits as a percent of total net operating revenues decreased from 54.5% in fiscal year 2006 to 51.0% in fiscal year 2007.

Supplies and other services increased 58.5%, or \$100.4 million, from fiscal year 2006 to fiscal year 2007. Within this expense category, services increased \$24.4 million while supplies increased \$74.7 million. For the Original Group, supplies and other services expense increased \$11.9 million. This increase is primarily due to volume increases and supply cost inflation. Supplies and other services increased as a percentage of net operating revenues from 27.2% in fiscal year 2006 to 29.5% for fiscal year 2007. Significant nonsupply cost increases in this category include recruiting costs, equipment leasing costs, utility costs and property insurance expense related to the Transaction.

The increase in purchased services for fiscal year 2007 amounted to 64.5%, or \$31.9 million. For the Original Group, this expense category increased \$5.3 million. Increases include expanded physician payments related to maintenance of Lee County's only trauma program, costs related to physician issues and concerns related to the acquisition and higher maintenance contract costs. Net patient service revenue is reduced by the provision for bad debts in the consolidated statements of operations. The provision for bad debts increased from fiscal year 2006 to fiscal year 2007 when viewed as a percent of gross patient revenue. For fiscal year 2007, this provision was 4.2% of gross patient service revenue while in fiscal year 2006 it was 4.1%. This increase in the provision for bad debts was made to account for greater patient responsibility related to higher co-payments and deductibles and the growing number of uninsured.

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Capital costs, which include depreciation, amortization and interest expense, increased from \$47.0 million in fiscal year 2006 to \$72.7 million in fiscal year 2007. For the Original Group, capital costs decreased by \$2.2 million. This \$25.7 million net increase is primarily due to the Transaction. Interest expense increased from \$11.5 million in fiscal year 2006 to \$22.5 million in fiscal year 2007. For the Original Group, the interest expense decreased \$0.3 million. Capital costs, expressed as a percentage of total operating revenues increased from 7.4% in fiscal year 2006 to 7.9% in fiscal year 2007.

Operating income was \$49.1 million in fiscal year 2007 compared to \$31.0 million in fiscal year 2006. The resulting operating margin (net of interest expense) was 2.9% versus 3.1% the prior year. The operating margin remained relatively flat.

Below is a table outlining our Board defined and monitored operating ratios. These ratios are compared with Moody's A rated hospitals.

	2006 Moody's Median	FYE 2006	FYE 2007	
Profitability Ratios				
Operating margin (%)	3.2%	3.1%	2.9%	+
Excess margin (%)	5.8%	6.3%	8.3%	+
EBITDA margin (%)	9.7%	10.5%	10.8%	+
Liquidity Ratios				
Days cash on hand (net of VRDB)	177.3	211.5	134.6	+
Cushion ratio	16.5	17.9	11.4	+
Cash-to-debt (%)	129.5%	132.1%	74.0%	+
Capitalization Ratios				
Debt to capitalization (%) - (net of VRDB)	36.2%	29.9%	46.1%	-
Annual debt service coverage	4.8	3.9	3.5	+
Debt to cash flow (net of VRDB)	3.3	2.8	5.2	-

* Operating margin is calculated as operating income less interest expense divided by total operating revenues.

* Excess margin is calculated as the increase in net assets divided by total operating revenues plus nonoperating revenues.

* EBITDA margin is calculated as operating income plus depreciation and amortization divided by total operating revenues.

* VRDB = Variable Rated Demand Bond

Annually, the Board establishes targets for these key ratios and then monitors these ratios each month to ensure that the System remains an A-rated organization. The operating margin, days cash on hand, cash-to-debt, debt to capitalization, annual debt service coverage, and debt to cash flow ratios fall outside the range of the Moody's 2006 Medians. This is due to the Transaction and the construction of the Project.

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Net days in accounts receivable decreased in fiscal year 2007 compared to fiscal year 2006 to 55.4 from prior year 56.9 primarily due to the Transaction as the acquired facilities have a higher percentage of Medicare in their payor mix resulting in a shorter payment cycle. The cash to debt ratio decreased from 132.1% in fiscal year 2006 to 74.0% in fiscal year 2007. Most of this reduction is related to the debt incurred to fund the Transaction and pay for the Project. Unrealized gains on investments and earnings in equity method investees of \$10.0 million contributed to the excess margin of 8.3%.

Cash Flows

Cash and cash equivalents increased \$6.4 million in fiscal year 2007. Cash flows from operating activities and investing activities were used to fund the cash outflows from non-capital financing activities, and capital and related financing activities during the year.

Net cash provided by operating activities was approximately \$89.0 million for fiscal year 2007 and approximately \$56.6 million for the prior year. The main factors contributing to the \$32.4 million increase in operating cash flow during fiscal year 2007 as compared to fiscal year 2006 are as follows:

- \$288.2 million in additional cash received from patient care services, \$222.7 million of which came from patient services provided at the HCA acquired hospitals; offset by
- \$252.2 million in additional cash payments made to employees and suppliers, \$218.0 million of which came from expense payments at the HCA acquired hospitals.

Net cash used in non-capital financing activities was \$2.9 million for fiscal year 2007 versus \$7.0 million provided by non-capital financing activities for fiscal year 2006. The majority of this activity is the result of the investment of restricted contributions made to Lee Memorial Health System Foundation, Inc. (the "Foundation").

Net cash used in capital and related financing activities was approximately \$169.5 million in fiscal year 2007 and \$59.4 million in fiscal year 2006 resulting in a \$110.1 million increase in the use of cash. This increase in the use of cash is primarily the result of \$140.3 million for the purchase of capital assets and construction of the Project during fiscal year 2007 compared to \$33.8 million during fiscal year 2006.

Net cash provided by investing activities was \$89.8 million for fiscal year 2007 versus \$10.6 million used in investing activities in the prior year. For fiscal year 2007, \$43.5 million was received as investment income, coupled with a decrease in investments held in the portfolio of \$44.7 million.

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General Trends

As reflected in the revenue table below, the System is dependent on the State and Federal governments for the majority of its revenues with 60.1% of the System revenue being derived from the Medicare and Medicaid programs. Over the past several years, the Medicare rate increases have not kept pace with overall medical expense increases. Management expects these trends to continue. This will put continued pressure on already thin operating margins necessitating continued efforts to enhance operating efficiencies. The System has been trained by General Motors on their lean production strategies and has adopted this methodology for waste reduction.

	2007	2006
Medicare	47.8%	44.2%
Medicaid	12.3%	13.0%
Commercial	29.3%	32.7%
Other	10.6%	10.1%
	<u>100.00%</u>	<u>100.00%</u>

Capital Assets

At September 30, 2007, the System had \$581.6 million invested in net capital assets. (A breakdown of these assets can be found in Note 6 to the consolidated financial statements.) This represents an increase of \$268.0 million from September 30, 2006.

The System expects to make total capital expenditures of approximately \$103.8 million in fiscal year 2008 primarily to complete the Project; facility upgrades, information systems and patient care equipment. These capital purchases will be funded directly from operations.

Debt Outstanding

As of September 30, 2007, the System had approximately \$665.3 million in debt (bonds, notes, etc.) outstanding compared to approximately \$392.3 million the previous year. The long-term debt is comprised of a number of bond issues, described in more detail in Note 8 to the consolidated financial statements. Approximately 73% of the System's debt is fixed while 27% is variable. All of the fixed rate bonds are insured and, therefore, carry a AAA bond rating. All of the variable rate bonds carry an A2/A rating from Moody's and S&P, respectively.

The Series 1985 C and D, 1992 Series B, 1995 Series A and 1997 Series B bonds are collateralized by a line of credit in an aggregate amount not to exceed \$185.2 million. Effective August 8, 2007, the System amended the existing liquidity facility which was scheduled to mature on June 24, 2008 by extending the maturity date to June 24, 2010. The bonds are subject to mandatory tender for purchase by the System within 180 days should this line of credit expire and the System not obtain an acceptable alternative line of credit or liquidity facility. Therefore, the bonds are classified as long-term in accordance with the repayment schedule. The System is required to pay an annual facility fee equal to 0.25% of the available amount under the line of credit facility. The credit facility contains certain financial covenants and restrictions including minimum debt service coverage and long-term debt to capital ratios along with unrestricted cash and investments limitations. As of September 30, 2007, the System was in compliance with all such covenants. There were no amounts borrowed under the credit facility during fiscal year 2007.

Lee Memorial Health System

Management's Discussion and Analysis (Unaudited)

September 30, 2008 and 2007

(in thousands of dollars)

Community Benefits

As a special purpose unit of government, the System is committed to meeting the needs and improving the health status of the people of Southwest Florida. The essential services that are provided throughout the health system were created from our commitment to the community and not because of an economic opportunity. Therefore, the System regularly assesses the needs of the community so that even the most vulnerable of its citizens are provided care even though a particular service might generate a low or negative margin.

The entire cost of providing care to low income citizens or to fund unprofitable services is subsidized through our tax exempt status. Therefore, the System regularly estimates the benefit of its tax exempt status as compared to the "community benefits" that are provided to the citizens as well as identifying the types of services that are provided often at significant financial loss to meet the needs of the community.

The analysis of the community benefit reveals that the System financial benefit of its tax exempt status was approximately \$42.9 million for fiscal year 2007 and \$21.5 million for fiscal year 2006. This includes the savings that are derived from not having to pay certain state and federal taxes, real estate taxes, sales and intangible taxes as well as lower malpractice costs due to sovereign immunity as a governmental entity, and lower cost of capital due to the use of tax-exempt financing.

The System estimates the benefits of the services provided to the community exceeded \$160.0 million in fiscal year 2007 and \$87.2 million in fiscal year 2006. This community benefit consists of charity care provided to patients whom might not have access to health care; low income services that are provided at less than cost (e.g., Medicaid); necessary services that are provided at a loss such as Trauma services and other community wellness and health education programs.

The System's commitment to the community is summarized into the following community benefit categories:

	2007	2006
Cost of charity care for low income patients	\$ 33.3	\$ 26.7
Cost of community outreach and educational programs and one-of-a-kind medical services	10.1	3.8
Cost of unpaid Medicaid services	19.1	9.0
Cost of unpaid Medicare and other government programs	97.5	47.7

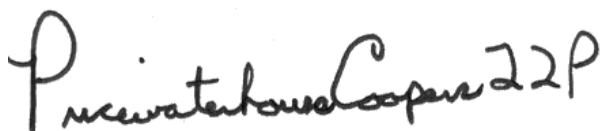
In summary, the System continues to provide benefits to the community well in excess of the value of its tax exempt status. The System continues to be focused on the provision of essential services to all of its citizens and uses its financial surplus to further its charitable purpose.

Report of Independent Certified Public Accountants

To the Board of Directors of
Lee Memorial Health System

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations and changes in net assets and of cash flows present fairly, in all material respects, the financial position of Lee Memorial Health System (the "System") at September 30, 2008 and 2007, and the changes in their financial position and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinions.

The Management's Discussion and Analysis ("MD&A") for the years ended September 30, 2008 and 2007 on pages 1 to 14 is not a required part of the basic financial statements as of and for the year then ended but is supplementary information required by accounting principles generally accepted in the United States of America. 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.



January 12, 2009

Lee Memorial Health System
Consolidated Balance Sheets
September 30, 2008 and 2007

(in thousands of dollars)

	2008	2007
Assets		
Current assets		
Cash and cash equivalents	\$ 16,555	\$ 13,692
Short-term investments	384,389	411,314
Equity method and other investments	-	20,999
Assets whose use is restricted	13,818	11,652
Patient accounts receivable, net of allowance for estimated uncollectibles of \$74,038 in 2008 and \$84,123 in 2007	144,774	137,776
Inventories	26,736	25,018
Other current assets	18,475	16,016
Total current assets	604,747	636,467
Noncurrent assets		
Long-term investments	100	33,369
Assets whose use is restricted	17,853	20,094
Capital assets, net	628,912	581,577
Other assets, net	125,259	131,135
Total assets	\$ 1,376,871	\$ 1,402,642
Liabilities and Net Assets		
Current liabilities		
Accounts payable	\$ 43,068	\$ 40,319
Current installments of long-term debt	13,163	11,514
Accrued expenses		
Employee compensation	47,426	44,620
Interest	11,614	11,780
Other	32,433	28,171
Estimated third-party settlements	1,208	3,022
Total current liabilities	148,912	139,426
Noncurrent liabilities		
Long-term debt, excluding current installments	648,891	653,832
Other liabilities	24,670	22,529
Total liabilities	822,473	815,787
Commitments and contingencies		
Net assets		
Restricted for		
Nonexpendable	5,406	4,756
Expendable	14,850	13,832
Invested in capital assets, net of related debt	(33,142)	(83,769)
Unrestricted	567,284	652,036
Total net assets	554,398	586,855
Total liabilities and net assets	\$ 1,376,871	\$ 1,402,642

The accompanying notes are an integral part of these consolidated financial statements.

Lee Memorial Health System
Consolidated Statements of Operations and Changes in Net Assets
Years Ended September 30, 2008 and 2007

(in thousands of dollars)

	2008	2007
Operating revenues		
Net patient service revenue, net of provision for doubtful accounts of \$112,205 in 2008 and \$117,488 in 2007	\$ 937,323	\$ 907,596
Other revenue	<u>18,208</u>	<u>16,011</u>
Total operating revenues	<u>955,531</u>	<u>923,607</u>
Operating expenses		
Salaries, wages and benefits	505,837	470,701
Supplies and other services	279,931	272,128
Purchased services	91,651	81,410
Depreciation and amortization	<u>56,783</u>	<u>50,221</u>
Total operating expenses	<u>934,202</u>	<u>874,460</u>
Operating income	<u>21,329</u>	<u>49,147</u>
Nonoperating items		
Interest expense	(18,270)	(22,479)
Investment income, including realized and unrealized (losses) and gains on investments	(37,095)	42,852
Earnings in equity method investees	-	4,786
Unrealized loss on swap valuation	(775)	(438)
Contributions and grants	1,959	2,722
Interest earned on restricted investments	(292)	694
Other	<u>687</u>	<u>6,531</u>
Total nonoperating (loss) income	<u>(53,786)</u>	<u>34,668</u>
(Decrease) increase in net assets	<u>(32,457)</u>	<u>83,815</u>
Net assets		
Beginning of year	<u>586,855</u>	<u>503,040</u>
End of year	<u>\$ 554,398</u>	<u>\$ 586,855</u>

The accompanying notes are an integral part of these consolidated financial statements.

Lee Memorial Health System
Consolidated Statements of Cash Flows
Years Ended September 30, 2008 and 2007

(in thousands of dollars)

	2008	2007
Cash flows from operating activities		
Received from patient care services	\$ 932,038	\$ 891,466
Payments to employees	(503,031)	(462,985)
Payments to suppliers	(366,575)	(355,120)
Other receipts	17,877	15,654
Net cash provided by operating activities	<u>80,309</u>	<u>89,015</u>
Cash flows from noncapital financing activities		
Restricted gifts received (non-capital related)	2,146	2,804
Miscellaneous nonoperating items	3,959	(5,683)
Net cash provided by (used in) noncapital financing activities	<u>6,105</u>	<u>(2,879)</u>
Cash flows from capital and related financing activities		
Proceeds from long-term borrowings	52,800	561,333
Bond issuance costs	-	(1,432)
Purchases of capital assets	(87,868)	(140,263)
Interest payments	(28,774)	(22,668)
Repayment of long-term debt	(64,831)	(288,669)
Purchase of new facilities, net (Note 13)	-	(277,834)
Net cash used in capital and related financing activities	<u>(128,673)</u>	<u>(169,533)</u>
Cash flows from investing activities		
Investment income received	53,669	43,484
Increase in investments	(29,546)	(18,612)
Decrease in equity method and other investments	20,999	63,323
Proceeds from escrow account	-	1,647
Net cash provided by investing activities	<u>45,122</u>	<u>89,842</u>
Increase in cash and cash equivalents	2,863	6,445
Cash and cash equivalents		
Beginning of year	13,692	7,247
End of year	<u>\$ 16,555</u>	<u>\$ 13,692</u>
Disclosure of supplemental cash flow information		
Donated capital assets	\$ -	\$ 5,342
Capital assets financed through capital lease obligations	8,646	-

The accompanying notes are an integral part of these consolidated financial statements.

Lee Memorial Health System
Consolidated Statements of Cash Flows
Years Ended September 30, 2008 and 2007

(in thousands of dollars)

	2008	2007
Reconciliation of operating income to net cash provided by operating activities		
Operating income	\$ 21,329	\$ 49,147
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation and amortization	56,783	50,221
Provision for bad debts	112,205	117,488
Changes in		
Patient accounts receivable	(115,676)	(135,014)
Estimated third-party settlements	(1,814)	1,396
Inventories	(1,718)	(5,250)
Other assets	(2,758)	1,596
Accounts payable	2,749	4,553
Accrued expenses	7,068	(991)
Other liabilities	2,141	5,869
Net cash provided by operating activities	<u>\$ 80,309</u>	<u>\$ 89,015</u>

The accompanying notes are an integral part of these consolidated financial statements.

Lee Memorial Health System

Notes to Consolidated Financial Statements

September 30, 2008 and 2007

(in thousands of dollars)

1. Description of Reporting Entity and Summary of Significant Accounting Policies

Description of Reporting Entity

Lee Memorial Health System (the "System") is a special purpose unit of local government created by special act of the Florida Legislature, Chapter 63-1552, Laws of Florida, Special Acts, 1963 as re-codified by Chapter 2000-439, Laws of Florida, Special Acts, 2000 (the "Enabling Act"). It is classified as an independent special district under laws of Florida. The System operates pursuant to the Enabling Act, as amended.

The System includes five acute care hospitals, Lee Memorial Hospital, HealthPark Medical Center, Southwest Florida Regional Medical Center ("SWR"), Gulf Coast Hospital ("GCH") and Cape Coral Hospital (collectively referred to as the "Hospital"), as well as other healthcare facilities and services, which include a home health agency, a nursing home, outpatient treatment and diagnostic centers, physicians' offices, and a rehabilitation hospital. Refer to Note 13 regarding the acquisition of SWR and GCH.

During fiscal year 2008, SWR and GCH have been combined into one reporting entity called Gulf Coast Medical Center ("GCMC"). This name change was done to more closely resemble the combined facility once the construction is completed on the metro campus and the two facilities merge into one. That facility will be known as Gulf Coast Medical Center. The facilities are expected to combine in early 2009.

Certain of these operations have been placed in subagencies for administrative purposes. Subagencies are created by resolution of the System's Board of Directors under authorization granted by its Enabling Act. These subagencies are not incorporated under the corporation laws of Florida.

Other System operations are carried out through subsidiary corporations, as follows:

- Cape Coral Hospital is managed through a not-for-profit organization, Cape Memorial Hospital, Inc. ("Cape Coral Hospital"). This corporation was created by the System's Board of Directors to receive and hold the assets purchased from Cape Coral Medical Center, Inc. ("CCMC") on July 1, 1996, upon acquisition of Cape Coral Hospital (Note 12). Its Board of Directors consists of the ten members of the System's Board of Directors.
- HealthPark Care Center, Inc. ("HPCC") is a not-for-profit corporation, which owns and operates the System's skilled nursing facility. Its Board of Directors consists of the ten members of the System's Board of Directors.
- Lee Memorial Home Health, Inc. is a not-for-profit corporation, which owns and operates the System's home health agency. Its Board of Directors consists of the ten members of the System's Board of Directors. Effective October 1, 2000, Lee Memorial Hospital Home Healthcare Services, Inc. ("Lee Memorial Healthcare"), a not-for-profit corporation which owned and operated the System's non-Medicare home health agency, was combined with Lee Memorial Home Health, Inc.

Lee Memorial Health System

Notes to Consolidated Financial Statements

September 30, 2008 and 2007

(in thousands of dollars)

- Lee Memorial Health System Foundation, Inc. (the "Foundation") is a not-for-profit corporation created by the System's Board of Directors and community leaders to serve as a fund-raising organization in support of the System. Its Board of Directors consists of persons prominent in the community and interested in serving the community and the System's needs. Two board positions are also reserved on an ex officio basis for the Chairman of the Board of Directors of the System or members of such board designated by the Chairman and the Chief Executive Officer of the System or his/her designee.
- Lee County Trauma Services District (the "District") is a not-for-profit organization located in Fort Myers, Florida. The District is a special purpose unit of local government created by a special act of the 2003 Florida Legislature, Chapter 63-1552, Laws of Florida, Special Acts, 1963 as recodified by Chapter 2003-357, Laws of Florida, Special Acts 2003. The District is classified as independent special district under the laws of Florida. The District serves as an integral member of the continuum of care offered by the System. Operations of the District began on October 1, 2003.

Summary of Significant Accounting Policies

All intercompany transactions have been eliminated in the accompanying consolidated financial statements.

Basis of Accounting

The System uses the proprietary fund method of accounting whereby revenues and expenses are recognized on the accrual basis. The System has elected to apply the provisions of all relevant pronouncements of the Financial Accounting Standards Board ("FASB"), including those issued after November 30, 1989, that do not conflict with or contradict GASB pronouncements.

Use of Estimates

The preparation of consolidated 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 consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents consist of amounts held as bank deposits and highly liquid investments with maturities of three months or less at date of purchase.

Inventories

Inventories consist principally of pharmaceuticals and medical and surgical supplies which are valued at the lower of cost, on a first-in first-out basis, or market.

Assets Whose Use Is Restricted

Assets whose use is restricted consist primarily of investments restricted under the terms of the System's bond indenture agreement. The current portion of assets whose use is restricted relates to the corresponding estimated current obligations.

Lee Memorial Health System

Notes to Consolidated Financial Statements

September 30, 2008 and 2007

(in thousands of dollars)

Capital Assets

Capital assets have been recorded at historical cost or fair market value at date of purchase or donation, respectively. Equipment under capital leases is stated at the present value of minimum lease payments at the inception of the lease. Routine maintenance and repairs are expensed when incurred. Expenditures that materially increase the value, change the capacity or extend the useful life of an asset are capitalized. Interest costs incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

Major asset classifications and estimated useful lives are generally in accordance with those recommended by the American Hospital Association. The straight-line method of computing depreciation is used for all depreciable assets. Equipment under capital leases is amortized under the straight-line method over the shorter of the lease term or estimated useful life of the asset as summarized below:

Buildings and improvements	10–40 years
Equipment	5–15 years

Goodwill

Goodwill consists of the excess of the purchase price over the fair value of assets and liabilities acquired in acquisitions accounted for under the purchase method of accounting. On an annual basis, or whenever events or changes in circumstances indicate that the carrying amounts may not be recoverable, the System reviews the recoverability of goodwill based primarily upon an analysis of discounted cash flows of the related investment asset as compared to the carrying value. Management evaluated goodwill and based on the analysis performed, no impairment loss was recorded for the year ended September 30, 2008.

Impairment of Long-Lived Assets

Long-lived assets are evaluated for recoverability whenever adverse events or changes in business climate indicate that the expected undiscounted future cash flows from the related asset may be less than previously anticipated. If the net book value of the related asset exceeds the undiscounted future cash flows of the asset, the carrying amount would be reduced to the present value of its expected future cash flows and an impairment loss would be recognized. For the years ended September 30, 2008 and 2007, the System does not believe there were any adverse events or changes in business that would indicate that an impairment reserve is required.

Bond Issuance Costs and Bond Discounts

Bond issuance costs and bond discounts are amortized to operations (interest expense) over the term of the related financing agreement using a method which approximates the effective interest method.

Net Patient Service Revenue

The System has agreements with third-party payors that provide for payments to the System at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods, as final settlements are determined.

Lee Memorial Health System
Notes to Consolidated Financial Statements
September 30, 2008 and 2007

(in thousands of dollars)

Charity Care

The System 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 System does not pursue collection of these amounts, they are not reported as net patient service revenue. The level of direct charity care provided during the years ended September 30, 2008 and 2007 was \$99,487 and \$94,904, respectively.

Investments and Investment Income

Investment securities held by the System, including investment in companies that are deemed to be external investment pools as addressed in GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, are carried at fair value. Realized gains and losses, based on the specific identification method, and unrealized gains and losses are included in investment income in the consolidated statements of operations and changes in net assets.

At September 30, 2008 and 2007, the System's investment in companies deemed to be external investment pools and the approximate ownership interest in each company were as follows:

	2008	2007
SEI Offshore Opportunity Fund II, Ltd.	7.5 %	0.0 %
SEI Offshore Opportunity Fund, Ltd. (held by the Foundation)	0.1	0.0
K2 Investment Partners II, L.L.C.	0.0	37.3
Third Avenue Global Value Fund L.P.	0.0	2.2
Guggenheim Plus II L.P.	0.0	1.9

Equity Method and Other Investments

The System uses the equity method of accounting for investments in companies over which the System has significant influence, but does not have effective control. The investment in these companies is not deemed to be external investment pools. Significant influence is generally deemed to exist when the System has an ownership interest in the voting stock of the investee of between 20% and 50%, although other factors, such as representation on the investee's Board of Directors, voting rights and the impact of commercial arrangements, are considered in determining whether the equity method of accounting is appropriate.

The cost method of accounting is used for investments in which the System has less than a 20% ownership interest and does not have the ability to exercise significant influence. Investments carried at cost are adjusted only for other-than-temporary declines in fair value. The System's investments accounted for under the cost method was \$0 and \$20,999 at September 30, 2008 and 2007, respectively and is included in equity method and other investments in the consolidated balance sheets.

The System's equity in the net income or losses of investments accounted for under the equity method of accounting is reported in earnings in equity method investees as a nonoperating item in the consolidated statements of operations and changes in net assets for the years ended September 30, 2008 and 2007.

Lee Memorial Health System

Notes to Consolidated Financial Statements

September 30, 2008 and 2007

(in thousands of dollars)

At September 30, 2006, the System had a significant equity method investment in Highland Enhanced Variable Rate Fund, Ltd. ("Highland"). The System had an approximate 44.2% ownership interest in Highland at September 30, 2006. The investment in Highland was sold effective September 28, 2007. At September 30, 2008 and 2007, the System's equity investment in Highland was \$0.

For the years ended September 30, 2008 and 2007, the System recorded \$0 and \$4,786, respectively, as earnings in equity method investees as a nonoperating item in the consolidated statements of operations and changes in net assets.

Joint Ventures

The System has entered into various partnership agreements to form corporations that will provide additional health care services throughout the community. The System's equity interest in each corporation is 50%. The System's investments are being accounted for under the equity method and each has been recorded at the amount of capital contributions, including cash contributions and the fair value of fixed assets contributed, adjusted for earnings or losses for each.

Functional Expenses

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

Risk Management

The System is exposed to various risks of loss from torts; theft of, damage to, and destruction of assets; business interruption; errors and omissions; employee injuries and illnesses; natural disasters; and employee health, dental, and accident benefits. Commercial insurance coverage is purchased for claims arising from such matters. Settled claims have not exceeded this commercial coverage in the current or preceding year.

Self-Insurance Programs

Estimated liabilities for self-insured medical malpractice, employee health and workers' compensation claims include estimates of the ultimate costs for both reported claims and claims incurred but not reported.

Income Taxes

The System is a special purpose unit of local government created by the Enabling Act. Certain of the System's controlled subsidiaries have been recognized by the Internal Revenue Service as tax-exempt organizations described in Section 501(c)(3) of the Internal Revenue Code (the "Code"). Income earned in furtherance of the System's tax-exempt or governmental purpose is exempt from federal and state income taxes. The Code provides for taxation of unrelated business income under certain circumstances. The System has no significant unrelated business income; however, such status is subject to final determination upon examination of the related income tax returns by the appropriate taxing authorities.

Lee Memorial Health System

Notes to Consolidated Financial Statements

September 30, 2008 and 2007

(in thousands of dollars)

Net Assets

Net assets of the System are classified in four components. Net assets invested in capital assets, net of related debt, consist of capital assets net of accumulated depreciation and reduced by the current balances of any outstanding borrowings used to finance the purchase or construction of those assets. Restricted expendable net assets are noncapital net assets that must be used for a particular purpose, as specified by creditors, grantors, or contributors external to the System, including amounts deposited with trustees as required by revenue bond indentures. Restricted nonexpendable net assets equal the principal portion of permanent endowments. Unrestricted net assets are the remaining net assets that do not meet the definition of invested in capital assets, net of related debt, or restricted.

Resources restricted by donors or grantors for specific operating purposes are reported in other operating revenue to the extent used in the period.

Operating Revenues and Expenses

The System's consolidated statement of operations distinguishes between operating and nonoperating revenues and expenses. Operating revenues result from exchange transactions associated with providing health care services, the System's principal activity. Non-exchange revenues, including taxes, grants, and contributions received for purposes other than capital asset acquisition, are reported as nonoperating items. Operating expenses are all expenses incurred to provide health care services, other than financing costs.

Concentrations of Credit Risk

Financial instruments which potentially subject the System to concentrations of credit risk consist principally of cash and cash equivalents, short- and long-term investments, equity method and other investments, patient accounts receivable, other assets and assets whose use is restricted under bond indenture agreements and by the board for future use.

The System places its cash and cash equivalents with what management believes to be high credit quality financial institutions. Included in cash and cash equivalents are bank deposits in the amount of approximately \$8,750 and \$7,223 as of September 30, 2008 and 2007, respectively. The System's short-term investments and assets whose use is restricted are primarily invested in time deposits with high credit quality financial institutions, U.S. Treasury bonds and notes, government-backed mortgage securities, high credit quality corporate notes and common stock. Long-term investments include high credit quality corporate notes, mutual funds invested in high credit quality long-term government and corporate notes, common stock and equity method and other investments.

Lee Memorial Health System
Notes to Consolidated Financial Statements
September 30, 2008 and 2007

(in thousands of dollars)

The System grants credit without collateral to its patients, most of who are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors as of September 30 is as follows:

	2008	2007
Medicare	23 %	26 %
Medicaid	14	8
Managed care	22	21
Commercial insurance	9	7
Self-pay and other	32	38
	<u>100 %</u>	<u>100 %</u>

New Accounting Pronouncements

In June 2007, the GASB issued GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, to provide guidance regarding how to identify, account for, and report intangible assets. This statement requires that an intangible asset be recognized in the statement of net assets only if it is considered identifiable. Additionally, this statement establishes a specified-conditions approach to recognizing intangible assets that are internally generated, provides guidance on recognizing internally generated computer software as an intangible asset, and on determining the useful life of intangible assets when the length of their life is limited by contractual or legal provisions. The requirements of this statement are effective for financial statements for periods beginning after June 15, 2009. The System is currently evaluating the impact that GASB Statement No. 51 will have on its financial statements.

In June 2008, the GASB issued GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, which addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments and provides a comprehensive framework for the measurement, recognition, and disclosure of derivative instrument transactions. A key provision in this Statement is that derivative instruments covered in its scope are reported at fair value. The changes in fair value of derivative instruments that are classified as hedging derivative instruments are reported in the statement of net assets as deferrals. Alternatively, the changes in fair value of derivative instruments considered to be ineffective hedges are reported in the statement of operations and changes in net assets as investment income (expense) or interest income (expense). Effectiveness is determined by considering whether the changes in cash flows of fair values of the potential hedging derivative instrument substantially offset the changes in cash flows or fair values of the hedgeable item. This statement is effective for financial statements for periods beginning after June 15, 2009. The System is current evaluating the impact that GASB Statement No. 53 will have on its financial statements.

Fair Value of Financial Instruments

The carrying value of net accounts receivable accrued liabilities (other than liabilities for malpractice and workers' compensation claims) and accounts payable approximates fair value due to the short-term nature of these accounts. Long-term receivables under agreement, less allowance for doubtful accounts, are valued by management to approximate fair market value. Malpractice and workers' compensation liabilities are stated at estimated fair value.

Lee Memorial Health System

Notes to Consolidated Financial Statements

September 30, 2008 and 2007

(in thousands of dollars)

The carrying amount of the Hospital Revenue Bonds at rates which vary with the market approximates the fair value of these instruments, as their interest rates approximate the rates available to the System for debt of similar types and maturities. The fair value of the Hospital Revenue Bonds issued at fixed rates was approximately \$349,173 and \$466,076 at September 30, 2008 and 2007, respectively.

Reclassifications

Certain items in the 2007 financial statements have been reclassified to conform to the 2008 presentation. These reclassifications had no effect on net assets, changes in net assets, or cash flows.

2. Third-Party Payors

The System has agreements with third-party payors that provide for payment at amounts different from its established rates. A summary of the basis of payment with major third-party payors follows:

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The System 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 governmental review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs.

Medicare

Inpatient acute care services, rehabilitative services, skilled nursing services, hospital outpatient services and home health services rendered to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors.

The System's Medicare cost reports have been audited and final settlements determined by the Medicare intermediary for all years through September 30, 2006. Retroactive adjustments for cost report settlements are accrued on an estimated basis in the period when the related services are rendered and adjusted in future periods when final settlements are determined.

Medicaid

Inpatient and outpatient services (except for laboratory and pathology services) rendered to Medicaid program beneficiaries are reimbursed under a cost reimbursement methodology. Reimbursable cost is determined in accordance with the principles of reimbursement established by the Florida Title XIX Hospital Reimbursement Plan, supplemented by the Medicare Principles of Reimbursement. The interim rates are tentatively established on an individual per diem basis for each hospital, subject to cost ceilings with exceptions. The System is reimbursed at a tentative interim rate with final settlement determined when the prospectively determined rate is adjusted after the intermediary audit of the combined Medicare and Medicaid cost report that was used to determine the prospective rate. Retroactive adjustments for interim rate changes anticipated after the intermediary audit of the cost report are accrued in the period when final settlements are determined.

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The System's Medicaid interim rates are based on the most recent "as filed" Medicare/Medicaid cost reports. The rates used in 2008 were based on the unaudited cost reports for 2006 and 2007.

The System's classification of patients and the appropriateness of their admission are subject to review by the fiscal intermediaries administering the Medicare and Medicaid programs.

Other

The System has also entered into payment arrangements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment to the System under these arrangements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined rates. Some of these arrangements provide for review of paid claims for compliance with the terms of the contract and result in retroactive settlement with third parties. Retroactive adjustments for other third party claims are recorded in the period when final settlement is determined.

3. Net Patient Service Revenue

Net patient service revenue, including subagency service revenue, for the years ended September 30 consists of the following:

	2008	2007
Gross patient service revenue	\$ 3,061,587	\$ 2,807,176
Third-party payor and other contractual adjustments	(2,012,059)	(1,782,092)
Provisions for doubtful accounts	<u>(112,205)</u>	<u>(117,488)</u>
Net patient service revenue	<u>\$ 937,323</u>	<u>\$ 907,596</u>

4. Assets Whose Use Is Restricted

Assets whose use is restricted which are required to meet current obligations of the System are reported in current assets. The fair market value of assets whose use is restricted at September 30 consists of the following:

	2008	2007
Held by trustee under bond indenture agreements	\$ 11,497	\$ 11,285
Held by trustee under note payable agreement	3,229	2,904
Held by Board for future use	321	367
Held in trust for other uses	<u>16,624</u>	<u>17,190</u>
Total assets whose use is restricted	31,671	31,746
Less: Amounts required to meet current obligations	<u>(13,818)</u>	<u>(11,652)</u>
Assets whose use is restricted, net of amounts required to meet current obligations	<u>\$ 17,853</u>	<u>\$ 20,094</u>

Investments which comprise assets whose use is restricted are included in the general investment portfolios of the System.

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5. Investments

The System has assessed the custodial credit risk, concentration of credit risk, credit risk and interest rate risk of its investments and assets whose use is restricted below.

- a. **Custodial Credit Risk** – The custodial credit risk for deposits is the risk that, in the event of the failure of a depository financial institution, the System will not be able to recover deposits or will not be able to recover collateral securities that are in the possession of an outside party. The System’s deposits are exposed to custodial credit risk if they are not covered by depository insurance and the deposits are uncollateralized, collateralized with securities held by the pledging financial institution or collateralized with securities held by the pledging financial institution’s trust department or agent but not held in the System’s name.

At September 30, 2008, the System’s investments were not exposed to custodial credit risk since the full amount of investments were insured or registered, or securities held by the System or its agent, in the System’s name.

- b. **Concentration of Credit Risk** – This is the risk of loss attributed to the magnitude of the System’s investment in a single issuer. Disclosure is required for investments in any one issuer that represent 5% or more of total investments. Investments issued or explicitly guaranteed by the U.S. government and investments in mutual funds, external investment pools, and other pooled investments are excluded from this requirement. The System’s investment policy states that no corporate fixed income issue shall represent more than 5% of any portfolio at the time of purchase, nor shall any single corporate position exceed 10%. Equity assets of any one issuer, when purchased, shall represent no more than 3% of the portfolio and shall not grow to exceed 10%.
- c. **Credit Risk** – This is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The System’s investment policy provides guidelines for its fund managers and lists specific allowable investments. The policy provides for the utilization of varying styles of managers so that portfolio diversification is maximized and total portfolio efficiency is enhanced.

The credit risk profile of the System’s long and short-term investments and assets whose use is restricted as of September 30, 2008 is as follows:

	Ratings for 2008					
	Fair Value	AAA	AA	A	BBB	N/A
Commercial paper and money market funds	\$ 64,512	\$ 3,882	\$ -	\$ -	\$ -	\$ 60,630
U.S. Government agencies	3,021	3,021	-	-	-	-
Corporate obligations	1,014	25	25	-	-	964
Mutual funds	266,970	-	-	-	-	266,970
External investment pools	80,643	-	-	-	-	80,643
	\$ 416,160	\$ 6,928	\$ 25	\$ -	\$ -	\$ 409,207

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- d. Interest Rate Risk – This is the risk that changes in interest rates will adversely affect the fair value of an investment. The System’s investment policy authorizes a strategic asset allocation that is designed to provide an optimal return over the System’s investment horizon within the System’s risk tolerance and cash requirements.

The distribution of the System’s long and short-term investments and assets whose use is restricted by maturity as of September 30, 2008 is as follows:

Investment Maturities for 2008						
	Fair Value	Less than 1 Year	13 to 24 Months	25 to 60 Months	Greater than 60 Months	N/A
Commercial paper and money market funds	\$ 64,512	\$ 3,882	\$ -	\$ -	\$ -	\$ 60,630
U.S. Government agencies	3,021	-	-	3,021	-	-
Corporate obligations	1,014	50	-	-	964	-
Mutual funds	266,970	-	-	-	-	266,970
External investment pools	80,643	-	-	-	-	80,643
	<u>\$ 416,160</u>	<u>\$ 3,932</u>	<u>\$ -</u>	<u>\$ 3,021</u>	<u>\$ 964</u>	<u>\$ 408,243</u>

During the years ended September 30, 2008 and 2007, the System recognized net gains of approximately \$43,762 and \$32,380, respectively, from the sale of investments. Realized gains and losses on investments that had been held for more than one fiscal year and sold in the current year were included as a change in the fair value of investments reported in the prior year(s) and the current year. The calculation of realized losses is independent of the calculation of the net increase in the fair value of investments. The net (decrease) increase in the fair value of investments and equity method investments were approximately (\$87,574) and \$9,979 for the years ended September 30, 2008 and 2007, respectively. This amount takes into account all changes in fair value (including purchases and sales) that occurred during the year. The net unrealized (loss) gain on investments and equity method investments held at September 30, 2008 and 2007 was approximately (\$49,850) and \$53,626, respectively.

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6. Capital Assets

Capital asset additions, retirements and balances for the years ended September 30, 2008 and 2007 were as follows:

	Balance at September 30, 2007	Additions and Transfers	Retirements and Transfers	Balance at September 30, 2008
Land	\$ 123,229	\$ 2,989	\$ -	\$ 126,218
Buildings and improvements	310,380	19,598	(158)	329,820
Equipment	415,782	27,900	(613)	443,069
Totals at historical cost	849,391	50,487	(771)	899,107
Less: Accumulated depreciation for				
Buildings and improvements	(218,092)	(27,402)	282	(245,212)
Equipment	(202,771)	(29,231)	473	(231,529)
	(420,863)	(56,633)	755	(476,741)
Construction-in-progress	153,049	95,338	(41,841)	206,546
Capital assets, net	<u>\$ 581,577</u>	<u>\$ 89,192</u>	<u>\$ (41,857)</u>	<u>\$ 628,912</u>
	Balance at September 30, 2006	Additions and Transfers	Retirements and Transfers	Balance at September 30, 2007
Land	\$ 21,167	\$ 102,062	\$ -	\$ 123,229
Buildings and improvements	255,217	55,163	-	310,380
Equipment	368,061	47,837	(116)	415,782
Totals at historical cost	644,445	205,062	(116)	849,391
Less: Accumulated depreciation for				
Buildings and improvements	(194,976)	(23,116)	-	(218,092)
Equipment	(175,870)	(26,991)	90	(202,771)
	(370,846)	(50,107)	90	(420,863)
Construction-in-progress	39,994	318,117	(205,062)	153,049
Capital assets, net	<u>\$ 313,593</u>	<u>\$ 473,072</u>	<u>\$ (205,088)</u>	<u>\$ 581,577</u>

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Construction-in-progress ("CIP") at September 30, 2008 consists primarily of construction cost for the new hospital facility adjacent to GCH at Daniels Parkway and Metro Parkway (the "Project"), computer equipment, surgical equipment and building renovations and improvements. There were numerous projects underway at September 30, 2008, which were being funded both through operations and by assets designated by the System's Board of Directors for the replacement of plant and equipment. As of September 30, 2008, estimated costs to complete the projects were approximately \$151,000. For the years ended September 30, 2008 and 2007, the System capitalized interest of approximately \$7,471 and \$2,954, respectively.

Depreciation expense was approximately \$56,644 and \$50,107 for the years ended September 30, 2008 and 2007, respectively.

7. Other Assets

Other assets as of September 30 consist of the following:

	2008	2007
Goodwill (Notes 12 and 13)	\$ 111,511	\$ 111,511
Debt issuance costs	10,308	10,307
Accumulated amortization	<u>(2,578)</u>	<u>(2,102)</u>
Debt issuance costs, net	<u>7,730</u>	<u>8,205</u>
Long-term receivables	8,310	15,256
Allowance for doubtful accounts	<u>(4,747)</u>	<u>(8,166)</u>
Long-term accounts receivable, net	<u>3,563</u>	<u>7,090</u>
Deposits and other	81	930
Investments in joint ventures	<u>2,374</u>	<u>3,399</u>
Other assets	<u>2,455</u>	<u>4,329</u>
Other assets, net	<u>\$ 125,259</u>	<u>\$ 131,135</u>

Long-term receivables relate to medical charges for patients who have been identified as parties to litigation. Collections, which are pending determination by negotiation or legal proceedings, accordingly are classified as non-current. The allowance for doubtful accounts is based on the expected collectability of these receivables.

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8. Long-Term Debt

Long-term debt as of September 30 consists of the following:

	2008	2007
Conversion of Hospital Revenue Refunding Bonds, 2003 Series A, LMHS Trust	\$ 52,800	\$ -
Hospital Revenue Bonds, 2007 Series A, payable in variable semi-annual installments beginning April 2009 through April 2037. Net of unamortized premium of \$9,075 in 2008	279,925	280,243
Hospital Revenue Refunding Bonds, 2005 Series A, payable in variable semi-annual installments beginning October 2005 through April 2024. Net of unamortized premium of \$1,537 and \$1,636, and deferred expense of \$3,761 and \$3,996 in 2008 and 2007, respectively	55,811	56,750
Hospital Revenue Refunding Bonds, 2003 Series A, payable in variable semi-annual installments beginning April 2028 through April 2033	-	52,800
Hospital Revenue Refunding Bonds, 2002 Series A, payable in variable semi-annual installments beginning November 2002 through April 2020, net of unamortized premium of \$985 and \$1,027 and deferred expense of \$1,397 and \$1,517 in 2008 and 2007, respectively	44,213	48,365
Variable Rate Hospital Revenue Bonds, 1997 Series B, payable in variable semi-annual installments beginning April 2025 through April 2027	61,505	61,505
Hospital Revenue Refunding Bonds, 1997 Series C, payable in variable annual installments through April 2020, net of unamortized discount of \$36 and \$39 and deferred expense of \$2,319 and \$2,512 in 2008 and 2007, respectively	33,930	36,768
Hospital Revenue Refunding Bonds, 1995 Series A, payable in variable annual installments beginning April 2017 through April 2025	40,000	40,000
Variable Rate Hospital Revenue Bonds, 1992 Series B, payable in variable annual installments through April 2022	38,700	40,400
Variable Rate Hospital Revenue Bonds, 1985 Series C and D, payable in variable annual installments beginning April 2014 through April 2020	40,000	40,000
Notes payable and capital leases	15,170	8,515
	<u>662,054</u>	<u>665,346</u>
Less: Current installments	<u>(13,163)</u>	<u>(11,514)</u>
	<u>\$ 648,891</u>	<u>\$ 653,832</u>

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Long-term liability activity for the years ended September 30, 2008 and 2007 were as follows:

	Balance			Balance	Amounts
	September 30,	Additions	Reductions	September 30,	Due Within
	2007			2008	One Year
Bonds					
LMHS Trust	\$ -	\$ 52,800	\$ -	\$ 52,800	\$ -
2007 Series A	280,243	-	(318)	279,925	460
2005 Series A	56,750	-	(939)	55,811	1,245
2003 Series A	52,800	-	(52,800)	-	-
2002 Series A	48,365	-	(4,152)	44,213	4,350
1997 Series B	61,505	-	-	61,505	-
1997 Series C	36,768	-	(2,838)	33,930	2,790
1995 Series A	40,000	-	-	40,000	-
1992 Series B	40,400	-	(1,700)	38,700	2,200
1985 Series C and D	40,000	-	-	40,000	-
Other	8,515	8,646	(1,991)	15,170	2,118
Total long-term liabilities	<u>\$ 665,346</u>	<u>\$ 61,446</u>	<u>\$ (64,738)</u>	<u>\$ 662,054</u>	<u>\$ 13,163</u>

	Balance			Balance	Amounts
	September 30,	Additions	Reductions	September 30,	Due Within
	2006			2007	One Year
Bonds					
2007 Series A	\$ -	\$ 280,402	\$ (159)	\$ 280,243	\$ -
2005 Series A	57,689	-	(939)	56,750	1,075
2003 Series A	52,800	-	-	52,800	-
2002 Series A	52,386	-	(4,021)	48,365	4,230
1997 Series B	61,505	-	-	61,505	-
1997 Series C	39,173	-	(2,405)	36,768	3,035
1995 Series A	40,000	-	-	40,000	-
1992 Series B	42,200	-	(1,800)	40,400	1,700
1985 Series C and D	40,000	-	-	40,000	-
Bridge loan	-	277,980	(277,980)	-	-
Other	6,536	3,092	(1,113)	8,515	1,474
Total long-term liabilities	<u>\$ 392,289</u>	<u>\$ 561,474</u>	<u>\$ (288,417)</u>	<u>\$ 665,346</u>	<u>\$ 11,514</u>

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Maturities under the long-term debt agreements, including interest, previously described are as follows:

Years Ending	Total	Principal	Interest
2009	\$ 40,531	\$ 11,045	\$ 29,486
2010	40,512	11,495	29,017
2011	40,504	11,990	28,514
2012	40,494	12,510	27,984
2013	40,520	13,170	27,350
2014-2018	206,721	79,940	126,781
2019-2023	207,339	100,260	107,079
2024-2028	200,832	116,825	84,007
2029-2033	199,973	143,545	56,428
2034-2037	160,303	142,020	18,283
	<u>\$ 1,177,729</u>	<u>\$ 642,800</u>	<u>\$ 534,929</u>

In April 2007, the System issued Hospital Revenue Bonds, 2007 Series A, in the amount of \$270,850. The 2007 Series A bonds were issued as fixed-rate bonds with interest payable semiannually on April 1 and October 1 of each year. The proceeds of the 2007 Series A bonds were used to replace the temporary bank loan established with Bank of America, N.A. to fund the purchase of SWR and GCH. The 2007 Series A bonds are comprised of \$262,345 of serial bonds bearing interest at a rate ranging from 4.5% to 5.25% as the bonds mature, and \$8,505 in term bonds bearing interest at 4.0% to 5.0%.

In August 2005, the System issued \$62,030 in Hospital Revenue Refunding Bonds, 2005 Series A. The bonds were issued as fixed-rate bonds with interest payable semiannually on April 1 and October 1 of each year. The proceeds of these bonds were used to advance refund \$58,015 of the 1997 Series A Hospital Revenue Bonds. The refunded portion of the 1997 Series A bonds is considered to be defeased and the liability for these bonds was removed from the System's consolidated financial statements. The 2005 Series A bonds are comprised of \$12,490 of serial bonds bearing interest at a rate ranging from 3.0% to 4.125% as the bonds mature, and \$49,540 in term bonds bearing interest at 4.25 to 5.0%.

Although the advanced refunding resulted in the recognition of an accounting loss of approximately \$4.5 million for the year ended September 30, 2005, the System in effect reduced its aggregate debt service payments by \$5.7 million over the next 19 years and obtained an economic gain (the difference between the present values of the old and new debt service payments) of \$4.0 million. The accounting loss is amortized over the life of new bonds.

In connection with the advance refunding, the System recorded an initial deferred expense of approximately \$4,506 associated with the unamortized 1997 Series A bond issue costs. The System amortizes the deferred expense ratably over the life of the 2005 Series A bonds and at September 30, 2008 and 2007, the 2005 Series A bonds are recorded net of \$3,761 and \$3,996, respectively. Proceeds from the 2005 Series A bonds have been deposited with a trustee. Escrowed funds are restricted for payment of the principal and interest of the refunded bonds as they come due. The escrowed funds were paid out in full on April 1, 2007.

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In December 2003, the System issued Hospital Revenue Bonds, 2003 Series A, in the amount of \$52,800. The 2003 Series A bonds were issued as Auction Reset Securities ("ARS") and bear interest at ARS rates determined by the auction agent for varying auction periods. Interest on the bonds is payable on a predetermined maturity date as set by the auction agent. The majority of the proceeds of the 2003 Series A bonds were used to fund the 122-bed expansion at HealthPark Medical Center. Simultaneously with this bond issue, the System entered into an interest-rate swap agreement, effectively converting the \$52,800 of variable-rate debt to fixed rates for a 10-year period. The resulting cost of funds is lower than it would have been had fixed-rate borrowing been issued directly.

In May 2008, the conversion of Hospital Revenue Refunding Bonds, 2003 Series A, LMHS Trust (the "Trust") was established and utilized to exit the failing auction rate market and preserve the Ambac bond insurance premium on the 2003 Series A bonds. Bank of America, N.A. has provided the System with a loan in the amount of \$52.8 million. The loan is a tax-exempt issuance of debt and carries a variable interest rate reset monthly based upon one month LIBOR. Proceeds from the loan were used to fund the Trust. The Trust then used those proceeds to purchase the 2003 Series A bonds as variable rate bonds which is considered an in-substance defeasance of these bonds. As such, the liability for these bonds was removed from the System's consolidated financial statements. The System is indifferent to the interest rate on the 2003 Series A bonds since all interest paid to the Trust is reimbursed back to the System as the sole beneficiary of the Trust. Therefore, the effective cost of the Trust is the interest on the Bank of America, N.A. loan. The transaction resulted in no economic gain or loss (the difference of old and new debt service payments) to the System. The Bank of America, N.A. loan becomes due and payable in May 2009. A commitment is currently in place to restructure this debt to long-term variable rate bonds. The anticipated closing date for the refinancing is scheduled for February 2009.

During the year ended September 30, 2002, a modification to the System's existing variable rate debt and a current refunding occurred. In January 2002, the System's \$191,505 variable rate debt (Series 1985 C and D, 1992 Series B, 1995 Series A, and 1997 Series B) was converted from a flexible rate of interest to a daily or weekly rate of interest. These bonds are backed by a revolving credit facility, explained in more detail below. In April 2002, \$68,055 in fixed rate debt was issued (Series 2002A Bonds) to current refund the 1992 Series A Bonds. Although the advance refunding resulted in the recognition of an accounting loss of \$2.2 million (which is being amortized over the life of the Series 2002 A bonds) for the year ended September 30, 2003, the System in effect reduced its aggregate debt service payments by \$6.0 million over the next 18 years and obtained an economic gain (the difference between the present values of the old and new debt service payments) of \$3.9 million. The System amortizes the accounting loss over the life of the 2002 Series A bonds and at September 30, 2008 and 2007, the 2002 Series A bonds are recorded net of \$1,397 and \$1,517, respectively.

In April 1997, the System issued Hospital Revenue Bonds, 1997 Series A and Series B, in the amount of \$61,505, net of \$1,200 in bond discounts, and \$61,505, respectively. The proceeds of the 1997 Series A and Series B bonds were used to liquidate the securities loan agreement used to purchase Cape Coral Hospital (Note 12). In August 2005, the 1997 Series A bonds were advance refunded through the issuance of the 2005 Series A bonds. The Series B bond is a term bond that bears interest at a variable rate which is payable based upon predetermined maturity dates established by the remarketing agent, under the terms of a remarketing agreement. At September 30, 2008 and 2007, the interest rate on the bonds was approximately 2.4% and 3.6%, respectively. The bonds are to be remarketed at varying maturities not to exceed 117 days.

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In August 1997, the System issued Hospital Revenue Refunding Bonds, 1997 Series C, in the amount of \$54,265. The Series C bonds include \$23,930 in serial bonds which bear interest at an initial rate of 5% increasing to 6% as the bonds mature through 2010 and interest is payable semi-annually on April 1 and October 1 of each year. The Series C bonds also include \$30,335 in 5% fixed rate term bonds due in varying amounts between April 1, 2017 and April 1, 2020. The proceeds of the 1997 Series C bonds were used to advance refund \$50,000 of outstanding 1991 Series A Hospital Revenue Bonds, consisting of \$25,000 Periodic Auction Reset Securities ("PARS") and \$25,000 of Inverse Floating Rate Securities ("INFLOS"). The refunded portion of the 1991 Series A PARS and INFLOS is considered to be defeased, and the liability for these bonds was removed from the System's consolidated financial statements.

In connection with the advance refunding, the System recorded an initial deferred expense of approximately \$4,445 associated with the unamortized 1991 Series A bond issue costs. The System amortizes the deferred expense ratably over the life of the 1997 Series C bonds and at September 30, 2008 and 2007, the 1997 Series C bonds are recorded net of \$2,319 and \$2,512, respectively.

In June 1995, the System issued Hospital Revenue Refunding Bonds, 1995 Series A in the amount of \$40,000. The proceeds of the 1995 Series A bonds were used to pay or reimburse the System for prior expenditures relating to the acquisition, construction, improvement and equipping of certain capital improvements to the System's hospital facilities including the acquisition of various physician practices and improvements to the Hospital's emergency room.

In July 1992, the System issued \$50,000 of Hospital Revenue Bonds, 1992 Series B. The majority of the proceeds of the 1992 Series B bonds were used to pay or reimburse the System for prior expenditures relating to the acquisition, construction, improvement and equipping of certain capital improvements to System facilities, and the acquisition of land for the construction of the 90 bed skilled nursing facility owned by HPCC.

In connection with the offering of the 1992 Series B bonds, the System converted the \$40,000 of Hospital Revenue Bonds, Series 1985. The proceeds from the Series 1985 bonds had been used to refinance certain existing debt, reimburse the System for certain capital expenditures, acquire certain facilities leased by the System and construction of a 220 bed hospital/medical office building.

The Series 1985 C and D, 1992 Series B, 1995 Series A, and the 1997 Series B bonds bear interest at variable rates determined by the remarketing agent (not to exceed 12%) for periods not to exceed 180 days. The Series 1985 C and D, 1992 Series B, 1995 Series A, and 1997 Series B bonds are subject to conversion from time to time to bear interest at variable rates or at a fixed rate. Interest is payable on a predetermined maturity date as determined by the remarketing agent. The effective interest rate on the converted Series 1985 C and D, 1992 Series B, 1995 Series A, and 1997 Series B bonds for the years ended September 30, 2008 and 2007 was approximately 2.7% and 3.6%, respectively.

The agreements between the System and the Trustee for the bonds provide for the establishment of specific accounts at various times to be held by the Trustee for the payment of construction costs, principal and interest and replacement of property and equipment.

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The Series 1985 C and D, 1992 Series B, 1995 Series A and 1997 Series B bonds are collateralized by a line of credit established with a bank in an aggregate amount not to exceed \$185,205 which expires on June 24, 2010. The bonds would be subject to mandatory tender for purchase by the System within 180 days should this line of credit expire and the System not obtain an acceptable alternative line of credit or liquidity facility. The System is required to pay an annual facility fee equal to .25% of the available amount under the line of credit facility.

As of September 30, 2008, a portion of the bonds covered by the line of credit agreement were tendered by the remarketing agent and total approximately \$101 million. These bonds have been tendered and remarketed many times both before and after September 30, 2008. The System has a commitment to replace the line of credit with a Direct Pay Letter of Credit and a direct loan in early 2009. As such, the bonds are classified as long-term in accordance with the repayment schedule. This will allow the bonds to trade with the ratings of the banks participating. It is expected to reduce the actual interest expense on the outstanding debt.

The bond agreements, for certain bonds not collateralized by the line of credit, require the System to maintain specified financial ratios, the most restrictive of which are a minimum debt service coverage ratio, long-term debt to capital ratio, and minimum cash and investment balances, and provide a pledge of revenues of the System on a parity basis. The System was in compliance with the covenants for the years ended September 30, 2008 and 2007. The net assets of non-obligated group members, which includes all consolidated entities except Lee Memorial Hospital and Cape Memorial Hospital, Inc., included in the consolidated financial statements at September 30, 2008 and 2007 was \$20,462 and \$15,702, respectively.

9. Capital Lease Obligations

During 2008, the System entered into two capital lease obligations for equipment that will expire within the next five years and one for a medical office building that will expire within fifteen years. At September 30, 2008 and 2007, assets under capital leases included in capital assets were \$8,689 and \$141 respectively. The accumulated amortization for these assets was \$481 and \$54 as of September 30, 2008 and 2007, respectively. Depreciation expense of \$422 and \$56 is included in depreciation and amortization expense on the accompanying statements of operations and changes in net assets for the years ended September 30, 2008 and 2007, respectively. At September 30, 2008 and 2007, an obligation of \$8,208 and \$87, respectively, was outstanding under the capital leases. During the years ended 2008 and 2007, interest expense of \$149 and \$8, respectively, was incurred. The majority of the increase in capital lease obligations was due to the leasing of a physician medical office building strategically located on the Del Prado Road - Pine Island Road corridor. The building houses System employed primary and specialty physicians.

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Future minimum lease payments are as follows:

Years Ending	
2009	\$ 946
2010	919
2011	922
2012	942
2013	858
Later years	<u>9,316</u>
Total minimum lease payments	13,903
Less: Amount representing estimated executory costs	<u>(177)</u>
Net minimum lease payments	13,726
Less: Amount representing interest	<u>(5,696)</u>
Present value of net minimum lease payments	<u>\$ 8,030</u>

10. Retirement Plans

Tax Sheltered Annuity Plan

The System provides a single-employer tax deferred annuity program for all eligible employees who elect to participate in the program. The annuity program is administered by the System. The Lee Memorial Hospital Tax Sheltered Annuity Plan (the "Plan") purchases annuity contracts for participating employees through salary reduction, thereby deferring taxability of these amounts. For employees with three years or more of eligible service, the System participates in the Plan by matching approximately 5% of the participating employees' salaries. The Board of Directors of the System has the sole discretion to amend the Plan and change the contribution amount. Contribution expense incurred by the System in connection with the Plan was approximately \$9,588 and \$8,426 for the years ended September 30, 2008 and 2007, respectively.

Retiree Health Insurance Plan

The System's Self-Funded Employee Health Plan (the "RHI Plan"), which provides medical benefits to active employees, also provides medical benefits to eligible retired employees under a defined benefit postemployment healthcare plan. The System's Board of Directors has the authority to establish and amend the benefit provisions of the RHI Plan which includes the postemployment healthcare benefits.

The contribution requirements of the retiree RHI Plan members and the System are established and may be amended by the System's Board of Directors. Current retiree RHI Plan members who are receiving benefits do not contribute to the RHI Plan as the System covered their health insurance based on current Medicare regulations which made the RHI Plan the secondary payer with Medicare paying as the primary payer.

Effective January 1, 2009, employees who retire at age 65 or later with 20 years of continuous full-time service or equivalent part-time service will receive, if they elect retiree health coverage, a \$2,500 check each year for the rest of their life which will be increased in subsequent years by 2%.

Lee Memorial Health System
Notes to Consolidated Financial Statements
September 30, 2008 and 2007

(in thousands of dollars)

The System is required to expense the annual required contribution ("ARC") of the employer which is an amount that is actuarially determined in accordance with the parameters of GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* ("OPEB"). The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover the normal cost each year and amortize any unfunded actuarially determined liabilities (or funding excess) over a period not to exceed thirty years. The System is currently funding the OPEB on a pay-as-you-go basis so no assets have been segregated and/or restricted to provide the postemployment benefits.

The System's annual OPEB expense of \$3.85 million was equal to the ARC. For the System, GASB No. 45 is effective as of October 1, 2007 and therefore, there is no ARC calculation for fiscal year 2007. The following table shows the components of the System's ARC for the year ended September 30, 2008:

Amortization of UAAL over 30 years	\$ 1,648
Normal cost at beginning of year	2,062
Interest OPEB obligation	<u>148</u>
Annual required contribution (ARC)	<u>\$ 3,858</u>

The funded status of the RHI Plan as of September 30, 2008 was as follows:

Actuarial accrued liability (AAL)	\$ 29,628
Actuarial value of plan assets	\$ -
Unfunded actuarial accrued liability (UAAL)	\$ 29,628
Funded ratio (actuarial value of plan assets/AAL)	0.00%
Covered payroll (active plan members)	\$ 431,569
UAAL as a percentage of covered payroll	6.87%

Actuarial valuations of an ongoing plan involve estimates of the value or reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality and the healthcare cost trends. Amounts determined regarding the funded status of the plan and the annual required contribution of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future.

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and the plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarially determined accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations.

Lee Memorial Health System
Notes to Consolidated Financial Statements
September 30, 2008 and 2007

(in thousands of dollars)

In the September 30, 2008 expenses, the projected unit credit ("PUC") actuarial cost method was used as the valuation methodology. The objective under PUC is to fund each participant's benefits under the plan as they would accrue. The actuarial assumptions include a 4.0% investment rate of return along with a 2% increase in the \$2,600 amount that will be paid annually to each retiree.

Defined Benefit Retirement Plan

Effective July 1, 1996, the System became the sponsor of the frozen retirement plan of former Cape Coral Medical Center, Inc. employees (the "CCMC Plan"). This plan was frozen on September 30, 1995 by the management in place at that time. The CCMC Plan is a noncontributory, single-employer defined benefit plan, administered by a committee appointed by the System. Under the provisions of the plan, the System has the authority to make amendments. There have been no new members of the plan since the date the plan was frozen. The plan provides Life-Only annuity benefits to plan members and beneficiaries. An actuarial report is prepared each year effective June 30 and is available from the System. The funding policy of the System is to contribute an amount at least equal to the annual required contribution prescribed by GASB Statement No. 25 and 27 and determined by the actuary. Since July 1, 1996, the annual required contributions have been zero.

As of and for its year ended June 30, 2008, the CCMC Plan reported the following net assets:

Net assets	
Common stock	\$ 9,134
Fixed income	
U.S. government securities	2,945
Corporate bonds	5,760
Short-term investments	<u>1,665</u>
Held in trust for pension benefits and pool participants	<u>\$ 19,504</u>

As of and for its year ended June 30, 2008, the CCMC Plan reported the following changes in net assets:

Additions	
Interest and dividend income	<u>\$ 681</u>
Total additions	<u>681</u>
Deductions	
Benefit payments	(999)
Other investment loss	(353)
Net depreciation in the fair value of instruments	(309)
Administrative expenses	<u>(62)</u>
Total deductions	<u>(1,723)</u>
Net increase	(1,042)
Net assets	
Beginning of year	<u>20,546</u>
End of year	<u>\$ 19,504</u>

Lee Memorial Health System
Notes to Consolidated Financial Statements
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(in thousands of dollars)

The System's annual pension cost, net pension asset and contributions made to the CCMC Plan for the years ended September 30, 2008 and 2007 were \$0.

The required contribution for the current year was determined as part of the July 1, 2007 actuarial valuation using the projected unit credit actuarial cost method. There was no contribution made for the years ended September 30, 2008 and 2007. The actuarial assumptions included:

- a. Investment return was 8.0% for the years ended September 30, 2008 and 2007 for funding, the discount rate and expected long-term rate of return on plan assets.
- b. No projected salary increases as the benefits are frozen.

Annual pension cost, contribution information and net pension obligation (asset) for the last three fiscal years are as follows:

Years Ending September 30,	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
2003	\$ -	0%	\$ -
2004	-	0%	-
2005	-	0%	-
2006	-	0%	-
2007	-	0%	-
2008	-	0%	-

The CCMC Plan's funding progress is summarized as follows:

Actuarial Valuation Date*	Actuarial Value of Assets (a)	Actuarial Present Value of Future Benefits (b)	Actuarial Accrued Liability (AAL) (c)	Unfunded Actuarial Accrued Liability (c-a)	Unfunded Ratio (a) / (c)	Covered Payroll	Unfunded AAL as a % of Payroll
July 1, 2003	\$ 18,258	\$ 16,070	\$ 16,070	\$ (2,188)	113.62%	\$ -	0.00%
July 1, 2004	18,910	16,596	16,596	(2,314)	113.94%	-	0.00%
July 1, 2005	19,067	18,066	18,066	(1,001)	105.54%	-	0.00%
July 1, 2006	19,145	18,769	18,769	(376)	102.00%	-	0.00%
July 1, 2007	20,546	19,294	19,294	(1,252)	106.49%	-	0.00%
July 1, 2008	19,504	20,102	20,102	598	97.03%	-	0.00%

* Valuation on measurement dates of June 30 / July 1 are used for reporting dates of September 30 / October 1.

Lee Memorial Health System

Notes to Consolidated Financial Statements

September 30, 2008 and 2007

(in thousands of dollars)

11. Commitments and Contingencies

Operating Leases

The System leases various equipment, office space and land under operating leases, which expire at various times. Total rental expense for all operating leases was approximately \$10,807 and \$8,188 for the years ended September 30, 2008 and 2007, respectively.

The remaining rental commitments under operating leases that have initial or remaining noncancelable lease terms in excess of one year are approximately as follows:

Years Ending	
2009	\$ 9,264
2010	7,209
2011	5,958
2012	5,248
2013	4,535
Thereafter	<u>14,054</u>
	<u>\$ 46,268</u>

Lee Healthcare Resources, Inc. ("LHR"), a non-affiliated corporation, purchased the Board's Wellness Center business in July 1999. LHR operates a Wellness Center at Lee Memorial Hospital and Cape Coral Hospital. As of June 1, 2003, the System bought back the Wellness Centers located at Lee Memorial Hospital and as of November 1, 2004, the System purchased the Wellness Center's assets located on the Cape Coral Hospital campus by assuming \$4.8 million in liabilities.

Professional Liability Insurance

The System is subject to various medical malpractice claims arising in the normal course of its business activities. The Hospital is self-insured for professional liability claims and is relying on a limitation of its liability established by the Waiver of Sovereign Immunity Act of the State of Florida (the "Act"). The Act limits the amount of damages the Hospital would be required to pay up to \$100 per claimant or \$200 per incident. In 1986, the Florida Supreme Court affirmed the constitutionality of the Act and its applicability to public hospitals. Various suits and claims arising in the ordinary course of business are pending against the Hospital. Management is of the opinion that future potential uninsured losses from incidents occurring prior to September 30, 2007, if any, will not be materially different from the amounts recorded in the accompanying consolidated financial statements.

Lee Memorial Health System
Notes to Consolidated Financial Statements
September 30, 2008 and 2007

(in thousands of dollars)

Management of the System has established a liability that provides for estimated malpractice claims identified under the Hospital's incident reporting system based on several factors including the nature of each claim, past experience, advice from legal counsel and actuarial studies which reflect liabilities discounted at 4% for the years ending September 30, 2008 and 2007. The estimated claims incurred, payments on claims and the balance of the reserve for professional liability claims for the years ended September 30, 2008 and 2007 were as follows:

	2008	2007
Amount of claims liabilities at the beginning of the year	\$ 12,772	\$ 11,051
Incurred claims	2,719	5,181
Payments on claims attributable to events of both the current fiscal year and prior fiscal years	<u>(2,334)</u>	<u>(3,460)</u>
Amount of claims liabilities at the end of the year	<u>\$ 13,157</u>	<u>\$ 12,772</u>

A resolution approved by the System's Board of Directors states that the Hospital agrees that any member of its medical staff, who is adjudged to be jointly at fault with the System in a professional liability claim, shall not bear a disproportionate burden of the loss on account of the operation of the Act and the doctrine of joint and several liability. Depending upon the determination by a court of competent jurisdiction of respective percentages of liability assessed against all parties to the litigation, and the amount of the final judgment, the System may reimburse a co-defendant staff physician for any personal loss disproportionate to the System's loss. No additional liability has been recognized in the accompanying consolidated financial statements as a result of this resolution.

Cape Coral Hospital, Inc.'s professional malpractice liability insurance is covered under the System's established program under the Act, effective for claims occurring on or after October 1, 2001.

Lee Memorial Home Health, Inc.'s professional malpractice liability insurance is covered under the System's established program under the Act, effective for claims occurring on or after January 1, 2005.

The System's Board of Directors opted to cover its nursing home for professional liability using its established program under the Act, effective for claims occurring on and after October 1, 2000.

As a provider of health care services, the System is subject to malpractice claims and litigation through the normal course of operations. Certain of these matters are covered by insurance arrangements described above. Losses which are subject to the deductible provisions have been estimated and accrued in the accompanying consolidated financial statements. The System has employed independent actuaries to estimate the ultimate costs, if any, of the settlement of such claims. Management believes the established reserves are adequately stated as of September 30, 2008.

Lee Memorial Health System
Notes to Consolidated Financial Statements
September 30, 2008 and 2007

(in thousands of dollars)

Health and Dental Insurance

The System is self-insured for group health insurance. Total expenses under this program amounted to approximately \$43,665 and \$35,176 for the years ended September 30, 2008 and 2007, respectively. Total reserves for group health insurance claims payable, including an estimate for incurred but not reported claims, was approximately \$5,170 and \$3,994 at September 30, 2008 and 2007, respectively. Management believes the established reserves are adequately stated as of September 30, 2008.

Workers' Compensation Insurance

The System is self-insured for workers' compensation insurance. Management of the System has established a liability for these types of claims based on actuarial evaluations in 2008 and 2007. The reserve for workers' compensation claims included in the consolidated financial statements was discounted at a rate of 4% for the years ended September 30, 2008 and 2007. The estimated claims incurred, payments on claims and the balance of the reserve for workers' compensation claims for the years ended September 30, 2008 and 2007 were as follows:

	2008	2007
Amount of claims liabilities at the beginning of the year	\$ 10,357	\$ 11,828
Incurred claims	4,336	3,046
Payments on claims attributable to events of both the current fiscal year and prior fiscal years	<u>(3,792)</u>	<u>(4,517)</u>
Amount of claims liabilities at the end of the year	<u>\$ 10,901</u>	<u>\$ 10,357</u>

Litigation

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

12. Related Party Transactions and Relationships

Transactions with Affiliates

During June 1996, master and asset purchase agreements (the "Agreements") were executed for the purchase of substantially all of the assets of CCMC by a newly formed subsidiary of the System, Cape Coral Hospital. The purchase was effective on July 1, 1996 with \$145,000 funded into a purchase escrow account.

Proceeds from the purchase escrow account and a secondary escrow account of \$29,400, including \$5,301 in other assets, were available to satisfy obligations of CCMC including the pension plan now administered by the System. Any residuary amount remaining subject to the escrow agreements after CCMC had concluded its affairs and obligations provided for in the Agreements would be paid to the System.

Lee Memorial Health System

Notes to Consolidated Financial Statements

September 30, 2008 and 2007

(in thousands of dollars)

In August 2005, the System entered into a Plan of Transfer and Change in Control Agreement (the "New Agreement") with CCMC. Simultaneously with the execution and delivery of the New Agreement, all residual funds remaining in the escrow accounts, less \$6 million were transferred to the System. The receipt of these escrowed funds resulted in a reduction in goodwill of \$22.8 million and the satisfaction of the escrow account receivable, including interest. The \$6 million was placed in a new escrow account (included in other current assets) and will be used to cover a limited number of identified remaining liabilities and obligations of CCMC. Pursuant to the New Agreement, the \$6 million will be released to the System over a six-year period as follows: \$2 million upon expiration of Year 2, \$2 million upon expiration of Year 4 and the final \$2 million plus accrued interest upon expiration of the contract in Year 6. Each scheduled disbursement is subject to the approval of the CCMC Board of Directors. During fiscal year 2007, the System received the first disbursement from the escrow, which resulted in a reduction in goodwill.

The System has a 50% ownership interest in a joint venture with another local-area governmental health care system. The System is accounting for the joint venture under the equity method of accounting. The purpose of the joint venture was to develop a regional service center, LEESAR HealthTrust Partners, LC ("LEESAR"), to meet the materials services and distribution needs of both health care systems. The investment in LEESAR, which is included in long-term other assets, was \$4,191 and \$3,730 at September 30, 2008 and 2007, respectively. Excess of revenues over expenses for LEESAR was approximately \$923 and \$583 for the years ended September 30, 2008 and 2007, respectively.

The System also owns a 50% interest in Bonita Community Health Center ("BCHC"), a not-for-profit organization. BCHC operates an urgent care center, an ambulatory surgical care center, a diagnostic imaging center and an outpatient rehabilitation center in Estero, Florida. Additionally, BCHC leases office space to physicians and other healthcare providers. The investment in BCHC is accounted for using the equity method. In conjunction with the issuance of long-term debt for the construction and equipping of the BCHC facility, the System has provided an unconditional guarantee to pay 50% of the obligations related to this debt should BCHC default. As of September 30, 2008, total long-term debt outstanding at BCHC was \$27,106. BCHC had net losses of \$3,003 and \$1,783 for the years ended September 30, 2008 and 2007, respectively.

LMR Imaging is a general partnership (the "Partnership") between Central Fort Myers Resources, Inc. and the System. The Partnership operates medical diagnostic imaging centers located at each of the three acute care hospital campuses and offsite locations at HealthPark and Riverwalk. The System's ownership interest in the general diagnostic and MRI business is 70% and 30%, respectively.

Access Medical South is a partnership between Morton Plant Hospital Association and the System to provide durable medical equipment services. The System's ownership interest in Access Medical South is 50%.

Access Infusion Partners was formed as a partnership between PHM of S.W. Florida, Inc. and the System to provide and administer intravenous therapy and related services. The System's ownership interest in Access Infusion Partners is 50%.

Lee Memorial Health System
Notes to Consolidated Financial Statements
September 30, 2008 and 2007

(in thousands of dollars)

13. Acquisition of New Hospitals

Effective October 1, 2006, the System acquired 100 percent ownership of the Southwest Florida Regional Medical Center ("SWR") and Gulf Coast Hospital ("GCH") located in Lee County from HCA. In addition to these two hospitals, the purchase included all other related businesses, land, and subsidiaries located within Lee County, and the rights to proceed with the construction of the new hospital facility adjacent to Gulf Coast Hospital at Daniels Parkway and Metro Parkway. The results of SWR's and GCH's operations have been included in the consolidated financial statements since that date.

At the time of the acquisition the System's strategic initiatives were to improve and strengthen services to meet the needs of the community, to pursue continuous improvement in quality and safety, to improve financial performance and to be the community's healthcare provider of choice. Achieving these goals required development and implementation of an effective integrated delivery system, creation of information systems that support an integrated delivery system and streamlined business systems, and improved care delivery processes, the implementation of recruitment and retention strategies to attract and retain a quality workforce, and the continued improvement of facilities that support the strategic initiatives of the System.

The acquisition supports these strategic initiatives by providing an opportunity to redesign healthcare services to optimize quality, access and financial outcomes, create economies of scale in supply purchasing and distribution and consolidation of all other administrative functions, avoid duplication of capital costs and reducing costs through greater operational efficiencies. For the community it meant better and more options in terms of servicing their health needs, increased opportunities to focus on community-wide initiatives focused on improving quality and a larger platform for providing services to the growing service area.

The aggregate purchase price was \$277.8 million including \$24.0 million in patient accounts receivable, \$8.4 million in inventory and other current assets, \$21.2 million in liabilities and \$169.6 million in property, plant and equipment which included the funds already spent toward the Project.

The following table summarizes the fair values of the assets acquired and liabilities assumed at the date of the acquisition.

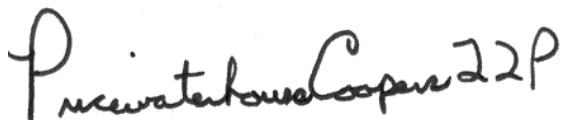
(in thousands of dollars)

Current assets	\$ 24,015
Property, plant and equipment	169,584
Inventory	7,859
Other assets	561
Goodwill	<u>97,065</u>
Total assets acquired	<u>299,084</u>
Current liabilities	(21,109)
Long-term debt	<u>(140)</u>
Total liabilities assumed	<u>(21,249)</u>
Net assets acquired	<u>\$ 277,835</u>

**Report of Independent Certified Public Accountants
on Accompanying Consolidating Information**

To the Board of Directors of
Lee Memorial Health System

The report on our audits of the consolidated financial statements of Lee Memorial Health System as of September 30, 2008 and 2007 and for the years then ended appears on page 15 of this document. Those audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations and cash flows of the individual companies. Accordingly, we do not express an opinion on the financial position, results of operations and cash flows of the individual companies. However, the consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.



January 12, 2009

Lee Memorial Health System
Consolidating Balance Sheet
September 30, 2008

Schedule I

(in thousands of dollars)

	Lee Memorial Hospital	Cape Memorial Hospital, Inc.	Gulf Coast Medical Center	Other	Lee Memorial Health System Foundation, Inc.	Eliminations	Total
Assets							
Current assets							
Cash and cash equivalents	\$ 7,589	\$ -	\$ 35	\$ 2	\$ 8,929	\$ -	\$ 16,555
Short-term investments	384,389	-	-	-	-	-	384,389
Equity method and other investments	-	-	-	-	-	-	-
Assets whose use is restricted	3,583	3,413	6,822	-	-	-	13,818
Patient accounts receivable, net	83,759	20,782	36,722	3,511	-	-	144,774
Inventories	14,023	4,348	8,348	17	-	-	26,736
Other current assets	16,255	61	1,163	38	958	-	18,475
Total current assets	509,598	28,604	53,090	3,568	9,887	-	604,747
Noncurrent assets							
Long-term investments	100	-	-	-	-	-	100
Assets whose use is restricted	3,229	2,645	-	22	11,957	-	17,853
Capital assets, net	246,910	74,514	303,243	4,244	1	-	628,912
Due from subsidiaries	73,738	101,580	-	-	-	(175,318) (a)	-
Other assets, net	66,706	16,241	98,437	1,040	1,625	(58,790) (b)	125,259
Total assets	\$ 900,281	\$ 223,584	\$ 454,770	\$ 8,874	\$ 23,470	\$ (234,108)	\$ 1,376,871

(a) To eliminate intercompany receivables and payables.

(b) To eliminate investments in subsidiaries.

Lee Memorial Health System
Consolidating Balance Sheet
September 30, 2008

Schedule I

(in thousands of dollars)

	Lee Memorial Hospital	Cape Memorial Hospital, Inc.	Gulf Coast Medical Center	Other	Lee Memorial Health System Foundation, Inc.	Eliminations	Total
Liabilities and Net Assets							
Current liabilities							
Accounts payable	\$ 27,902	\$ 466	\$ 14,254	\$ 446	\$ -	\$ -	\$ 43,068
Current installments of long-term debt	10,893	1,662	608	-	-	-	13,163
Accrued expenses							
Employee compensation	37,411	4,295	4,106	1,575	39	-	47,426
Interest	3,418	1,408	6,788	-	-	-	11,614
Other	20,262	5,317	5,963	891	-	-	32,433
Estimated third-party settlements	<u>(1,324)</u>	<u>2,360</u>	<u>172</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,208</u>
Total current liabilities	98,562	15,508	31,891	2,912	39	-	148,912
Noncurrent liabilities							
Long-term debt, excluding current installments	250,455	118,698	279,738	-	-	-	648,891
Due to subsidiaries	-	-	166,648	7,475	1,195	(175,318) (a)	-
Other liabilities	<u>17,122</u>	<u>4,629</u>	<u>2,658</u>	<u>253</u>	<u>8</u>	<u>-</u>	<u>24,670</u>
Total liabilities	<u>366,139</u>	<u>138,835</u>	<u>480,935</u>	<u>10,640</u>	<u>1,242</u>	<u>(175,318)</u>	<u>822,473</u>
Commitments and contingencies							
Net assets							
Restricted for							
Nonexpendable	-	-	-	-	5,406	-	5,406
Expendable	-	-	-	-	14,850	-	14,850
Invested in capital assets, net of related debt	(14,438)	(45,846)	22,897	4,244	1	-	(33,142)
Unrestricted	<u>548,580</u>	<u>130,595</u>	<u>(49,062)</u>	<u>(6,010)</u>	<u>1,971</u>	<u>(58,790) (b)</u>	<u>567,284</u>
Total net assets	<u>534,142</u>	<u>84,749</u>	<u>(26,165)</u>	<u>(1,766)</u>	<u>22,228</u>	<u>(58,790)</u>	<u>554,398</u>
Total liabilities and net assets	<u>\$ 900,281</u>	<u>\$ 223,584</u>	<u>\$ 454,770</u>	<u>\$ 8,874</u>	<u>\$ 23,470</u>	<u>\$ (234,108)</u>	<u>\$ 1,376,871</u>

Lee Memorial Health System
Consolidating Statement of Operations
Year Ended September 30, 2008

Schedule II

(in thousands of dollars)

	Lee Memorial Hospital	Cape Memorial Hospital, Inc.	Gulf Coast Medical Center	Other	Lee Memorial Health System Foundation, Inc.	Eliminations	Total
Operating revenues							
Net patient service revenue	\$ 937,323	\$ 160,268	\$ 223,835	\$ 23,297	\$ -	\$ (407,400)	\$ 937,323
Other revenue	18,208	1,159	1,733	910	3,740	(7,542)	18,208
Total operating revenues	<u>955,531</u>	<u>161,427</u>	<u>225,568</u>	<u>24,207</u>	<u>3,740</u>	<u>(414,942)</u>	<u>955,531</u>
Operating expenses							
Salaries, wages and benefits	505,837	74,400	111,223	18,889	1,244	(205,756)	505,837
Supplies and other services	279,931	48,553	80,748	2,250	2,022	(133,573)	279,931
Purchased services	91,651	8,911	27,006	5,411	220	(41,548)	91,651
Depreciation and amortization	56,783	8,244	20,483	615	23	(29,365)	56,783
Total operating expenses	<u>934,202</u>	<u>140,108</u>	<u>239,460</u>	<u>27,165</u>	<u>3,509</u>	<u>(410,242)</u>	<u>934,202</u>
Operating income (loss)	<u>21,329</u>	<u>21,319</u>	<u>(13,892)</u>	<u>(2,958)</u>	<u>231</u>	<u>(4,700)</u>	<u>21,329</u>
Nonoperating items							
Interest expense	(18,270)	(4,445)	(7,339)	(163)	(7)	11,954	(18,270)
Investment income, including realized and unrealized (losses) and gains on investments	(37,095)	147	94	-	(139)	(102)	(37,095)
Earnings in equity method investees	-	-	-	-	-	-	-
Unrealized loss on swap valuation	(775)	-	-	-	-	-	(775)
Contributions and grants	-	-	-	-	1,959	-	1,959
Interest earned on restricted investments	-	-	-	-	(292)	-	(292)
Other	687	(99)	490	6,724	(595)	(6,520)	687
Total nonoperating (loss) income	<u>(55,453)</u>	<u>(4,397)</u>	<u>(6,755)</u>	<u>6,561</u>	<u>926</u>	<u>5,332</u>	<u>(53,786)</u>
(Decrease) increase in net assets	(34,124)	16,922	(20,647)	3,603	1,157	632	(32,457)
Net assets							
Beginning of year	568,266	67,827	(5,518)	(5,369)	21,071	(59,422)	586,855
End of year	<u>\$ 534,142</u>	<u>\$ 84,749</u>	<u>\$ (26,165)</u>	<u>\$ (1,766)</u>	<u>\$ 22,228</u>	<u>\$ (58,790)</u>	<u>\$ 554,398</u>

Lee Memorial Health System
Consolidating Balance Sheet
September 30, 2007

Schedule III

(in thousands of dollars)

	Lee Memorial Hospital	Cape Memorial Hospital, Inc.	Gulf Coast Medical Center	Other	Lee Memorial Health System Foundation, Inc.	Eliminations	Total
Assets							
Current assets							
Cash and cash equivalents	\$ 6,007	\$ -	\$ 32	\$ 2	\$ 7,652	\$ -	\$ 13,693
Short-term investments	411,314	-	-	-	-	-	411,314
Equity method and other investments	20,999	-	-	-	-	-	20,999
Assets whose use is restricted	3,521	1,426	6,704	-	-	-	11,651
Patient accounts receivable, net	77,574	19,159	38,032	3,011	-	-	137,776
Inventories	12,157	3,762	9,085	14	-	-	25,018
Other current assets	13,758	475	808	43	931	-	16,015
Estimated third-party settlements	-	-	-	-	-	-	-
Total current assets	<u>545,330</u>	<u>24,822</u>	<u>54,661</u>	<u>3,070</u>	<u>8,583</u>	<u>-</u>	<u>636,466</u>
Noncurrent assets							
Long-term investments	33,369	-	-	-	-	-	33,369
Assets whose use is restricted	2,904	4,539	-	6	12,645	-	20,094
Capital assets, net	252,122	76,350	248,671	4,424	10	-	581,577
Due from subsidiaries	21,972	87,190	-	3,750	-	(112,912) (a)	-
Other assets, net	72,850	16,391	98,531	1,022	1,763	(59,422) (b)	131,135
Total assets	<u>\$ 928,547</u>	<u>\$ 209,292</u>	<u>\$ 401,863</u>	<u>\$ 12,272</u>	<u>\$ 23,001</u>	<u>\$ (172,334)</u>	<u>\$ 1,402,641</u>

(a) To eliminate intercompany receivables and payables.

(b) To eliminate investments in subsidiaries.

Lee Memorial Health System
Consolidating Balance Sheet
September 30, 2007

Schedule III

(in thousands of dollars)

	Lee Memorial Hospital	Cape Memorial Hospital, Inc.	Gulf Coast Medical Center	Other	Lee Memorial Health System Foundation, Inc.	Eliminations	Total
Liabilities and Net Assets							
Current liabilities							
Accounts payable	\$ 26,425	\$ 468	\$ 13,160	\$ 265	\$ 1	\$ -	\$ 40,319
Current installments of long-term debt	9,937	1,530	47	-	-	-	11,514
Accrued expenses							
Employee compensation	35,825	3,973	3,505	1,281	36	-	44,620
Interest	3,544	1,561	6,674	-	-	-	11,779
Other	18,576	3,268	5,340	987	-	-	28,171
Estimated third-party settlements	(1,569)	4,319	272	-	-	-	3,022
Total current liabilities	<u>92,738</u>	<u>15,119</u>	<u>28,998</u>	<u>2,533</u>	<u>37</u>	<u>-</u>	<u>139,425</u>
Noncurrent liabilities							
Long-term debt, excluding current installments							
	253,286	120,263	280,283	-	-	-	653,832
Due to subsidiaries	-	-	96,055	14,964	1,893	(112,912) (a)	-
Other liabilities	14,257	6,083	2,045	144	-	-	22,529
Total liabilities	<u>360,281</u>	<u>141,465</u>	<u>407,381</u>	<u>17,641</u>	<u>1,930</u>	<u>(112,912)</u>	<u>815,786</u>
Commitments and contingencies							
Net assets							
Restricted for							
Nonexpendable	-	-	-	-	4,756	-	4,756
Expendable	-	-	-	-	13,832	-	13,832
Invested in capital assets, net of related debt	(5,001)	(45,443)	(31,659)	(1,676)	10	-	(83,769)
Unrestricted	573,267	113,270	26,141	(3,693)	2,473	(59,422) (b)	652,036
Total net assets	<u>568,266</u>	<u>67,827</u>	<u>(5,518)</u>	<u>(5,369)</u>	<u>21,071</u>	<u>(59,422)</u>	<u>586,855</u>
Total liabilities and net assets	<u>\$ 928,547</u>	<u>\$ 209,292</u>	<u>\$ 401,863</u>	<u>\$ 12,272</u>	<u>\$ 23,001</u>	<u>\$ (172,334)</u>	<u>\$ 1,402,641</u>

Lee Memorial Health System
Consolidating Statement of Operations
Year Ended September 30, 2007

Schedule IV

(in thousands of dollars)

	Lee Memorial Hospital	Cape Memorial Hospital, Inc.	Gulf Coast Medical Center	Other	Lee Memorial Health System Foundation, Inc.	Eliminations	Total
Operating revenues							
Net patient service revenue	\$ 907,596	\$ 150,352	\$ 236,361	\$ 18,365	\$ -	\$ (405,078)	\$ 907,596
Other revenue	16,011	1,222	1,335	844	5,170	(8,571)	16,011
Total operating revenues	<u>923,607</u>	<u>151,574</u>	<u>237,696</u>	<u>19,209</u>	<u>5,170</u>	<u>(413,649)</u>	<u>923,607</u>
Operating expenses							
Salaries, wages and benefits	470,701	71,015	103,864	18,226	1,184	(194,289)	470,701
Supplies and other services	272,128	47,374	84,950	1,973	4,009	(138,306)	272,128
Purchased services	81,410	7,694	26,598	2,341	188	(36,821)	81,410
Depreciation and amortization	50,221	7,849	16,608	582	64	(25,103)	50,221
Total operating expenses	<u>874,460</u>	<u>133,932</u>	<u>232,020</u>	<u>23,122</u>	<u>5,445</u>	<u>(394,520)</u>	<u>874,460</u>
Operating income (loss)	<u>49,147</u>	<u>17,642</u>	<u>5,676</u>	<u>(3,913)</u>	<u>(275)</u>	<u>(19,130)</u>	<u>49,147</u>
Nonoperating items							
Interest expense	(22,479)	(5,321)	(11,286)	(202)	(8)	16,817	(22,479)
Investment income, including realized and unrealized gains and (losses) on investments	42,852	335	86	-	1,053	(1,474)	42,852
Earnings in equity method investees	-	-	-	-	-	-	-
Unrealized loss on swap valuation	(438)	-	-	-	-	-	(438)
Contributions and grants	-	-	-	-	2,722	-	2,722
Interest earned on restricted investments	-	-	-	-	694	-	694
Other	6,531	1,731	6	4,306	(154)	(5,889)	6,531
Total nonoperating income (loss)	<u>26,466</u>	<u>(3,255)</u>	<u>(11,194)</u>	<u>4,104</u>	<u>4,307</u>	<u>9,454</u>	<u>29,882</u>
Increase (decrease) in net assets	75,613	14,387	(5,518)	191	4,032	(9,676)	79,029
Net assets							
Beginning of year	487,867	53,440	-	(5,560)	17,039	(49,746)	503,040
End of year	<u>\$ 563,480</u>	<u>\$ 67,827</u>	<u>\$ (5,518)</u>	<u>\$ (5,369)</u>	<u>\$ 21,071</u>	<u>\$ (59,422)</u>	<u>\$ 582,069</u>