



LIFESPAN CORPORATION AND AFFILIATES

Consolidated Financial Statements

September 30, 2007 and 2006

(With Independent Auditors' Report Thereon)

LIFESPAN CORPORATION AND AFFILIATES

Consolidated Financial Statements

September 30, 2007 and 2006

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KPMG LLP
50 Kennedy Plaza
Providence, RI 02903

Independent Auditors' Report

The Board of Directors
Lifespan Corporation:

We have audited the accompanying consolidated statements of financial position of Lifespan Corporation and Affiliates (Lifespan) as of September 30, 2007 and 2006, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of Lifespan's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 Lifespan'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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Lifespan as of September 30, 2007 and 2006, and the results of their operations and changes in net assets, and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

As described in note 7 to the consolidated financial statements, Lifespan adopted the provisions of Financial Accounting Standards Board (FASB) Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of FASB Statements No. 87, 88, 106 and 132(R), in 2007.

KPMG LLP

January 28, 2008

LIFESPAN CORPORATION AND AFFILIATES

Consolidated Statements of Financial Position

September 30, 2007 and 2006

(In thousands)

Assets	2007	2006	Liabilities and Net Assets	2007	2006
Current assets:			Current liabilities:		
Cash and cash equivalents	\$ 77,401	\$ 95,582	Accounts payable	\$ 54,649	\$ 50,700
Patient accounts receivable	200,666	195,304	Accrued employee benefits and compensation	57,433	74,755
Less allowance for doubtful accounts	<u>(43,656)</u>	<u>(45,866)</u>	Other accrued expenses	14,185	14,656
Net patient accounts receivable	157,010	149,438	Current portion of long-term debt	3,495	8,095
Other receivables	20,334	16,519	Current portion of estimated third-party payor settlements	26,342	33,682
Current portion of contributions receivable, net	<u>6,711</u>	<u>4,876</u>	Current portion of estimated malpractice and other self-insurance costs	<u>26,105</u>	<u>22,154</u>
Total receivables	184,055	170,833	Total current liabilities	182,209	204,042
Assets limited as to use	21,894	19,258	Long-term debt, net of current portion	292,359	296,510
Inventories	12,023	10,701	Estimated third-party payor settlements, net of current portion	65,047	77,154
Prepaid expenses and other current assets	<u>5,509</u>	<u>5,332</u>	Estimated malpractice self-insurance costs, net of current portion	67,265	62,448
Total current assets	300,882	301,706	Other liabilities	<u>66,642</u>	<u>43,389</u>
Assets limited as to use	1,138,697	978,334	Total liabilities	673,522	683,543
Less amount required to meet current obligations	<u>(21,894)</u>	<u>(19,258)</u>	Net assets:		
Noncurrent assets limited as to use	1,116,803	959,076	Unrestricted	970,463	815,100
Property and equipment, net	681,598	615,478	Temporarily restricted	215,206	180,341
Other assets:			Permanently restricted	<u>281,831</u>	<u>238,590</u>
Contributions receivable, net	11,212	12,059	Total net assets	1,467,500	1,234,031
Deferred charges and financing costs, net	7,911	8,551			
Other noncurrent assets	<u>22,616</u>	<u>20,704</u>			
Total other assets	<u>41,739</u>	<u>41,314</u>			
Total assets	\$ <u>2,141,022</u>	\$ <u>1,917,574</u>	Total liabilities and net assets	\$ <u>2,141,022</u>	\$ <u>1,917,574</u>

See accompanying notes to consolidated financial statements.

LIFESPAN CORPORATION AND AFFILIATES

Consolidated Statements of Operations and Changes in Net Assets

Years ended September 30, 2007 and 2006

(In thousands)

	2007	2006
Unrestricted revenues and other support:		
Net patient service revenue	\$ 1,244,173	\$ 1,186,086
Other revenue	69,679	70,928
Endowment earnings contributed toward community benefit	10,401	9,050
Net assets released from restrictions used for operations	15,059	13,687
Net assets released from restrictions used for research	66,477	68,593
	<u>1,405,789</u>	<u>1,348,344</u>
Total unrestricted revenues and other support		
Operating expenses:		
Compensation and benefits	787,788	743,650
Supplies and other expenses	323,281	318,887
Purchased services	75,096	70,928
Provision for bad debts	78,827	80,515
Depreciation and amortization	47,068	44,086
Interest	13,988	15,341
License fees	31,545	31,545
	<u>1,357,593</u>	<u>1,304,952</u>
Total operating expenses		
Income from operations	<u>48,196</u>	<u>43,392</u>
Nonoperating gains and losses:		
Unrestricted gifts and bequests	3,052	1,546
Unrestricted income from board-designated investments	5,845	4,404
Net realized gains on sales of board-designated investments	50,529	32,552
Loss on advance refunding of debt	—	(15,913)
Grants to outside agencies	(766)	(553)
Fundraising expenses	(4,591)	(3,577)
Other nonoperating losses, net	(41)	(487)
	<u>54,028</u>	<u>17,972</u>
Total nonoperating gains, net		
Excess of revenues over expenses	<u>\$ 102,224</u>	<u>\$ 61,364</u>

LIFESPAN CORPORATION AND AFFILIATES

Consolidated Statements of Operations and Changes in Net Assets (Continued)

Years ended September 30, 2007 and 2006

(In thousands)

	2007	2006
Unrestricted net assets:		
Excess of revenues over expenses	\$ 102,224	\$ 61,364
Other changes in unrestricted net assets:		
Net unrealized gains on investments	35,900	252
Net assets released from restrictions used for purchase of property and equipment	15,265	17,991
Effect of adoption of provisions of FASB Statement No. 158	1,543	—
Cumulative effect to October 1, 2005 of change in accounting principle for conditional asset retirement obligations	—	(2,689)
Change in minimum pension liability	—	6,400
Donated equipment	431	27
Increase in unrestricted net assets	155,363	83,345
Temporarily restricted net assets:		
Gifts, grants, and bequests	92,585	94,990
Income from restricted endowment and other restricted investments	16,854	12,494
Net assets released from restrictions	(96,801)	(100,271)
Net realized and unrealized gains on investments	18,971	5,107
Appropriations from permanently restricted net assets	3,256	2,892
Increase in temporarily restricted net assets	34,865	15,212
Permanently restricted net assets:		
Gifts, grants, and bequests	2,341	924
Income from and net realized gains on sales of permanently restricted investments	15,112	10,901
Net unrealized gains on investments	29,044	2,503
Appropriations to temporarily restricted net assets	(3,256)	(2,892)
Increase in permanently restricted net assets	43,241	11,436
Increase in net assets	233,469	109,993
Net assets, beginning of year	1,234,031	1,124,038
Net assets, end of year	\$ 1,467,500	\$ 1,234,031

See accompanying notes to consolidated financial statements.

LIFESPAN CORPORATION AND AFFILIATES

Consolidated Statements of Cash Flows
Years ended September 30, 2007 and 2006

(In thousands)

	2007	2006
Cash flows from operating activities:		
Increase in net assets	\$ 233,469	\$ 109,993
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Effect of adoption of provisions of FASB Statement No. 158	(1,543)	—
Loss on advance refunding of debt	—	15,913
Cumulative effect to October 1, 2005 of change in accounting principle for conditional asset retirement obligations	—	2,689
Change in minimum pension liability	—	(6,400)
Net realized and unrealized gains on investments	(149,556)	(51,315)
Restricted gifts, grants, and bequests	(94,926)	(95,914)
Depreciation and amortization	47,068	44,086
Provision for estimated self-insurance costs	103,464	95,973
Decrease in liabilities for estimated self-insurance costs resulting from claims paid	(94,696)	(83,529)
Net increase in patient accounts receivable	(7,572)	(24,020)
Increase in accounts payable	3,949	4,822
(Decrease) increase in accrued employee benefits and compensation	(17,322)	10,250
(Decrease) increase in estimated third-party payor settlements	(19,447)	11,894
Decrease (increase) in all other current and noncurrent assets and liabilities, net	16,095	(832)
Net cash provided by operating activities	18,983	33,610
Cash flows from investing activities:		
Purchase of property and equipment	(113,188)	(87,859)
Net (increase) decrease in trustee-held bond funds	(948)	8,191
Other net increases in assets limited as to use	(9,859)	(27,727)
Net cash used in investing activities	(123,995)	(107,395)
Cash flows from financing activities:		
Payments on long-term debt	(8,095)	(7,725)
Restricted gifts, grants, and bequests	94,926	95,914
Proceeds from issuance of long-term debt	—	201,610
Payments to defease refunded bonds	—	(203,253)
Net cash provided by financing activities	86,831	86,546
Net (decrease) increase in cash and cash equivalents	(18,181)	12,761
Cash and cash equivalents at:		
Beginning of year	95,582	82,821
End of year	\$ 77,401	\$ 95,582
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 14,839	\$ 15,462

See accompanying notes to consolidated financial statements.

LIFESPAN CORPORATION AND AFFILIATES

Notes to Consolidated Financial Statements

September 30, 2007 and 2006

(In thousands)

(1) Description of Organization and Summary of Significant Accounting Policies

(a) Organization and Basis of Presentation

Lifespan Corporation and Affiliates (Lifespan) is an integrated regional health care delivery system of teaching hospitals and other care givers established in August 1994, with hospitals located throughout Rhode Island. Lifespan Corporation (Lifespan Corp.) is governed by a 17-member board of directors that includes the chairs of the boards of trustees of its four hospital affiliates. As a complement to its role in service and education, Lifespan actively supports research.

Lifespan Corp. is a nonprofit holding company located in Providence, Rhode Island, which operates for the benefit of and to support each of its nonprofit charitable hospitals and other affiliated corporations. The affiliates of Lifespan Corp. are governed by boards of trustees which are elected annually by Lifespan Corp.'s directors.

Affiliated corporations of Lifespan Corp. are as follows:

<u>Sole corporate member</u>	<u>Affiliate</u>
Lifespan Corp.	Rhode Island Hospital (RIH) The Miriam Hospital (TMH) Emma Pendleton Bradley Hospital (Bradley) Newport Health Care Corporation (NHCC) RIH Ventures (RIHV) South Providence Realty Corporation (SPRC) Hospital Properties, Inc. (HPI) R.I. Sound Enterprises Insurance Co., Ltd. (RISE) Lifespan Risk Services, Inc. (LRS) Lifespan Diversified Services, Inc. (LDS) Rhode Island Hospital Foundation (RIHF) The Miriam Hospital Foundation (TMHF) Bradley Hospital Foundation (BHF) Lifespan Foundation (LF) Lifespan Management Services Organization, Inc. (MSO) Health Ventures, Inc. (HVI) Lifespan of Massachusetts, Inc. (Lifespan MA)
Newport Health Care Corporation (NHCC)	Newport Hospital (NH) Newport Hospital Foundation, Inc. (NHF) NHCC Medical Associates, Inc. Newport Health Property Management, Inc.
Lifespan Diversified Services, Inc. (LDS)	VNA Technicare, Inc., d/b/a Lifespan Home Medical

LIFESPAN CORPORATION AND AFFILIATES

Notes to Consolidated Financial Statements

September 30, 2007 and 2006

(In thousands)

The consolidated financial statements include the accounts of Lifespan Corp. and its affiliates after elimination of significant intercompany accounts and transactions.

(b) *Adoption of New Accounting Standard*

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (FAS 158). As of September 30, 2007, Lifespan adopted the provisions of FAS 158, which requires an employer to recognize in its statement of financial position an asset for a benefit plan's overfunded status or a liability for a plan's underfunded status, and to recognize changes in that funded status in the year in which the changes occur through changes in unrestricted net assets. The funded-status amount is measured as the difference between the fair value of plan assets and the benefit obligation including all actuarial gains and losses and prior service cost. The adoption of FAS 158 resulted in the recording of a \$1,543 increase to unrestricted net assets in 2007 in the accompanying consolidated statement of operations and changes in net assets. The adjustment to unrestricted net assets represents the net unrecognized actuarial gain and prior service cost, both of which were previously netted in prior periods against the funded status of Lifespan's pension and other postretirement benefit plans in the consolidated statements of financial position (see note 7).

FAS 158 also requires an employer to measure the funded status of its pension and other postretirement benefit plans as of the year-end statement of financial position date for fiscal years ending after December 15, 2008. Lifespan does not expect the change in measurement date from June 30 to September 30 to have a material impact on the consolidated financial statements.

(c) *Use of Estimates*

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(d) *Cash and Cash Equivalents*

Cash and cash equivalents include all highly liquid debt instruments with maturities of three months or less when purchased, excluding amounts limited as to use by board-designation or other arrangements under trust agreements.

(e) *Investments and Investment Income*

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the consolidated statements of financial position. Investments in collective investment funds with monthly pricing and liquidity are measured based on the fair value of the underlying investments; otherwise, such investments are recorded at historical cost. Investments of less than 5% in limited partnerships are recorded at historical cost. Management believes the fair value of the investments in these limited partnerships exceeds their carrying amount.

LIFESPAN CORPORATION AND AFFILIATES

Notes to Consolidated Financial Statements

September 30, 2007 and 2006

(In thousands)

Investments of 5% or more in limited partnerships, limited liability corporations or similar investments are accounted for at fair value, with changes in fair value recorded as realized gains or losses in each net asset class using the equity method. Investments in derivative financial instruments are not material. Investments in real estate included in assets held in trust as permanently restricted funds are measured at fair market value based on independent appraisals conducted by the trustee from time to time.

The aggregate amount of the fair value of permanently restricted investments complies with the inflation protection requirements of the General Laws of the State of Rhode Island. Prudent appropriations of permanently restricted investments are periodically made to support operating activities and property and equipment acquisitions.

Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess of revenues over expenses unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments other than those accounted for using the equity method are excluded from the excess of revenues over expenses.

Realized gains or losses on sales of investments are determined by the average cost method. Realized gains or losses on unrestricted investments are recorded as nonoperating gains or losses; realized gains or losses on restricted investments are recorded as an addition to or deduction from the appropriate restricted net assets. A decline in the market value of an investment security below its cost that is designated to be other than temporary is recognized through an impairment charge classified as a realized loss and a new cost basis is established.

Investment income from funds available for self-insurance liabilities and funds held by trustees under bond indenture agreements is recorded as other revenue. Lifespan maintains a spending policy for certain board-designated funds of its patient care affiliates which provides that investment income from such funds is recorded within unrestricted revenues as endowment earnings contributed toward community benefit.

Income from permanently restricted investments is recorded as nonoperating gains when unrestricted by donor and as an addition to the net assets of the appropriate restricted fund when restricted by donor.

(f) Assets Limited as to Use

Assets limited as to use primarily include designated assets set aside by Lifespan's Board for future capital improvements, over which the Board retains control and may at its discretion subsequently use for other purposes, and assets whose use by Lifespan has been permanently restricted by donors or limited by donors to a specific purpose, as well as assets held by trustees under bond indenture agreements, self-insurance arrangements and irrevocable split-interest trusts. Amounts required to meet current liabilities of Lifespan are reported in current assets in the consolidated statements of financial position.

LIFESPAN CORPORATION AND AFFILIATES

Notes to Consolidated Financial Statements

September 30, 2007 and 2006

(In thousands)

(g) *Property and Equipment*

Property and equipment acquisitions are recorded at cost. Depreciation is computed over the estimated useful life of each class of depreciable asset using the straight-line method. Buildings and improvements lives range from 5 to 40 years and equipment from 3 to 20 years. Certain software development costs are amortized using the straight-line method over a period of five years. Net interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

(h) *Deferred Financing Costs*

Deferred financing costs, which relate to the issuance of long-term bonds payable to the Rhode Island Health and Educational Building Corporation (RIHEBC), are being amortized ratably over the periods the bonds are outstanding.

(i) *Temporarily Restricted Net Assets*

Temporarily restricted net assets are those whose use by Lifespan has been limited by grantors or donors to a specific purpose, including research activities.

(j) *Excess of Revenues over Expenses*

The consolidated statements of operations and changes in net assets include excess of revenues over expenses. Changes in unrestricted net assets which are excluded from excess of revenues over expenses, consistent with industry practice, include unrealized gains and losses on investments, net assets released from restrictions used for purchase of property and equipment, the effect of adoption of provisions of FASB Statement No. 158, the cumulative effect of the change in accounting principle for conditional asset retirement obligations, and the change in minimum pension liability.

(k) *Net Patient Service Revenue*

The Lifespan hospitals provide care to patients under Medicare, Medicaid, managed care and commercial insurance contractual arrangements. The hospitals have agreements with many third-party payors that provide for payments at amounts less than their established rates. 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 some third-party payors.

Medicare utilizes a prospective payment system for most inpatient hospital services rendered to Medicare program beneficiaries based on the classification of each case into a diagnostic-related group (DRG). Medicare outpatient hospital services are primarily paid using an ambulatory payment classification system.

Most hospital services to Rhode Island Medicaid patients are reimbursed based on negotiated costs under a prospective cost arrangement. The tentative hospital reimbursement rates are determined by certain negotiated budgeted expenditures and budgeted volume. Variances from budgeted volume are reimbursable at rates which may differ from the budgeted rate.

LIFESPAN CORPORATION AND AFFILIATES

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September 30, 2007 and 2006

(In thousands)

The majority of payments from managed care and commercial insurance companies are based upon negotiated fixed pricing arrangements, whereby a combination of per diem rates and specific case rates are utilized for inpatient services, along with fixed fees applicable to outpatient services.

Settlements and adjustments arising under reimbursement arrangements with some third-party payors, primarily Medicare, Medicaid and Blue Cross, are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. Lifespan has classified a portion of accrued estimated third-party payor settlements as long-term because such amounts, by their nature or by virtue of regulation or legislation, will not be paid within one year. Changes in the Medicare and Medicaid programs, such as the reduction of reimbursement, could have an adverse impact on certain Lifespan affiliates.

(l) Provision for Bad Debts

The Lifespan hospitals grant credit without collateral to their patients, most of whom are local residents and are insured under third-party payor arrangements. Additions to the allowance for doubtful accounts are made by means of the provision for bad debts. Accounts deemed uncollectible are deducted from the allowance and subsequent recoveries are added. The amount of the provision for bad debts is based upon management's assessment of historical and expected net collections, business and economic conditions, trends in federal and state governmental health care coverage and other collection indicators.

(m) Charity Care

The Lifespan hospitals provide care to patients who meet certain criteria under their charity care policies without charge or at amounts less than their established rates. Because the Lifespan hospitals do not pursue collection of amounts determined to qualify as charity care, they are not reported as net patient service revenue.

(n) Donor-Restricted Gifts

Unconditional promises to give that are expected to be collected within one year are recorded at net realizable value. Unconditional promises to give that are expected to be collected in future years are recorded at the present value of their estimated future cash flows. The discounts on those amounts are computed using risk-free interest rates applicable to the years in which the promises are received. Amounts received that are restricted by the donor for specific purposes are reported as temporarily restricted or permanently restricted support that increases those net asset classes. When a donor restriction expires, that is, when a stipulated purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restrictions.

(o) Inventories

Inventories, consisting primarily of medical/surgical supplies and pharmaceuticals, are stated at the lower of cost or market.

LIFESPAN CORPORATION AND AFFILIATES

Notes to Consolidated Financial Statements

September 30, 2007 and 2006

(In thousands)

(p) *Estimated Self-Insurance Costs*

Lifespan is self-insured for losses arising from professional liability/medical malpractice and general liability claims. Effective August 1, 2006, Lifespan is self-insured for losses arising from workers' compensation claims. The provision for self-insured losses includes estimates of the ultimate costs for both reported claims and claims incurred but not reported. Lifespan has established a revocable trust fund for payment of workers' compensation claims. Independent actuaries have been retained to assist Lifespan with determining both the provision for self-insured losses and amounts to be deposited in funds available for self-insurance liabilities.

Lifespan provides self-insured health benefit options to the employees of all affiliates. Lifespan has recorded a provision for estimated claims, which is based on Lifespan's own experience. The provision for self-insured losses includes estimates of the ultimate costs for both reported claims and claims incurred but not yet reported.

(q) *Fair Value of Financial Instruments*

The carrying amounts recorded in the consolidated statements of financial position for cash and cash equivalents, patient accounts receivable, assets limited as to use, accounts payable, accrued expenses, estimated third-party payor settlements, and estimated self-insurance costs approximate their respective fair values. The estimated fair value of Lifespan's long-term debt is disclosed in note 11.

(r) *Reclassifications*

Certain 2006 amounts have been reclassified to conform with the 2007 reporting format.

(2) *Disproportionate Share*

RIH, TMH, Bradley, and NH (the Hospitals) are participants in the State of Rhode Island's Disproportionate Share Program, established in 1995 to assist hospitals which provide a disproportionate amount of uncompensated care. Under the program, Rhode Island hospitals, including the Hospitals, receive federal and state Medicaid funds as additional reimbursement for treating a disproportionate share of low income patients. Total payments to the Hospitals under the Disproportionate Share Program aggregated \$46,744 and \$47,083 in 2007 and 2006, respectively, and are reflected as part of net patient service revenue in the accompanying consolidated statements of operations and changes in net assets.

The State of Rhode Island has assessed a license fee to all Rhode Island hospitals, based on each hospital's 2004 net patient service revenue as defined. The Hospitals' license fee expense was \$31,545 in both 2007 and 2006. The hospitals in the State of Rhode Island accepted the fee as part of an agreement with the State's Department of Health and Human Services in return for an equitable distribution of funds to those hospitals meeting certain criteria in providing services to the Medicaid population.

For periods beyond 2007, the federal government could change the level of federal matching funds for the Disproportionate Share Program. Accordingly, it may be necessary for the State of Rhode Island to modify the program and the reimbursement to Rhode Island hospitals under the program. At this time, the scope of such modifications or their effect on the Hospitals cannot be reasonably determined.

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Notes to Consolidated Financial Statements

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(In thousands)

(3) Charity Care and Community Services

Lifespan maintains records to identify and monitor the level of charity care it provides. These records include the amount of charges forgone for services and supplies furnished under its charity care policies and the estimated cost of those services and supplies.

The following information measures the level of charity care provided by Lifespan during the years ended September 30:

	<u>2007</u>		<u>2006</u>
Charges forgone, based on established rates	\$ 107,354	\$	77,673
Estimated costs and expenses incurred to provide charity care	\$ 36,345	\$	26,531

Lifespan also provides numerous other services to the community for which charges are not generated. These services include certain emergency services, community health screenings, health/medical education, patient advocacy, foreign language translation and physician referral services.

Lifespan subsidizes the cost of treating patients who receive government assistance where reimbursement is below cost.

Administrative uncompensated care, based on charges, amounted to \$8,847 and \$9,279 in 2007 and 2006, respectively. The related cost of such care approximated \$3,027 and \$3,198 in 2007 and 2006, respectively.

In addition to the cost of charity care and other community service programs, Lifespan provided \$78,827 and \$80,515 for uncollectible patient accounts, based on charges net of contractual allowances, during the years ended September 30, 2007 and 2006, respectively. The cost associated with such provisions approximated \$26,836 and \$28,101 in 2007 and 2006, respectively.

LIFESPAN CORPORATION AND AFFILIATES

Notes to Consolidated Financial Statements

September 30, 2007 and 2006

(In thousands)

(4) Investments

The composition of assets limited as to use at September 30, 2007 and 2006 is set forth in the following table.

	2007	2006
Funds available for self-insurance liabilities:		
Cash and short-term investments	\$ 3,719	\$ 6,128
U.S. government and agency obligations	11,816	20,182
Corporate equity securities	7,211	5,118
Corporate obligations	79,901	57,353
Collective investment funds	13,845	9,661
	116,492	98,442
Internally board-designated:		
Cash and short-term investments	—	5,582
U.S. government and agency obligations	18,789	18,250
Corporate equity securities	168,030	151,954
Corporate obligations	28,990	32,845
Collective investment funds	334,717	266,465
Other investments	2,749	3,674
	553,275	478,770
Held by trustee under bond indenture agreements:		
Cash and short-term investments	2,428	37
U.S. government and agency obligations	822	2,265
	3,250	2,302
Temporarily restricted funds:		
Cash and short-term investments	1,476	1,977
U.S. government and agency obligations	5,856	5,110
Corporate equity securities	52,353	42,539
Corporate obligations	9,031	9,197
Collective investment funds	117,648	86,568
Other investments	317	306
	\$ 186,681	\$ 145,697

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Notes to Consolidated Financial Statements

September 30, 2007 and 2006

(In thousands)

	2007	2006
Permanently restricted funds:		
Cash and short-term investments	\$ 377	\$ 4,496
U.S. government and agency obligations	9,381	11,715
Corporate equity securities	99,398	90,749
Corporate obligations	18,538	25,432
Collective investment funds	131,060	115,500
Other investments (note 5)	20,245	5,231
	278,999	253,123
Total	\$ 1,138,697	\$ 978,334

Investment income, gains and losses for cash equivalents and assets limited as to use are comprised of the following for the years ended September 30:

	2007	2006
Other revenue:		
Investment income	\$ 8,320	\$ 11,746
Endowment earnings contributed toward community benefit:		
Dividend and interest income	\$ 10,401	\$ 9,050
Nonoperating gains and losses:		
Net unrestricted income from board-designated investments	\$ 5,845	\$ 4,404
Net realized gains on sales of securities	50,529	32,552
	\$ 56,374	\$ 36,956
Other changes in unrestricted net assets:		
Net unrealized gains on investments	\$ 35,900	\$ 252
Changes in temporarily restricted net assets:		
Income from restricted endowment and other restricted investments	\$ 16,854	\$ 12,494
Net realized and unrealized gains on investments	18,971	5,107
	\$ 35,825	\$ 17,601
Changes in permanently restricted net assets:		
Income from and net realized gains on sales of investments	\$ 15,112	\$ 10,901
Net unrealized gains on investments	29,044	2,503
	\$ 44,156	\$ 13,404

Included in the above net realized gains in 2007 and 2006 are investment impairment charges totaling \$9,802 and \$631, respectively, to reflect other than temporary declines in the fair market value of certain equity and debt securities.

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(In thousands)

Information regarding investments with unrealized losses at September 30, 2007 and 2006 is presented below, segregated between those that have been in a continuous unrealized loss position for less than twelve months and those that have been in a continuous unrealized loss position for twelve or more months:

	Less than 12 months		12 months or longer		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
September 30, 2007:						
Internally board-designated, temporarily restricted and permanently restricted funds:						
Collective investment funds	\$ 2,216	\$ 276	\$ 25,582	\$ 133	\$ 27,798	\$ 409
Total temporarily impaired securities	\$ 2,216	\$ 276	\$ 25,582	\$ 133	\$ 27,798	\$ 409
September 30, 2006:						
Funds available for self-insurance liabilities:						
U.S. government and agency obligations	\$ 1,450	\$ 3	\$ —	\$ —	\$ 1,450	\$ 3
Corporate obligations	14,922	302	18,735	455	33,657	757
Total debt securities	16,372	305	18,735	455	35,107	760
Corporate equity securities	366	53	663	100	1,029	153
	16,738	358	19,398	555	36,136	913
Internally board-designated, temporarily restricted and permanently restricted funds:						
U.S. government and agency obligations	13,506	66	14,301	465	27,807	531
Corporate obligations	7,960	115	11,458	467	19,418	582
Total debt securities	21,466	181	25,759	932	47,225	1,113
Corporate equity securities	21,527	3,040	10,128	1,578	31,655	4,618
Collective investment funds	42,135	2,716	3,330	311	45,465	3,027
	85,128	5,937	39,217	2,821	124,345	8,758
Total temporarily impaired securities	\$ 101,866	\$ 6,295	\$ 58,615	\$ 3,376	\$ 160,481	\$ 9,671

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(In thousands)

The following table sets forth changes in internally board-designated investments for the years ended September 30, 2007 and 2006:

	2007	2006
Internally board-designated investments at beginning of year	\$ 478,770	\$ 438,888
Investment income:		
Dividend and interest income	13,419	11,868
Net realized gains on sales of securities	51,321	33,249
Net unrealized gains on investments	34,374	2,760
Unrestricted gifts and bequests	3,052	1,292
Deposits	13,913	30
Withdrawals	(41,574)	(9,317)
Internally board-designated investments at end of year	\$ 553,275	\$ 478,770

(5) Assets Held in Trust

Certain Lifespan affiliates (Bradley, RIH, and NH) are beneficiaries of various irrevocable charitable and split-interest trusts. The fair market value of these investments at September 30, 2007 and 2006 was approximately \$72,113 and \$51,634, respectively, and is reported as permanently restricted funds within assets limited as to use in the consolidated statements of financial position.

Included in permanently restricted funds is real estate held in trust for the benefit of Bradley. During 2007 the Bradley trustee employed property valuation consultants to conduct an independent appraisal of the real estate, which resulted in an unrealized gain of \$15,531.

(6) Property and Equipment

Property and equipment, by major category, is as follows at September 30:

	2007	2006
Land and improvements	\$ 29,781	\$ 29,629
Buildings and improvements	796,106	673,380
Equipment	455,923	445,199
	1,281,810	1,148,208
Less accumulated depreciation and amortization	648,793	642,266
	633,017	505,942
Construction in progress	48,581	109,536
Property and equipment, net	\$ 681,598	\$ 615,478

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Depreciation and amortization expense for the years ended September 30, 2007 and 2006 amounted to \$47,068 and \$44,086, respectively.

The estimated cost of completion of construction in progress approximated \$93,400 at September 30, 2007, comprised principally of RIH projects (\$79,375). In addition, RIH and TMH have several building renovation projects pending contractual commitments with estimated costs of completion of approximately \$42,000 and \$8,600, respectively.

It is Lifespan's policy to capitalize the net amount of interest cost associated with significant capital additions as a component of the cost of such assets, which is amortized over the asset's estimated useful life. No interest was capitalized in 2007 and 2006.

(7) Pension and Other Postretirement Benefits

Pension Benefits – Lifespan Corporation Retirement Plan

Lifespan Corp. sponsors the Lifespan Corporation Retirement Plan (the Plan), which was established effective January 1, 1996 when the Rhode Island Hospital Retirement Plan (the RIH Plan) merged into The Miriam Hospital Retirement Plan (the TMH Plan). Upon completion of the merger, the new plan was renamed and is governed by provisions of the Lifespan Corporation Retirement Plan. Each employee who was a participant in the RIH Plan or the TMH Plan and was an eligible employee on January 1, 1996 continues to be a participant on and after January 1, 1996, subject to the provisions of the Plan. Employees are included in the Plan on the first of the month which is the later of their first anniversary of employment and the attainment of age 18. Effective January 1, 1997, the Bradley Hospital Retirement Plan (the Bradley Plan) merged into the Plan. Each employee who was a participant in the Bradley Plan and was an eligible employee on January 1, 1997 continues to be a participant on and after January 1, 1997, subject to the provisions of the Plan.

Effective December 31, 1997, the Pension Plan for Employees of Newport Health Care Corporation and Subsidiaries (the NHCC Plan), merged into the Plan. Each employee who was a participant in the NHCC Plan and was an eligible employee on December 31, 1997 continues to be a participant in the Plan on and after December 31, 1997, subject to the provisions of the Plan.

The Plan is intended to constitute a plan described in Section 414(k) of the Internal Revenue Code, under which benefits are derived from employer contributions based on the separate account balances of participants in addition to the defined benefits provided under the Plan, which are based on an employee's years of credited service and annual compensation. Lifespan's funding policy is to contribute amounts to the Plan sufficient to meet minimum funding requirements set forth in the Employee Retirement Income Security Act of 1974, plus such additional amounts as may be determined to be appropriate by Lifespan.

Substantially all employees of RIH, TMH, Bradley, NHCC and Lifespan Corp. who meet the above requirements are eligible to participate in the Plan. Lifespan uses a measurement date of June 30 for the Plan.

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(In thousands)

As of September 30, 2007, Lifespan adopted the provisions of FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (FAS 158). FAS 158 requires an employer to recognize in its statement of financial position an asset for a benefit plan's overfunded status or a liability for a plan's underfunded status, and to recognize changes in that funded status in the year in which the changes occur through changes in unrestricted net assets. The funded-status amount is measured as the difference between the fair value of plan assets and the benefit obligation including all actuarial gains and losses and prior service cost. The adjustment to unrestricted net assets at the adoption of FAS 158 represents the net unrecognized actuarial gain and prior service cost, both of which were previously netted in prior periods against the Plan's funded status in the consolidated statements of financial position, pursuant to the provisions of FASB Statement No. 87, *Employers' Accounting for Pensions* (FAS 87). These amounts will be recognized in future periods as net periodic pension cost, as required by FAS 87.

The estimated amounts that will be amortized from unrestricted net assets into net periodic pension cost in 2008 are as follows:

Net actuarial gain	\$	(798)
Prior service cost		997
		199
	\$	199

Additional actuarial gains and losses that both arise in subsequent periods and are not recognized as net periodic pension cost in the same period will be recognized as a component of unrestricted net assets. These future actuarial gains and losses will be recognized as a component of net periodic pension cost on the same basis as the amounts recognized in unrestricted net assets at the adoption of FAS 158.

The following tables set forth the Plan's projected benefit obligations and the fair value of plan assets.

		2007		2006
Change in projected benefit obligation:				
Projected benefit obligation at beginning of year	\$	348,112	\$	363,010
Service cost		19,181		21,198
Interest cost		22,437		19,495
Actuarial loss (gain)		10,087		(37,825)
Benefits paid		(16,333)		(16,701)
Administrative expenses		(1,175)		(1,065)
Projected benefit obligation at end of year	\$	382,309	\$	348,112

The accumulated benefit obligation at the end of 2007 and 2006 was \$331,011 and \$300,221, respectively.

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	2007	2006
Change in plan assets:		
Fair value of plan assets at beginning of year	\$ 298,116	\$ 265,119
Actual return on plan assets	51,271	32,251
Employer contributions	25,669	18,512
Benefits paid	(16,333)	(16,701)
Administrative expenses	(1,175)	(1,065)
	\$ 357,548	\$ 298,116

The funded status of the Plan and amounts recognized in the consolidated statement of financial position at September 30, 2007, pursuant to FAS 158, are as follows:

Funded status, end of year:	
Fair value of plan assets	\$ 357,548
Projected benefit obligation	382,309
	\$ (24,761)

Amounts recognized in the consolidated statement of financial position, end of year:

Pension liability:	
Noncurrent (included in other liabilities)	\$ 24,761
Unrestricted net assets:	
Net actuarial gain	\$ 10,778
Prior service cost	(4,696)
Effect of adoption of provisions of FAS 158	\$ 6,082

As required by FAS 87, the following information is presented for September 30, 2006 (this disclosure is no longer applicable under FAS 158, therefore, 2007 information is not presented):

Reconciliation of funded status:	
Funded status	\$ (49,996)
Unrecognized actuarial loss	8,733
Unrecognized prior service cost	5,693
Net pension liability recognized in the consolidated statement of financial position	\$ (35,570)

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The net pension liability recognized in the consolidated statement of financial position consisted of:

Current (included in accrued employee benefits and compensation)	\$	24,990
Noncurrent (included in other liabilities)		10,580
Total net pension liability	\$	35,570

Lifespan recorded a change in minimum pension liability of \$6,400 at September 30, 2005, as required by FAS 87. The adjustment is prescribed when the accumulated benefit obligation of a pension plan exceeds the fair value of underlying pension plan assets in an amount greater than accrued pension liabilities. The adjustment referenced above was comprised of:

Minimum pension liability included in other liabilities	\$	(13,093)
Intangible pension asset included in other noncurrent assets		6,693
Net charge to unrestricted net assets in 2005	\$	(6,400)

In 2006, the net minimum pension liability of \$6,400 recorded at September 30, 2005 was reversed since the excess of accumulated benefit liabilities over Plan assets was less than the net pension liability recognized in the consolidated statement of financial position.

Net Periodic Pension Cost

Components of net periodic pension cost are as follows for the years ended September 30:

	2007	2006
Service cost	\$ 19,181	\$ 21,198
Interest cost	22,437	19,495
Expected return on plan assets	(22,313)	(20,766)
Amortization of net actuarial loss	639	4,465
Amortization of prior service cost	998	998
Net periodic pension cost	\$ 20,942	\$ 25,390

The following weighted average assumptions were used by the Plan's actuary to determine net periodic pension cost and benefit obligations:

	2007	2006
Discount rate for benefit obligations	6.25%	6.25%
Discount rate for net periodic pension cost	6.25	5.00
Rate of compensation increase	4.50	4.50
Expected long-term rate of return on plan assets	8.00	8.00

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(In thousands)

The asset allocation for the Plan at June 30, 2007 and 2006, and the target allocation for 2008, by asset category, are as follows:

<u>Asset category</u>	<u>Target allocation 2008</u>	<u>Percentage of plan assets at June 30</u>	
		<u>2007</u>	<u>2006</u>
U.S. equity	25 – 40%	24.0%	23.4%
Absolute return	0 – 15%	9.4	9.9
International equity	10 – 30%	30.5	26.1
Venture capital	0 – 10%	1.7	1.8
Commodities	0 – 10%	11.0	11.5
Real estate	0 – 15%	8.2	8.6
Fixed income	15 – 35%	15.2	18.7
Cash and cash equivalents	0 – 10%	—	—
Total		<u>100.0%</u>	<u>100.0%</u>

The above table does not include \$69,121 and \$56,033 of Plan assets at June 30, 2007 and 2006, respectively, attributable to the separate savings account balances of participants which are managed in various mutual funds by Fidelity Investments.

The overall financial objective of the Plan is to meet present and future obligations to beneficiaries, while minimizing long-term contributions to the Plan (by earning an adequate return on Plan assets), with moderate volatility in year-to-year contribution levels.

The primary investment objective of the Plan is to provide a satisfactory return on investment in support of the above objective. The Plan's specific investment objective is to attain an average annual real total return (net of investment management fees) of at least 5% over the long term (rolling five-year periods). Real total return is the sum of capital appreciation (or loss) and current income (dividends and interest) adjusted for inflation by the Consumer Price Index.

Lifespan employs a rigorous process to annually determine the expected long-term rate of return on Plan assets which is only changed based on significant shifts in economic and financial market conditions. These estimates are primarily driven by actual historical asset-class returns along with our long-term outlook for a globally diversified portfolio. Asset allocations are regularly updated based on evaluations of future market returns for each asset class.

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Expected Cash Flows

Information about the expected cash flows for the Plan follows:

Employer contributions:		
2008 (expected)	\$	23,130
Expected benefit payments:		
2008	\$	17,900
2009		18,700
2010		17,900
2011		18,600
2012		19,400
2013 through 2017		101,700

Management evaluates its Plan assumptions annually and the expected contribution in 2008 could increase.

Other Postretirement Benefits

In addition to providing pension benefits, RIH and TMH provide certain health care and life insurance benefits to retired employees. As of December 31, 2003, health care and life insurance postretirement benefits were eliminated for all active RIH employees with fewer than fifteen years of consecutive service. As of December 31, 2004, health care postretirement benefits were eliminated for all active TMH employees who had not attained age 55 and completed five years of consecutive service.

As of September 30, 2007, Lifespan adopted the provisions of FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (FAS 158). FAS 158 requires an employer to recognize in its statement of financial position an asset for a benefit plan's overfunded status or a liability for a plan's underfunded status, and to recognize changes in that funded status in the year in which the changes occur through changes in unrestricted net assets. The funded-status amount is measured as the difference between the fair value of plan assets and the benefit obligation including all actuarial gains and losses and prior service cost. The adjustment to unrestricted net assets at the adoption of FAS 158 represents the net unrecognized actuarial loss and prior service benefit, both of which were previously netted in prior periods against the plan's funded status in the consolidated statements of financial position, pursuant to the provisions of FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other than Pensions* (FAS 106). These amounts will be recognized in future periods as net periodic postretirement benefit cost, as required by FAS 106.

The estimated amounts that will be amortized from unrestricted net assets into net periodic postretirement benefit cost in 2008 are as follows:

Net actuarial loss	\$	656
Prior service benefit		(1,056)
	\$	<u>(400)</u>

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Additional actuarial gains and losses that both arise in subsequent periods and are not recognized as net periodic postretirement benefit cost in the same period will be recognized as a component of unrestricted net assets. These future actuarial gains and losses will be recognized as a component of net periodic postretirement benefit cost on the same basis as the amounts recognized in unrestricted net assets at the adoption of FAS 158.

Benefit Obligations

	2007	2006
Change in benefit obligation:		
Accumulated postretirement benefit obligation at beginning of year	\$ 25,042	\$ 26,718
Service cost	584	725
Interest cost	1,542	1,320
Benefits paid	(1,484)	(1,361)
Actuarial gain	(706)	(2,360)
	<u>24,978</u>	<u>25,042</u>
Accumulated postretirement benefit obligation at end of year	\$ 24,978	\$ 25,042

Funded Status

Lifespan has never funded its postretirement benefit obligations. The funded status of the postretirement benefit plan, reconciled to the amount reported in the consolidated statements of financial position, follows:

	2007	2006
Benefit obligations	\$ 24,978	\$ 25,042
Funded status	(24,978)	(25,042)
Unrecognized net actuarial loss	—	10,891
Unrecognized prior service benefit	—	(5,901)
	<u>(24,978)</u>	<u>(5,901)</u>
Accrued postretirement benefit cost recognized in the consolidated statements of financial position	\$ (24,978)	\$ (20,052)

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(In thousands)

Amounts recognized in the consolidated statements of financial position at September 30, 2007 and 2006 consist of:

	2007	2006
Accrued postretirement benefit cost:		
Current (included in accrued employee benefits and compensation)	\$ 1,700	\$ 1,361
Noncurrent (included in other liabilities)	23,278	18,691
Total accrued postretirement benefit cost	\$ 24,978	\$ 20,052
Unrestricted net assets:		
Net actuarial loss	\$ (9,383)	\$ —
Prior service benefit	4,844	—
Effect of adoption of provisions of FAS 158	\$ (4,539)	\$ —

Net Periodic Postretirement Benefit Cost

Components of net periodic postretirement benefit cost are as follows for the years ended September 30:

	2007	2006
Service cost	\$ 584	\$ 725
Interest cost	1,542	1,320
Amortization of prior service benefit	(1,056)	(1,056)
Amortization of net actuarial loss	801	1,006
Net periodic postretirement benefit cost	\$ 1,871	\$ 1,995

The following weighted average assumptions were used by the plan's actuary to determine net periodic postretirement benefit cost and benefit obligations:

	2007	2006
Discount rate for benefit obligations	6.25%	6.25%
Discount rate for net periodic postretirement benefit cost	6.25	5.00

Assumed Health Care Cost Trend Rates at September 30:

	2007	2006
Health care cost trend rate assumed for next year	9%	10%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5%	5%
Year that the rate reaches the ultimate trend rate	2014	2014

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Assumed health care cost trend rates have a significant effect on the amounts reported. A one-percentage-point change in assumed health care cost trend rates would have the following effects as of September 30, 2007:

	1-Percentage- Point Increase	1-Percentage- Point Decrease
Effect on total of service cost and interest cost	\$ 185	(165)
Effect on accumulated postretirement benefit obligation	1,855	(1,661)

Expected Cash Flows

Information about the expected cash flows for the postretirement benefit plan follows:

Expected benefit payments:	
2008	\$ 1,700
2009	1,900
2010	2,200
2011	2,300
2012	2,500
2013 through 2017	13,200

The effects of adopting the provisions of FAS 158 on the consolidated statement of financial position at September 30, 2007 are presented in the following table:

	Prior to adopting FAS 158	Effect of adopting FAS 158	As reported at September 30, 2007
Noncurrent pension liability	\$ 30,843	\$ (6,082)	\$ 24,761
Noncurrent accrued postretirement benefit cost	18,739	4,539	23,278
Total liabilities	675,065	(1,543)	673,522
Unrestricted net assets	968,920	1,543	970,463

Supplemental Executive Retirement Plans

Lifespan Corporation maintains a nonqualified supplemental executive retirement plan (SERP) established in 1998 for a key management employee, under which the accrued benefits earned are being funded over a ten-year period. Other senior management employees are participants in an additional nonqualified SERP formed by Lifespan Corporation in 2006.

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(In thousands)

(8) Estimated Self-Insurance Costs

Professional Liability/Medical Malpractice

Professional liability/medical malpractice coverage for RIH, TMH, Bradley and NHCC is supplied on a claims-made basis by RISE, Lifespan's affiliated captive insurance company, which underwrites the medical malpractice risk of Lifespan (including RIH's contractual commitment to indemnify certain eligible physicians on its medical staff). The adequacy of the coverage provided and the funding levels are reviewed annually by independent actuaries and consultants. The professional liability insurance provided by RISE has liability limits of \$4,000 per claim with no annual aggregate. RISE provides a second layer of coverage which has limits of an additional \$2,000 per claim with a \$2,000 annual aggregate. In addition, commercial umbrella excess insurance has been obtained to increase the professional liability limits to \$22,000 per claim. Also covered under the Lifespan professional liability policy are 462 physicians not employed by RIH. Each of these physicians is provided with a \$2,000 indemnification per claim and a \$6,000 annual indemnification aggregate.

General Liability

General liability coverage is provided to RIH, TMH, Bradley, and NHCC by RISE amounting to \$4,000 per claim and \$4,000 in the annual aggregate. Commercial excess liability insurance has been obtained by Lifespan which provides aggregate general liability coverage of \$80,000.

Lifespan has recorded a provision for estimated losses on malpractice and general liability incidents, based on actuarial studies and its own experience. The amounts accrued for estimated malpractice and general liability self-insurance costs at September 30, 2007 and 2006 have been discounted at 5%. Had Lifespan provided for losses at undiscounted levels, estimated self-insurance liabilities would have been increased by approximately \$8,000 and \$7,500 at September 30, 2007 and 2006, respectively.

Workers' Compensation

Through July 31, 2006, workers' compensation coverage was provided to Lifespan by an external insurance company. Beginning on August 1, 2006, Lifespan has recorded a provision for workers' compensation losses, based on actuarial studies and its own experience. The amount accrued for estimated workers' compensation self-insurance costs at September 30, 2007 and 2006 has been discounted at 5%. Had such losses been provided for at undiscounted levels, estimated self-insurance liabilities would have been increased by approximately \$648 and \$141 at September 30, 2007 and 2006, respectively.

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(9) Patient Service Revenue and Related Reimbursement

A major portion of Lifespan's revenue is received from third-party payors. The following is an approximate percentage breakdown of gross patient service revenue by payor type for the years ended September 30:

	2007	2006
Medicare and Senior Care	38%	39%
Blue Cross	21	21
Medicaid and RItE Care	16	15
Managed care	14	14
Commercial, self-pay, and other	11	11
	100%	100%

Lifespan grants credit to patients, most of whom are local residents. Lifespan generally does not require collateral or other security in extending credit to patients; however, it routinely obtains assignment of (or is otherwise entitled to receive) patients' benefits payable under their health insurance programs, plans or policies (e.g., Medicare, Medicaid, Blue Cross, managed care, and commercial insurance policies).

Cost reports filed annually with third-party payors are subject to audit prior to final settlement. The 2007 Medicare and Medicaid cost reports have not been filed and therefore are not settled. In addition, the following cost reports have not been settled:

	RIH	TMH	Bradley	NH
Medicare 2006	X	X		X
Medicare 2005	X	X		
Medicaid 2006	X	X	X	X
Medicaid 2005	X	X	X	X
Medicaid 2004		X	X	X

Regulations in effect require annual settlements based upon cost reports filed by the Hospitals. These settlements are estimated and recorded in the accompanying consolidated financial statements. Changes in these estimates are reflected in the consolidated financial statements in the year in which they occur. Net patient service revenue in the accompanying consolidated statements of operations and changes in net assets was increased by \$23,586 and \$7,997 in 2007 and 2006, respectively, to reflect changes in the estimated settlements for certain prior years.

Revenues from Medicare and Medicaid programs accounted for approximately 38% and 16%, respectively, of Lifespan's gross patient service revenue for the year ended September 30, 2007. Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. Lifespan believes that they are in compliance with all applicable laws and regulations. Compliance with laws and regulations can be subject to future government review and interpretation as well as significant

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regulatory action; failure to comply with such laws and regulations can result in fines, penalties, and exclusion from Medicare and Medicaid programs.

(10) Income Tax Status

Lifespan Corp. and substantially all of its affiliates are not-for-profit corporations as described in Section 501(c)(3) of the Internal Revenue Code (the Code) and are exempt from Federal income taxes pursuant to Section 501(a) of the Code. RISE is a Bermuda corporation not subject to taxes. MSO, LRS, HVI and VNA Technicare, Inc. are for-profit corporations.

(11) Long-Term Debt

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

	2007	2006
Hospital Financing Revenue fixed rate serial and term bonds due May 15, 2009 through 2032 in annual amounts ranging from \$2,355 to \$15,020 at rates ranging from 4% to 5% (2006A Series – Lifespan Obligated Group)	\$ 192,135	\$ 192,135
Hospital Financing Revenue fixed rate serial and term bonds due May 15, 2008 through 2026 in annual amounts ranging from \$5,560 to \$14,705 at rates ranging from 5.2% to 5.75% (1996 Series-Lifespan Obligated Group)	55,735	60,990
Hospital Financing Revenue fixed rate serial and term bonds due July 1, 2008 through 2029 in annual amounts ranging from \$660 to \$1,890 at rates ranging from 4.6% to 5.3% (1999 Series – NH)	25,605	26,235
Hospital Financing Revenue fixed rate serial and term bonds due August 15, 2008 through 2012 in annual amounts ranging from \$1,275 to \$1,595 at rates ranging from 5% to 6.375% (2002 Series-Lifespan Obligated Group)	7,130	8,340
Hospital Financing Revenue variable rate bonds (3.83% at September 30, 2007) due March 1, 2008 through 2014 in an annual amount of \$1,000 (2004 Series – NH)	7,000	8,000
Unamortized premium – 2006A Series	8,348	9,042
Unamortized discount – 1996 and 2002 Series	(99)	(137)
	295,854	304,605
Less current portion	3,495	8,095
Long-term debt, excluding current portion	\$ 292,359	\$ 296,510

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The estimated fair value of Lifespan's long-term debt at September 30, 2007 amounts to \$286,072 and is estimated using discounted cash flow analyses, based on Lifespan's current incremental borrowing rates for similar types of borrowing arrangements.

On February 14, 2006, Rhode Island Health and Educational Building Corporation (RIHEBC) issued, on behalf of the Lifespan Obligated Group, which consisted of RIH and TMH, \$192,135 of tax-exempt bonds (the 2006 A Bonds) for the purpose of refunding \$123,405 and \$65,315 of the Lifespan Obligated Group's 1996 Bonds and 2002 Bonds, respectively. On September 12, 2006, the Board of Directors of Lifespan Corporation, acting as the sole member of each of The Miriam Hospital Foundation and Rhode Island Hospital Foundation (the Foundations), adopted resolutions authorizing the Foundations to become members of the Lifespan Obligated Group. The Boards of Trustees of each of the Foundations, as well as the existing members of the Lifespan Obligated Group, RIH and TMH, previously authorized related resolutions. The effective date for such change was October 1, 2006.

A total of \$195,087 of the net proceeds of the 2006 bond issue and \$8,166 of the refunded bonds' unspent debt service funds was deposited into trust funds for the purpose of these partial refundings. The principal balance outstanding on the 1996 and 2002 refunded bonds, which are considered extinguished, was \$123,405 and \$65,315, respectively, at September 30, 2007. The trusts are held by an independent trustee and are invested in obligations of the United States Government which mature and bear interest in such amounts and at such times as will be sufficient to pay the principal and interest as it comes due on the 1996 and 2002 refunded bonds.

The above outstanding 2006 Hospital Financing Revenue Bonds (Lifespan Obligated Group – RIH, TMH and the Foundations) are secured by a pledge of the gross receipts of RIH and TMH and by mortgage liens on RIH's and TMH's real property and all buildings, structures and improvements thereon. RIH, TMH and the Foundations are jointly and severally liable for repayment of the 2006 A Bonds. Payment of the principal and interest on the 2006 A Bonds when due is guaranteed by a financial guaranty insurance policy issued by Financial Security Assurance, Inc.

The above advance refunding resulted in a nonoperating loss of \$15,913 in 2006.

On July 9, 2002, RIHEBC issued, on behalf of the Lifespan Obligated Group, \$78,000 of tax-exempt bonds (the 2002 Bonds) to finance routine capital expenditures, renovations of the RIH emergency department and construction and equipping of a cancer center on the campus of RIH.

The above outstanding 2002 Hospital Financing Revenue Bonds (Lifespan Obligated Group – RIH, TMH and the Foundations) are secured by mortgage liens on RIH's and TMH's real property and all buildings, structures and improvements thereon. RIH, TMH and the Foundations are jointly and severally liable for repayment of the 2002 Bonds.

On December 1, 1996, RIHEBC issued, on behalf of the Lifespan Obligated Group, \$214,585 of tax-exempt bonds (the 1996 Bonds), to finance portions of Lifespan's, RIH's and TMH's 1996, 1997, 1998, and 1999 expenditures for routine capital equipment and facility renovation/replacement, and to advance refund \$8,455 of TMH 1989 Series A bonds, \$1,900 of TMH 1992 Series A bonds and \$10,065 of TMH 1992 Series B bonds. A total of \$20,580 of the net proceeds from the 1996 bond issue and \$1,004 of

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(In thousands)

the refunded bonds' unspent debt service funds was deposited into a trust fund for the purpose of this refunding. The principal balance outstanding on the TMH-refunded bonds, which are considered extinguished, was \$13,730 at September 30, 2007. The trust is held by an independent trustee and is invested in obligations of the United States Government which mature and bear interest in such amounts and at such times as will be sufficient to pay the principal and interest as it comes due on the TMH-refunded bonds.

Prior to the issuance of the 1996 Bonds, RIH drew \$97,585 under a credit facility with four financial institutions (the Facility) and deposited that amount into a trust fund along with \$735 of the refunded bonds' unspent debt service funds for the purpose of advance refunding \$95,995 of RIH's 1991 Series A bonds. The Facility matured in January 2000. The principal balance outstanding on the RIH-refunded bonds, which are considered extinguished, was \$79,600 at September 30, 2007. The trust is held by an independent trustee and is invested in obligations of the United States Government which mature and bear interest in such amounts and at such times as will be sufficient to pay the principal and interest as it comes due on the RIH-refunded bonds.

The above outstanding 1996 Hospital Financing Revenue Bonds (Lifespan Obligated Group – RIH, TMH and the Foundations) are secured by a pledge of the gross receipts of RIH and TMH. RIH, TMH and the Foundations are jointly and severally liable for repayment of the 1996 Bonds. Payment of the principal and interest on the 1996 Bonds when due is guaranteed by a financial guaranty insurance policy issued by MBIA Insurance Corporation.

Under the terms of the 2006, 2002 and 1996 Bonds, RIH and TMH are required to satisfy certain measures of financial performance as long as the bonds are outstanding. At September 30, 2007, management believes RIH and TMH were in compliance with all covenants of the bonds.

On March 1, 2004, RIHEBC issued, on behalf of Newport Hospital (NH), \$10,000 of tax-exempt bonds (the 2004 Bonds) to finance the renovation of an inpatient medical/surgical unit as well as the purchase of CT Scan equipment and new beds.

On February 1, 1999, RIHEBC issued, on behalf of NH, \$30,000 of tax-exempt bonds (the 1999 Bonds) to finance the acquisition, construction, renovation and equipping of various NH facilities. The 1999 Bonds are secured by a pledge of the gross receipts of NH.

Payment of the principal and interest on the 2004 and 1999 Bonds when due is guaranteed by Newport Hospital Foundation, Inc. Under the terms of the 2004 and 1999 Bonds, NH is required to satisfy certain measures of financial performance as long as the bonds are outstanding. At September 30, 2007, management believes NH was in compliance with all covenants of the bonds.

Lifespan's aggregate maturities of long-term debt for the five fiscal years ending in September 2012 are as follows: 2008, \$3,495; 2009, \$5,975; 2010, \$10,370; 2011, \$10,785, and 2012, \$11,295.

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Agreements underlying the various Hospital Financing Revenue Bonds require that RIH, TMH and NH maintain certain trustee-held funds, included with assets limited as to use in the consolidated statements of financial position, as follows:

Bond Funds – RIH, TMH and NH are required to make quarterly deposits to the trustee sufficient to provide sinking funds for the payment of principal and interest to bondholders when due.

Debt Service Reserve Fund – RIH and TMH are required to apply monies in the Debt Service Reserve Fund to remedy deficiencies in the 2002 Bond Fund, if any.

The balances of these trustee-held funds at September 30 are summarized as follows:

	2007	2006
RIH and TMH:		
Bond Funds	\$ 2,104	\$ 35
Debt Service Reserve Fund – 2002 Series	648	1,769
	2,752	1,804
Newport Hospital Bond Fund – 1999 Series	498	498
Total	\$ 3,250	\$ 2,302

(12) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes at September 30:

	2007	2006
General health care service activities	\$ 168,268	\$ 137,069
Research	46,938	43,272
Total	\$ 215,206	\$ 180,341

Permanently restricted net assets are restricted in perpetuity at September 30, the income from which is expendable to support the following:

	2007	2006
General health care service activities	\$ 254,792	\$ 215,167
Research	27,039	23,423
Total	\$ 281,831	\$ 238,590

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(In thousands)

(13) Leases

Lifespan leases building space and equipment under various noncancelable operating lease agreements. Future minimum lease payments, by year and in the aggregate, under noncancelable operating leases with terms of one year or more consist of the following at September 30, 2007:

	<u>Amount</u>
Year ending September 30:	
2008	\$ 14,388
2009	12,674
2010	11,217
2011	9,891
2012	<u>9,199</u>
Total minimum lease payments	<u>\$ 57,369</u>

Rental expense, including rentals under leases with terms of less than one year, for the years ended September 30, 2007 and 2006 was \$19,613 and \$18,094, respectively.

(14) Concentrations of Credit Risk

Financial instruments which potentially subject Lifespan to concentrations of credit risk consist primarily of accounts receivable and certain investments. The risk associated with temporary cash investments is mitigated by the fact that the investments are placed with what management believes are high credit quality financial institutions. Investments, which include government and agency obligations, stocks, and corporate bonds, are not concentrated in any corporation or industry.

Lifespan receives a significant portion of its payments for services rendered from a limited number of government and commercial third-party payors, including Medicare, Blue Cross, Medicaid, and various managed care entities. Lifespan has not historically incurred any significant concentrated credit losses in the normal course of business.

(15) Malpractice and Other Litigation

Certain Lifespan hospitals have been named as defendants in a number of pending actions seeking damages for alleged medical malpractice. In the opinion of management, any liability and legal defense costs resulting from these actions will be within the limits of each hospital's malpractice insurance coverage provided by RISE and/or commercial excess carriers.

Lifespan is also involved in a number of miscellaneous suits and general liability suits arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on Lifespan's future financial position or results from operations.

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(16) Related-Party Transactions

Lifespan Physicians Professional Service Organization, Inc. (the PSO), incorporated on December 20, 1996, is a collaborative venture between Lifespan Corp. and New England Physicians Alliance (NEPA) organized for the purpose of contributing to the mission of Lifespan and NEPA.

The amounts included in operating expenses in the consolidated statements of operations and changes in net assets related to services provided to Lifespan by the PSO for the years ended September 30, 2007 and 2006 are \$2,802 and \$2,748, respectively.

(17) Functional Expenses

Lifespan provides general health care services to residents within its geographic location. Expenses related to providing these services are as follows for the years ended September 30:

	<u>2007</u>	<u>2006</u>
Health care services	\$ 1,064,540	\$ 1,016,786
Research	79,864	82,308
General and administrative:		
Depreciation and amortization	47,068	44,086
Interest	13,988	15,341
License fees	31,545	31,545
Other	120,588	114,886
Total general and administrative	<u>213,189</u>	<u>205,858</u>
	<u>\$ 1,357,593</u>	<u>\$ 1,304,952</u>

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(In thousands)

(18) Promises to Give

Included in contributions receivable are the following unconditional promises to give:

	2007	2006
Capital campaigns	\$ 14,732	\$ 14,437
Other restricted	5,878	5,725
Unconditional promises to give before unamortized discount and allowance for uncollectibles	20,610	20,162
Less unamortized discount at rates ranging from 4.4% to 4.6%	(2,256)	(2,825)
Subtotal	18,354	17,337
Less allowance for uncollectibles	(431)	(402)
Net unconditional promises to give	\$ 17,923	\$ 16,935
Amount due in:		
Less than one year	\$ 7,708	5,792
One to five years	11,278	12,396
More than five years	1,624	1,974
Total	\$ 20,610	\$ 20,162

(19) Cumulative Effect of Change in Accounting Principle

In March 2005, FASB Interpretation No. 47 (FIN 47), *Accounting for Conditional Asset Retirement Obligations*, was issued. Under FIN 47, costs related to legal obligations to perform certain activities in connection with the retirement, disposal, or abandonment of assets are required to be accrued. Lifespan adopted the provisions of FIN 47 effective October 1, 2005.

Lifespan has identified asbestos abatement as a conditional asset retirement obligation. Asbestos abatement costs were estimated based on relevant facts and circumstances. At September 30, 2006, Lifespan recorded site improvements of \$1,153, related accumulated depreciation of \$936, asset retirement obligations of \$182 and \$2,724 included in other accrued expenses and other liabilities, respectively, and a cumulative effect of change in accounting principle to October 1, 2005 of \$2,689.

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(20) Affiliation with Care New England Health System

On July 26, 2007, Lifespan Corporation and Care New England Health System (the Parties) entered into a Master Affiliation Agreement. Under this Agreement, Lifespan Corporation would become the sole corporate member of Care New England Health System. Care New England Health System is an integrated delivery network established in February 1996 which includes Butler Hospital, Kent County Memorial Hospital, Women & Infants Hospital of Rhode Island, Kent County Visiting Nurse Association (d/b/a VNA of Care New England) and their related affiliates. The Parties submitted a pre-merger notification to the federal antitrust enforcement agencies and were notified by the Federal Trade Commission that it would not issue a Second Request for Information; the 30-day waiting period expired on December 17, 2007. Approval will be sought from the Rhode Island Attorney General's Office and the Rhode Island Department of Health. Decisions are expected some time during the next year.