
**ANNUAL DISCLOSURE REPORT
OF
STANFORD HOSPITAL AND CLINICS
FOR
THE FISCAL YEAR ENDED AUGUST 31, 2008**

DATED JANUARY 8, 2009

ANNUAL DISCLOSURE REPORT
OF
STANFORD HOSPITAL AND CLINICS
FOR
THE FISCAL YEAR ENDED AUGUST 31, 2008

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I. INTRODUCTION

Pursuant to the following Continuing Disclosure Agreements (the “Disclosure Agreements”) executed and delivered in connection with the following bond issues (the “Bonds”), Stanford Hospital and Clinics (the “Corporation”) hereby provides its annual disclosure report for the fiscal year ended August 31, 2008 (the “Annual Disclosure Report”):

- Continuing Disclosure Agreement dated March 31, 1998 (the “Series B Disclosure Agreement”) relating to the \$193,895,000 California Health Facilities Financing Authority Revenue Bonds (UCSF-Stanford Health Care) 1998 Series B (the “1998 Series B Bonds”)
- Continuing Disclosure Agreement dated July 1, 2003 (the “Series 2003 Disclosure Agreement”) relating to the \$250,000,000 California Health Facilities Financing Authority Revenue Bonds (Stanford Hospital and Clinics) 2003 Series A, 2003 Series B, 2003 Series C and 2003 Series D (collectively, the “2003 Bonds”)
- Continuing Disclosure Agreement dated June 1, 2008 (the “Series 2008 Disclosure Agreement”) relating to the \$156,200,000 California Health Facilities Financing Authority Revenue Bonds (Stanford Hospital and Clinics) 2008 Series A-1, and A-3, (collectively, the “2008 Bonds”)

Annual Report

The Corporation’s Annual Disclosure Report includes this Introduction and both appendices attached hereto.

Other Matters

This Annual Disclosure Report is provided solely pursuant to the Disclosure Agreements. The filing of this Annual Disclosure Report does not constitute or imply any representation (i) that all of the information provided is material to investors, (ii) regarding any other financial, operating or other information about the Corporation or the Bonds, or (iii) that no changes, circumstances or events have occurred since the end of the fiscal year to which this Annual Disclosure Report relates (other than as contained in this Annual Disclosure Report), or any other date specified with respect to any of the information contained in this Annual Disclosure Report, or that no other information exists, which may have a bearing on the security for the Bonds, or an investor’s decision to buy, sell, or hold the Bonds. The information contained in this Annual Disclosure Report has been obtained from sources which are believed to be reliable, but such information is not guaranteed as to accuracy or completeness. No statement in this Annual Disclosure Report should be construed as a prediction or representation about future financial performance of the Corporation.

Cautionary Statement Regarding Forward-Looking Statements in this Annual Disclosure Report

Certain statements and information in this Annual Disclosure Report constitute “forward-looking statements.” Such statements generally are identifiable by the terminology used, such as “plan,” “expect,” “estimate,” “budget,” “assume,” or other similar words. Such forward-looking statements include but are not limited to certain interest expense estimates under the caption “DEBT SERVICE REQUIREMENTS” in this Annual Disclosure Report and certain statements in Appendix A attached hereto.

The achievement of the results or other expectations contained in such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause actual results, performance or achievements described to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. The Corporation does not plan to issue any updates or revisions to those forward-looking statements if or when changes in its expectations or events, conditions or circumstances, on which such statements are based occur.

Capitalized terms not otherwise defined herein shall have the meanings set forth in the applicable Disclosure Agreement.

Dated: January 8, 2009.

STANFORD HOSPITAL AND CLINICS

By: /s/ Dan Morissette
Chief Financial Officer

**II. AUDITED FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED AUGUST 31, 2008 AND 2007**

The audited financial statements of the Corporation and subsidiaries for the fiscal years ended August 31, 2008 and 2007 are attached hereto as Appendix A.

III. DEBT SERVICE REQUIREMENTS

The table below sets forth, for each year ending November 15, the amounts required to be paid by the Corporation for payment of the principal, whether by payment or maturity or mandatory sinking account redemption, and interest on the 2008 Bonds, the 2003 Bonds, the debt service on the 1998 Series B Bonds and the total debt service on the 1998 Series B Bonds, the 2003 Bonds and the 2008 Bonds. Interest on the 2003 B,C & D Bonds and the 2008 Series A and B Bonds during future periods has been estimated at an assumed rate based upon the interest rate exchange agreements in effect as of August 31, 2008.

| Bond Year Ending Nov. 15 | 1998 B Debt Service | 2003 A Debt Service | 2003 B,C & D* Debt Service* | 2008 Series A1, A2, A3 Debt Service* | 2008 Series B1, B2 Debt Service* | Total Debt Service |
|-----------------------------------|------------------------|------------------------|--------------------------------|---|-------------------------------------|-------------------------------|
| 2009 | \$12,116,750 | \$8,901,925 | \$5,047,500 | 9,654,347 | 6,100,782 | \$41,821,304 |
| 2010 | \$12,119,500 | \$8,902,788 | \$5,047,500 | 9,654,347 | 6,100,782 | \$41,824,917 |
| 2011 | \$12,117,250 | \$8,407,615 | \$5,047,500 | 11,904,347 | 6,100,782 | \$43,577,494 |
| 2012 | \$12,114,750 | \$8,903,365 | \$5,047,500 | 10,620,894 | 6,100,782 | \$42,787,291 |
| 2013 | \$12,116,500 | \$8,408,115 | \$5,047,500 | 12,081,948 | 6,100,782 | \$43,754,845 |
| 2014 | \$12,111,750 | \$8,904,615 | \$5,047,500 | 10,412,373 | 6,100,782 | \$42,577,020 |
| 2015 | \$12,115,250 | \$8,408,865 | \$5,047,500 | 11,876,213 | 6,100,782 | \$43,548,610 |
| 2016 | \$12,116,000 | \$8,903,615 | \$5,047,500 | 10,884,418 | 6,100,782 | \$43,052,316 |
| 2017 | \$12,118,500 | \$8,404,865 | \$5,047,500 | 10,826,002 | 6,100,782 | \$42,497,649 |
| 2018 | \$12,117,000 | \$8,903,645 | \$5,047,500 | 10,917,586 | 6,100,782 | \$43,086,513 |
| 2019 | \$12,116,000 | \$8,904,775 | \$5,047,500 | 9,953,609 | 6,100,782 | \$42,122,666 |
| 2020 | \$12,119,750 | \$8,408,670 | \$5,047,500 | 11,573,011 | 6,100,782 | \$43,249,713 |
| 2021 | \$12,117,250 | \$8,904,315 | \$5,047,500 | 10,131,216 | 6,100,782 | \$42,301,063 |
| 2022 | \$12,118,000 | \$8,407,460 | \$5,047,500 | 11,439,489 | 6,100,782 | \$43,113,232 |
| 2023 | \$12,116,000 | \$3,490,605 | \$10,447,500 | 10,822,695 | 6,100,782 | \$42,977,582 |
| 2024 | \$12,115,500 | \$0 | \$13,465,790 | 10,825,370 | 6,100,782 | \$42,507,442 |
| 2025 | \$12,115,500 | \$0 | \$13,976,400 | 10,750,264 | 6,100,782 | \$42,942,946 |
| 2026 | \$12,120,000 | \$0 | \$13,960,090 | 10,150,158 | 6,100,782 | \$42,331,030 |
| 2027 | \$12,117,750 | \$0 | \$13,633,685 | 11,444,523 | 6,100,782 | \$43,296,740 |
| 2028 | \$12,113,000 | \$0 | \$14,007,280 | 10,063,819 | 6,100,782 | \$42,284,881 |
| 2029 | \$12,119,750 | \$0 | \$13,757,320 | 11,280,403 | 6,100,782 | \$43,258,255 |
| 2030 | \$12,116,250 | \$0 | \$14,003,995 | 10,874,700 | 6,100,782 | \$43,095,727 |
| 2031 | \$12,111,750 | \$0 | \$13,830,480 | 10,255,124 | 6,100,782 | \$42,298,136 |
| 2032 | \$0 | \$0 | \$14,050,235 | 23,380,018 | 6,100,782 | \$43,531,036 |
| 2033 | \$0 | \$0 | \$14,149,800 | 22,665,334 | 6,100,782 | \$42,915,916 |
| 2034 | \$0 | \$0 | \$14,032,540 | 23,531,211 | 6,100,782 | \$43,664,533 |
| 2035 | \$0 | \$0 | \$14,105,185 | 22,888,318 | 6,100,782 | \$43,094,285 |
| 2036 | \$0 | \$0 | \$14,161,005 | 23,254,299 | 6,100,782 | \$43,516,086 |
| 2037 | \$0 | \$0 | \$0 | 37,609,280 | 6,100,782 | \$43,710,063 |
| 2038 | \$0 | \$0 | \$0 | 38,210,614 | 6,100,782 | \$44,311,397 |
| 2039 | \$0 | \$0 | \$0 | 38,295,498 | 6,100,782 | \$44,396,280 |
| 2040 | \$0 | \$0 | \$0 | 38,080,561 | 6,100,782 | \$44,181,343 |
| 2041 | \$0 | \$0 | \$0 | 0 | 37,150,782 | \$37,150,782 |
| 2042 | \$0 | \$0 | \$0 | 0 | 37,074,568 | \$37,074,568 |
| 2043 | \$0 | \$0 | \$0 | 0 | 37,460,269 | \$37,460,269 |
| 2044 | \$0 | \$0 | \$0 | 0 | 37,539,749 | \$37,539,749 |
| 2045 | \$0 | \$0 | \$0 | 0 | 37,772,078 | \$37,772,078 |
| Total | \$351,388,250 | \$162,080,755 | \$289,362,597 | \$516,311,989 | \$382,222,476 | \$1,701,366,067 |

* Interest calculated based upon the Interest Rate Exchange Agreements in effect as of 8/31/2008

IV. SELECTED FINANCIAL AND OPERATING DATA WITH RESPECT TO THE FISCAL YEAR ENDED AUGUST 31, 2008

The Consolidated Financial Statements of the Corporation and subsidiaries (the “Financial Statements”) for the fiscal year ended August 31, 2008 with comparative data for 2007 are presented in Appendix A. See Note 2 to the Financial Statements for a summary of significant accounting policies. The Selected Financial and Operating Data with Respect to the Fiscal Year Ended August 31, 2008 below should be read in conjunction with the Financial Statements and accompanying notes.

The tables below provide (i) Historical Utilization, (ii) Historical Consolidated Capitalization, (iii) Liquidity, (iv) Debt Service Coverage, and (v) Sources of Gross Patient Service Revenue.

| | Fiscal year ended August 31, 2008 |
|---------------------------------|--------------------------------------|
| (i) | |
| Historical Utilization | |
| Discharges | |
| Acute | 22,075 |
| Behavioral Health | 797 |
| Rehab/SNF | 292 |
| Total | 23,164 |
| Patient Days | |
| Acute | 122,759 |
| Behavioral Health | 8,928 |
| Rehab/SNF | 3,736 |
| Total | 135,423 |
| Short Stay OP | 6,620 |
| Total | 142,043 |
| Average Daily Census | |
| Acute | 335.4 |
| Behavioral Health | 24.4 |
| Rehab/SNF | 10.2 |
| Total | 370.0 |
| Average Length of Stay | |
| Acute | 5.6 |
| Behavioral Health | 11.2 |
| Rehab/SNF | 12.8 |
| Total | 5.8 |
| Case Mix Index | 1.96 |
| Emergency room visits | 46,156 |
| Short Stay OP procedures | 21,940 |
| Other Outpatient visits* | 256,358 |
| Surgeries | |
| Inpatient | 11,453 |
| Outpatient | 11,179 |
| Total | 22,632 |

Source: Stanford Hospital and Clinics records

* Actual visits will be more, these amounts are billing events which may include multiple visits

(ii)
Historical Consolidated Capitalization

| | For the Year Ended August 31, 2008 |
|--|---|
| | (In Thousands) |
| Long Term Debt | |
| Long-Term Debt | \$583,326 |
| Debt Subject to short-term remarketing | 249,414 |
| Total Long Term Debt* | 832,650 |
| Consolidated Net Assets | 909,053 |
| Total Consolidated Capitalization | \$1,741,703 |
| | |
| Net Long-Term Debt as a percentage of | |
| Total Consolidated Capitalization | 47.8% |

* Less current portion of long term debt; includes original issue premium, original issue discount and debt subject to short term remarketing

(iii)
**Liquidity of the Corporation
and its Subsidiaries**

| | For the Year Ended August 31, 2008 |
|--|---|
| | (In Thousands) |
| Cash and Cash Equivalents | 268,869 |
| Investments | 60,068 |
| Investments in University Managed Pool | 688,644 |
| Less temporarily and permanently restricted assets | (33,597) |
| Total Liquid Assets | \$983,984 |
| | |
| Days Cash on Hand | 242.6 |

(iv)
Debt Service Coverage

| | For the Year Ended August 31, 2008 |
|--|---|
| | (In Thousands) |
| Excess of revenues over expenses | \$76,334 |
| Depreciation and Amortization Expense | 65,812 |
| Interest Expense | 26,334 |
| Interest Rate Swap Mark to Market Adjustment | 42,600 |
| Loss on Extinguishments of Debt | 17,855 |
| Funds Available for Debt Service | \$228,935 |
| Maximum Annual Debt Service | \$44,396 |
| Maximum Annual Debt Service Coverage | 5.16 |

(v)
Sources of Gross Patient Service Revenue

| | For the Year Ended August 31, 2008 |
|--|---|
| | (In Thousands) |
| Medicare | 27% |
| Medi-Cal | 5 |
| Managed Care – Capitation | 2 |
| Managed Care – Discounted Fee for Services | 51 |
| Indemnity Insurance, Self Pay, Other | 15 |
| TOTAL | 100% |

APPENDIX A

Stanford Hospital and Clinics and Subsidiaries

**Consolidated Financial Statements
August 31, 2008 and 2007**

Stanford Hospital and Clinics and Subsidiaries

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August 31, 2008 and 2007

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Report of Independent Auditors

To the Board of Directors
Stanford Hospital and Clinics and Subsidiaries

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations and changes in net assets and cash flows present fairly, in all material respects, the financial position of Stanford Hospital and Clinics and subsidiaries ("SHC") at August 31, 2008 and 2007 and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of SHC's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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.

As discussed in Notes 2 and 9 to the consolidated financial statements, in 2007 SHC adopted Statement of Financial Accounting Standard No. 158, *Employers' Accounting for Defined Benefit Pension and Postretirement Plans*.



December 11, 2008

Stanford Hospital and Clinics and Subsidiaries
Consolidated Balance Sheets
August 31, 2008 and 2007
(in thousands of dollars)

| | 2008 | 2007 |
|---|--------------|--------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 268,869 | \$ 39,278 |
| Assets limited as to use, held by trustee | 504 | 2,333 |
| Patient accounts receivable, net of allowance for doubtful accounts of \$74,758 at August 31, 2008 and \$72,695 at August 31, 2007 | 240,989 | 215,953 |
| Other receivables | 9,912 | 15,346 |
| Inventories | 20,420 | 20,636 |
| Prepaid expenses and other | 8,428 | 5,833 |
| Total current assets | 549,122 | 299,379 |
| Investments | 60,068 | 44,674 |
| Investments in University managed pools | 688,644 | 815,970 |
| Assets limited as to use, held by trustee, net of current portion | 163,246 | 331,607 |
| Property and equipment, net | 706,700 | 511,421 |
| Other assets | 63,398 | 83,898 |
| Total assets | \$ 2,231,178 | \$ 2,086,949 |
| Liabilities and Net Assets | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | \$ 143,723 | \$ 101,385 |
| Accrued salaries and related benefits | 82,819 | 72,874 |
| Due to related parties | 23,091 | 22,252 |
| Third-party payor settlements | 14,704 | 14,526 |
| Current portion of long-term debt | 7,877 | 8,033 |
| Debt subject to short-term remarketing arrangements | 249,414 | - |
| Self-insurance reserves | 20,008 | 21,579 |
| Total current liabilities | 541,636 | 240,649 |
| Self-insurance reserves, net of current portion | 80,222 | 86,866 |
| Other long-term liabilities | 54,389 | 18,217 |
| Long-term debt, net of current portion | 583,236 | 840,703 |
| Total liabilities | 1,259,483 | 1,186,435 |
| Net assets: | | |
| Unrestricted | 909,053 | 843,693 |
| Temporarily restricted | 56,150 | 51,310 |
| Permanently restricted | 6,492 | 5,511 |
| Total net assets | 971,695 | 900,514 |
| Total liabilities and net assets | \$ 2,231,178 | \$ 2,086,949 |

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

Stanford Hospital and Clinics and Subsidiaries
Consolidated Statements of Operations and Changes in Net Assets
Years Ended August 31, 2008 and 2007
(in thousands of dollars)

| | 2008 | 2007 |
|--|-------------------|-------------------|
| Operating revenues: | | |
| Net patient service revenue | \$ 1,578,755 | \$ 1,459,744 |
| Premium revenue | 20,755 | 20,205 |
| Other revenue | 51,225 | 48,788 |
| Net assets released from restrictions used for operations | 4,816 | 4,379 |
| Total operating revenues | <u>1,655,551</u> | <u>1,533,116</u> |
| Operating expenses: | | |
| Salaries and benefits | 714,856 | 638,789 |
| Professional services | 24,713 | 23,323 |
| Supplies | 235,542 | 224,996 |
| Purchased services | 385,273 | 361,475 |
| Provision for doubtful accounts, net | 51,578 | 44,733 |
| Depreciation and amortization | 65,812 | 44,287 |
| Interest | 26,334 | 22,988 |
| Other | 120,382 | 99,889 |
| Expense recoveries from related parties | (74,184) | (65,437) |
| Total operating expenses | <u>1,550,306</u> | <u>1,395,043</u> |
| Income from operations | 105,245 | 138,073 |
| Interest and investment income | 14,385 | 11,108 |
| Income and gains on University managed pools | 17,159 | 100,394 |
| Interest rate swaps mark to market adjustments | (42,600) | (1,302) |
| Loss on extinguishment of debt | (17,855) | - |
| Excess of revenues over expenses | 76,334 | 248,273 |
| Other changes in unrestricted net assets: | | |
| Transfer to Stanford University | (7,670) | (6,776) |
| Transfer to Lucile Salter Packard Children's Hospital | (2,808) | (14,352) |
| Change in net unrealized losses on investments | 227 | (278) |
| Net assets released from restrictions used for: | | |
| Purchase of property and equipment | 599 | 1,360 |
| Change in pension liability | (2,212) | 3,593 |
| Change in fair value of interest rate swaps | - | 438 |
| Increase in unrestricted net assets before discontinued operations and cumulative effect of change in accounting principle | 64,470 | 232,258 |
| Income (loss) from discontinued operations | 890 | (23,869) |
| Cumulative effect of change in accounting principle | - | 11,613 |
| Increase in unrestricted net assets | <u>65,360</u> | <u>220,002</u> |
| Changes in temporarily restricted net assets: | | |
| Contributions | 8,508 | 31,240 |
| Investment income | 586 | 569 |
| Income and gains on University managed pools | 1,161 | 2,511 |
| Net assets released from restrictions for: | | |
| Operations | (4,816) | (4,379) |
| Purchase of property and equipment | (599) | (1,360) |
| Increase in temporarily restricted net assets | <u>4,840</u> | <u>28,581</u> |
| Changes in permanently restricted net assets: | | |
| Contributions | 981 | 1,920 |
| Increase in permanently restricted net assets | <u>981</u> | <u>1,920</u> |
| Increase in net assets | <u>71,181</u> | <u>250,503</u> |
| Net assets, beginning of year | 900,514 | 650,011 |
| Net assets, end of year | <u>\$ 971,695</u> | <u>\$ 900,514</u> |

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

Stanford Hospital and Clinics and Subsidiaries
Consolidated Statements of Cash Flows
Years Ended August 31, 2008 and 2007
(in thousands of dollars)

| | <u>2008</u> | <u>2007</u> |
|---|-------------------|------------------|
| Cash flows from operating activities: | | |
| Increase in net assets | \$ 71,181 | \$ 250,503 |
| Cumulative effect of change in accounting principle | - | (11,613) |
| Adjustments to reconcile increase in net assets to net cash provided by operating activities: | | |
| Gain from sale of discontinued operations | (21,273) | - |
| Loss on extinguishment of debt | 17,855 | - |
| Depreciation and amortization of bond discounts | 67,031 | 45,998 |
| Provision for doubtful accounts | 54,189 | 46,175 |
| Change in fair value of interest rate swaps | 42,600 | 863 |
| Income and gains on investments in University managed pools | (9,628) | (83,632) |
| Unrealized (gains) losses on investments | (227) | 278 |
| Realized gains on investments | (125) | (2,246) |
| Contributions received for long lived assets or endowment | (1,800) | (29,412) |
| Transfer to Lucile Salter Packard Children's Hospital | 2,808 | 14,352 |
| Changes in operating assets and liabilities: | | |
| Patient accounts receivable | (80,032) | (68,947) |
| Due to related parties | 839 | (11,769) |
| Other receivables, inventory, other assets, prepaid expenses and other | 3,207 | (7,858) |
| Accounts payable, accrued liabilities and pension liabilities | 36,058 | (8,881) |
| Accrued salaries and related benefits | 9,945 | (7,684) |
| Third-party payor settlements | 178 | (8,561) |
| Self-insurance reserves | (8,215) | (5,729) |
| Other long-term liabilities | (6,830) | 8,885 |
| Cash provided by operating activities | <u>177,761</u> | <u>120,722</u> |
| Cash flows from investing activities: | | |
| Purchases of investments | (82,524) | (65,957) |
| Sales of investments | 67,786 | 71,591 |
| Purchases of investments in University managed pools | (10,768) | (31,971) |
| Sales of investments in University managed pools | 147,747 | 737 |
| Decrease in assets limited as to use | 170,190 | 68,840 |
| Purchases of property and equipment | (252,421) | (140,762) |
| Net proceeds from sale of discontinued operations | 21,273 | - |
| Cash provided by (used in) investing activities | <u>61,283</u> | <u>(97,522)</u> |
| Cash flows from financing activities: | | |
| Proceeds from issuance of debt | 514,200 | 1,150 |
| Costs of issuance of debt | (2,950) | - |
| Payment of long-term debt and capital lease obligation | (523,354) | (7,485) |
| Contributions received for long lived assets or endowment | 2,651 | 1,718 |
| Cash used in financing activities | <u>(9,453)</u> | <u>(4,617)</u> |
| Net increase in cash and cash equivalents | 229,591 | 18,583 |
| Cash and cash equivalents, beginning of year | 39,278 | 20,695 |
| Cash and cash equivalents, end of year | <u>\$ 268,869</u> | <u>\$ 39,278</u> |
| Supplemental disclosures of cash flow information: | | |
| Interest paid | \$ 39,680 | \$ 33,894 |
| Payables for property and equipment | 8,857 | 11,689 |
| Increase in value of interest in University managed pools | 9,628 | 83,632 |
| Assets acquired under capital leases | - | 5,875 |

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

Stanford Hospital and Clinics and Subsidiaries

Notes to Consolidated Financial Statements

(in thousands of dollars)

1. Organization

Stanford Hospital and Clinics ("Stanford Hospital") operates a licensed acute care hospital and a cancer center in Palo Alto, California, along with numerous outpatient physician clinics in the San Francisco Bay Area, in community settings, and in association with regional hospitals. Stanford Hospital is a principal teaching affiliate of the Stanford University School of Medicine ("SoM") and provides primary and specialty health services to adults, including cardiac care, cancer treatment, solid organ transplantation services, neurosciences, and orthopedics services designated by management as Stanford Hospital's "Strategic Clinical Services". Stanford Hospital, together with Lucile Salter Packard Children's Hospital at Stanford ("LPCH"), operates the clinical settings through which the SoM educates medical and graduate students, trains residents and clinical fellows, supports faculty and community clinicians and conducts medical and biological sciences research.

The Board of Trustees of Leland Stanford Junior University (the "University") is the sole corporate member of Stanford Hospital and LPCH. As part of their ongoing operations, Stanford Hospital and LPCH engage in certain related party transactions as described further in Note 11.

The consolidated financial statements include Stanford Hospital's interest in Menlo Health Alliance, LLC ("MHA"), Stanford University Medical Indemnity and Trust Insurance Company, Inc ("SUMIT"), and Stanford Emanuel Radiation Oncology Center, LLC ("SEROC") (collectively "SHC").

Stanford Hospital's interest in MHA was 100% for the years ended August 31, 2008 and 2007. MHA is a wholly owned California limited liability company that operates an outpatient clinic.

Stanford Hospital's share of net assets in SUMIT, a captive insurance carrier, was 82.0% and 91.8% for the years end August 31, 2008 and 2007, respectively. LPCH's share of net assets in SUMIT was 18.0% and 8.2% for the years end August 31, 2008 and 2007, respectively. This is recorded as a minority interest in accounts payable and accrued liabilities on the consolidated balance sheets.

SEROC is a joint venture between Stanford Hospital and Emanuel Medical Center ("EMC"). SEROC operates an outpatient clinic that provides radiation oncology services to patients in Turlock, California and surrounding communities. Stanford Hospital's interest in SEROC was 60% during the years ended August 31, 2008 and 2007. The remaining interest of 40% is recorded as minority interest in accounts payable and accrued liabilities on the consolidated balance sheets.

2. Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements of SHC include the accounts of Stanford Hospital and its subsidiaries, MHA, SUMIT and SEROC, which are controlled and owned more than 50% by Stanford Hospital. All significant inter-company accounts and transactions are eliminated in the consolidation.

Basis of Presentation

The accompanying consolidated financial statements are prepared on the accrual basis of accounting. Net assets of SHC and changes therein have been classified and are reported as follows:

Stanford Hospital and Clinics and Subsidiaries

Notes to Consolidated Financial Statements

(in thousands of dollars)

2. Summary of Significant Accounting Policies (Continued)

Basis of Presentation (continued)

- **Unrestricted net assets** — Unrestricted net assets represent those resources of SHC that are not subject to donor-imposed stipulations. The only limits on unrestricted net assets are broad limits resulting from the nature of SHC and the purposes specified in its articles of incorporation or bylaws and, limits resulting from contractual agreements, if any.
- **Temporarily restricted net assets** — Temporarily restricted net assets represent contributions, which are subject to donor-imposed restrictions that can be fulfilled by actions of SHC pursuant to those stipulations or by the passage of time.
- **Permanently restricted net assets** — Permanently restricted net assets represent contributions that are subject to donor-imposed restrictions that they be maintained permanently by SHC. Generally, the donors of these assets permit SHC to use all or part of the investment return on these assets.

Expenses are generally reported as decreases in unrestricted net assets. A restriction expires when the stipulated time period has elapsed, when the stipulated purpose for which the resource was restricted has been fulfilled, or both. Temporarily restricted contributions are recorded as restricted revenue when received and when the restriction expires, the net assets are shown as released from restriction on the consolidated statements of operations and changes in net assets. Investment income on temporarily or permanently restricted assets that is restricted by donor or law is recorded within the respective net asset category, and when the restriction expires, the net assets are shown as released from restriction.

Cash and Cash Equivalents

Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturities of three months or less. Cash equivalents consist primarily of demand deposits and money market mutual funds.

Assets Limited as to Use, Held by Trustee

Assets limited as to use include various accounts held with a trustee in accordance with indenture requirements. The indenture terms require that the trustee control the expenditure of bond proceeds for capital projects. Assets limited as to use consist of cash and cash equivalents and short-term investments, recorded at cost, which approximates fair value. Amounts required to fund current liabilities of SHC have been classified as current assets in the consolidated balance sheets at August 31, 2008 and 2007.

Inventories

Inventories, which consist primarily of hospital operating supplies and pharmaceuticals, are stated at the lower of cost or market value determined using the first-in, first-out method.

Investments

Investments held directly by SHC consist of cash and cash equivalents, common stocks, mutual funds and fixed-income securities (government bonds), and are stated at fair value. Fair value is based on quoted market prices. Investment earnings (including realized gains and losses on investments, interest, dividends and impairment loss on investment securities) are included in investment income unless the income or loss is restricted by donor or law. Income on investments of donor restricted funds is added to or deducted from the appropriate net asset category based on the donor's restriction. Unrestricted unrealized gains and losses on other than trading securities are separately reported below the excess of revenues over expenses.

Stanford Hospital and Clinics and Subsidiaries

Notes to Consolidated Financial Statements

(in thousands of dollars)

2. Summary of Significant Accounting Policies (Continued)

Investments in University managed pools

Investments in University managed pools consist of funds invested in the University's Merged Pools ("MP"), Expendable Funds Pool ("EFP"), and Active Cash Fund ("ACF") (collectively the "Pools"). Under the terms of the SHC's agreement with the University, the University has discretion to invest funds invested in the Pools. SHC may deposit funds in the Pools at its discretion. SHC can withdraw funds from ACF at any time; however, withdrawals from the MP and EFP require advance notice to the University. SHC's share of the Pools is stated at fair value as determined by the University. The University determines fair value based upon the fair value of the underlying assets in the Pools.

The University allocates investment earnings to SHC from the University managed pools based on SHC's share of the Pools. Earnings include interest, dividends, distributions, investment gains and losses, and the increases or decreases in the value of SHC's share of the pools. For the years ended August 31, 2008 and 2007, all investment gains and losses are treated as realized and included in the excess of revenues over expenses.

The increases or decreases in the value of SHC's share of the Pools are recorded as income and gains on University managed pools unless the income is restricted by donor or law. Income on investments of donor restricted funds invested in the University managed pools is added to or deducted from the appropriate net asset category based on the donor's restriction.

Property and Equipment

Property and equipment are stated at cost except for donated assets, which are recorded at fair market value at the date of donation. Depreciation and amortization of property and equipment is provided using the straight-line method over the estimated useful lives of the assets, which are as follows:

| | |
|----------------------------|----------------|
| Land improvements | 10 to 25 years |
| Buildings and improvements | 7 to 40 years |
| Equipment | 3 to 20 years |

Significant replacements and improvements are capitalized, while maintenance and repairs, which do not improve or extend the life of the respective assets, are charged to expense as incurred. Upon sale or disposal of property and equipment, the cost and accumulated depreciation are removed from the respective accounts, and any gain or loss is included in the consolidated statements of operations and changes in net assets.

Equipment includes medical equipment, furniture and fixtures and computer software and hardware.

Equipment under capital leases is recorded at present value at the inception of the leases and is amortized on the straight-line method over the shorter of the lease term or the estimated useful life of the equipment. The amortization of the assets recorded under capital leases is included in depreciation and amortization expense in the accompanying consolidated statements of operations and changes in net assets.

Interest costs incurred on borrowed funds during the period of construction of capital assets is capitalized, net of any interest earned, as a component of the cost of acquiring those assets.

Stanford Hospital and Clinics and Subsidiaries

Notes to Consolidated Financial Statements

(in thousands of dollars)

2. Summary of Significant Accounting Policies (Continued)

Asset Retirement Obligations

Asset retirement obligations ("ARO") are legal obligations associated with the retirement of long-lived assets. These liabilities are initially recorded at fair value as other long-term liabilities and the related asset retirement costs are capitalized by increasing the carrying amount of the related assets by the same amount as the liability. Asset retirement costs are subsequently accreted over the useful lives of the related assets. SHC recorded current period accretion expense of \$311 and \$293 in the consolidated statements of operations and changes in net assets for the years ended August 31, 2008 and 2007. ARO liability of \$6,130 and \$5,767 is included in other long-term liabilities on the consolidated balance sheet as of August 31, 2008 and 2007, respectively.

Other Assets

Other assets include deferred financing costs, long-term portion of contributions receivable, investments in Waverley Surgery Center, L.P. ("Waverley"), investments in Stanford PET-CT ("PET-CT") and other long-term assets.

Deferred financing costs represent costs incurred in conjunction with the issuance of SHC's long-term debt. These costs are amortized on a straight-line basis, which approximates the effective interest method, over the life of the debt.

Waverley is a California limited partnership which operates an ambulatory surgical center in Palo Alto, providing outpatient surgical and related health care services. PET-CT is a California limited liability company which provides radiological services to patients of the community, including patients served by SHC and physicians affiliated with the SoM. SHC and the University each appoint one-half of the members of the governing board of PET-CT and are its only members.

SHC's interest in Waverley was 33.70% for the years ended August 31, 2008 and 2007. SHC's interest in PET-CT was 50% for the years ended August 31, 2008 and 2007. As SHC has 50% or less ownership and does not have control, these investments are recorded using the equity method.

Contributions Receivable

Unconditional promises to give ("contributions") are recorded at fair value at the date the promise is received. Donations for specific purposes are reported as either temporary or permanently restricted net assets and are included as restricted contributions. Contributions to be received after one year are discounted at an appropriate discount rate commensurate with the risks involved and applicable to the years in which the promises are received, and recorded in their respective net asset category. The discount rates range from 2.92% to 3.51% in 2008 and 4.43% to 4.85% in 2007. Amortization of the discount is included in contributions in the consolidated statements of operations and changes in net assets. Conditional promises to give are recognized when the condition is substantially met.

Contributions receivable as of August 31, 2008 and 2007 were \$29,877 and \$31,430, respectively. Current portion of contributions receivable of \$1,933 and \$5,658 is included in other receivables in the consolidated balance sheets as of August 31, 2008 and 2007, respectively. Long term portion of contributions receivable of \$27,944 and \$25,772 is included in other assets in the consolidated balance sheets as of August 31, 2008 and 2007, respectively.

Stanford Hospital and Clinics and Subsidiaries

Notes to Consolidated Financial Statements

(in thousands of dollars)

2. Summary of Significant Accounting Policies (Continued)

Premiums and Discounts on Long-Term Debt

Premiums and discounts arising from the original issuance of long-term debt are amortized on a straight-line basis, which approximates the effective interest method, over the life of the debt. The unamortized portion of these premiums and discounts are included in long-term debt on the consolidated balance sheets.

Interest Rate Swap Agreements

SHC has entered into several interest rate swap agreements, also known as risk management or derivative instruments, to reduce the effect of interest rate fluctuation on its variable rate bonds. SHC designates at inception whether the swap agreement is considered hedging or non-hedging for accounting purposes in accordance with Statement of Financial Accounting Standard No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133). All swaps are recognized on the consolidated balance sheets at their fair value. The net cash payments or receipts under the interest rate swap agreements have been recorded as an increase (decrease) to interest expense.

Changes in the fair value of the interest rate swaps that are effective and qualify as a cash flow hedge are recorded as change in unrestricted net assets. Changes in the fair value of interest rate swaps not designated as hedges are included in excess of revenues over expenses.

Any hedge ineffectiveness (which represents the amount by which the changes in the fair value of the derivative exceed the variability in the cash flows of the forecasted transaction) is included in excess of revenues over expenses.

Excess of Revenues over Expenses

The consolidated statements of operations include excess of revenues over expenses. Changes in unrestricted net assets which are excluded from excess of revenues over expenses, include transfers of assets to and from affiliates for other than goods and services, change in unrealized gains and losses on marketable investments, contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets), changes in pension liability, changes in fair value of interest rate swaps considered effective, income or loss from discontinued operations and cumulative effect of changes in accounting principles.

Net Patient Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors including Medicare and Medi-Cal, and others for services rendered, including estimated retroactive audit adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods, as final settlements are determined. Contracts, laws and regulations governing the Medicare and Medi-Cal programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates may change by a material amount in the near term.

Stanford Hospital and Clinics and Subsidiaries

Notes to Consolidated Financial Statements

(in thousands of dollars)

2. Summary of Significant Accounting Policies (Continued)

Premium Revenue

SHC has capitated agreements with various health maintenance organizations (“HMOs”) to provide medical services to enrollees. Under these agreements, monthly payments are received based on the number of health plan enrollees. These receipts are recorded as premium revenue in the consolidated statements of operations and changes in net assets. Costs are accrued when services are rendered under these contracts, including cost estimates of incurred but not reported (“IBNR”) claims. The IBNR accrual (which is included in accounts payable and accrued liabilities in the consolidated balance sheets) includes an estimate of the costs of services for which SHC is responsible, including referrals to outside healthcare providers.

Charity Care

SHC provides either full or partial charity care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Amounts determined to qualify as charity care are not reported as net patient service revenue. SHC also provides services to other indigent patients under Medi-Cal and other publicly sponsored programs, which reimburse at amounts less than the cost of the services provided to the recipients. The difference between the cost of services provided to these indigent persons and the expected reimbursement is included in the estimated cost of charity care.

Income Taxes

SHC and SUMIT are not-for-profit corporations and tax-exempt pursuant to Section 501(c)(3) of the Internal Revenue Code. The estimated tax liability pertaining to unrelated business taxable income associated with Waverley has been recorded as \$513 and \$987 at August 31, 2008 and 2007, respectively, and is included in accounts payable and accrued liabilities on the consolidated balance sheets.

Self-Insurance Plans

SHC self-insures for professional liability risks, postretirement medical benefits, workers’ compensation, health and dental. These liabilities are reflected as self-insurance reserves in the consolidated balance sheets.

- **Professional Liability** — SHC is self-insured through SUMIT for medical malpractice and general liability losses under claims-made coverage. SHC also maintains professional liability reserves for claims not covered by SUMIT which totals \$5,548. For the policy period September 1, 2007 to September 1, 2008, SUMIT retains 100% of the risk related to the first \$15,000 per occurrence. The next \$115,000 is transferred to various reinsurance companies. For the period from September 1, 2005 to September 1, 2007, SHC maintained the same coverage limits as fiscal year 2008.
- **Postretirement Medical Benefits** – Liabilities for post-retirement medical claims for current and retired employees are actuarially determined.
- **Workers’ Compensation** — SHC purchases insurance for workers’ compensation claims with a \$750 deductible per occurrence. Workers’ compensation insurance provides statutory limits for the State of California. An actuarial estimate of retained losses (or losses retained within the deductible) has been used to record a liability.
- **Health and Dental** — Liabilities for health and dental claims for current employees are based on estimated costs.

Stanford Hospital and Clinics and Subsidiaries
Notes to Consolidated Financial Statements
(in thousands of dollars)

2. Summary of Significant Accounting Policies (Continued)

Fair Value of Financial Instruments

Due to the short-term nature of cash and cash equivalents, accounts payable and accrued liabilities, and accrued salaries and related benefits, their carrying value approximates their fair value. The fair value of the amounts payable under third-party reimbursement contracts is not readily determinable. The fair value of long-term debt is estimated based on quoted market prices for the bonds or similar financial instruments.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant estimates relate to patient accounts receivable allowances, amounts due to third party payors, retirement plan obligations, and self insurance reserves. Actual results could differ from those estimates.

Reclassification

Certain reclassifications have been made to the 2007 consolidated financial statements to conform to the 2008 presentation.

Discontinued Operations

In August 2008, SHC sold certain assets and liabilities of its clinical laboratory testing outreach business to an unrelated party for \$30,000 plus the assumption of certain property leases valued at approximately \$2,000 less sales expense and other exit costs of \$8,727.

This transaction has been accounted for in accordance with Statement of Financial Accounting Standard No. 144, *Accounting for the Impairment of Disposal of Long-Lived Assets* (SFAS 144). As a result, the gains or losses from the operations of the clinical testing laboratory outreach business have been reported as discontinued operations for the years ended August 31, 2008 and 2007.

The net operating losses included in the results of discontinued operations for the years ended August 31, 2008 and 2007 were \$20,383 and \$23,869, respectively.

The following table sets forth the components of discontinued operations for the years ended August 31, 2008 and 2007:

| | 2008 | 2007 |
|--|-----------------|--------------------|
| Total operating revenue | \$ 29,520 | \$ 27,490 |
| Total operating expenses | 49,903 | 51,359 |
| Loss from operations | <u>(20,383)</u> | <u>(23,869)</u> |
| Net proceeds from sale | 21,273 | - |
| Income (loss) from discontinued operations | <u>\$ 890</u> | <u>\$ (23,869)</u> |

Stanford Hospital and Clinics and Subsidiaries

Notes to Consolidated Financial Statements

(in thousands of dollars)

2. Summary of Significant Accounting Policies (Continued)

Recent Pronouncements

In fiscal year 2007, SHC adopted the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)* (SFAS 158). The effect of the adoption of SFAS 158 for fiscal year 2007 is discussed in note 9. The provision of SFAS 158 that requires measurement of plan assets and benefit obligations as of the end of the fiscal year is effective for the fiscal year ending August 31, 2009.

The following pronouncements are effective for the fiscal year ending August 31, 2009, except for SFAS 161, which is effective for the fiscal year ending August 31, 2010. SHC is assessing the impact of the following pronouncements.

In September 2006, the FASB issued Statement of Financial Accounting Standard No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 establishes a common definition for fair value to be applied to generally accepted accounting principles requiring use of fair value, establishes a framework for measuring fair value and expands the related disclosure requirements about fair value measurements.

In February 2007, the FASB issued Statement of Financial Accounting Standard No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 permits entities to choose to measure eligible items at fair value at specific election dates (the "fair value option"). Unrealized gains and losses on items for which the fair value option has been elected shall be reported in earnings at each subsequent reporting period.

In March 2008, the FASB issued Statement of Financial Accounting Standard No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS 161). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities.

In August 2008, the FASB issued FASB Staff Position No. 117-1, *Endowments for Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act and Enhanced Disclosures for All Endowment Funds* (FSP 117-1). FSP 117-1 provides guidance on the net asset classification of donor-restricted endowment funds for a not-for-profit organization that is subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA). California adopted a version of UPMIFA which will be effective January 1, 2009. FSP 117-1 also requires additional disclosures about an organization's endowment funds, whether or not the organization is subject to UPMIFA.

Stanford Hospital and Clinics and Subsidiaries

Notes to Consolidated Financial Statements

(in thousands of dollars)

3. Net Patient Service Revenue

SHC has agreements with third-party payers that provide for payments at amounts different from SHC's established rates. A summary of payment arrangements with major third-party payor's follows:

- **Medicare** — Inpatient acute care services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Medicare reimburses hospitals for covered outpatient services rendered to its beneficiaries by way of an outpatient prospective payment system based on ambulatory payment classifications. SHC's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review.

Inpatient non-acute services, certain outpatient services and medical education costs related to Medicare beneficiaries are paid based, in part, on a cost reimbursement methodology. SHC is reimbursed for cost reimbursable items at a tentative rate with final settlement of such items determined after submission of annual cost reports and audits thereof by the Medicare fiscal intermediary. The estimated amounts due to or from the program are reviewed and adjusted annually based on the status of such audits and any subsequent appeals. Differences between final settlements and amounts accrued in previous years are reported as adjustments to net patient service revenue in the year examination is substantially completed. SHC's Medicare cost reports have been audited by the Medicare fiscal intermediary through August 31, 2001.

Professional services are reimbursed based on a fee schedule.

- **Medi-Cal** — Inpatient services rendered to Medi-Cal program beneficiaries are reimbursed under a contract at a prospectively determined negotiated per diem rate. Outpatient services are reimbursed based upon prospectively determined fee schedules. Professional services are reimbursed based on a fee schedule.
- **Other** — SHC has entered into agreements with numerous non-government third-party payors to provide patient care to beneficiaries under a variety of payment arrangements. These include arrangements with:
 - Commercial insurance companies, including workers' compensation plans, which reimburse SHC at negotiated charges.
 - Managed care contracts such as those with HMOs and PPOs, which reimburse SHC at contracted or per diem rates, which are usually less than full charges.
 - Counties in the State of California, which reimburse SHC for certain indigent patients covered under county contracts.

Amounts due from Blue Cross represent 17% of net patient accounts receivable at August 31, 2008 and 2007. Amounts due from Medicare represent 14% of net patient accounts receivable at August 31, 2008 and 2007. SHC does not believe there are significant credit risks associated with this health care payor or this government agency.

SHC recognized net patient service revenue of \$15,142 and \$8,212 as a result of prior years favorable developments related to reimbursement for the years ended August 31, 2008 and 2007, respectively.

Stanford Hospital and Clinics and Subsidiaries
Notes to Consolidated Financial Statements
(in thousands of dollars)

3. Net Patient Service Revenue (Continued)

Net patient service revenue, including premium revenue, by major payor for the years ended August 31 is as follows:

| | 2008 | 2007 |
|--|---------------------|---------------------|
| Medicare | \$ 313,281 | \$ 303,847 |
| Medi-Cal | 27,614 | 27,017 |
| Managed Care - Capitation | 20,754 | 20,203 |
| Managed Care - Discounted Fee for Services | 1,020,097 | 934,316 |
| Self pay and other | 167,651 | 133,960 |
| Related party | 50,113 | 60,606 |
| Total | <u>\$ 1,599,510</u> | <u>\$ 1,479,949</u> |

4. Charity Care

Information related to SHC's charity care for the years ended August 31 is as follows:

| | 2008 | 2007 |
|-----------------------------------|-------------|-------------|
| Charity care at established rates | \$ 50,536 | \$ 40,051 |
| Estimated cost of charity care | \$ 14,525 | \$ 11,591 |

Estimated cost in excess of reimbursement for Medi-Cal and county services was \$66,043 and \$52,807, respectively, for the years ended August 31, 2008 and 2007.

5. Assets Limited As to Use, Held by Trustee

The composition of assets limited as to use at August 31 is as follows:

| | 2008 | | 2007 | |
|--|-------------------|-------------------|-------------------|-------------------|
| | Cost | Fair Value | Cost | Fair Value |
| Cash and cash equivalents | <u>\$ 163,750</u> | \$ 163,750 | <u>\$ 333,940</u> | \$ 333,940 |
| Less: Current portion of assets limited as to use, held by trustee | | <u>(504)</u> | | <u>(2,333)</u> |
| Assets limited as to use, held by trustee, net of current portion | | <u>\$ 163,246</u> | | <u>\$ 331,607</u> |

SHC is required to maintain a debt service reserve fund with the trustee in connection with the 2003 bonds (see Note 8). The value of the deposits with the trustee was \$14,269 at August 31, 2008 and 2007. SHC has entered into an agreement with a broker to invest the deposits held by the trustee, whereby the broker has guaranteed a fixed rate of 4.3% return on the deposits. The broker has deposited collateral with the trustee in the event it defaults under the agreement.

Stanford Hospital and Clinics and Subsidiaries
Notes to Consolidated Financial Statements
(in thousands of dollars)

6. Investments and Investments in University Managed Pools

The composition of investments held directly by SHC at August 31 is as follows:

| | 2008 | | 2007 | |
|---------------------------|------------------|-------------------|------------------|-------------------|
| | Cost | Fair Value | Cost | Fair Value |
| Investments: | | | | |
| Cash and cash equivalents | \$ 13,447 | \$ 13,447 | \$ 12,341 | \$ 12,341 |
| Mutual funds | 45,537 | 46,621 | 31,769 | 31,995 |
| Equity securities | - | - | - | 338 |
| Total | <u>\$ 58,984</u> | <u>\$ 60,068</u> | <u>\$ 44,110</u> | <u>\$ 44,674</u> |

The composition of investments in University managed pools at August 31 is as follows:

| | Fair Value | |
|--|-------------------|-------------------|
| | 2008 | 2007 |
| Investments in University Managed Pools: | | |
| Merged Pool | \$ 672,904 | \$ 605,242 |
| Active Cash Fund | 12,030 | 207,253 |
| Expendable Funds Pool | 3,710 | 3,475 |
| Total | <u>\$ 688,644</u> | <u>\$ 815,970</u> |

The Merged Pool (MP) is the primary investment pool in which funds are invested. The MP is invested with the objective of maximizing long-term total return. It is a unitized pool in which the fund holders purchase investments and withdraw funds based on a monthly share value. The MP's investments at August 31, 2008 and 2007 consist of approximately 1% and 4% cash and cash equivalents, 2% and 3% fixed income securities, 2% and 2% in real estate, 31% and 40% public equity securities and mutual funds, and 64% and 51% in limited partnerships, respectively.

7. Property and Equipment

Property and equipment consist of the following as of August 31:

| | 2008 | 2007 |
|--------------------------------|-------------------|-------------------|
| Land and improvements | \$ 25,761 | \$ 25,729 |
| Buildings and improvements | 559,621 | 532,287 |
| Equipment | 411,841 | 264,892 |
| | <u>997,223</u> | <u>822,908</u> |
| Less: Accumulated depreciation | (580,796) | (520,144) |
| Construction-in-progress | 290,273 | 208,657 |
| Property and equipment, net | <u>\$ 706,700</u> | <u>\$ 511,421</u> |

Depreciation and amortization expense totaled \$65,812 and \$44,287 for the years ending August 31, 2008 and 2007, respectively, and is included in the consolidated statements of operations and changes in net assets.

Stanford Hospital and Clinics and Subsidiaries
Notes to Consolidated Financial Statements
(in thousands of dollars)

7. Property and Equipment (Continued)

During 2007, medical equipment acquired under capital leases totaled \$5,875 and were included in property and equipment in the consolidated balance sheet. Amortization expense under capital leases is included in depreciation expense in the consolidated statements of operations and changes in net assets. Accumulated amortization was \$1,371 and \$196 as of August 31, 2008 and 2007.

Interest expense on debt issued for construction projects and income earned on the funds held pending use are capitalized until the projects are placed in service and depreciated over the estimated useful life of the asset. Capitalized interest expense net of capitalized investment income was \$4,465 and \$2,562 for the years ended August 31, 2008 and 2007, respectively.

8. Long-Term Debt

SHC's outstanding debt at August 31 is summarized below:

| | 2008 | 2007 |
|--|-------------------|-------------------|
| 1998 Series B Fixed Rate Bonds, payable in varying annual amounts through 2031, with an interest rate of 5% | \$ 167,195 | \$ 170,775 |
| 2003 Series A Fixed Rate Bonds, payable in varying annual amounts from November 2007 through 2023, with interest rates ranging from 2% to 5% | 91,990 | 96,310 |
| 2003 Series B, C and D Variable Rate Bonds, maturing in November, 2036, with an interest rate of 1.77% at August 31, 2008 and 3.55% at August 31, 2007 | 150,000 | 150,000 |
| 2006 Series A Variable Rate Bonds, maturing in November 2040, with an interest rate of 3.56% at August 31, 2007 | - | 260,300 |
| 2006 Series B Variable Rate Bonds, maturing in November 2045, with an interest rate of 3.58% at August 31, 2007 | - | 168,200 |
| 2008 Series A Variable Rate Bonds, maturing in November 2040, with an interest rate of 2.24% at August 31, 2008 | 260,300 | - |
| 2008 Series B Variable Rate Bonds, maturing in November 2045, with an interest rate of 1.53% at August 31, 2008 | 168,200 | - |
| Promissory note, maturing in July 2014, with an interest rate of 7.03% at August 31, 2008 and 2007 | 999 | 1,132 |
| Total principal amounts | <u>838,684</u> | <u>846,717</u> |
| Unamortized original issue premium, net of discount | 1,843 | 2,019 |
| Current portion of long-term debt | (7,877) | (8,033) |
| Debt subject to short-term remarketing arrangements | <u>(249,414)</u> | <u>-</u> |
| Long-term portion, net of current portion | <u>\$ 583,236</u> | <u>\$ 840,703</u> |

Stanford Hospital and Clinics and Subsidiaries
Notes to Consolidated Financial Statements
(in thousands of dollars)

8. Long-Term Debt (Continued)

In June 2008, The California Health Facilities Financing Authority ("CHFFA") on behalf of SHC, refunded the 2006 Variable Rate Bonds in the aggregate principal amount of \$428,500 and issued 2008 Variable Rate Bonds in the aggregate principal amount of \$428,500. The 2008 bonds were comprised of \$260,300 of 2008 Series A Variable Rate Bonds that were issued as Series A-1, Series A-2, and Series A-3; and \$168,200 of 2008 Series B Variable Rate Bonds that were issued as Series B-1 and Series B-2. As a result of the bond refinancing, the 2006 bond issuance costs of \$17,855 were included in loss on extinguishment of debt for the year ended August 31, 2008.

The 2008 Series A-1 \$70,500 and Series A-3 \$85,700 Variable Rate Bonds are subject to mandatory repurchase tenders after June 15, 2009 and June 15, 2011, respectively. The 2008 Series A-2 bonds are 7 day Variable Rate Demand Bonds ("VRDB") in the amount of \$104,100 secured by a letter of credit which expires June 2011. The 2008 Series B bonds are 7 day VRDB's with self-liquidity. SHC has an arrangement with Stanford University to access on a same-day basis up to \$200,000 of SHC's investments which are managed for SHC by Stanford University.

In June 2008, SHC converted the \$150,000 2003 Series B, C and D Variable Rate Bonds from 35 day auction rate notes to 7 day Variable Rate Demand Bonds ("VRDB"). In order to provide liquidity for the VRDB's, SHC entered into a three year Standby Bond Purchase Agreement in the amount of \$150,000. The 2008 bonds, together with the 2003 bonds and 1998 bonds are collectively referred to as the "Revenue Bonds". The Revenue Bonds are a limited obligation of CHFFA and are payable solely from payments made by SHC. Payments of principal and interest on the bonds are collateralized by a pledge against the revenues of SHC. The Revenue Bonds are insured by municipal bond guaranty policies. The Master Trust Indenture of SHC includes, among other things, limitations on additional indebtedness, liens on property, restrictions on the disposition or transfer of assets, and maintenance of certain financial ratios. SHC may redeem the Revenue Bonds, in whole or in part, prior to the stated maturities. Total debt outstanding under the Master Trust Indenture is in the aggregate principal amounts of \$837,685 and \$877,985 as of August 31, 2008 and 2007, respectively.

Scheduled principal payments on long-term debt including unsecured promissory notes are summarized below, assuming remarketing of the 2003 and 2008 Variable Rate Bonds:

| | | |
|------------|----|----------------|
| 2009 | \$ | 7,877 |
| 2010 | | 8,713 |
| 2011 | | 9,114 |
| 2012 | | 11,261 |
| 2013 | | 11,010 |
| Thereafter | | 790,709 |
| | \$ | <u>838,684</u> |

The estimated fair value of the Revenue Bonds as of August 31, 2008 and 2007 was \$828,443 and \$849,572, respectively.

In 1998, SHC advance refunded its 1993 and 1995 bonds in the amount of \$111,014 by issuing the 1998 bonds. As of August 31, 2008 and 2007, \$32,415 and \$39,725, respectively, of advance refunded bonds, which are considered extinguished, remain outstanding.

Stanford Hospital and Clinics and Subsidiaries

Notes to Consolidated Financial Statements

(in thousands of dollars)

8. Long-Term Debt (Continued)

Interest Rate Swap Agreements

SHC has entered into various interest rate swap agreements (swap agreements) with varying maturities through November 2040. The purpose of the swap agreements, also known as risk management or derivative instruments, is to reduce the effect of interest rate fluctuation on its variable rate bonds.

The swap agreements require SHC to pay fixed interest rates varying from 3.365% to 3.81% on a notional amount and to receive a variable interest payment computed based on a percentage of the 30-day London Interbank Offered Rate ("LIBOR") based on the same notional amount. Certain swap agreements require mutual posting of collateral between SHC and the counterparties should the fair market value of the swap agreements exceed a predetermined threshold dollar amount.

The notional amounts under the swap agreements were \$749,400 at August 31, 2008 and 2007. The swap agreements can be canceled at anytime by SHC by settling the contracts at the current fair market value.

The swap agreements are recognized on the consolidated balance sheets at their fair value. The fair market value of the swap agreements as of August 31, 2008 was a liability of \$38,973 included in other non-current liabilities. As of August 31, 2007, the fair market value was recorded as an asset of \$3,625 included in non-current assets.

In June 2008, the underlying bonds that were being hedged were refinanced and as a result, the swap agreements are no longer treated as a hedge for accounting purposes. As a result, the change in the fair market value of the swap agreements of \$42,600 for the year ended August 31, 2008 has been included in the excess of revenue over expenses in the consolidated statements of operations and changes in net assets.

In 2007, the deemed effective portion of the change in the fair value of interest rate swaps of \$438 was excluded from excess of revenues over expenses in the consolidated statements of operations and changes in net assets for the year ended August 31, 2007.

Interest expense includes the net of cash receipts and cash payments under the interest swap agreements. Interest expense includes net cash payments of \$3,198 and net cash receipts of \$975 for the years ended August 31, 2008 and 2007, respectively.

Stanford Hospital and Clinics and Subsidiaries

Notes to Consolidated Financial Statements

(in thousands of dollars)

9. Retirement Plans

SHC provides retirement benefits through defined benefit and defined contribution retirement plans covering substantially all benefit eligible employees.

Defined Contribution Retirement Plan

Employer contributions to the defined contribution retirement plan are based on a percentage of participant annual compensation. Employer contributions to this plan for SHC employees excluding LPCH leased employees (see Note 11) totaling \$34,864 and \$31,392 for the years ended August 31, 2008 and 2007, respectively, are included in salaries and benefits expense in the consolidated statements of operations and changes in net assets.

Defined Benefit Pension Plan

Certain employees of the Hospitals are covered by a noncontributory defined benefit pension plan (the "Staff Pension Plan"). Benefits are based on years of service and the employee's compensation. Contributions to the plans are based on actuarially determined amounts sufficient to meet the benefits to be paid to plan participants.

As of August 31, 2004, SHC assumed the pension liability of the employees leased to LPCH. SHC received \$2,527 in cash during the year ended August 31, 2005, which represented the pension liability as of August 31, 2004. In addition, SHC received \$454 and \$440 in cash for the years ending August 31, 2008 and 2007, respectively, which represented the current year pension expense related to LPCH leased employees.

The funded status is measured as the difference between the projected benefit obligation and the fair value of plan assets. Under the transition provisions of SFAS 158, actuarial gains or losses and prior-service costs or credits that have not yet been included in net periodic benefit expense as of the adoption date are recognized as components of the ending balance of minimum pension liability. The minimum pension liability decreased by \$6,909 for the year ended August 31, 2007, with \$3,316 of the decrease attributable to the adoption of SFAS 158. The decrease in minimum pension liability is included on the consolidated statements of operations and changes in net assets for the year ended August 31, 2007.

Postretirement Medical Benefit Plan

SHC currently provides health insurance coverage for SHC employees upon retirement as early as age 55, with years of service as defined by specific criteria. The health insurance coverage for retirees who are under age 65 is the same as that provided to active employees. A Medicare supplement option is provided for retirees over age 65.

The funded status is measured as the difference between the accumulated postretirement benefit obligation and the fair value of plan assets. Under the transition provisions of SFAS 158, actuarial gains or losses and prior-service costs or credits that have not yet been included in net periodic benefit expense as of the adoption date are recognized as components of the ending balance of minimum postretirement medical benefit liability. The minimum postretirement medical benefit liability decreased by \$8,297 for the year ended August 31, 2007, with the full decrease attributable to the adoption of SFAS 158. The decrease in minimum postretirement medical benefit liability is included on the consolidated statements of operations and changes in net assets for the year ended August 31, 2007.

Stanford Hospital and Clinics and Subsidiaries
Notes to Consolidated Financial Statements
(in thousands of dollars)

9. Retirement Plans (Continued)

The following tables present information on plan assets and obligations, costs, and actuarial assumptions for the Staff Pension Plan and the Postretirement Medical Benefit Plan for the years ended August 31, 2008 and 2007, respectively.

The tables for the Postretirement Medical Benefit Plan include SHC and LPCH leased employees. The total Postretirement Medical Benefit Liability was \$62,818 and \$65,732 as of August 31, 2008 and 2007, respectively. SHC recorded a liability in the self-insurance reserves in the consolidated balance sheets of \$50,477 and \$55,202 as of August 31, 2008 and 2007, respectively, which represents the liability for SHC employees excluding LPCH leased employees.

The change in pension and other post-retirement plan assets and the related change in benefit obligations, using a measurement date of June 30, as of and for the years ended August 31 are as follows:

| | Staff Pension Plan Obligations | | Postretirement Medical Benefits Net of Medicare Part D Subsidy | |
|--|---|-------------------|---|------------------|
| | 2008 | 2007 | 2008 | 2007 |
| Change in plan assets: | | | | |
| Fair value of plan assets at beginning of year | \$ 152,074 | \$ 135,408 | \$ - | \$ - |
| Actual return on plan assets | (11,576) | 22,842 | - | - |
| Employer contributions | 6,898 | 1,152 | 3,657 | 3,344 |
| Participants contributions | - | - | 682 | 680 |
| Benefits paid | (6,619) | (7,328) | (4,339) | (4,024) |
| Fair value of plan assets at end of year | <u>\$ 140,777</u> | <u>\$ 152,074</u> | <u>\$ -</u> | <u>\$ -</u> |
| Change in benefit obligation: | | | | |
| Benefit obligation at beginning of year | \$ 157,568 | \$ 152,559 | \$ 66,339 | \$ 68,497 |
| Service cost | 1,720 | 1,720 | 1,583 | 1,660 |
| Interest cost | 9,952 | 9,749 | 4,071 | 4,257 |
| Participants contributions | - | - | 682 | 680 |
| Benefits paid | (6,619) | (7,328) | (4,339) | (4,024) |
| Actuarial (gain) loss | (15,793) | 868 | (4,793) | (4,731) |
| Benefit obligation at end of year | <u>\$ 146,828</u> | <u>\$ 157,568</u> | <u>\$ 63,543</u> | <u>\$ 66,339</u> |

Stanford Hospital and Clinics and Subsidiaries
Notes to Consolidated Financial Statements
(in thousands of dollars)

9. Retirement Plans (Continued)

| | Staff Pension Plan Obligations | | Postretirement Medical Benefits Net of Medicare Part D Subsidy | |
|---|---|-------------------|---|--------------------|
| | <u>2008</u> | <u>2007</u> | <u>2008</u> | <u>2007</u> |
| Amounts recognized in consolidated balance sheets: | | | | |
| Plan assets minus benefit obligation | \$ (6,051) | \$ (5,494) | \$ (63,543) | \$ (66,339) |
| Contributions made from July 1 to August 31 | - | 4,262 | 725 | 607 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net benefit liability recognized | <u>\$ (6,051)</u> | <u>\$ (1,232)</u> | <u>\$ (62,818)</u> | <u>\$ (65,732)</u> |
| | | | | |
| | Staff Pension Plan Obligations | | Postretirement Medical Benefits Net of Medicare Part D Subsidy | |
| | <u>2008</u> | <u>2007</u> | <u>2008</u> | <u>2007</u> |
| Amounts recognized in consolidated balance sheets (after SFAS 158) consist of: | | | | |
| Current liabilities | \$ - | \$ - | \$ (4,262) | \$ (4,365) |
| Noncurrent liabilities | (6,051) | (1,232) | (58,556) | (61,367) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net benefit liability recognized | <u>\$ (6,051)</u> | <u>\$ (1,232)</u> | <u>\$ (62,818)</u> | <u>\$ (65,732)</u> |
| | | | | |
| Amounts recognized in accumulated other comprehensive income: | | | | |
| Prior service credit | \$ - | \$ - | \$ (2,585) | \$ (3,419) |
| Net loss (gain) | 3,524 | (3,316) | (8,972) | (4,627) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Accumulated other comprehensive income | <u>\$ 3,524</u> | <u>\$ (3,316)</u> | <u>\$ (11,557)</u> | <u>\$ (8,046)</u> |

No estimated net gain and prior service credit for the staff pension plan will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year. The estimated net gain and prior service credit for the postretirement medical plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year are \$1,053 and \$834, respectively.

Total benefit obligation at the end of the year for Postretirement Medical Benefits excluding Medicare Part D subsidiary increased to \$70,216.

The accumulated benefit obligation for the defined benefit pension plan was \$142,876 and \$152,418 as of June 30, 2008 and 2007, respectively.

Stanford Hospital and Clinics and Subsidiaries
Notes to Consolidated Financial Statements
(in thousands of dollars)

9. Retirement Plans (Continued)

Net benefit expense related to the plans for the years ended August 31 includes the following components:

| | Staff Pension Plan Obligations | |
|---------------------------------|---|-----------------|
| | 2008 | 2007 |
| Service cost | \$ 1,720 | \$ 1,720 |
| Interest cost | 9,952 | 9,749 |
| Expected return on plan assets | (11,057) | (10,061) |
| Recognized net actuarial loss | - | 55 |
| Total net periodic benefit cost | <u>\$ 615</u> | <u>\$ 1,463</u> |

| | Postretirement Medical Benefits | | | |
|--------------------------------------|---|-----------------|--|-----------------|
| | Net of Medicare Part D Subsidy | | Excluding Medicare Part D Subsidy | |
| | 2008 | 2007 | 2008 | 2007 |
| Service cost | \$ 1,583 | \$ 1,660 | \$ 1,673 | \$ 1,813 |
| Interest cost | 4,071 | 4,257 | 4,747 | 4,888 |
| Amortization of prior service cost | (834) | (834) | (834) | (834) |
| Recognized net actuarial (gain) loss | (448) | 11 | 184 | 689 |
| Total net periodic benefit cost | <u>\$ 4,372</u> | <u>\$ 5,094</u> | <u>\$ 5,770</u> | <u>\$ 6,556</u> |

Actuarial Assumptions

The weighted-average assumptions used to determine benefit obligations are as follows for the years ended August 31:

| | Staff Pension Plan Obligations | | Postretirement Medical Benefits | |
|-------------------------------|---|-------------|--|-------------|
| | 2008 | 2007 | 2008 | 2007 |
| Weighted-average assumptions | | | | |
| Discount rate | 7.38% | 6.47% | 7.12% | 6.35% |
| Rate of compensation increase | 5.50% | 5.50% | N/A | N/A |

Stanford Hospital and Clinics and Subsidiaries
Notes to Consolidated Financial Statements
(in thousands of dollars)

9. Retirement Plans (Continued)

Actuarial Assumptions (continued)

The discount rate, expected rate of return on plan assets, and the projected covered payroll growth rates used in determining the above net benefit expense are as follows for the years ended August 31:

| | Staff Pension Plan Obligations | | Postretirement Medical Benefits | |
|--------------------------------|--------------------------------------|-------|---------------------------------------|-------|
| | 2008 | 2007 | 2008 | 2007 |
| Weighted-average assumptions | | | | |
| Discount rate | 6.47% | 6.53% | 6.35% | 6.42% |
| Expected return on plan assets | 8.00% | 8.00% | N/A | N/A |
| Rate of compensation increase | 5.50% | 5.50% | N/A | N/A |

To develop the assumption for the expected rate of return on plan assets, SHC considered the historical and future expected returns. The historical return of the plan assets for the past ten years ending June 30, 2008 averaged 6.5%. An independent investment consulting firm provided SHC with an estimate of the future expected returns for each asset class based on SHC's asset allocation targets. The evaluation of the historical returns and the future expected returns resulted in the use of 8.0% as the assumption for the expected return on plan assets.

To determine the accumulated post-retirement benefit obligation as of August 31, 2008, a 10.0% annual rate of increase in the pre-65 per capita costs and 11.0% annual rate of increase in the post-65 prescription drug per capita costs, and 8.0% rate of increase in the post-65 per capita cost of all other medical benefits was assumed for 2008, declining gradually to 5.0% by 2014 for pre-65 per capita costs, 2014 for post-65 prescription drug per capita cost, and 2011 for post-65 per capita costs of all other medical benefits, and remaining at this rate thereafter.

Assumed healthcare cost trend rates have a significant effect on the amounts reported for the post-retirement medical benefit plan. Increasing the health care cost trend rate by 1% in each future year would increase the accumulated post-retirement benefit obligation by \$2,136 and the aggregate service and interest cost by \$218. Decreasing the health care cost trend rate by 1% in each future year would decrease the accumulated post-retirement benefit obligation by \$1,910 and the aggregate service and interest cost by \$194.

Plan Assets

SHC's staff pension plan weighted-average asset allocations as of the measurement date June 30, 2008 and 2007, respectively by asset category are as follows:

| <u>Asset Category</u> | <u>June 30, 2008</u> | <u>June 30, 2007</u> |
|-----------------------|----------------------|----------------------|
| Equity securities | 66% | 68% |
| Debt securities | 21% | 21% |
| Real estate | 12% | 10% |
| Other | 1% | 1% |
| Total | 100% | 100% |

Stanford Hospital and Clinics and Subsidiaries

Notes to Consolidated Financial Statements

(in thousands of dollars)

9. Retirement Plans (Continued)

Plan Investments

The investment objective of the staff pension plan funds is to maximize the total rate of return (income and appreciation) within the limits of prudent risk taking and Section 404 of ERISA. The funds are diversified across asset classes to achieve an optimal balance between risk and return and between income and capital appreciation. Many of the pension liabilities are long term. The investment horizon is also long-term; however, the investment plan also ensures adequate near-term liquidity to meet benefit payments.

The allowable asset mix range and target asset allocations are:

| <u>Asset Category</u> | <u>Acceptable Range</u> | <u>Target Allocation</u> |
|-----------------------|-------------------------|--------------------------|
| Equity securities | 40% to 85% | 62% |
| Debt securities | 20% to 50% | 30% |
| Real Estate | 0% to 15% | 8% |
| Cash equivalents | 0% to 40% | < 1% |

Appropriate investments include common, preferred and convertible equities of domestic and foreign companies, mutual and commingled trust funds, top tier commercial paper, certificates of deposit, and fixed income securities whose assets are rated investment grade or better. Financial futures and options on futures traded on exchanges are also permitted for hedging purposes. Prohibited investments include commodities, unregistered securities, short sales and interest rate swaps. All assets must have readily ascertainable market value and be easily marketable.

The equity portfolio will generally be invested with minimal emphasis on market timing and broadly diversified with not less than 90% of the market value in the portfolio listed on the New York or American Stock Exchanges or traded on NASDAQ. With certain aggregate market value limitations, foreign-based common stocks, real estate investment trusts and American Depository Receipts may also be included to further diversify the portfolio.

Fixed income investments may consist of U.S. government, U.S. government guaranteed, and U.S. government agency securities. Corporate bond holdings must have an investment grade credit rating at the time of purchase and during the holding period. No more than 20% of the total fixed income portfolio may be invested in foreign government, agency and high grade corporate bonds of countries with minimum long term local currency ratings of A by Moody's or Standard and Poor's.

Real estate investments shall be diversified geographically by property type and/or by property size. No more than 5% of real estate holdings may be invested at any time in a single property.

Expected Contributions

SHC expects to contribute \$3,075 to its Staff Pension Plan for both SHC and LPCH leased employees during the fiscal year ending August 31, 2009. SHC expects to contribute \$4,411 to its Postretirement Medical Plan for both SHC and LPCH leased employees during the fiscal year ending August 31, 2009.

Stanford Hospital and Clinics and Subsidiaries
Notes to Consolidated Financial Statements
(in thousands of dollars)

9. Retirement Plans (Continued)

Expected Benefit Payments

The following benefit payments, which reflect expected future service, are expected to be paid for the fiscal years ending August 31:

| | Pension Benefits | Postretirement Medical Benefits | |
|-------------|-------------------------|--|--|
| | | Net of Medicare Part D Subsidy | Excluding Medicare Part D Subsidy |
| 2009 | \$ 7,473 | \$ 4,411 | \$ 4,826 |
| 2010 | 7,972 | 4,705 | 5,194 |
| 2011 | 8,490 | 5,057 | 5,618 |
| 2012 | 9,122 | 5,388 | 6,024 |
| 2013 | 9,825 | 5,676 | 6,388 |
| 2014 - 2018 | 57,853 | 29,188 | 33,873 |

10. Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets consist of the following at August 31:

| | 2008 | 2007 |
|---------------------------------|------------------|------------------|
| Plant replacement and expansion | \$ 31,138 | \$ 31,946 |
| Other patient services | 12,060 | 8,512 |
| Indigent care | 6,506 | 5,568 |
| Clinical services | 3,414 | 2,491 |
| Education | 3,032 | 2,793 |
| Total | <u>\$ 56,150</u> | <u>\$ 51,310</u> |

Permanently restricted net assets consist of investments to be held in perpetuity, invested to generate income to support the following purposes at August 31:

| | 2008 | 2007 |
|---------------------------------|-----------------|-----------------|
| Clinical services | \$ 4,000 | \$ 3,000 |
| Education | 1,235 | 1,235 |
| Plant replacement and expansion | 901 | 920 |
| Indigent care and other | 356 | 356 |
| Total | <u>\$ 6,492</u> | <u>\$ 5,511</u> |

Stanford Hospital and Clinics and Subsidiaries

Notes to Consolidated Financial Statements

(in thousands of dollars)

11. Related-Party Transactions

Transactions with the University and SoM

SHC has various transactions with the University and the SoM. SHC records expense transactions where direct and incremental economic benefits are received by SHC.

Expenses paid to the University and the SoM are reported as operating expenses in the statements of operations and changes in net assets and are management's best estimates of SHC's arms-length payments of such amounts for its market specific circumstances. To the extent that payments to the University and the SoM exceed an arms-length estimated amount relative to the benefits received by SHC, they are recorded as transfers to the University and the SoM in other changes in net assets.

SHC purchases certain services from the University and the SoM. Payment for these services is based on management's best estimate of its market specific circumstances.

Services provided by the SoM include physician services that benefit SHC, such as emergency room coverage, physicians providing medical direction to SHC, and physicians providing service to the clinical practice, which are covered by the Professional Services Agreement ("PSA"). Such expenses are reflected as purchased services in the consolidated statements of operations and changes in net assets, and total \$215,403 and \$207,993 for the years ended August 31, 2008 and 2007, respectively.

Services provided by the University include telecommunications, transportation, utilities, blood products, and certain administrative services, which consist of legal, internal audit, and risk management. Total costs incurred by SHC were \$72,953 and \$64,427 for the years ended August 31, 2008 and 2007, respectively, and are reflected in various categories in the consolidated statements of operations and changes in net assets.

SHC paid service fees to the University in the amount of \$4,406 and \$4,457 for the years ended August 31, 2008 and 2007, respectively. The service fees represent costs for the utilization of infrastructure owned by the University such as road improvements, parking garages and generators and are reflected in the consolidated statements of operations and changes in net assets as other expense. Expected payments over the next 25 years total \$55,797. Annual service fees range from approximately \$4,352 for the year ending August 31, 2009 to \$455 for the year ending August 31, 2033.

SHC also received payment for services provided to the University including primarily building maintenance, housekeeping, and security. Costs incurred by SHC in providing these services are reflected in the respective categories in the consolidated statements of operations and changes in net assets. Reimbursement from the University totaled \$24,064 and \$22,333 for the years ended August 31, 2008 and 2007, respectively, and is reflected in the consolidated statements of operations and changes in net assets as expense recoveries.

In addition, SHC received certain grant monies for clinical trials from the University. Grant revenue totaled \$5,443 and \$3,992 for the years ended August 31, 2008 and 2007, respectively, and is reflected in the statements of operations and changes in net assets as net patient service revenue and recoveries.

Stanford Hospital and Clinics and Subsidiaries

Notes to Consolidated Financial Statements

(in thousands of dollars)

11. Related-Party Transactions (Continued)

Transactions with the University and SoM (continued)

During the year ended August 31, 2004, SHC paid \$5,500 to the University. The amount represented a prepayment of a 51 year lease for property owned by the University. The remaining amount included in other assets in the consolidated balance sheets is \$4,673 and \$4,782 as of August 31, 2008 and 2007, respectively.

For the years ended August 31, 2008 and 2007, SHC transferred \$7,675 and \$6,776 to the University related to academic grants.

Transactions with LPCH

Shared Services - SHC and LPCH share certain departments, including facilities design and construction, materials management, managed care contracting, payroll, compliance, risk management and general services. Shared service costs are included in the respective categories on the consolidated statements of operations and changes in net assets, and are allocated between SHC and LPCH based on negotiated rates. Reimbursement received from LPCH totaled \$25,223 and \$21,241 for the years ended August 31, 2008 and 2007, respectively, and is reflected in the consolidated statements of operations and changes in net assets as expense recoveries.

Purchased Services - SHC provides various services to LPCH. These services include operating room, cardiac catheterization, interventional radiology, radiation oncology and laboratory. The cost of these services is charged back to LPCH based on a percentage of charges intended to approximate cost or a cost per procedure. Costs of these purchased services are reflected in the appropriate category in the consolidated statements of operations and changes in net assets. Reimbursement of purchased services from LPCH totaled \$50,113 and \$60,606 for the years ended August 31, 2008 and 2007, respectively, and is reflected in the consolidated statements of operations and changes in net assets as net patient service revenue.

Other Services - Other services provided by SHC include services provided by interns and residents, billings and collections, building maintenance and utilities. Reimbursement of these services totaled \$23,444 and \$20,337 for the years ended August 31, 2008 and 2007, respectively, and is reflected in the consolidated statements of operations and changes in net assets as expense recoveries. SHC also leased 2,513 and 2,540 full time and part time employees to LPCH during the years ended August 31, 2008 and 2007, respectively.

Transfers to LPCH

Effective September 1, 2006, LPCH and the University entered into the LPCH PSA pursuant to which the University assigned to LPCH the right to all revenues related to pediatric and obstetric practices of SoM faculty. Prior to September 1, 2006, the University had assigned to SHC the right to all revenue related to pediatric and obstetric practices of SoM faculty. As part of the LPCH PSA, LPCH assumed the right to all pediatric and obstetric revenues after September 1, 2006. SHC transferred net assets of \$807 and \$14,352 to LPCH in connection with this transfer agreement during the years ended August 31, 2008 and 2007, respectively.

In FY08, SHC agreed to execute an equity transfer of \$2,001 to LPCH which represents a fixed allocation of 18% of the total net assets of SUMIT of \$3,665 as of August 31, 2007. Previously net assets were allocated relative to the percentage of the premiums paid to SUMIT in each fiscal year.

Stanford Hospital and Clinics and Subsidiaries
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12. Operating and Capital Leases

SHC leases various equipment and facilities under non-cancelable lease agreements expiring at various dates. Total rental expense (included in other expense in the consolidated statements of operations and changes in net assets) under these leases for the years ended August 31, 2008 and 2007 was \$32,947 and \$28,337, respectively.

Net minimum future lease payments under all non-cancelable operating leases and capital lease obligations for periods subsequent to August 31, 2008 are as follows:

| Year Ending August 31, | Operating | Capital |
|---|-------------------|-----------------|
| 2009 | \$ 29,910 | \$ 1,261 |
| 2010 | 22,908 | 1,261 |
| 2011 | 20,286 | 1,261 |
| 2012 | 19,846 | 841 |
| 2013 | 18,920 | - |
| Thereafter | 124,023 | - |
| | <u>\$ 235,893</u> | 4,624 |
| Less amount representing interest | | (236) |
| Subtotal | | <u>4,388</u> |
| Current portion | | (1,152) |
| Long-term portion, net of current portion | | <u>\$ 3,236</u> |

Capital lease obligations totaled \$4,388 of which \$1,152 is included in accounts payable and accrued liabilities on the consolidated balance sheet. The remaining capital lease obligation of \$3,236 is included in other long term liabilities on the consolidated balance sheet.

SHC leases space in its medical office building to others under noncancelable operating lease arrangements. Future minimum base rentals to be received under these leases in place as of August 31, 2008 are as follows:

| Year Ending August 31, | |
|-------------------------------|-----------------|
| 2009 | \$ 1,704 |
| 2010 | 655 |
| 2011 | 164 |
| 2012 | 166 |
| 2013 | 135 |
| Thereafter | 56 |
| | <u>\$ 2,880</u> |

Stanford Hospital and Clinics and Subsidiaries
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13. Commitments and Contingencies

SHC is aware of certain asserted and unasserted legal claims. While the outcome cannot be determined at this time, management is of the opinion that the liability, if any, from these actions will not have a material effect on SHC's financial position.

SHC has four irrevocable letters of credit with a bank in the amount of \$126,866 which are required as security for the workers' compensation self-insurance arrangement. No amounts have been drawn on these letters of credit as of August 31, 2008.

At August 31, 2008, SHC had contractual obligations of approximately \$134,200 primarily related to the construction of the Stanford Medical Outpatient Center in Redwood City, the upgrade of the clinical information systems and consulting services.

Effective September 1, 2004, SHC entered into a seven year agreement with Perot Systems Health Care Services LLC ("Perot"), pursuant to which Perot will provide certain information technology services to SHC. Under the terms of the 2008 amended agreement, SHC will be charged a fixed annual service charge including expenses, payable monthly, for core services as defined, and additional fees plus expenses for special projects. The annual fixed service charges are subject to adjustment under certain conditions, but unless so adjusted, amount to approximately \$45,955 for the year ending August 31, 2009, decreasing annually thereafter to approximately \$39,600 for the year ending August 31, 2011. SHC has certain rights to reduce the scope of services to be purchased and to terminate the agreement early for a termination fee. The amount of the termination fee depends on when the right to terminate is exercised and reduces annually, ranging from \$8,300 for the year ending August 31, 2009 to \$6,000 for the year ending August 31, 2010.

The healthcare industry is subject to numerous laws and regulations of federal, state and local governments. Compliance with these laws and regulations can be subject to future government review and interpretation, as well as to regulatory actions unknown or unasserted at this time. Recently, government activity has increased with respect to investigations and allegations concerning possible violations by healthcare providers of regulations that could result in the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. SHC is subject to similar regulatory reviews, and while such reviews may result in repayments and/or civil remedies that could have a material effect on SHC's financial results of operations in a given period, management believes that such repayments and/or civil remedies would not have a material effect on SHC's financial position.

The percentage of SHC employees excluding LPCH leased employees that are covered by collective bargaining arrangements is approximately 40%. There are currently no expired agreements.

14. Functional Expenses

Expenses are categorized on a functional basis for the years ended August 31:

| | 2008 | 2007 |
|---------------------------|---------------------|---------------------|
| Patient services | \$ 1,428,826 | \$ 1,282,630 |
| Management and general | 118,722 | 110,405 |
| Fundraising | <u>2,758</u> | <u>2,008</u> |
| Total functional expenses | <u>\$ 1,550,306</u> | <u>\$ 1,395,043</u> |

Stanford Hospital and Clinics and Subsidiaries
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(in thousands of dollars)

15. Subsequent Event

The fair value of the Investments in University Managed Pools declined subsequent to August 31, 2008 as a result of significant declines in financial markets globally.

APPENDIX B

List of Nationally Recognized Municipal Securities Information Repositories

Bloomberg Municipal Repositories

P.O. Box 840
Princeton, NJ 08542-0840
Phone: 609.279.3225
Fax: 609.279.5962
Email: Munis@Bloomberg.com

Standard & Poor's JJ Kenny Repository

55 Water Street
45th Floor
New York, NY 10041
Phone: 212.438.4595
Fax: 212.438.3975
Email: nrmsir_repository@sandp.com

Interactive Data

Attn: Repository
100 Williams Street
New York, NY 10038
Phone: 212.771.6899
Fax: 212.771.7390
Email: NRMSIR@interactivedata.com

DPC Data, Inc.

One Executive Drive
Fort Lee, NJ 07024
Phone: 201.346.0701
Fax: 201.947.0107
Email: nrmsir@dpcdata.com