Financial Statements

Memorial Hospital of South Bend, Inc.
Years Ended December 31, 2007 and 2006
With Report of Independent Auditors

0802-0912348

Memorial Hospital of South Bend, Inc.

Financial Statements

Years Ended December 31, 2007 and 2006

Contents

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Report of Independent Auditors

The Board of Trustees
Memorial Hospital of South Bend, Inc.

We have audited the accompanying balance sheets of Memorial Hospital of South Bend, Inc. (the Hospital) as of December 31, 2007 and 2006, and the related statements of operations and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Hospital's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Memorial Hospital of South Bend, Inc. at December 31, 2007 and 2006, and the results of its operations and changes in its net assets and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the financial statements, the Hospital adopted Statement of Financial Accounting Standards (SFAS) No. 158, *Employers' Accounting for Defined-Benefit Pension and Other Retirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)*, which changed its method of accounting for its defined-benefit and other postretirement benefits.

As discussed in Note 13 to the financial statements, the Hospital adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109.*

Ernst + Young LLP

February 12, 2008

Memorial Hospital of South Bend, Inc.

Balance Sheets

	December 31 2007	December 31 2006
Assets		
Cash and cash equivalents	**$ 24,639,124**	$ 7,837,644
Short-term investments	**4,006,623**	2,258,959
Prepaid accounts receivable less allowances for doubtful accounts (2007 – $10,031,250; 2006 – $9,961,965)	**61,936,577**	62,796,884
Due from third-party payors	**16,321,609**	27,979,453
Other receivables	**909,750**	873,651
Inventories	**9,974,486**	8,377,308
Prepaid expenses	**714,724**	1,123,754
Due from affiliated corporations	**295,392**	–
Total current assets	**118,798,285**	111,247,653
Assets limited as to use, less current portion:		
Internally designated investments	**196,762,611**	186,836,370
Externally designated investments under debt agreements	**58,322,528**	24,028
Externally designated investments – insurance trust	**2,441,931**	–
Unamortized bond issuance costs	**4,087,006**	3,454,831
Other assets	**748,805**	828,509
Interest in net assets of recipient organization	**8,768,375**	8,963,466
	271,131,256	200,107,204
Property and equipment:		
Land	**18,964,553**	17,764,533
Buildings and improvements	**212,052,046**	206,251,137
Equipment	**167,704,548**	163,285,341
Construction in progress	**42,420,135**	12,062,571
	441,141,282	399,363,582
Less allowances for depreciation and amortization	**195,872,975**	176,660,388
	245,268,307	222,703,194
Interest rate swaps	**2,964,909**	4,433,360
	$ 638,162,757	$ 538,491,411

	December 31	
	2007	2006
Liabilities and net assets		
Accounts payable	**$ 13,046,708**	$ 7,962,496
Accrued expenses	**16,254,707**	16,655,023
Due to affiliates	**–**	142,246
Current maturities of long-term debt	**3,659,832**	3,735,289
Total current liabilities	**32,961,247**	28,495,054
Noncurrent liabilities:		
Long-term debt, less current maturities	**232,864,808**	156,046,031
Asset retirement obligation and other liabilities	**3,822,970**	3,922,979
Interest rate and basis swaps	**7,021,599**	2,473,816
	243,709,377	162,442,826
Total liabilities	**276,670,624**	190,937,880
Net assets:		
Unrestricted	**352,723,758**	338,590,065
Temporarily restricted	**8,768,375**	8,963,466
Total net assets	**361,492,133**	347,553,531
	$ 638,162,757	$ 538,491,411

See accompanying notes.

Memorial Hospital of South Bend, Inc.

Statements of Operations and Changes in Net Assets

	Year Ended December 31 2007	2006
Unrestricted revenue, gains, and other support		
Net patient service revenue	**$ 358,833,429**	$ 338,321,550
Other revenue	**8,791,410**	9,262,313
Net assets released from restrictions used for operations	**856,584**	522,752
	368,481,423	348,106,615
Expenses		
Salaries and wages	**115,849,352**	110,876,328
Employee benefits	**29,158,207**	29,548,653
Supplies and other	**111,284,361**	100,830,046
Professional fees and purchased services	**36,075,637**	34,210,878
Depreciation and amortization	**20,503,082**	19,809,339
Interest	**7,243,838**	6,834,118
Provision for bad debts	**26,698,241**	23,278,415
	346,812,718	325,387,777
Income from operations before asset retirement obligation	**21,668,705**	22,718,838
Asset retirement obligation	–	2,820,800
Income from operations	**21,668,705**	19,898,038
Nonoperating		
Investment income, net	**14,129,736**	20,277,894
Unrealized (losses) gains on swap transactions, net	**(6,016,234)**	13,489,554
Loss on early extinguishment of debt	–	(4,588,803)
	8,113,502	29,178,645
Revenue and gains in excess of expenses	**29,782,207**	49,076,683

Memorial Hospital of South Bend, Inc.

Statements of Operations and Changes in Net Assets (continued)

	Year Ended December 31	
	2007	**2006**
Unrestricted net assets		
Revenue and gains in excess of expenses	**$ 29,782,207**	$ 49,076,683
Net assets released from restrictions used for capital purposes	**690,000**	198,582
Transfers to affiliates	**(16,338,514)**	(3,281,694)
Increase in unrestricted net assets	**14,133,693**	45,993,571
Temporarily restricted net assets		
Change in interest in recipient organization	**(195,091)**	846,029
(Decrease) increase in temporarily restricted net assets	**(195,091)**	846,029
Increase in net assets	**13,938,602**	46,839,600
Net assets at beginning of year	**347,553,531**	300,713,931
Net assets at end of year	**$ 361,492,133**	$ 347,553,531

See accompanying notes.

Memorial Hospital of South Bend, Inc.

Statements of Cash Flows

	Year Ended December 31	
	2007	**2006**
Operating activities		
Change in net assets	**$ 13,938,602**	$ 46,839,600
Adjustments to reconcile change in net assets to net cash (used in) provided by operating activities:		
Depreciation and amortization	**20,503,082**	19,809,339
Provision for bad debts	**26,698,241**	23,278,415
Unrealized losses (gains) on swap transactions, net	**6,016,234**	(13,489,554)
Net losses (gains) on investments	**4,485,530**	(16,943,388)
Transfer to affiliates	**16,338,514**	3,281,694
Changes in operating assets and liabilities:		
Patient accounts receivable	**(25,837,934)**	(37,851,578)
Other receivables, inventories, due from affiliated corporations, and prepaid expenses	**(1,519,639)**	(2,424,150)
Interest in net assets of recipient organization	**195,091**	(846,029)
Other assets	**(552,471)**	474,055
Investments	**(76,899,866)**	25,292,164
Accounts payable, accrued expenses, and other current liabilities	**4,541,650**	(146,735)
Other long-term liabilities	**(100,009)**	3,922,979
Due from (to) third-party payors	**11,657,844**	(11,966,881)
Net cash (used in) provided by operating activities	**(535,131)**	39,229,931
Investing activities		
Net additions to property and equipment	**(43,068,195)**	(33,203,908)
Cash used in investing activities	**(43,068,195)**	(33,203,908)
Financing activities		
Principal payments on long-term debt and other	**(3,256,680)**	(41,662,325)
Net proceeds from debt obligations	**80,000,000**	38,580,000
Transfer to affiliates	**(16,338,514)**	(3,281,694)
Net cash provided by (used in) financing activities	**60,404,806**	(6,364,019)
Increase (decrease) in cash and cash equivalents	**16,801,480**	(337,996)
Cash and cash equivalents at beginning of year	**7,837,644**	8,175,640
Cash and cash equivalents at end of year	**$ 24,639,124**	$ 7,837,644

See accompanying notes.

1. Organization

Memorial Hospital of South Bend, Inc. (the Hospital) is a tax-exempt Indiana corporation under Internal Revenue Code Section 501(c)(3) and an affiliate of Memorial Health System, Inc. (the Corporation). The Hospital provides inpatient, outpatient, and emergency care services to residents of South Bend, Indiana, and surrounding communities. Through the Corporation, the Hospital is also affiliated with Memorial Home Care, Inc. (Home Care) and Memorial Health Foundation, Inc. (MHF). The Hospital owns a 25% interest in MRI of Northern Indiana LLC, an outpatient diagnostic imaging center.

2. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Estimates also affect the reported amounts of revenue and expenses during the reporting period. Although estimates are considered to be fairly stated at the time the estimates are made, actual results could differ from those estimates.

Cash Equivalents

All investments that are not limited as to use with a maturity of three months or less at the time of acquisition are reflected as cash equivalents. The carrying value of cash equivalents approximates fair value.

Accounts Receivable

The Hospital evaluates the collectibility of its accounts receivable based on the length of time the receivable is outstanding, payor class, and the anticipated future uncollectible amounts based on historical experience. Accounts receivable are charged to the allowance for doubtful accounts when they are deemed uncollectible.

Assets Limited as to Use

Assets limited as to use include assets set aside by the Board of Trustees (the Board) for future capital improvements and community health enhancement initiatives, which the Board, at its discretion, may subsequently use for other purposes. Additionally, assets limited as to use include assets held by trustees under debt and self-funded insurance agreements.

2. Summary of Significant Accounting Policies (continued)

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value based on quoted market prices for those or similar investments. Dividend and interest income, realized gains and losses, and changes to market values of investments are reported as nonoperating investment income in the statements of operations and changes in net assets.

Investments in alternative investments, primarily hedge funds and funds of funds, that invest in marketable securities and derivative products are reported using the equity method. The values provided by the respective fund managers are based on historical costs, appraisals, and other estimates that require varying degrees of judgment. The financial statements of the equity earnings related to these alternative investments are included in nonoperating investment income.

Inventories

Inventories, consisting of pharmaceuticals and other supplies, are stated at the lower of cost (average cost method) or market.

Unamortized Bond Issuance Costs

Costs incurred in connection with the issuance of long-term debt are deferred and amortized over the term of the related financing.

Property and Equipment

Property and equipment are carried at cost, except donated assets, which are recorded at fair market value at date of donation. Allowances for depreciation and amortization are computed primarily utilizing the straight-line method over the estimated useful lives of the assets, which range from 3 to 40 years.

Contributions and Interest in Net Assets of Recipient Organization

Unconditional pledges to give cash and other assets are reported at fair value at the date the pledge is received to the extent estimated to be collectible by the Hospital. Pledges received that

2. Summary of Significant Accounting Policies (continued)

have been limited by donors to a specific time period or purpose are reported as temporarily restricted support. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statements of operations and changes in net assets as net assets released from restrictions.

MHF solicits contributions on behalf of the Hospital. Contributions received by MHF ($1,563,000 in 2007 and $2,131,000 in 2006) that will ultimately benefit the Hospital are recorded as contribution revenue by MHF. The Hospital records an interest in net assets of MHF (recipient organization). The change in net assets of the recipient organization is included in temporarily restricted net assets in the statements of operations and changes in net assets.

Temporarily Restricted Net Assets

Temporarily restricted net assets are used to differentiate resources, the use of which is restricted by donors or grantors to a specific time period or purpose, from resources on which no restrictions have been placed or that arise from the general operations of the Hospital. Temporarily restricted gifts and bequests are recorded as an addition to temporarily restricted net assets in the period received. Assets released from restrictions that are used for the purchase of property and equipment or capital purposes are reported in the statements of operations and changes in net assets as additions to unrestricted net assets. Resources restricted by donors for specific operating purposes are reported in unrestricted revenue, gains, and other support to the extent expended within the period.

Net Patient Service Revenue

The Hospital has agreements with various third-party payors that provide for payments to the Hospital 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 received or due from patients, third-party payors, and others for services rendered. These amounts include estimated adjustments under certain reimbursement agreements with third-party payors, which are subject to audit by the applicable administering agency. These adjustments are accrued on an estimated basis and are adjusted in future periods as final settlements are determined (see Note 3).

2. Summary of Significant Accounting Policies (continued)

Community Commitment

The Hospital provides care to all patients regardless of their ability to pay. Charity care provided by the Hospital is excluded from net patient service revenue (see Note 4).

Adoption of New Accounting Standard

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 158, *Employer's Accounting for Defined Benefit Pension and Other Postretirement Benefit Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R).* SFAS No. 158 requires plan sponsors of defined-benefit pension and other postretirement benefit plans (collectively, "postretirement benefit plans") to recognize the funded status of their postretirement benefit plans in the balance sheet, measure the fair value of plan assets and benefit obligations as of the date of the fiscal year-end, and provide additional disclosures. On December 31, 2007, the Corporation adopted the recognition and disclosure provisions of SFAS No. 158. The effect of adopting SFAS No. 158 on the Corporation's financial condition at December 31, 2007, is included in other long-term liabilities on the Corporation's consolidated financial statements. See Note 5 for further discussion of the effect of adopting SFAS No. 158 on the Corporation's consolidated financial statements.

Revenue and Gains in Excess of Expenses

The statements of operations and changes in net assets include revenue and gains in excess of expenses. Changes in unrestricted net assets, which are excluded from revenue and gains in excess of expenses, consistent with industry practice, include contributions of long-lived assets, including assets acquired using contributions, which by donor restriction were to be used for the purpose of acquiring such assets, and transfers to affiliates.

Interest Rate and Basis Swaps

All interest rate and basis swaps are measured at fair value based on quoted market interest rates. None of the swaps are designated as hedging instruments; therefore, the unrealized gains or losses on the fair value of the swaps are included in revenue and gains in excess of expenses in the statements of operations and changes in net assets.

2. Summary of Significant Accounting Policies (continued)

Asset Retirement Obligations

The Hospital accounts for the fair value of legal obligations associated with long-lived asset retirements in accordance with Statement of Financial Accounting Standards Board (FASB) Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (FIN 47). The asset retirement obligation, which primarily relates to future asbestos remediation, related to buildings on the Hospital's campus. The fair value of the obligation amounted to approximately $2,488,000 and $2,334,000 at December 31, 2007 and 2006, respectively. The Hospital adopted FIN 47 during 2006. The cumulative effect of initially applying FIN 47 was $2,820,800, recognized as an expense in revenue and gains in excess of expenses in the accompanying consolidating statements of operations and changes in net assets for the year ended December 31, 2006.

Reclassifications

Certain amounts in the 2006 financial statements have been reclassified to conform to the 2007 presentation.

3. Contractual Arrangements With Third-Party Payors

The Medicare and Medicaid programs pay the Hospital for inpatient and outpatient services at predetermined rates based on treatment diagnosis. Changes in the Medicare and Medicaid programs or reduction of funding levels for the programs could have an adverse effect on future amounts recognized as net patient service revenue.

The laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

3. Contractual Arrangements With Third-Party Payors (continued)

Managed care reimbursement agreements provide for payment of patient services at a fixed percentage of covered charges. The Hospital has also entered into contractual arrangements with various health maintenance and preferred provider organizations, the terms of which call for the Hospital to be paid for covered services at predetermined rates.

Revenue is presented net of estimated contractual adjustments, which represent the difference between the Hospital's standard charges for services and the estimated payments from the various third-party payors. Revenues received under the Medicare payment arrangement account for 25% and 24% of net patient service revenue for the years ended December 31, 2007 and 2006, respectively.

The Hospital grants credit without collateral to its patients, most of whom are local residents and are insured under third-party arrangements. Major components of net patient accounts receivable include 17% from Medicare and 22% from Blue Cross at December 31, 2007, and 23% from Medicare and 17% from Blue Cross at December 31, 2006.

Adjustments arising from reimbursement arrangements with third-party payors are accrued for on an estimated basis in the period in which the services are rendered. Estimates for cost report settlements and contractual allowances can differ from actual reimbursement based on the results of subsequent reviews and cost report audits. For the years ended December 31, 2007 and 2006, net patient service revenue has been increased by approximately $3,163,000 and $963,000, respectively, for third-party settlements, favorably settled appeals, and changes in estimates related to expected Indiana Disproportionate Share reimbursements for services rendered in previous years.

4. Community Commitment

Community commitment represents charity care unreimbursed for services rendered at a reduced fee, or no fee, due to the inability of the patient to pay for services. The estimated amount of the community commitment provided was approximately $10,225,000 and $9,247,000 in 2007 and 2006, respectively.

Additionally, the Hospital reinvests funds into the community to improve the health status of community members, in particular under-served populations. Each year, the Hospital tithes based on previous year's financial results. The estimated amount of tithing funds expended was approximately $1,323,000 and $1,381,000 in 2007 and 2006, respectively.

5. Pension Plan

The Corporation has noncontributory, defined-benefit pension plans, which include a final average pay plan and a cash balance plan. The cash balance plan was frozen as of December 31, 2007, and the much smaller grandfathered final average pay was not altered. The assets in the cash balance plan will continue to earn interest, but service credits are frozen.

On December 31, 2007, the Corporation adopted the recognition and disclosure provisions of SFAS No. 158. SFAS No. 158 required the Corporation to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligation) of its pension plan in the December 31, 2007, consolidated balance sheet, with a corresponding adjustment to unrestricted net assets. The adjustment to unrestricted net assets at adoption represents the net unrecognized actuarial losses, unrecognized prior service credits, and unrecognized transition assets remaining from the initial adoption of SFAS No. 87, *Employers' Accounting for Pensions*, all of which were previously netted against the plan's funded status in the Corporation's consolidated balance sheet pursuant to the provisions of SFAS No. 87. These amounts will be subsequently recognized as net periodic pension cost pursuant to the Corporation's historical accounting policy for amortizing such amounts. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic pension cost in the same periods will be recognized as other changes in unrestricted net assets. Those amounts will be subsequently recognized as a component of net periodic pension cost on the same basis as the amounts recognized in unrestricted net assets at adoption of SFAS No. 158.

The Corporation's pension plan expense for the years ended December 31, 2007 and 2006, was approximately $3,962,000 and $6,130,000, respectively. The Corporation recognized a $1,248,000 nonrecurring pension curtailment gain from the termination of benefits, and the election by employees to transfer to the new defined-benefit contribution pension plan.

5. Pension Plan (continued)

The summary of the changes in the benefit obligation and plan assets and the resulting funded status of the plan is as follows (in thousands):

	December 31 2007	2006
Accumulated benefit obligation	**$ 116,231**	$ 131,311
Change in projected benefit obligation		
Projected benefit obligation at beginning of year	**$ 131,311**	$ 125,346
Service cost	**6,608**	6,551
Interest cost	**7,451**	6,832
Plan amendments	**642**	–
Actuarial gain (loss)	**1,623**	(2,032)
Curtailments	**(26,255)**	–
Benefits paid and prepaid expense	**(5,149)**	(5,386)
Projected benefit obligation at end of year	**$ 116,231**	$ 131,311
Change in plan assets		
Fair value of plan assets at beginning of year	**$ 111,751**	$ 99,817
Actual return on plan assets	**4,513**	11,320
Employer contributions	**3,000**	6,000
Benefits paid	**(5,149)**	(5,386)
Fair value of plan assets at end of year	**$ 114,115**	$ 111,751
Funded status		
Funded status of the plan	**$ (2,116)**	$ (19,560)
Unrecognized net actuarial loss	**–**	20,343
Unamortized prior service cost	**(34)**	(1,968)
Additional minimum liability	**–**	(12,945)
Accrued pension costs	**(2,150)**	(14,130)
SFAS No. 158 adjustment to unrestricted net assets	**34**	–
Amounts recognized in consolidated balance sheets	**$ (2,116)**	$ (14,130)

5. Pension Plan (continued)

The components of net periodic benefit cost for the defined-benefit pension plan were as follows (in thousands):

	Years Ended December 31 2007	2006
Service cost	**$ 6,608**	$ 6,551
Interest cost	**7,451**	6,832
Expected return on plan assets	**(9,290)**	(8,235)
Prior service credit recognized	**(274)**	(299)
Curtailment gain	**(1,248)**	–
Recognized losses	**715**	1,280
Benefit cost	**$ 3,962**	$ 6,129

5. Pension Plan (continued)

Assumptions used to determine benefit obligations at the measurement date are as follows:

	December 31	
	2007	**2006**
Discount rate	**6.00%**	5.75%
Expected return on plan assets	**8.50**	8.50
Rate of compensation increase	**4.28**	4.28

Assumptions used to determine net pension expense at the measurement date are as follows:

	December 31	
	2007	**2006**
Discount rate	**5.75%**	5.75%
Expected return on plan assets	**8.50**	8.50
Rate of compensation increase	**4.28**	4.28

The change in discount rate from 5.75% to 6.0% decreased the projected benefit obligation by approximately $4,298,000. The change in demographics increased the projected benefit obligation by approximately $1,577,000. All other assumptions increased the projected benefit obligation by approximately $4,345,000.

The following is a summary of the pension plan asset allocations at December 31:

	2007	**2006**
Common stocks	**6%**	6%
Cash and cash equivalents	**–**	1
Fixed income	**30**	26
Pooled equity	**25**	30
Miscellaneous	**16**	16
Hedge funds	**23**	21
Total	**100%**	100%

5. Pension Plan (continued)

The composition and fair value of the plan assets at December 31 are summarized as follows (in thousands):

	2007	2006
Investments:		
Interest-bearing cash	**$ 384**	$ 643
Corporate bonds	**33,831**	29,294
Marketable equity securities	**53,045**	57,873
Hedge funds	**26,846**	29,930
Interest receivable	**9**	11
	$ 114,115	$ 117,751

The Corporation employs a total return investment approach whereby a mix of equities and fixed income investments are used to maximize the long-term return of plan assets for a prudent level of risk. Risk tolerance is established through careful consideration of plan liabilities, plan funded status, and corporate financial condition. The investment portfolio contains a diversified blend of equity, fixed-income, and alternative investments. Equity investments are diversified across United States and non-United States corporate stocks, as well as growth, value, and small and large capitalizations. Other assets such as real estate, private equity, and hedge funds are used to enhance long-term returns while improving portfolio diversification. The Corporation's external investment managers may use derivatives to gain market exposure in an efficient and timely manner. Investment risk is measured and monitored on an ongoing basis through quarterly investment portfolio reviews, annual liability measurements, and periodic asset/liability studies.

The following pension benefit payments, which reflect expected future service, as appropriate, are expected to be paid in the years ended December 31 (in thousands):

2008	$ 6,601
2009	7,176
2010	6,864
2011	6,854
2012	6,577
2013–2017	38,737

6. Lease Obligations

The Hospital leases certain office space and equipment under noncancelable operating leases. At December 31, 2007, the minimum future rental payments under these leases are as follows (in thousands):

2008	$ 2,701
2009	2,313
2010	2,141
2011	1,663
2012	959
Thereafter	84
	$ 9,861

Rental expense for the years ended December 31, 2007 and 2006, was approximately $2,079,000 and $1,845,000, respectively.

7. Long-Term Debt

Long-term debt consists of the following at December 31 (in thousands):

	2007	2006
Tax-exempt bonds issued on behalf of the Hospital by the Hospital Authority of St. Joseph County:		
Health System Revenue Bonds, Series 2007, bearing interest at variable rates at December 31, 2007, due in varying annual installments on August 15 of each year through 2046	**$ 80,000**	$ –
Health System Revenue Bonds, Series 2006, bearing interest at variable rates hedged with a floating to fixed interest rate swap at 3.5% at December 31, 2007, due in varying annual installments on August 15 of each year through 2033	**38,580**	38,580
Health System Revenue Bonds, Series 2003A, bearing interest at variable rates at December 31, 2007, due in varying annual installments on August 15 of each year through 2033	**39,850**	40,600
Health System Revenue Bonds, Series 2000, interest ranging from 4.875% to 5.00%, due in varying annual installments from 2007 to 2010	**320**	435
Health System Revenue Bonds, Series 1998A, interest ranging from 4.60% to 5.50%, due in varying annual installments on August 15 of each year through 2028	**79,480**	81,630
Capital leases	**1,561**	1,881
	239,791	163,126
Less unamortized discount	**3,266**	3,345
	236,525	159,781
Less current maturities	**3,660**	3,735
	$ 232,865	$ 156,046

7. Long-Term Debt (continued)

In May 2007, the Hospital Authority of St. Joseph County, on behalf of the Corporation, issued revenue bonds in the principal amount of $80,000,000 (Series 2007 Bonds). The Series 2007 Bonds, together with other available monies, will be used to finance various capital improvements, the surgery suite, and energy plant project.

The Series 2007 Bonds initially are issued as LIBOR-based bonds with a maturity date of August 15, 2046. The LIBOR-based interest rate will be the rate of interest per annum equal to 67% of the three month LIBOR rate plus 0.87%, with the provision that the LIBOR will never exceed 14% per annum.

The Series 2007 Bonds are subject to optional or mandatory redemption prior to maturity, and the LIBOR-based bonds are subject to mandatory tender upon conversion to another interest rate period. If the LIBOR-based bonds are converted to a different interest rate period, they will be subject to the mandatory tender at a purchase price equal to the then-applicable optional redemption price for the LIBOR-based bonds.

The Series 2007 Bonds are subject to mandatory redemption through the operation of a sinking fund on each August 15 commencing with the year 2035 to, and including the year, 2046 in amounts sufficient to redeem the principal amounts.

As of the date of the issuance of the Series 2007 Bonds, under the terms of a Master Trust Indenture, the Corporation and the Hospital formed the Obligated Group. MHF and Home Care constitute Designated Affiliates under the terms of the Master Trust Indenture. The Obligated Group is comprised of the same entities for all outstanding Bond Series.

The Series 2007, 2006, 2003A, and 2000 Bonds are all secured by the pledged revenues of the Obligated Group. The Series 1998A Bonds are not secured by any pledges of, mortgage on, or security interest in assets of the Obligated Group or any Designated Affiliate.

During January 2007, the Corporation entered into a basis swap agreement with the specific terms as follows:

Origination Date	Notional Amounts	Hospital Receives	Hospital Pays	Termination Date
January 2007	$105,000,000	74.6% of LIBOR-BBA	SIFMA tax-exempt index	January 2041

7. Long-Term Debt (continued)

The SIFMA tax-exempt index (formerly BMA tax-exempt index) is a 7-day, high-grade market index comprised of tax-exempt Variable Rate Demand Obligations (VDRO).

In August and September of 2007, the Corporation entered into two forward starting SIFMA Yield Curve Swaps with the specific terms as follows:

Effective Date	Notional Amounts	Hospital Receives	Hospital Pays	Termination Date
August 2008	$60,000,000	10-yr USD-SIFMA -.65%	SIFMA tax-exempt index	August 2027
September 2008	$60,000,000	10-yr USD-SIFMA -.65%	SIFMA tax-exempt index	September 2027

Additionally, in August of 2007, the Corporation entered into another Fixed Spread Basis Swap with the specific terms as follows:

Origination Date	Notional Amounts	Hospital Receives	Hospital Pays	Termination Date
August 2007	$135,000,000	61.7% of USD-LIBOR-BBA +.76%	SIFMA tax-exempt index	August 2041

In March 2006, the Hospital Authority of St. Joseph County, on behalf of the Corporation, issued revenue refunding bonds in the principal amount of $38,580,000 (Series 2006 Bonds) to refund a portion of the Series 2000 Bonds. A loss on early extinguishment of debt of $4,589,000 was recorded in the statement of operations and changes in net assets for the year ended December 31, 2006. The Series 2006 Bonds were issued as variable interest rate and hedged with a floating to fixed interest rate swap at 3.5%. The interest rate for the Series 2006 Bonds is a weekly interest rate determined by the remarketing agent.

The Series 2006 Bonds are subject to mandatory redemption through the operation of a sinking fund on each August 15 commencing with the year 2011 to, and including the year, 2033 in amounts sufficient to redeem the principal amounts.

7. Long-Term Debt (continued)

During January 2006, the Corporation entered into a floating to fixed interest rate swap agreement with an effective date of March 16, 2006, for the purpose of hedging the variable interest rate on the Series 2006 Bonds with the specific terms as follows:

Origination Date	Notional Amounts	Hospital Receives	Hospital Pays	Termination Date
March 2006	$38,580,000	61.9% of 30-day LIBOR plus .31%	3.5%	August 15, 2033

In February 2003, the Hospital Authority of St. Joseph County, on behalf of the Corporation, issued variable interest rate Auction Rate Securities in the aggregate principal amount of $42,000,000 (Series 2003 Bonds). The proceeds from the Series 2003 Bonds were used to pay or reimburse the Corporation for the payment of certain costs related to acquiring, constructing, renovating, remodeling, and equipping certain health facilities. The interest rate for the Series 2003 Bonds is determined in successive 35-day auction periods.

The Series 2003 Bonds are subject to mandatory redemption through the operation of a sinking fund on each August 15 commencing with the year 2006 to, and including the year, 2033 in amounts sufficient to redeem the principal amounts.

In December 2000, the Hospital Authority of St. Joseph County, on behalf of the Corporation, issued $39,600,000 of Health System Revenue Bonds, Series 2000 (the Series 2000 Bonds). The bond proceeds were used to pay, reimburse, and refinance certain costs the Hospital incurred for the acquisition, construction, and renovation of its health facilities and to pay certain expenses incurred in connection with the issuance of the Series 2000 Bonds.

The terms of the bond agreements require that various funds be held on deposit with a trustee in accordance with the terms of the Master Trust Indenture. These funds are classified on the Hospital's balance sheet as externally designated investments and consist primarily of a project fund of $58,268,000, a debt service reserve fund of approximately $54,000, and a capitalized interest fund of approximately $1,000 at December 31, 2007.

The Series 2007, 2006, 2003, 2000, and 1998A Bonds were issued pursuant to the Master Trust Indentures, which contain various covenants, including achievements of specified financial ratios and limitations on additional debt.

7. Long-Term Debt (continued)

The Hospital has four revolving credit agreements, which allow it to borrow principal amounts up to $2,000,000 under each agreement. Effective dates of the agreements are January 25, 2008, January 28, 2008, May 31, 2008, and January 2, 2009. The interest on amounts borrowed is set at 6.75%, as defined by the agreements. At December 31, 2007 and 2006, no amounts were outstanding under these agreements.

Fixed to floating interest rate swap agreements with Citigroup, Inc. effectively convert notional amounts indicated from a fixed rate to a variable rate of interest. The Hospital's goal is to maintain 75% of the Hospital's long-term debt at variable rate interest. Financial settlement of the terms of the agreement occurs on a monthly basis to Citigroup, Inc. and semiannually to the Hospital.

Fixed to floating interest rate swap agreements consist of the following at December 31, 2007:

Origination Date	Notional Amounts	Hospital Receives	Hospital Pays	Termination Date
May 2003	$98,000,000	3.38%	30-day LIBOR	May 2008

Basis swap interest rate agreements with Citigroup, Inc. float a percentage of taxable interest cost against tax-exempt interest cost. They provide a hedge against rising interest rates on the Hospital's variable rate exposure created as a result of fixed to floating interest rate swaps and variable rate debt issued. The Hospital's goal is to maintain a two times basis swap notional amount against the Hospital's total variable rate exposure. Financial settlement of the terms of the agreements occurs on a monthly basis to Citigroup, Inc. and semiannually to the Hospital. The Hospital's basis swap interest rate agreements consist of the following at December 31, 2007:

Origination Date	Notional Amounts	Hospital Receives	Hospital Pays	Termination Date
March 2001	$140,000,000	75.125% of 90-day LIBOR	SIFMA tax-exempt index	March 2031
July 2002	$56,000,000	75.125% of 90-day LIBOR	SIFMA tax-exempt index	July 2022
February 2003	$30,000,000	81.125% of 90-day LIBOR	SIFMA tax-exempt index	February 2033
February 2003	$30,000,000	80.625% of 90-day LIBOR	SIFMA tax-exempt index	February 2023

7. Long-Term Debt (continued)

The Hospital entered into a fixed interest rate payor swap agreement with Citigroup, Inc. The agreement fixes interest cost on a stated notional amount amortizing to zero as adjusted on an annual basis until the termination of the swap agreement. Financial settlement of the terms of the agreement occurs every 35th day for both parties. The significant terms of the fixed interest rate payor swap agreement are as follows:

Origination Date	Notional Amounts	Hospital Receives	Hospital Pays	Termination Date
March 2003	$10,400,000	65% of 30-day LIBOR plus .45%	3.8%	July 28, 2034

The Hospital entered into a fixed spread basis swap agreement with Citigroup, Inc. The agreement floats a percentage of taxable interest cost plus a fixed spread against tax-exempt interest cost. Financial settlement of the terms of the agreement occurs semiannually for Citigroup, Inc. and the Hospital.

Origination Date	Notional Amounts	Hospital Receives	Hospital Pays	Termination Date
June 2004	$77,850,000	62.6% of USD-LIBOR-BBA + .785%	SIFMA tax-exempt index	August 2033

Net interest paid or received under the above swap agreements is included in interest expense. The net differential for the Hospital as a result of the swap agreements amounted to receipt of $163,000 and payment of $441,000 for the years ended December 31, 2007 and 2006, respectively, and is reflected as an increase and reduction to interest expense, respectively. The swap agreements do not qualify for hedge accounting; therefore, the change in the fair value of the swap agreements is recorded as an unrealized nonoperating loss of $6,016,000 and an unrealized nonoperating gain of $13,490,000 for the years ended December 31, 2007 and 2006, respectively.

Interest capitalized during 2007 and 2006 was approximately $1,416,000 and $493,000, respectively. Interest paid during 2007 and 2006 was approximately $8,609,000 and $7,004,000, respectively.

7. Long-Term Debt (continued)

Maturities of long-term debt and capital lease obligations for each of the next five years are as follows (in thousands):

2008	$	3,812
2009		3,747
2010		3,749
2011		3,805
2012		3,935

8. Transactions With Affiliates

The Corporation leased space in various office properties owned by the Hospital for approximately $241,000 and $258,000 in 2007 and 2006, respectively. The Hospital leased space from Home Care for approximately $95,000 and $246,000 in 2007 and 2006, respectively. The Hospital leased space from the Corporation for approximately $682,000 in 2007 and $516,000 in 2006.

The Hospital purchased temporary services from Home Care for approximately $42,000 in 2007 and 2006. Various other services and supplies were purchased from affiliated companies for approximately $597,000 in 2007 and in 2006.

It is the Corporation's policy to allocate certain administrative expenses to the Hospital on an annual basis. These expenses amounted to approximately $29,507,000 and $27,546,000 in 2007 and 2006, respectively, and are included in professional fees and purchased services in the accompanying financial statements.

9. Fair Value of Financial Instruments

The fair value of the Hospital's long-term debt, including the current portion, is approximately $238,543,000 and $162,033,000 at December 31, 2007 and 2006, respectively

9. Fair Value of Financial Instruments (continued)

The composition and fair value of investments held by the Hospital at December 31 are summarized as follows (in thousands):

	2007	2006
United States government and agency securities and government insured repurchase agreements	**$ 11,246**	$ 8,491
Corporate bonds	**49,787**	46,714
Marketable equity securities	**102,780**	101,415
Alternative investments	**32,888**	29,145
2007 bond fund	**58,268**	–
Cash and cash equivalents	**6,565**	3,354
	$ 261,534	$ 189,119

Total investment return for the years ended December 31 is summarized as follows (in thousands):

	2007	2006
Investment return:		
Dividend and interest income	**$ 14,873**	$ 3,334
Net equity earnings on alternative investments	**3,743**	2,622
Net realized and unrealized gains/losses from investments	**(4,486)**	14,322
	$ 14,130	$ 20,278
Reported as:		
Investment income, net	**$ 14,130**	$ 20,278

The carrying values of cash and cash equivalents, accounts receivable, and accounts payable and accrued expenses are reasonable estimates of their fair value due to the short-term nature of these financial instruments.

10. Functional Expenses

The Hospital provides general healthcare services to residents within its geographic location. Expenses related to this and general and administrative functions for the years ended December 31 are as follows (in thousands):

	2007	2006
Healthcare services	**$ 267,001**	$ 246,336
General and administrative	**79,811**	81,873
	$ 346,812	$ 328,209

11. Commitments

At December 31, 2007, the Hospital is contractually obligated for approximately $4,300,000, which primarily relates to routine capital expenditures. During 2007, the Corporation's Board of Trustees approved a project for the construction of new surgical suites, an energy plant, a receiving dock, a main entrance, and the renovation of existing outpatient surgery space. In addition to the routine capital expenditures, the Corporation is contractually obligated for approximately $18,829,000, which primarily relates to the approved energy plant and surgery project.

12. Professional Liability Insurance

Professional liability insurance coverage is provided under a claims-made policy. Should the claims-made policy be terminated, the Hospital has the option to purchase insurance for claims having occurred during its term, but reported subsequently. Prior to July 1, 1999, the Indiana Medical Malpractice Act provided for a maximum recovery of $750,000 per occurrence for professional liability, $100,000 of which would be paid by the Hospital, and the balance of which would be paid by the State of Indiana Patient Compensation Fund. Since July 1999, the Indiana Medical Malpractice Act has provided recovery up to $1,250,000 per occurrence, with the first $250,000 covered by the Hospital. The Corporation maintains an irrevocable, trustee fund for its self-insurance program. The fair value of the trustee fund at December 31, 2007 and 2006, was $2,717,000 and $1,042,000, respectively, for the Corporation, of which $2,442,000 relates to the Hospital. The discounted amount of malpractice and general liability claims was $2,717,000 and $2,559,000 at December 31, 2007 and 2006, respectively. The interest rate used to discount these claims was 5% at December 31, 2007 and 2006.

13. Income Taxes

The Corporation and its related affiliates, except for Memorial Home Care, Inc., have been determined to qualify as a tax-exempt organization under 501(c)(3) of the Internal Revenue Code (the Code). Most of the income received by Memorial Health System, Inc. Exempt Group is exempt from taxation under Section 501(a) of the Code, as income related to the mission of the organization. Accordingly, there is no material provision for income tax for these entities. Some of the income received by exempt entities is subject to taxation as unrelated business income. Memorial Health System, Inc. and its subsidiaries file income tax returns in the U.S. federal and various states.

In July 2006, the FASB issued FIN 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109.* This interpretation requires that realization of an uncertain income tax position must be more likely than not (i.e., greater than 50% likelihood of receiving a benefit) before it can be recognized in the financial statements. Furthermore, this interpretation prescribes the benefit to be recorded in the financial statements as the amount most likely to be realized assuming a review by tax authorities having all relevant information and applying current conventions. This interpretation also clarifies the financial statement classification of tax-related penalties and interest and sets forth new disclosures regarding unrecognized tax benefits. This interpretation is effective for fiscal years beginning after December 15, 2006, and the Corporation has adopted this interpretation for the year ended December 31, 2007. There was no impact on the financial statements as of December 31, 2007, from the adoption of FIN 48.

14. Restricted Net Assets

Temporarily restricted net assets are available for the following purposes at December 31:

	2007	2006
Net assets currently available for:		
Community services	**$ 398,685**	$ 431,482
Hospital support services	**143,146**	158,180
Quality initiatives	**1,287,588**	1,418,381
People development/education	**1,311,748**	1,333,925
Financial support services	**3,882**	1,162
Growth initiatives	**5,623,326**	5,620,336
	$ 8,768,375	$ 8,936,466

15. Litigation and Compliance Matters

The Hospital is a defendant in certain litigation arising in the ordinary course of business. The Corporation has also elected to participate in the Internal Revenue Service's Tax Exempt Bonds Voluntary Compliance Agreement Program. Although the outcome of these matters cannot be determined with certainty, management believes that the ultimate resolution of these matters will not have any material adverse effect on the Hospital's operations or financial condition.