

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-Q**

**(Mark One)**

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended March 31, 2007**

**OR**

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 333-71934**



**VANGUARD HEALTH SYSTEMS, INC.**

*(Exact name of registrant as specified in its charter)*

**Delaware**

*(State or other jurisdiction of incorporation or organization)*

**62-1698183**

*(I.R.S. Employer Identification No.)*

**20 Burton Hills Boulevard, Suite 100  
Nashville, TN 37215**

*(Address and zip code of principal executive offices)*

**(615) 665-6000**

*(Registrant's telephone number, including area code)*

Indicate by check mark whether the registrant (1) has filed all reports required to be filed under Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☒

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

There were 749,550 shares of common stock outstanding as of May 1, 2007 (all of which are privately owned and not traded on a public market).

**VANGUARD HEALTH SYSTEMS, INC.**  
**QUARTERLY REPORT ON FORM 10-Q**  
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**PART I**  
**FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

**VANGUARD HEALTH SYSTEMS, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

	June 30, 2006	(Unaudited) March 31, 2007
	<i>(In millions except share and per share amounts)</i>	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 123.6	\$ 122.8
Restricted cash	—	6.1
Accounts receivable, net of allowance for uncollectible accounts of approximately \$103.5 and \$109.9 at June 30, 2006 and March 31, 2007, respectively	294.1	301.6
Inventories	45.3	47.1
Assets held for sale	52.1	—
Prepaid expenses and other current assets	45.9	68.5
	<hr/>	<hr/>
Total current assets	561.0	546.1
Property, plant and equipment, net of accumulated depreciation	1,159.5	1,170.9
Goodwill	812.8	689.0
Intangible assets, net of accumulated amortization	69.0	65.8
Investments in unconsolidated subsidiaries	8.2	8.0
Other assets	40.0	60.3
	<hr/>	<hr/>
Total assets	\$ 2,650.5	\$ 2,540.1
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 151.8	\$ 139.5
Accrued salaries and benefits	78.5	65.0
Accrued health claims	44.0	57.9
Accrued interest	13.3	26.4
Other accrued expenses and current liabilities	72.1	64.9
Current maturities of long-term debt	8.3	8.0
	<hr/>	<hr/>
Total current liabilities	368.0	361.7
Minority interests in equity of consolidated entities	9.4	9.2
Other liabilities	73.0	84.5
Long-term debt, less current maturities	1,510.9	1,518.1
Commitments and contingencies		
Stockholders' Equity:		
Common Stock; \$.01 par value, 1,000,000 shares authorized, 749,550 shares issued and outstanding at June 30, 2006 and March 31, 2007	—	—
Additional paid-in capital	643.7	644.2
Retained earnings (deficit)	45.5	(77.6)
	<hr/>	<hr/>
Total stockholders' equity	689.2	566.6
	<hr/>	<hr/>
Total liabilities and stockholders' equity	\$ 2,650.5	\$ 2,540.1
	<hr/>	<hr/>

See accompanying notes.

**VANGUARD HEALTH SYSTEMS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**

	Three months ended March 31,		Nine months ended March 31,	
	2006	2007	2006	2007
<i>(In millions)</i>				
Patient service revenues	\$ 538.4	\$ 586.3	\$ 1,566.4	\$ 1,676.2
Premium revenues	98.7	98.2	274.2	296.1
Total revenues	637.1	684.5	1,840.6	1,972.3
Costs and Expenses:				
Salaries and benefits (includes stock compensation of \$0.5, \$(0.1), \$1.1 and \$0.7, respectively)	261.1	279.1	759.6	821.1
Supplies	105.4	109.7	301.4	321.5
Medical claims expense	74.3	73.1	196.7	220.3
Purchased services	32.6	40.1	94.8	111.9
Provision for doubtful accounts	42.7	47.2	125.0	134.6
Other operating expenses	41.6	53.3	141.6	151.4
Rents and leases	9.2	9.8	25.4	28.6
Depreciation and amortization	24.1	29.5	70.7	87.7
Interest, net	26.1	31.6	77.2	93.2
Impairment loss	—	—	—	123.8
Other	1.1	0.3	4.6	3.8
Income (loss) from continuing operations before income taxes	18.9	10.8	43.6	(125.6)
Income tax expense (benefit)	7.9	4.2	18.0	(13.1)
Income (loss) from continuing operations	11.0	6.6	25.6	(112.5)
Discontinued operations, net of taxes	4.6	(3.3)	0.9	(10.6)
Net income (loss)	\$ 15.6	\$ 3.3	\$ 26.5	\$ (123.1)

See accompanying notes.

**VANGUARD HEALTH SYSTEMS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

	Nine months ended March 31, 2006	Nine months ended March 31, 2007
	(In millions)	
<b>Operating activities:</b>		
Net income (loss)	\$ 26.5	\$ (123.1)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Loss (income) from discontinued operations	(0.9)	10.6
Depreciation and amortization	70.7	87.7
Provision for doubtful accounts	125.0	134.6
Deferred income taxes	16.7	(15.4)
Amortization of loan costs	3.0	3.3
Accretion of principal on senior discount notes	11.5	12.9
Gain on disposal of assets	(0.9)	(1.2)
Stock compensation	1.1	0.7
Debt extinguishment costs	0.1	–
Impairment loss	–	123.8
Changes in operating assets and liabilities from continuing operations:		
Accounts receivable	(142.1)	(169.1)
Inventories	(3.4)	(1.8)
Prepaid expenses and other current assets	10.1	(30.2)
Accounts payable	(15.3)	(1.6)
Accrued expenses and other current liabilities	5.8	34.3
Other liabilities	(23.0)	11.9
Net cash provided by operating activities – continuing operations	84.9	77.4
Net cash provided by operating activities – discontinued operations	4.6	2.3
Net cash provided by operating activities	89.5	79.7
<b>Investing activities:</b>		
Acquisitions, including working capital settlement payments	(0.4)	–
Capital expenditures	(174.1)	(120.7)
Purchases of short-term investments	(98.4)	(90.0)
Sales of short-term investments	98.4	90.0
Proceeds from asset dispositions	6.1	9.4
Other	(0.3)	0.6
Net cash used in investing activities – continuing operations	(168.7)	(110.7)
Net cash provided by investing activities – discontinued operations	25.4	36.5
Net cash used in investing activities	(143.3)	(74.2)
<b>Financing activities:</b>		
Proceeds from long-term debt	175.0	–
Payments of long-term debt and capital leases	(29.3)	(6.2)
Payments of loan costs and debt termination fees	(0.6)	–
Proceeds from joint venture partner contributions	–	0.1
Proceeds from exercise of stock options	0.1	0.2
Payments to retire outstanding stock	(0.1)	(0.2)
Payments to repurchase equity incentive units	(1.5)	(0.2)
Net cash provided by (used in) financing activities	143.6	(6.3)
Net increase (decrease) in cash and cash equivalents	89.8	(0.8)
Cash and cash equivalents, beginning of period	79.2	123.6
Cash and cash equivalents, end of period	\$ 169.0	\$ 122.8
Net cash paid for interest	\$ 63.2	\$ 68.4
Net cash paid for income taxes	\$ 1.5	\$ 0.6

See accompanying notes.

**VANGUARD HEALTH SYSTEMS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**March 31, 2007**  
**(Unaudited)**

**1. BUSINESS AND BASIS OF PRESENTATION**

**Business**

Vanguard is an investor-owned healthcare company whose affiliates own and operate hospitals and related healthcare businesses in urban and suburban areas. As of March 31, 2007, Vanguard's affiliates owned and managed 16 acute care hospitals with 4,314 licensed beds and related outpatient service locations complementary to the hospitals providing healthcare services in San Antonio, Texas; metropolitan Phoenix, Arizona; metropolitan Chicago, Illinois; and Massachusetts. Vanguard also owns managed health plans in Chicago, Illinois and Phoenix, Arizona and two surgery centers in Orange County, California.

**Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements include the accounts of subsidiaries and affiliates controlled by Vanguard. Vanguard generally considers control to represent the majority of an entity's voting interests. Vanguard also consolidates any entities for which it receives the majority of the entity's expected returns or is at risk for the majority of the entity's expected losses based upon its investment or financial interest in the entity. All material intercompany accounts and transactions have been eliminated. As none of Vanguard's common shares are publicly held, no earnings per share information is presented in the accompanying unaudited condensed consolidated financial statements. The majority of Vanguard's expenses are "cost of revenue" items. Costs that could be classified as general and administrative include certain Vanguard corporate office costs, which approximated \$7.1 million, \$8.8 million, \$22.9 million and \$22.7 million for the three months ended March 31, 2006 and 2007, and the nine months ended March 31, 2006 and 2007, respectively.

The unaudited condensed consolidated financial statements as of March 31, 2007 and for the three months and nine months ended March 31, 2006 and 2007 have been prepared in conformity with accounting principles generally accepted in the United States for interim reporting and in accordance with Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, the unaudited condensed consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial position and the results of operations for the periods presented. The results of operations for the periods presented are not necessarily indicative of the expected results for the fiscal year ending June 30, 2007. The interim unaudited condensed consolidated financial statements should be read in connection with the audited consolidated financial statements as of and for the year ended June 30, 2006 included in Vanguard's Annual Report on Form 10-K filed with the Securities and Exchange Commission on September 20, 2006.

*Use of Estimates*

In preparing Vanguard's financial statements in conformity with accounting principles generally accepted in the United States, management makes estimates and assumptions that affect the amounts recorded or classification of items in the unaudited condensed consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

**Reclassifications**

Vanguard adjusted its condensed consolidated balance sheet as of June 30, 2006 to classify the fixed assets, goodwill and intangible assets and certain current assets of its California hospitals, which were sold on October 1, 2006, as assets held for sale. Vanguard adjusted its condensed consolidated statements of operations for the three months and nine months ended March 31, 2006 and its condensed consolidated statement of cash flows for the nine months ended March 31,

2006, to reflect California hospitals' operating results as discontinued operations. See Note 3 for further discussion of discontinued operations.

## 2. STOCK-BASED COMPENSATION

Vanguard's only stock-based employee compensation is in the form of stock option grants to employees. Vanguard used the minimum value pricing model permitted under SFAS 123 to determine stock compensation costs related to stock option grants prior to July 1, 2006. On July 1, 2006, Vanguard adopted the provisions of Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment* ("SFAS 123(R)"), to account for stock option grants subsequent to July 1, 2006. Vanguard adopted SFAS 123(R) on a prospective basis as required for companies that chose to adopt SFAS 123 using the transition guidance set forth in SFAS 148. SFAS 123(R) requires that stock-based employee compensation be measured at fair value using models that incorporate certain minimum inputs, the most notable of which are the Black-Scholes-Merton model and various lattice models. SFAS 123(R) no longer permits nonpublic companies to use the minimum value pricing model. Upon adoption of SFAS 123(R), Vanguard chose to utilize the Black-Scholes-Merton model for option valuation purposes and to calculate separate forfeiture estimates for stock option grants to members of executive management and for stock option grants to other employees. Under SFAS 123, Vanguard calculated a blended forfeiture rate for all option grants. Vanguard's adoption of SFAS 123(R) did not significantly impact its income or loss from continuing operations, income or loss before income taxes, net income or loss, cash flows from operating activities or cash flows from financing activities for the three months or nine months ended March 31, 2007.

In March 2005, the United States Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") to provide supplemental implementation guidance to the provisions of SFAS 123(R). Vanguard has applied the guidance set forth in SAB 107 in determining its accounting treatment and related disclosures for stock-based employee compensation.

### 2004 Stock Incentive Plan

After the Blackstone merger, Vanguard adopted the 2004 Stock Incentive Plan ("the 2004 Option Plan"). As of March 31, 2007, the 2004 Option Plan, as amended, allows for the issuance of up to 101,117 options to purchase common stock of Vanguard to its employees. The stock options may be granted as Liquidity Event Options, Time Options or Performance Options at the discretion of the Board. The Liquidity Event Options vest 100% at the eighth anniversary of the date of grant and have an exercise price per share as determined by the Board or a committee thereof. The Time Options vest 20% at each of the first five anniversaries of the date of grant and have an exercise price per share as determined by the Board or a committee thereof. The Performance Options vest 20% at each of the first five anniversaries of the date of grant and have an exercise price equal to \$3,000 per share or as determined by the Board. The Time Options and Performance Options immediately vest upon a change of control, while the Liquidity Event Options immediately vest only upon a qualifying Liquidity Event, as defined in the 2004 Option Plan. As of March 31, 2007, 64,948 options were outstanding under the 2004 Option Plan.

	2004 Option Plan	
	Number of Options	Weighted Avg Exercise Price
Options outstanding at June 30, 2006	70,657	\$ 1,644.12
Options granted	7,022	1,714.20
Options exercised	(195)	1,000.00
Options cancelled	(12,536)	1,622.23
Options outstanding at March 31, 2007	64,948	\$ 1,657.85
Options available for grant at March 31, 2007	35,833	\$ 1,717.25
Options exercisable at March 31, 2007	10,390	\$ 1,949.66

The following table provides information relating to the 2004 Option Plan as of March 31, 2007.

Exercise price	\$1,000.00	\$1,150.37	\$1,167.50	\$3,000.00
Number outstanding	21,670	19,895	3,837	19,546
Weighted average remaining contractual life	7.8 years	8.8 years	9.8 years	8.4 years
Weighted average value	\$360.93	\$426.22	\$589.01	\$0.00
Number exercisable	3,741	1,855	–	4,794

The following table sets forth the weighted average assumptions utilized in the minimum value pricing model for stock option grants under the 2004 Option Plan prior to July 1, 2006 and those utilized in the Black-Scholes-Merton valuation model for grants under the 2004 Option Plan subsequent to July 1, 2006.

	<b>Minimum Value</b>	<b>Black-Scholes- Merton</b>
Risk-free interest rate	4.5%	4.7%
Dividend yield	0.0%	0.0%
Volatility (annual)	N/A	37.7%
Expected option life	10 years	7.5 years

For stock options included in the Black-Scholes-Merton valuation model, Vanguard used historical stock price information of certain peer group companies for a period of time equal to the expected option life period to determine estimated volatility. Vanguard determined the expected life of the stock options by averaging the contractual life of the options and the vesting period of the options.

### 3. DISCONTINUED OPERATIONS

On October 1, 2006, certain of Vanguard's subsidiaries completed the sale of its three hospitals in Orange County, California (West Anaheim Medical Center, Huntington Beach Hospital and La Palma Intercommunity Hospital) to subsidiaries of Prime Healthcare, Inc. for net proceeds of \$40.0 million, comprised of cash proceeds of \$37.0 million and \$3.0 million of proceeds placed in escrow to be distributed to a subsidiary of Vanguard on July 2, 2007. Approximately \$12.8 million of retained working capital, including \$25.3 million of patient accounts receivable, was excluded from the sale. The following table sets forth the components of discontinued operations for the three months and nine months ended March 31, 2006 and 2007, respectively (in millions).

	<b>Three months ended March 31,</b>		<b>Nine months ended March 31,</b>	
	<b>2006</b>	<b>2007</b>	<b>2006</b>	<b>2007</b>
Total revenues	\$ 43.7	\$ 0.9	\$ 129.6	\$ 47.2
Operating expenses	45.4	5.9	134.0	62.5
Allocated interest	1.7	–	5.2	2.0
Gain on sale of assets	(11.1)	–	(11.1)	(1.0)
Income tax expense (benefit)	3.1	(1.7)	0.6	(5.7)
Discontinued operations, net of taxes	\$ 4.6	\$ (3.3)	\$ 0.9	\$ (10.6)

The interest allocation for the three months and nine months ended March 31, 2006 and the nine months ended March 31, 2007 was based upon the ratio of net assets to be sold to the sum of Vanguard's total net assets and Vanguard's outstanding debt. Income taxes were calculated using an effective tax rate of approximately 40.0% for the quarter and nine months ended March 31, 2006, approximately 34.0% for the quarter ended March 31, 2007 and approximately 35.0% for the nine months ended March 31, 2007.

The following table sets forth the components of assets held for sale and liabilities to be assumed by purchaser as of June 30, 2006 that are included in the acute care services segment (in millions).

	<b>June 30, 2006</b>
Current assets-CA hospitals	\$ 3.7
Net property, plant and equipment-CA hospitals	40.0
Goodwill-CA hospitals	3.0
Net intangible assets-CA hospitals	0.4
Net property, plant and equipment-other	5.0
	<hr/>
Total assets held for sale	52.1
Liabilities to be assumed by purchaser	(7.4)
	<hr/>
Net assets to be divested	\$ 44.7
	<hr/>

#### 4. INTANGIBLE ASSETS

The following table provides information regarding the intangible assets, including deferred loan costs, included on the accompanying condensed consolidated balance sheets as of June 30, 2006 and March 31, 2007 (in millions).

Class of Intangible Asset	Gross Carrying Amount		Accumulated Amortization	
	June 30, 2006	March 31, 2007	June 30 2006	March 31, 2007
Amortized intangible assets:				
Deferred loan costs	\$ 43.8	\$ 43.8	\$ 6.7	\$ 10.0
Contracts	31.4	31.4	5.5	7.8
Physician income and other guarantees	2.0	5.7	0.3	1.4
Other	1.3	1.3	0.2	0.4
	<hr/>	<hr/>	<hr/>	<hr/>
Subtotal	78.5	82.2	12.7	19.6
Indefinite-lived intangible assets:				
License and accreditation	3.2	3.2	—	—
	<hr/>	<hr/>	<hr/>	<hr/>
Total	\$ 81.7	\$ 85.4	\$ 12.7	\$ 19.6
	<hr/>	<hr/>	<hr/>	<hr/>

#### 5. IMPAIRMENT OF GOODWILL AND LONG-LIVED ASSETS

Vanguard has experienced gradual changes to the business climate at its Chicago hospitals, the most significant being payer mix shifts, which have resulted in weaker than expected operating results at those hospitals. Vanguard believes that these trends may not be temporary in nature and may not be sufficiently offset by various initiatives to improve operating results. Accordingly, Vanguard performed an impairment test of the long-lived assets of these hospitals under SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and SFAS 142, *Goodwill and Other Intangible Assets*, effective December 31, 2006. Based upon independent third party estimates of the fair value of the hospitals, Vanguard recorded a \$123.8 million (\$110.5 million, net of tax benefit) impairment charge during December 2006. The independent third party fair value estimates were developed using a discounted net cash flows approach and two market-based approaches. As a result of the impairment charge, Vanguard reduced goodwill for its acute care services segment \$123.8 million during December 2006.

The following table provides a rollforward of goodwill from June 30, 2006 to March 31, 2007 (in millions).

	<b>Acute Care Services</b>	<b>Health Plans</b>	<b>Total</b>
Balance as of June 30, 2006	\$ 733.4	\$ 79.4	\$ 812.8
Impairment of goodwill	(123.8)	—	(123.8)
Balance as of March 31, 2007	\$ 609.6	\$ 79.4	\$ 689.0

Vanguard evaluates the carrying value of long-lived assets when impairment indicators are present or when circumstances indicate that impairment may exist under the provisions of SFAS 144. Vanguard reviews goodwill for impairment annually during its fourth fiscal quarter or more frequently if certain impairment indicators arise under the provisions of SFAS 142. These impairment tests include multiple assumptions and estimates that can change over time and could result in further impairment charges that could materially adversely impact our results of operations or statement of position.

## 6. FINANCING ARRANGEMENTS

A summary of Vanguard's long-term debt at June 30, 2006 and March 31, 2007 follows (in millions).

	<b>June 30, 2006</b>	<b>March 31, 2007</b>
9.0% Senior Subordinated Notes	\$ 575.0	\$ 575.0
11.25% Senior Discount Notes	151.4	164.3
Term loans payable under credit facility	789.7	783.8
Capital leases	0.4	0.1
Other	2.7	2.9
	<u>1,519.2</u>	<u>1,526.1</u>
Less: current maturities	(8.3)	(8.0)
	<u>\$ 1,510.9</u>	<u>\$ 1,518.1</u>

### 9.0% Notes

In connection with the Blackstone merger on September 23, 2004, two of Vanguard's wholly owned subsidiaries, Vanguard Health Holding Company II, LLC and Vanguard Holding Company II, Inc. (collectively the "Issuers"), completed a private placement of \$575.0 million 9% Senior Subordinated Notes due 2014 ("9.0% Notes"). Interest on the 9.0% Notes is payable semi-annually on October 1 and April 1, with the first interest payment made on April 1, 2005. The 9.0% Notes are general unsecured senior subordinated obligations and rank junior in right of payment to all existing and future senior indebtedness of the Issuers. All payments on the 9.0% Notes are guaranteed jointly and severally on a senior subordinated basis by Vanguard and its domestic subsidiaries, other than those subsidiaries that do not guarantee the obligations of the borrowers under the senior credit facilities.

At any time prior to October 1, 2007, the Issuers may redeem up to 35% of the aggregate principal amount of the 9.0% Notes with the net proceeds of certain equity offerings at a redemption price of 109% of the principal amount of the 9.0% Notes plus accrued and unpaid interest. Prior to October 1, 2009, the issuers may redeem the 9.0% Notes, in whole or in part, at a price equal to 100% of the principal amount thereof plus a make-whole premium. On or after October 1, 2009, the Issuers may redeem all or part of the 9.0% Notes at various redemption prices given the date of redemption as set forth in the indenture governing the 9.0% Notes. The initial redemption price for the 9.0% Notes on October 1, 2009 is equal to 104.50% of their principal amount, plus accrued and unpaid interest. The redemption price declines each year after 2009. The redemption price will be 100% of the principal amount, plus accrued and unpaid interest, beginning on October 1, 2012.

On January 26, 2005, Vanguard exchanged all of its outstanding 9.0% senior subordinated notes due 2014 for new 9.0% senior subordinated notes due 2014 with identical terms and conditions, except that they were registered under the Securities Act of 1933. Terms and conditions of the exchange offer were set forth in the registration statement on Form S-4 filed with the Securities and Exchange Commission that became effective on December 23, 2004.

### **11.25% Notes**

In connection with the Blackstone merger on September 23, 2004, two of Vanguard's wholly owned subsidiaries, Vanguard Health Holding Company I, LLC and Vanguard Holding Company I, Inc. (collectively the "Discount Issuers"), completed a private placement of \$216.0 million aggregate principal amount at maturity (\$124.7 million in gross proceeds) of 11.25% Senior Discount Notes due 2015 ("11.25% Notes"). The 11.25% Notes accrete at the stated rate compounded semi-annually on April 1 and October 1 of each year to, but not including, October 1, 2009. From and after October 1, 2009, cash interest on the 11.25% Notes will accrue at 11.25% per annum, and will be payable on April 1 and October 1 of each year, commencing on April 1, 2010 until maturity. The 11.25% Notes are general senior unsecured obligations and rank junior in right of payment to all existing and future senior indebtedness of the Discount Issuers but senior to any of the Discount Issuers' future senior subordinated indebtedness. All payments on the 11.25% Notes are guaranteed by Vanguard as a holding company guarantee.

At any time prior to October 1, 2007, the Discount Issuers may redeem up to 35% of the aggregate principal amount at maturity of the 11.25% Notes with the net proceeds of certain equity offerings at 111.25% of the accreted value of the 11.25% Notes plus accrued and unpaid interest. Prior to October 1, 2009, the issuers may redeem the 11.25% Notes, in whole or in part, at a price equal to 100% of the accreted value thereof, plus accrued and unpaid interest, plus a make-whole premium. On or after October 1, 2009, the Discount Issuers may redeem all or a part of the 11.25% Notes at various redemption prices given the date of redemption as set forth in the indenture governing the 11.25% Notes. The initial redemption price for the 11.25% Notes on October 1, 2009 is equal to 105.625% of their principal amount, plus accrued and unpaid interest. The redemption price declines each year after 2009. The redemption price will be 100% of the principal amount, plus accrued and unpaid interest, beginning on October 1, 2012.

On January 26, 2005, Vanguard exchanged all of its outstanding 11.25% senior discount notes due 2015 for new 11.25% senior discount notes due 2015 with identical terms and conditions, except that they were registered under the Securities Act of 1933. Terms and conditions of the exchange offer were set forth in the registration statement on Form S-4 filed with the Securities and Exchange Commission that became effective on December 23, 2004.

### **Credit Facility Debt**

In connection with the Blackstone merger on September 23, 2004, two of Vanguard's wholly owned subsidiaries, Vanguard Health Holding Company II, LLC and Vanguard Health Company II, Inc. (the "Co-borrowers"), entered into new senior secured credit facilities (the "merger credit facilities") with various lenders and Bank of America, N.A. as administrative agent and Citicorp North America, Inc. as syndication agent, and repaid all amounts outstanding under its previous 2004 credit facility. The merger credit facilities included a seven-year term loan facility in the aggregate principal amount of \$800.0 million (of which \$475.0 million was funded at closing) and a six-year \$250.0 million revolving credit facility. Vanguard borrowed \$60.0 million of the available \$325.0 million term loans in order to fund a portion of its purchase price of three hospitals in Massachusetts on December 31, 2004 and borrowed an additional \$90.0 million on February 18, 2005 to fund the working capital of these hospitals and to fund capital expenditures. Vanguard borrowed the final \$175.0 million of the available term loans in September 2005 for capital expenditures and general corporate purposes. All of such loans were scheduled to mature on September 23, 2011.

On September 26, 2005, the Co-borrowers refinanced and repriced all \$795.7 million of the then outstanding term loans under the merger credit facilities by borrowing \$795.7 million of replacement term loans that also mature on September 23, 2011 (the "2005 term loan facility"). In addition, upon the occurrence of certain events, the Co-borrowers may request an incremental term loan facility to be added to the 2005 term loan facility in an amount not to exceed \$300.0 million in the aggregate, subject to receipt of commitments by existing lenders or other financing institutions and to the satisfaction of certain other conditions. The revolving loan facility under the merger credit facilities did not change in connection with the term loan refinancing. As of March 31, 2007, \$783.8 million was outstanding under the 2005 term loan facility. The total remaining borrowing capacity under the revolving credit facility, net of letters of credit, was \$210.0 million as of March 31, 2007.

The 2005 term loan facility borrowings bear interest at a rate equal to, at Vanguard's option, either LIBOR plus 2.25% per annum or a base rate plus 1.25% per annum. These interest rates reflect a savings of 1.00% per annum over the interest rate options for term loan borrowings under the merger credit facilities. Borrowings under the revolving credit facility currently bear interest at a rate equal to, at Vanguard's option, LIBOR plus 2.0% per annum or a base rate plus 1.0% per annum, subject to an increase of up to 0.50% per annum should Vanguard's leverage ratio increase over certain designated levels. Vanguard pays a commitment fee to the lenders under the revolving credit facility in respect of unutilized commitments thereunder at a rate equal to 0.50% per annum. Vanguard also pays customary letter of credit fees.

The 2005 term loan facility and the revolving credit facility contain a number of covenants that, among other things, restrict, subject to certain exceptions, Vanguard's ability, and the ability of its subsidiaries, to sell assets, incur additional indebtedness or issue preferred stock, repay other indebtedness (including the 9.0% Notes and 11.25% Notes), pay dividends and distributions or repurchase its capital stock, create liens on assets, make investments, loans or advances, make certain acquisitions, engage in mergers or consolidations, enter into sale and leaseback transactions, engage in certain transactions with affiliates, amend certain material agreements governing its indebtedness, including the 9.0% Notes and 11.25% Notes, change the business conducted by its subsidiaries and enter into hedging agreements. In addition, the senior credit facilities require Vanguard to maintain the following financial covenants: a maximum total leverage ratio, a maximum senior leverage ratio, a minimum interest coverage ratio and a maximum capital expenditures limitation. Vanguard was in compliance with each of these financial covenants as of March 31, 2007. Obligations under the credit agreement are unconditionally guaranteed by Vanguard and Vanguard Health Holding Company I, LLC ("VHS Holdco I") and, subject to certain exceptions, each of VHS Holdco I's wholly-owned domestic subsidiaries (the "U.S. Guarantors"). Obligations under the credit agreement are also secured by substantially all of the assets of Vanguard Health Holding Company II, LLC ("VHS Holdco II") and the U.S. Guarantors including a pledge of 100% of the membership interests of VHS Holdco II, 100% of the capital stock of substantially all U.S. Guarantors (other than VHS Holdco I) and 65% of the capital stock of each of VHS Holdco II's non-U.S. subsidiaries that are directly owned by VHS Holdco II or one of the U.S. Guarantors and a security interest in substantially all tangible and intangible assets of VHS Holdco II and each U.S. Guarantor.

## 7. INCOME TAXES

Significant components of the provision for income taxes are as follows (in millions).

	Nine months ended	
	March 31, 2006	March 31, 2007
Current:		
Federal	\$ 1.7	\$ 0.7
State	0.2	1.6
Total current	1.9	2.3
Deferred:		
Federal	14.9	(13.8)
State	(0.6)	(4.2)
	14.3	(18.0)
Change in valuation allowance	1.8	2.6
Total income tax expense (benefit)	\$ 18.0	\$ (13.1)

The effective income tax rate differed from the federal statutory rate for the periods presented as follows:

	Nine months ended	
	March 31, 2006	March 31, 2007
Income tax at federal statutory rate	35.0 %	35.0 %
Income tax at state statutory rate	(1.2)%	3.5 %
Nondeductible impairment expense	0.0 %	(23.9)%
Nondeductible goodwill	2.2 %	0.0 %
Nondeductible expenses and other	1.1 %	(1.1)%
Change in valuation allowance	4.2 %	(3.1)%
Effective income tax rate	41.3%	10.4%

Net non-current deferred tax assets of \$30.6 million and \$51.4 million are included in other assets in the accompanying condensed consolidated balance sheets as of June 30, 2006 and March 31, 2007, respectively. Net current deferred tax assets of \$8.9 million and \$9.2 million are included in prepaid expenses and other current assets in the accompanying condensed consolidated balances sheets as of June 30, 2006 and March 31, 2007, respectively.

As of March 31, 2007, Vanguard had generated net operating loss (“NOL”) carryforwards for federal income tax and state income tax purposes of approximately \$156.0 million and \$413.0 million, respectively, which expire from 2007 to 2025. Approximately \$3.9 million of these NOLs are subject to annual limitation for federal purposes. These limitations are not expected to significantly affect Vanguard’s ability to ultimately recognize the benefit of these NOLs in future years.

Vanguard must make estimates in recording its provision for income taxes, including the determination of deferred tax assets and liabilities and any valuation allowance that may be required against the deferred tax assets. Vanguard had a valuation allowance for combined continuing and discontinued operations of \$11.9 million and \$15.7 million as of June 30, 2006 and March 31, 2007, respectively.

On May 18, 2006, Texas repealed its current income tax and replaced it with a gross margins tax to be accounted for as an income tax. Vanguard became subject to the Texas margins tax on July 1, 2006.

## 8. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In February 2007, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (“SFAS 159”). SFAS 159 gives entities the option to voluntarily choose, at certain election dates, to measure many financial assets and liabilities at fair value. Elections are made on an instrument by instrument basis and are irrevocable once made. Subsequent changes to the fair value of any instrument for which an election is made are reflected through earnings. SFAS 159 is effective for Vanguard as of July 1, 2008 with early adoption permitted. Vanguard does not expect SFAS 159 to have a significant impact on its future financial position, results of operations or cash flows.

On September 15, 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurement* (“SFAS 157”). SFAS 157 sets forth comprehensive guidance for measuring fair value of assets and liabilities. Under the provisions of SFAS 157, fair value should be based on the assumptions market participants would use to complete the sale of an asset or transfer of a liability. SFAS 157 provides a hierarchy of information to be used to determine the applicable market assumptions, and fair value measurements would be separately disclosed under each applicable layer of the hierarchy. SFAS 157 does not expand or restrict the use of fair value for measuring assets and liabilities but provides a single methodology to be used when fair value accounting is applied. SFAS 157 is effective for Vanguard’s fiscal year beginning July 1, 2008 with early adoption permitted. Vanguard does not expect the adoption of SFAS 157 to significantly impact its future financial position or results of operations.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109, *Accounting for Income Taxes* ("FIN 48"). FIN 48 sets forth the minimum recognition criteria tax positions are required to meet before being recognized in the financial statements. FIN 48 requires recognition when a tax position is more likely than not to be sustained upon examination. Measurement of the tax position is determined as the largest amount of benefit, determined on a cumulative probability basis, which is more likely than not to be realized upon ultimate settlement. FIN 48 also provides guidance regarding derecognition and classification of tax positions, interest and penalties and multiple expanded disclosures including a rollforward of aggregate unrecognized tax benefits and detail for tax uncertainties for which it is reasonably possible that estimated tax benefits will significantly change during the subsequent twelve months. FIN 48 is effective for Vanguard's fiscal year beginning July 1, 2007. Vanguard does not expect FIN 48 to have a significant impact on its financial position or results of operations but would require potential balance sheet reclassifications and significant additional disclosures in its consolidated financial statements.

## 9. SEGMENT INFORMATION

Vanguard's acute care hospitals and related healthcare businesses are similar in their activities and the economic environments in which they operate (i.e. urban markets). Accordingly, Vanguard's reportable operating segments consist of 1) acute care hospitals and related healthcare businesses, collectively, and 2) health plans consisting of MacNeal Health Providers, a contracting entity for outpatient services provided by MacNeal Hospital and Weiss Memorial Hospital and participating physicians in the Chicago area, Phoenix Health Plan, a Medicaid managed health plan operating in Arizona, and Abrazo Advantage Health Plan, a Medicare and Medicaid dual eligible managed health plan operating in Arizona.

The following table provides unaudited condensed financial information by business segment for the three month and nine month periods ended March 31, 2006 and 2007, including a reconciliation of Segment EBITDA to income (loss) from continuing operations before income taxes (in millions).

	Three months ended March 31, 2006				Three months ended March 31, 2007			
	Health Plans	Acute Care Services	Eliminations	Consolidated	Health Plans	Acute Care Services	Eliminations	Consolidated
Patient service revenues	\$ —	\$ 538.4	\$ —	\$ 538.4	\$ —	\$ 586.3	\$ —	\$ 586.3
Premium revenues	98.7	—	—	98.7	98.2	—	—	98.2
Inter-segment revenues	—	8.4	(8.4)	—	—	8.4	(8.4)	—
Total revenues	98.7	546.8	(8.4)	637.1	98.2	594.7	(8.4)	684.5
Operating expenses - external	82.8	483.6	—	566.4	82.2	530.2	—	612.4
Operating expenses - inter-segment	8.4	—	(8.4)	—	8.4	—	(8.4)	—
Total operating expenses	91.2	483.6	(8.4)	566.4	90.6	530.2	(8.4)	612.4
Segment EBITDA(1)	7.5	63.2	—	70.7	7.6	64.5	—	72.1
Less:								
Interest, net	(0.5)	26.6	—	26.1	(0.2)	31.8	—	31.6
Depreciation and amortization	1.1	23.0	—	24.1	1.1	28.4	—	29.5
Minority interests	—	0.8	—	0.8	—	0.6	—	0.6
Equity method income	—	(0.1)	—	(0.1)	—	(0.3)	—	(0.3)
Stock compensation	—	0.5	—	0.5	—	(0.1)	—	(0.1)
Gain on disposal of assets	—	(0.9)	—	(0.9)	—	(1.3)	—	(1.3)
Monitoring fees	—	1.3	—	1.3	—	1.3	—	1.3
Income from continuing operations before income taxes	\$ 6.9	\$ 12.0	\$ —	\$ 18.9	\$ 6.7	\$ 4.1	\$ —	\$ 10.8

	Nine months ended March 31, 2006				Nine months ended March 31, 2007			
	Health Plans	Acute Care Services	Eliminations	Consolidated	Health Plans	Acute Care Services	Eliminations	Consolidated
Patient service revenues	\$ —	\$ 1,566.4	\$ —	\$ 1,566.4	\$ —	\$ 1,676.2	\$ —	\$ 1,676.2
Premium revenues	274.2	—	—	274.2	296.1	—	—	296.1
Inter-segment revenues	—	27.7	(27.7)	—	—	26.7	(26.7)	—
Total revenues	274.2	1,594.1	(27.7)	1,840.6	296.1	1,702.9	(26.7)	1,972.3
Operating expenses - external	220.8	1,422.6	—	1,643.4	248.2	1,540.5	—	1,788.7
Operating expenses - inter-segment	27.7	—	(27.7)	—	26.7	—	(26.7)	—
Total operating expenses	248.5	1,422.6	(27.7)	1,643.4	274.9	1,540.5	(26.7)	1,788.7
Segment EBITDA(1)	25.7	171.5	—	197.2	21.2	162.4	—	183.6
Less:								
Interest, net	(1.1)	78.3	—	77.2	(0.1)	93.3	—	93.2
Depreciation and amortization	3.3	67.4	—	70.7	3.2	84.5	—	87.7
Minority interests	—	2.4	—	2.4	—	2.0	—	2.0
Equity method income	—	(0.9)	—	(0.9)	—	(0.9)	—	(0.9)
Stock compensation	—	1.1	—	1.1	—	0.7	—	0.7
Debt extinguishment costs	—	0.1	—	0.1	—	—	—	—
Gain on disposal of assets	—	(0.9)	—	(0.9)	—	(1.2)	—	(1.2)
Impairment loss	—	—	—	—	—	123.8	—	123.8
Monitoring fees	—	3.9	—	3.9	—	3.9	—	3.9
Income (loss) from continuing operations before income taxes	\$ 23.5	\$ 20.1	\$ —	\$ 43.6	\$ 18.1	\$ (143.7)	\$ —	\$ (125.6)
Capital expenditures – continuing operations	\$ 0.1	\$ 174.0	\$ —	\$ 174.1	\$ 0.1	\$ 120.6	\$ —	\$ 120.7
Segment assets					\$ 162.3	\$ 2,377.8	\$ —	\$ 2,540.1

(1) Segment EBITDA is defined as income before interest expense (net of interest income), income taxes, depreciation and amortization, minority interests, equity method income or loss, stock compensation, debt extinguishment costs, merger expenses, gain or loss on disposal of assets, impairment loss, monitoring fees and discontinued operations, net of taxes. Management uses Segment EBITDA to measure performance for Vanguard's segments and to develop strategic objectives and operating plans for those segments. Segment EBITDA eliminates the uneven effect of non-cash depreciation of tangible assets and amortization of intangible assets, much of which results from acquisitions accounted for under the purchase method of accounting. Segment EBITDA also eliminates the effects of changes in interest rates which management believes relate to general trends in global capital markets, but are not necessarily indicative of the operating performance of Vanguard's segments. Management believes that Segment EBITDA provides useful information about the financial performance of Vanguard's segments to investors, lenders, financial analysts and rating agencies. Additionally, management believes that investors and lenders view Segment EBITDA as an important factor in making investment decisions and assessing the value of Vanguard. Segment EBITDA is not a substitute for net income, operating cash flows or other cash flow statement data determined in accordance with accounting principles generally accepted in the United States. Segment EBITDA, as presented, may not be comparable to similarly titled measures of other companies.

## **10. COMMITMENTS AND CONTINGENCIES**

Management evaluates contingencies based upon the best available information and believes that adequate provision for potential losses associated with contingencies has been made. In management's opinion, based on current available information, these commitments described below will not have a material effect on Vanguard's results of operations or financial position, but the construction and facility expansion obligations could have an effect on the timing of Vanguard's cash flows, including its need to borrow available amounts under its revolving credit facility.

### **Capital Expenditures and Construction Commitments**

Vanguard currently has multiple capital expansion and replacement projects underway. As of March 31, 2007, Vanguard estimated its remaining commitments related to the expansion projects in San Antonio and Phoenix and its remaining obligations for other capital projects in process to be approximately \$58.2 million.

### **Claims and Litigation**

While in the process of closing the October 1, 2006 sale of the fixed assets of its three California hospitals to subsidiaries of Prime Healthcare Services, Inc. (collectively, the "Buyer"), Vanguard received a letter (the "BC Claims Letter") dated September 29, 2006, from Blue Cross of California ("BC-CA") threatening to sue the Vanguard subsidiaries that, prior to the sale, owned Huntington Beach Hospital and La Palma Intercommunity Hospital for breach of contract if Buyer did not assume the provider contracts that Huntington Beach Hospital and La Palma Intercommunity Hospital each purportedly had with BC-CA. In the BC Claims Letter BC-CA estimated its compensatory damages at approximately \$73.7 million and stated that it may also be entitled to punitive damages in the event of Buyer's non-assumption of these two contracts. Vanguard had written BC-CA on September 27, 2006, to confirm that in a meeting between Vanguard and BC-CA held on August 22, 2006, an official of BC-CA had assured Vanguard that, in a sale of the fixed assets of these two hospitals, the two contracts would automatically terminate upon consummation of the sale of the assets without liability to Vanguard's subsidiaries; and to inform BC-CA that Vanguard had relied upon such assurances from BC-CA in planning to close the sale of the assets of these two hospitals without Buyer's assumption of these two contracts. Additionally, in the BC Claims Letter, BC-CA denied that a Blue Cross official had previously given these assurances to Vanguard. Despite these threats from BC-CA, on October 1, 2006 Vanguard's subsidiaries closed the sale of these two California hospitals (see Note 3) to Buyer without Buyer's assumption of these two provider agreements with BC-CA based upon (1) Vanguard's belief that its subsidiaries had good and valid legal defenses to any BC-CA suit for breach and (2) Buyer's execution in connection with the closing of the sale of the assets of an agreement providing full indemnification to Vanguard and its subsidiaries in respect of the damages and expenses which Vanguard and its subsidiaries might incur in respect of these BC-CA claims. Effective November 30, 2006, Vanguard's subsidiaries, BC-CA and Buyer entered into a written interim agreement providing that the parties would treat the BC-CA provider agreements at Huntington Beach and La Palma Intercommunity Hospitals as if they were in full force between Buyer and BC-CA at the two hospitals for services rendered between October 1, 2006 and December 31, 2006. This agreement was not extended by the parties when it expired on December 31, 2006. On April 23, 2007, Vanguard received a letter from outside counsel to BC-CA dated April 20, 2007, reducing BC-CA's estimate of its compensatory damages in this matter from approximately \$73.7 million to approximately \$20.0 million and agreeing with Vanguard's proposal to meet to discuss these matters.

In the event that BC-CA brings suit for breach of contract in this matter, Vanguard's subsidiaries intend to vigorously defend against the litigation. However, in the event such legal defenses are inadequate or Vanguard is unsuccessful in enforcing the indemnity against Buyer, then the ultimate resolution of this matter may have a material adverse effect on Vanguard's financial position, results of operations or cash flows.

### **Patient Service Revenues**

Final determinations of amounts earned under the Medicare and Medicaid programs often occur in subsequent years because of audits by the programs, rights of appeal and the application of numerous technical provisions. Differences between original estimates and subsequent revisions (including final settlements) are included in the condensed consolidated statements of operations in the period in which the revisions are made. Management believes that adequate provision has been made for adjustments that may result from final determination of amounts earned under the Medicare and Medicaid programs. Net adjustments for final third party settlements resulted in increases to income from continuing operations before income taxes of \$0.5 million and \$0.4 million for the three months ended March 31, 2006 and 2007, respectively, and \$3.3

million and \$2.3 million for the nine months ended March 31, 2006 and 2007, respectively. Vanguard recorded \$19.3 million and \$21.3 million of charity care deductions from continuing operations during the three months ended March 31, 2006 and 2007, respectively, and \$55.2 million and \$67.8 million for the nine months ended March 31, 2006 and 2007, respectively.

During the quarter ended March 31, 2007, Vanguard recorded \$15.6 million of revenues for payments received in April 2007 under the Bexar, County Texas upper payment limit (“UPL”) Medicaid payment program that relate to services provided in previous quarters during fiscal years 2005, 2006 and 2007. The UPL payment also positively impacted pre-tax income by \$9.8 million during the quarter ended March 31, 2007 related to services provided in previous quarters during fiscal years 2005, 2006 and 2007. Approximately \$11.6 million of these revenues and \$5.9 million of the increase to pre-tax income are attributable to services provided during the fiscal years ended June 30, 2005 and 2006. The impact of continuing UPL payments under this Medicaid program through the currently approved expiration date of October 31, 2007 will not be material.

### **Governmental Regulation**

Laws and regulations governing the Medicare, Medicaid and other federal healthcare programs are complex and subject to interpretation. Vanguard’s management believes that it is in compliance with all applicable laws and regulations in all material respects. However, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare, Medicaid and other federal healthcare programs. Vanguard is not aware of any material regulatory proceeding or investigation underway or threatened involving allegations of potential wrongdoing.

### **Acquisitions**

Vanguard has acquired and will continue to acquire businesses with prior operating histories. Acquired companies may have unknown or contingent liabilities, including liabilities for failure to comply with healthcare laws and regulations, such as billing and reimbursement, anti-kickback and physician self-referral laws. Although Vanguard institutes policies designed to conform practices to its standards following completion of acquisitions and attempts to structure its acquisitions as asset acquisitions in which Vanguard does not assume liability for seller wrongful actions, there can be no assurance that Vanguard will not become liable for past activities that may later be alleged to be improper by private plaintiffs or government agencies. Although Vanguard obtains general indemnifications from sellers covering such matters, there can be no assurance that any specific matter will be covered by such indemnifications, or if covered, that such indemnifications will be adequate to cover potential losses and fines.

### **Professional and General Liability Risks**

Given the nature of its operating environment, Vanguard is subject to professional and general liability claims and related lawsuits in the ordinary course of business. For professional and general liability claims incurred from June 1, 2002 to May 31, 2006, Vanguard’s wholly owned captive subsidiary insured its professional and general liability risks at a \$10.0 million retention level. For professional and general liability claims incurred subsequent to May 31, 2006, Vanguard self-insures the first \$9.0 million per claim, and the captive subsidiary insures the next \$1.0 million per claim. Vanguard maintains excess coverage from independent third party insurers on a claims-made basis for individual claims exceeding \$10.0 million up to \$75.0 million, but limited to total annual payments of \$65.0 million in the aggregate. The captive insurance subsidiary funds its portion of claims costs from premium payments received from Vanguard. Vanguard’s reserve for reported and unreported professional and general liability claims was \$58.8 million and \$64.5 million as of June 30, 2006 March 31, 2007, respectively. Vanguard adjusts its professional and general liability reserve from time to time as it receives updated information. Due to changes in historical loss trends, Vanguard increased its professional liability reserve related to prior fiscal years by \$1.1 million during the quarter ended March 31, 2007. Vanguard decreased its professional liability reserve related to prior fiscal years by \$4.9 million during the quarter ended March 31, 2006 and by \$6.9 million and \$4.3 million during the nine months ended March 31, 2006 and 2007, respectively. Given the fact that Vanguard has operated its hospitals for relatively short periods of time, management expects that additional adjustments to prior year estimates may occur as Vanguard’s reporting history and loss portfolio matures. Vanguard’s professional liability costs remain sensitive to market factors affecting premiums for excess coverage and the quantity and severity of professional liability claims. Also, Vanguard is exposed to increased payments to malpractice claimants in the event physicians practicing at Vanguard’s hospitals are unable to obtain adequate malpractice insurance or in the event Vanguard employs more physicians.

## Guarantees

As part of its contract with the Arizona Health Care Cost Containment System (“AHCCCS”), one of Vanguard’s health plans, Phoenix Health Plan, is required to maintain a performance guarantee, the amount of which is based upon Plan membership and capitation premiums received. As of March 31, 2007, Vanguard maintained this performance guarantee in the form of \$19.0 million of surety bonds that expire on October 2, 2007 collateralized by approximately \$2.9 million of letters of credit.

Vanguard has entered into physician relocation agreements under which it guarantees minimum monthly income or revenues to physicians during a period of time (typically 12 months to 24 months) in which they establish their practices in the community. In return for the minimum guarantee payment, the physicians are required to practice in the community for a specified period of time (typically 3 to 4 years) or else return the payments to Vanguard. On January 1, 2006, Vanguard adopted Financial Accounting Standards Board Staff Position No. FIN 45-3, *Application of FASB Interpretation No. 45 to Minimum Revenue Guarantees Granted to a Business or Its Owners* (“FIN 45-3”). FIN 45-3 requires that a liability be recorded at fair value for all guarantees entered into on or after January 1, 2006. Vanguard determines this liability and an offsetting intangible asset by calculating an estimate of expected payments to be made over the guarantee period. Vanguard reduces the liability as it makes guarantee payments and amortizes the intangible asset over the term of the physicians’ agreements. As of March 31, 2007, Vanguard had a net intangible asset of \$3.7 million and a remaining liability of \$1.6 million related to these physician income guarantees. The maximum amount of Vanguard’s unpaid physician income guarantees under FIN 45-3 as of March 31, 2007 was approximately \$4.3 million. Vanguard also had physician income guarantees entered into prior to January 1, 2006, for which the maximum remaining liability was approximately \$0.6 million as of March 31, 2007.

## Variable Interest Entities

Vanguard is a party to four contractual agreements whereby it may be required to make monthly payments to the developers and managers of four medical office buildings located on its hospital campuses through minimum rent revenue guarantees. Vanguard entered into these agreements to provide an incentive to the developers to fund the construction of the medical office buildings and manage the buildings upon their completion in order to make physician office space available near its hospital campuses. One of the contracts commenced prior to the effective date of Financial Interpretation Number 46, *Variable Interest Entities*, (as amended by FIN 46R) and is scheduled to terminate in March 2016. Due to the significance of Vanguard’s minimum rent revenue payments to the operations of the medical office building, Vanguard consolidated this entity for financial reporting purposes effective June 30, 2006. A second contract commenced in June 2004 for a period of 12 years. Vanguard deemed this contract a variable interest entity in which Vanguard is not the primary beneficiary. Vanguard is no longer making minimum rent revenue guarantee payments under this contract. Vanguard expects to achieve the permanent release of its guaranty under the third contract during fiscal 2007 and deems the developer landlord to be the primary beneficiary. Vanguard is no longer making minimum rent revenue guarantee payments under the fourth contract and does not expect to make future payments under this contract.

## 11. FINANCIAL INFORMATION FOR SUBSIDIARY GUARANTORS AND NON-GUARANTOR SUBSIDIARIES

Vanguard conducts substantially all of its business through its subsidiaries. Most of Vanguard’s subsidiaries jointly and severally guarantee Vanguard’s senior secured credit facilities on a senior secured basis and the 9.0% Notes on an unsecured senior subordinated basis. Certain of Vanguard’s other consolidated wholly-owned and non wholly-owned entities do not guarantee the 9.0% Notes in conformity with the provisions of the indenture governing the 9.0% Notes and do not guarantee Vanguard’s senior secured credit facilities in conformity with the provisions thereof. The condensed consolidating financial information for the parent company, the issuers of the 9.0% Notes, the issuers of the 11.25% Notes, the subsidiary guarantors, the non-guarantor subsidiaries, certain eliminations and consolidated Vanguard as of June 30, 2006 and March 31, 2007 and for the three months and nine months ended March 31, 2006 and 2007 follows.

**VANGUARD HEALTH SYSTEMS, INC.**  
**CONDENSED CONSOLIDATING BALANCE SHEETS**  
**June 30, 2006**

	Parent	Issuers of 9.0% Notes	Issuers of 11.25% Notes	Guarantor Subsidiaries	Combined Non- Guarantors	Eliminations	Total Consolidated
<b>ASSETS</b>							
	<i>(In millions)</i>						
Current assets:							
Cash and cash equivalents	\$ —	\$ —	\$ —	\$ 38.5	\$ 85.1	\$ —	\$ 123.6
Accounts receivable, net	—	—	—	249.3	44.8	—	294.1
Inventories	—	—	—	40.1	5.2	—	45.3
Assets held for sale	—	—	—	45.6	6.5	—	52.1
Prepaid expenses and other current assets	0.1	—	—	28.7	20.8	(3.7)	45.9
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Total current assets	0.1	—	—	402.2	162.4	(3.7)	561.0
Property, plant and equipment, net	—	—	—	1,073.5	86.0	—	1,159.5
Goodwill	—	—	—	725.5	87.3	—	812.8
Intangible assets, net	—	33.5	3.6	3.7	28.2	—	69.0
Investments in unconsolidated subsidiaries	608.8	—	—	8.2	26.6	(635.4)	8.2
Other assets	—	—	—	39.7	0.3	—	40.0
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Total assets	\$ 608.9	\$ 33.5	\$ 3.6	\$ 2,252.8	\$ 390.8	\$ (639.1)	\$ 2,650.5
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>							
Current liabilities:							
Accounts payable	\$ —	\$ —	\$ —	\$ 136.8	\$ 15.0	\$ —	\$ 151.8
Accrued expenses and other current liabilities	—	13.3	—	130.2	78.9	(14.5)	207.9
Current maturities of long-term debt	—	8.0	—	—	0.3	—	8.3
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Total current liabilities	—	21.3	—	267.0	94.2	(14.5)	368.0
Other liabilities	—	—	—	25.0	63.4	(6.0)	82.4
Long-term debt, less current maturities	—	1,356.8	151.4	2.7	—	—	1,510.9
Intercompany	(80.3)	(1,136.2)	(120.8)	1,462.1	23.8	(148.6)	—
Stockholders' equity	689.2	(208.4)	(27.0)	496.0	209.4	(470.0)	689.2
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Total liabilities and stockholders' equity	\$ 608.9	\$ 33.5	\$ 3.6	\$ 2,252.8	\$ 390.8	\$ (639.1)	\$ 2,650.5
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**VANGUARD HEALTH SYSTEMS, INC.**  
**CONDENSED CONSOLIDATING BALANCE SHEETS**  
**March 31, 2007**  
**(Unaudited)**

	Parent	Issuers of 9.0% Notes	Issuers of 11.25% Notes	Guarantor Subsidiaries	Combined Non- Guarantors	Eliminations	Total Consolidated
<b>ASSETS</b>							
	<i>(In millions)</i>						
Current assets:							
Cash and cash equivalents	\$ —	\$ —	\$ —	\$ 34.5	\$ 88.3	\$ —	\$ 122.8
Restricted cash	—	—	—	4.3	1.8	—	6.1
Accounts receivable, net	—	—	—	269.7	31.9	—	301.6
Inventories	—	—	—	41.9	5.2	—	47.1
Prepaid expenses and other current assets	—	—	—	55.3	16.3	(3.1)	68.5
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Total current assets	—	—	—	405.7	143.5	(3.1)	546.1
Property, plant and equipment, net	—	—	—	1,096.2	74.7	—	1,170.9
Goodwill	—	—	—	605.4	83.6	—	689.0
Intangible assets, net	—	30.3	3.5	6.8	25.2	—	65.8
Investments in unconsolidated subsidiaries	608.4	—	—	8.0	26.6	(635.0)	8.0
Other assets	—	—	—	60.3	—	—	60.3
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Total assets	\$ 608.4	\$ 30.3	\$ 3.5	\$ 2,182.4	\$ 353.6	\$ (638.1)	\$ 2,540.1
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<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>							
Current liabilities:							
Accounts payable	\$ —	\$ —	\$ —	\$ 129.2	\$ 10.3	\$ —	\$ 139.5
Accrued expenses and other current liabilities	—	26.4	—	112.9	90.0	(15.1)	214.2
Current maturities of long-term debt	—	7.9	—	—	0.1	—	8.0
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Total current liabilities	—	34.3	—	242.1	100.4	(15.1)	361.7
Other liabilities	—	—	—	45.4	49.4	(1.1)	93.7
Long-term debt, less current maturities	—	1,350.9	164.2	3.0	—	—	1,518.1
Intercompany	41.8	(1,056.6)	(120.7)	1,471.1	26.6	(362.2)	—
Stockholders' equity	566.6	(298.3)	(40.0)	420.8	177.2	(259.7)	566.6
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Total liabilities and stockholders' equity	\$ 608.4	\$ 30.3	\$ 3.5	\$ 2,182.4	\$ 353.6	\$ (638.1)	\$ 2,540.1
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**VANGUARD HEALTH SYSTEMS, INC.**  
**CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS**  
**For the three months ended March 31, 2006**  
**(Unaudited)**

	Parent	Issuers of 9.0% Notes	Issuers of 11.25% Notes	Guarantor Subsidiaries	Combined Non- Guarantors	Eliminations	Total Consolidated
<i>(In millions)</i>							
Patient service revenues	\$ —	\$ —	\$ —	\$ 494.3	\$ 51.3	\$ (7.2)	\$ 538.4
Premium revenues	—	—	—	11.5	95.7	(8.5)	98.7
Total revenues	—	—	—	505.8	147.0	(15.7)	637.1
Salaries and benefits	0.5	—	—	234.0	26.6	—	261.1
Supplies	—	—	—	96.0	9.4	—	105.4
Medical claims expense	—	—	—	6.6	74.9	(7.2)	74.3
Purchased services	—	—	—	27.2	5.4	—	32.6
Provision for doubtful accounts	—	—	—	38.9	3.8	—	42.7
Other operating expenses	0.1	—	—	33.0	17.0	(8.5)	41.6
Rents and leases	—	—	—	7.2	2.0	—	9.2
Depreciation and amortization	—	—	—	19.9	4.2	—	24.1
Interest, net	—	28.1	4.0	(6.1)	0.1	—	26.1
Management fees	—	—	—	(1.7)	1.7	—	—
Other	—	—	—	(4.1)	5.2	—	1.1
Total costs and expenses	0.6	28.1	4.0	450.9	150.3	(15.7)	618.2
Income (loss) from continuing operations before income taxes	(0.6)	(28.1)	(4.0)	54.9	(3.3)	—	18.9
Income tax expense	7.9	—	—	—	0.6	(0.6)	7.9
Equity in earnings of subsidiaries	24.1	—	—	—	—	(24.1)	—
Income (loss) from continuing operations	15.6	(28.1)	(4.0)	54.9	(3.9)	(23.5)	11.0
Discontinued operations, net of taxes	—	—	—	(1.3)	5.9	—	4.6
Net income (loss)	\$ 15.6	\$ (28.1)	\$ (4.0)	\$ 53.6	\$ 2.0	\$ (23.5)	\$ 15.6

**VANGUARD HEALTH SYSTEMS, INC.**  
**CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS**  
**For the three months ended March 31, 2007**  
**(Unaudited)**

	Parent	Issuers of 9.0% Notes	Issuers of 11.25% Notes	Guarantor Subsidiaries	Combined Non- Guarantors	Eliminations	Total Consolidated
<i>(In millions)</i>							
Patient service revenues	\$ —	\$ —	\$ —	\$ 543.6	\$ 48.9	\$ (6.2)	\$ 586.3
Premium revenues	—	—	—	13.2	85.1	(0.1)	98.2
Total revenues	—	—	—	556.8	134.0	(6.3)	684.5
Salaries and benefits	(0.1)	—	—	251.3	27.9	—	279.1
Supplies	—	—	—	100.7	9.0	—	109.7
Medical claims expense	—	—	—	8.8	70.5	(6.2)	73.1
Purchased services	—	—	—	35.5	4.6	—	40.1
Provision for doubtful accounts	—	—	—	44.1	3.1	—	47.2
Other operating expenses	0.1	—	—	44.9	8.4	(0.1)	53.3
Rents and leases	—	—	—	7.5	2.3	—	9.8
Depreciation and amortization	—	—	—	25.5	4.0	—	29.5
Interest, net	—	29.4	4.4	(2.0)	(0.2)	—	31.6
Management fees	—	—	—	(2.3)	2.3	—	—
Other	—	—	—	(2.9)	3.2	—	0.3
Total costs and expenses	—	29.4	4.4	511.1	135.1	(6.3)	673.7
Income (loss) from continuing operations before income taxes	—	(29.4)	(4.4)	45.7	(1.1)	—	10.8
Income tax expense (benefit)	4.2	—	—	—	0.3	(0.3)	4.2
Equity in earnings of subsidiaries	7.5	—	—	—	—	(7.5)	—
Income (loss) from continuing operations	3.3	(29.4)	(4.4)	45.7	(1.4)	(7.2)	6.6
Discontinued operations, net of taxes	—	—	—	(2.6)	(0.7)	—	(3.3)
Net income (loss)	\$ 3.3	\$ (29.4)	\$ (4.4)	\$ 43.1	\$ (2.1)	\$ (7.2)	\$ 3.3

**VANGUARD HEALTH SYSTEMS, INC.**  
**CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS**  
**For the nine months ended March 31, 2006**  
**(Unaudited)**

	Parent	Issuers of 9.0% Notes	Issuers of 11.25% Notes	Guarantor Subsidiaries	Combined Non- Guarantors	Eliminations	Total Consolidated
<i>(In millions)</i>							
Patient service revenues	\$ —	\$ —	\$ —	\$1,436.6	\$ 151.0	\$ (21.2)	\$ 1,566.4
Premium revenues	—	—	—	34.1	266.0	(25.9)	274.2
Total revenues	—	—	—	1,470.7	417.0	(47.1)	1,840.6
Salaries and benefits	1.1	—	—	681.2	77.3	—	759.6
Supplies	—	—	—	275.0	26.4	—	301.4
Medical claims expense	—	—	—	19.9	198.0	(21.2)	196.7
Purchased services	—	—	—	79.9	14.9	—	94.8
Provision for doubtful accounts	—	—	—	114.6	10.4	—	125.0
Other operating expenses	0.2	—	—	116.6	50.7	(25.9)	141.6
Rents and leases	—	—	—	19.9	5.5	—	25.4
Depreciation and amortization	—	—	—	58.9	11.8	—	70.7
Interest, net	—	81.2	11.7	(16.9)	1.2	—	77.2
Management fees	—	—	—	(4.9)	4.9	—	—
Other	0.1	—	—	(0.8)	5.3	—	4.6
Total costs and expenses	1.4	81.2	11.7	1,343.4	406.4	(47.1)	1,797.0
Income (loss) from continuing operations before income taxes	(1.4)	(81.2)	(11.7)	127.3	10.6	—	43.6
Income tax expense	18.0	—	—	—	0.9	(0.9)	18.0
Equity in earnings of subsidiaries	45.9	—	—	—	—	(45.9)	—
Income (loss) from continuing operations	26.5	(81.2)	(11.7)	127.3	9.7	(45.0)	25.6
Discontinued operations, net of taxes	—	—	—	(4.6)	5.5	—	0.9
Net income (loss)	\$ 26.5	\$ (81.2)	\$ (11.7)	\$ 122.7	\$ 15.2	\$ (45.0)	\$ 26.5

**VANGUARD HEALTH SYSTEMS, INC.**  
**CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS**  
**For the nine months ended March 31, 2007**  
**(Unaudited)**

	Parent	Issuers of 9.0% Notes	Issuers of 11.25% Notes	Guarantor Subsidiaries	Combined Non- Guarantors	Eliminations	Total Consolidated
<i>(In millions)</i>							
Patient service revenues	\$ —	\$ —	\$ —	\$1,542.9	\$ 153.2	\$ (19.9)	\$ 1,676.2
Premium revenues	—	—	—	38.6	257.8	(0.3)	296.1
<b>Total revenues</b>	<b>—</b>	<b>—</b>	<b>—</b>	<b>1,581.5</b>	<b>411.0</b>	<b>(20.2)</b>	<b>1,972.3</b>
Salaries and benefits	0.7	—	—	736.5	83.9	—	821.1
Supplies	—	—	—	292.6	28.9	—	321.5
Medical claims expense	—	—	—	26.9	213.3	(19.9)	220.3
Purchased services	—	—	—	97.8	14.1	—	111.9
Provision for doubtful accounts	—	—	—	125.6	9.0	—	134.6
Other operating expenses	0.2	—	—	125.8	25.7	(0.3)	151.4
Rents and leases	—	—	—	22.0	6.6	—	28.6
Depreciation and amortization	—	—	—	75.6	12.1	—	87.7
Interest, net	—	89.9	13.0	(9.2)	(0.5)	—	93.2
Management fees	—	—	—	(7.0)	7.0	—	—
Impairment loss	—	—	—	120.1	3.7	—	123.8
Other	—	—	—	0.5	3.3	—	3.8
<b>Total costs and expenses</b>	<b>0.9</b>	<b>89.9</b>	<b>13.0</b>	<b>1,607.2</b>	<b>407.1</b>	<b>(20.2)</b>	<b>2,097.9</b>
Income (loss) from continuing operations before income taxes	(0.9)	(89.9)	(13.0)	(25.7)	3.9	—	(125.6)
Income tax expense (benefit)	(13.1)	—	—	—	1.4	(1.4)	(13.1)
Equity in earnings of subsidiaries	(135.3)	—	—	—	—	135.3	—
<b>Income (loss) from continuing operations</b>	<b>(123.1)</b>	<b>(89.9)</b>	<b>(13.0)</b>	<b>(25.7)</b>	<b>2.5</b>	<b>136.7</b>	<b>(112.5)</b>
Discontinued operations net of taxes	—	—	—	(4.9)	(5.7)	—	(10.6)
<b>Net loss</b>	<b>\$ (123.1)</b>	<b>\$ (89.9)</b>	<b>\$ (13.0)</b>	<b>\$ (30.6)</b>	<b>\$ (3.2)</b>	<b>\$ 136.7</b>	<b>\$ (123.1)</b>

**VANGUARD HEALTH SYSTEMS, INC.**  
**CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS**  
**For the nine months ended March 31, 2006**  
**(Unaudited)**

	Parent	Issuers of 9.0% Notes	Issuers of 11.25% Notes	Guarantor Subsidiaries	Combined Non- Guarantors	Eliminations	Total Consolidated
<i>(In millions)</i>							
<b>Operating activities:</b>							
Net income (loss)	\$ 26.5	\$ (81.2)	\$ (11.7)	\$ 122.7	\$ 15.2	\$ (45.0)	\$ 26.5
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities							
Loss (income) from discontinued operations	—	—	—	4.6	(5.5)	—	(0.9)
Depreciation and amortization	—	—	—	58.9	11.8	—	70.7
Provision for doubtful accounts	—	—	—	114.6	10.4	—	125.0
Deferred income taxes	16.7	—	—	—	—	—	16.7
Amortization of loan costs	—	2.8	0.2	—	—	—	3.0
Accretion of principal on senior discount notes	—	—	11.5	—	—	—	11.5
Loss (gain) on disposal of assets	—	—	—	(6.4)	5.5	—	(0.9)
Debt extinguishment costs	0.1	—	—	—	—	—	0.1
Stock compensation	1.1	—	—	—	—	—	1.1
Changes in operating assets and liabilities, net of effects of acquisitions:							
Equity in earnings of subsidiaries	(45.9)	—	—	—	—	45.9	—
Accounts receivable	—	—	—	(132.5)	(9.6)	—	(142.1)
Inventories	—	—	—	(3.4)	—	—	(3.4)
Prepaid expenses and other current assets	10.6	—	—	(29.9)	29.4	—	10.1
Accounts payable	—	—	—	(17.4)	2.1	—	(15.3)
Accrued expenses and other liabilities	(11.7)	11.8	—	8.2	(24.6)	(0.9)	(17.2)
Net cash provided by (used in) operating activities – continuing operations	(2.6)	(66.6)	—	119.4	34.7	—	84.9
Net cash provided by operating activities – discontinued operations	—	—	—	3.4	1.2	—	4.6
Net cash provided by (used in) operating activities	(2.6)	(66.6)	—	122.8	35.9	—	89.5
<b>Investing activities:</b>							
Acquisitions	—	—	—	(0.4)	—	—	(0.4)
Capital expenditures	—	—	—	(167.4)	(6.7)	—	(174.1)
Proceeds from short-term investments	—	—	—	—	(98.4)	—	(98.4)
Sales of short-term investments	—	—	—	—	98.4	—	98.4
Proceeds from asset dispositions	—	—	—	6.1	—	—	6.1
Other	—	—	—	(22.7)	(0.2)	22.6	(0.3)
Net cash used in investing activities – continuing operations	—	—	—	(184.4)	(6.9)	22.6	(168.7)
Net cash provided by investing activities – discontinued operations	—	—	—	14.6	10.8	—	25.4
Net cash provided by (used in) investing activities	—	—	—	(169.8)	3.9	22.6	(143.3)
<b>Financing activities:</b>							
Proceeds from long-term debt	—	175.0	—	—	—	—	175.0
Payments of long-term debt and capital leases	—	(28.1)	—	(0.9)	(0.3)	—	(29.3)
Payments of loan costs and debt termination fees	—	—	—	(0.6)	—	—	(0.6)
Proceeds from exercise of stock options	0.1	—	—	—	—	—	0.1
Payments to retire outstanding stock	(0.1)	—	—	—	—	—	(0.1)
Payments to repurchase equity incentive units	(1.5)	—	—	—	—	—	(1.5)
Cash provided by (used in) intercompany activity	3.3	(80.3)	—	128.4	(28.8)	(22.6)	—
Net cash provided by (used in) financing activities	1.8	66.6	—	126.9	(29.1)	(22.6)	143.6
Net increase (decrease) in cash and cash equivalents	(0.8)	—	—	79.9	10.7	—	89.8
Cash and cash equivalents, beginning of period	0.8	—	—	(5.9)	84.3	—	79.2
Cash and cash equivalents, end of period	\$ —	\$ —	\$ —	\$ 74.0	\$ 95.0	\$ —	\$ 169.0

**VANGUARD HEALTH SYSTEMS, INC.**  
**CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS**  
**For the nine months ended March 31, 2007**  
**(Unaudited)**

	Parent	Issuers of 9.0% Notes	Issuers of 11.25% Notes	Guarantor Subsidiaries	Combined Non- Guarantors	Eliminations	Total Consolidated
<i>(In millions)</i>							
<b>Operating activities:</b>							
Net loss	\$ (123.1)	\$ (89.9)	\$ (13.0)	\$ (30.6)	\$ (3.2)	\$ 136.7	\$ (123.1)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities							
Loss from discontinued operations	—	—	—	4.9	5.7	—	10.6
Depreciation and amortization	—	—	—	75.6	12.1	—	87.7
Provision for doubtful accounts	—	—	—	125.6	9.0	—	134.6
Deferred income taxes	(15.4)	—	—	—	—	—	(15.4)
Amortization of loan costs	—	3.2	0.2	(0.1)	—	—	3.3
Accretion of principal on senior discount notes	—	—	12.8	0.1	—	—	12.9
Loss (gain) on disposal of assets	—	—	—	(4.4)	3.2	—	(1.2)
Stock compensation	0.7	—	—	—	—	—	0.7
Impairment loss	—	—	—	120.1	3.7	—	123.8
Changes in operating assets and liabilities, net of effects of acquisitions:							
Equity in earnings of subsidiaries	135.3	—	—	—	—	(135.3)	—
Accounts receivable	—	—	—	(167.8)	(1.3)	—	(169.1)
Inventories	—	—	—	(2.6)	0.8	—	(1.8)
Prepaid expenses and other current assets	0.1	—	—	(33.1)	2.8	—	(30.2)
Accounts payable	—	—	—	3.2	(4.8)	—	(1.6)
Accrued expenses and other liabilities	2.4	13.1	—	35.0	(2.9)	(1.4)	46.2
Net cash provided by (used in) operating activities – continuing operations	—	(73.6)	—	125.9	25.1	—	77.4
Net cash provided by operating activities – discontinued operations	—	—	—	1.7	0.6	—	2.3
Net cash provided by (used in) operating activities	—	(73.6)	—	127.6	25.7	—	79.7
<b>Investing activities:</b>							
Capital expenditures	—	—	—	(111.9)	(8.8)	—	(120.7)
Proceeds from short-term investments	—	—	—	—	(90.0)	—	(90.0)
Sales of short-term investments	—	—	—	—	90.0	—	90.0
Other	—	—	—	9.8	0.2	—	10.0
Net cash used in investing activities – continuing operations	—	—	—	(102.1)	(8.6)	—	(110.7)
Net cash provided by (used in) investing activities – discontinued operations	—	—	—	36.6	(0.1)	—	36.5
Net cash used in investing activities	—	—	—	(65.5)	(8.7)	—	(74.2)
<b>Financing activities:</b>							
Payments of long-term debt and capital leases	—	(5.9)	—	(0.2)	(0.1)	—	(6.2)
Proceeds from joint venture partner contributions	—	—	—	—	0.1	—	0.1
Payments to repurchase equity incentive units	—	—	—	(0.2)	—	—	(0.2)
Cash provided by (used in) intercompany activity	—	79.5	—	(65.7)	(13.8)	—	—
Net cash provided by (used in) financing activities	—	73.6	—	(66.1)	(13.8)	—	(6.3)
Net increase (decrease) in cash and cash equivalents	—	—	—	(4.0)	3.2	—	(0.8)
Cash and cash equivalents, beginning of period	—	—	—	38.5	85.1	—	123.6
Cash and cash equivalents, end of period	\$ —	\$ —	\$ —	\$ 34.5	\$ 88.3	\$ —	\$ 122.8

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

### **Forward Looking Statements**

This report on Form 10-Q contains "forward-looking statements" within the meaning of the federal securities laws which are intended to be covered by the safe harbors created thereby. Forward-looking statements are those statements that are based upon management's current plans and expectations as opposed to historical and current facts and are often identified in this report by use of words including but not limited to "may," "believe," "will," "project," "expect," "estimate," "anticipate," and "plan." These statements are based upon estimates and assumptions made by Vanguard's management that, although believed to be reasonable, are subject to numerous factors, risks and uncertainties that could cause actual outcomes and results to be materially different from those projected. These factors, risks and uncertainties include, among others, the following:

- Our high degree of leverage and interest rate risk
- Our ability to incur substantially more debt
- Operating and financial restrictions in our debt agreements
- Our ability to successfully implement our business strategies
- Our ability to successfully integrate our recent and any future acquisitions
- The highly competitive nature of the healthcare industry
- Governmental regulation of the industry, including Medicare and Medicaid reimbursement levels
- Pressures to contain costs by managed care organizations and other insurers and our ability to negotiate acceptable terms with these third party payers
- Our ability to attract and retain qualified management and healthcare professionals, including physicians and nurses
- Potential federal or state reform of healthcare
- Future governmental investigations
- Costs associated with HIPAA regulations and other management information systems integrations
- The availability of capital to fund our corporate growth strategy
- Potential lawsuits or other claims asserted against us
- Our ability to maintain or increase patient membership and control costs of our managed healthcare plans
- Changes in general economic conditions
- Our exposure to the increased amounts of and collection risks associated with uninsured accounts and the co-pay and deductible portions of insured accounts
- Dependence on our senior management team and local management personnel
- Volatility of professional and general liability insurance for us and the physicians who practice at our hospitals and increases in the quantity and severity of professional liability claims

- Our ability to maintain and increase patient volumes and control the costs of providing services, including salaries and benefits, supplies and bad debts
- Our failure to comply, or allegations of our failure to comply, with applicable laws and regulations
- The geographic concentration of our operations
- Technological and pharmaceutical improvements that increase the cost of providing, or reduce the demand for, healthcare services
- Costs and compliance risks associated with Section 404 of the Sarbanes-Oxley Act
- Material non-cash charges to earnings from impairment of goodwill or long-lived assets associated with declines in the fair market values of our reporting units or operating entities

Our forward-looking statements speak only as of the date made. Except as required by law, we undertake no obligation to publicly update or revise any forward-looking statements contained herein, whether as a result of new information, future events or otherwise. We advise you, however, to consult any additional disclosures we make in our other filings with the Securities and Exchange Commission, including, without limitation, the discussion of risks and other uncertainties under the caption “Item 1A. Business - Risk Factors” contained in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006 as supplemented by the additional risk factor set forth in “Item 1A. Risk Factors” of this report. You are cautioned to not rely on such forward-looking statements when evaluating the information contained in this report. In light of the significant uncertainties inherent in the forward-looking statements included in this report, you should not regard the inclusion of such information as a representation by us that our objectives and plans anticipated by the forward-looking statements will occur or be achieved, or if any of them do, what impact they will have on our results of operations and financial condition.

## Executive Overview

As of March 31, 2007, we owned and operated 16 hospitals with a total of 4,314 licensed beds, and related outpatient service facilities complementary to the hospitals in San Antonio, Texas, metropolitan Phoenix, Arizona, metropolitan Chicago, Illinois, and Massachusetts, and two surgery centers in Orange County, California. On October 1, 2006, we sold our three California hospitals with combined 491 licensed beds to subsidiaries of Prime Healthcare, Inc. for a base purchase price of \$44.0 million, prior to adjustments for working capital items included in the sale and transaction expenses. The operating results of the California hospitals are classified as discontinued operations in our condensed consolidated statements of operations for the quarters and nine month periods ended March 31, 2006 and 2007. As of March 31, 2007, we also owned three health plans as set forth in the following table.

Health Plan	Location	March 31, 2007 Membership
Phoenix Health Plan (“PHP”) – managed Medicaid	Arizona	96,400
Abrazo Advantage Health Plan (“AAHP”) – managed Medicare and Dual Eligible	Arizona	3,500
MacNeal Health Providers (“MHP”) – capitated outpatient and physician services	Illinois	43,900
		143,800

Our objective is to provide high-quality, cost-effective healthcare services through an integrated delivery platform serving the needs of the communities in which we operate. We focus our business development efforts and operations on hospital and other related healthcare facilities where we see an opportunity to improve operating performance and profitability and increase market share.

## **Operating Environment**

The operating environment for hospital management companies is undergoing a significant change that presents both challenges and opportunities for us. In order to remain competitive in the markets we serve, we must adapt our operating strategies to not only accommodate changing environmental factors but to make them operating advantages for us relative to our peers. These factors will require changing our previous business model that focused primarily on service expansion to improve revenues and economies of scale to reduce expenses. These strategies remain important but will now become subsets of a corporate strategy focused on quality of care. As consumers become more involved in their healthcare decisions, perceived quality of care will become an even greater factor in where physicians choose to practice and where patients choose to receive care. The following paragraphs discuss some of the new challenges that we currently face and that we expect to become more prominent during the foreseeable future. We believe that if we implement a corporate strategy focused on quality of care, then we can meet each of these challenges and become a provider of choice in the communities we serve.

### *Pay for Performance Reimbursement*

Many payers, including Medicare and several large managed care organizations, currently require providers to report certain quality measures in order to receive the full amount of payment increases that were awarded automatically in the past. For federal fiscal year 2007, Medicare expanded the number of quality measures to be reported to 21 from 10 during federal fiscal year 2006. In November 2006, CMS issued a final rule that calls for hospitals seeking a full Medicare inpatient payment increase to report 15 additional quality measures for federal fiscal year 2008. These measures include risk-adjusted outcomes measures such as 30-day mortality measures for patients who suffered a heart attack, heart failure or pneumonia; additional measures related to patients who undergo surgical procedures such as hospital-acquired infections data and several patient satisfaction indicators. Many large managed care organizations have developed quality measurement criteria that are similar to or even more stringent than the Medicare requirements. We have invested and will continue to invest significant capital to upgrade our clinical information systems to enable us to report these quality measures.

While current payer guidelines are based upon the reporting of quality measures, we believe it is only a matter of time until the quality measures themselves determine reimbursement rates for hospital services. For example, on April 13, 2007, CMS proposed reforms in the hospital inpatient prospective payment system that would implement a provision of the Deficit Reduction Act of 2005 ("DRA") that takes the first steps toward preventing Medicare from giving hospitals higher payment for the additional costs of treating a patient that acquires a condition (including an infection) during a hospital stay. The DRA required CMS to select at least two conditions that are (1) high cost, high volume or both; (2) assigned to a higher paying DRG when present as a secondary diagnosis; and (3) are reasonably preventable through application of evidence-based guidelines. Under the proposed rule, beginning in federal fiscal year 2009 (which commences October 1, 2008) cases with these conditions would not be paid at a higher DRG unless they were present on admission. The proposed rule identifies six conditions, including three serious preventable events (sometimes called "never events") that meet the statutory criteria and seeks public comment on 7 additional conditions. Thus, our ability to demonstrate quality of care in our hospitals could significantly impact our future operating results.

### *Physician Integration*

Our ability to attract skilled physicians to our hospitals is critical to our success. We have significant physician recruitment goals in place with primary emphasis on family practice and internal medicine, internists, obstetrics and gynecology, cardiology, neurology and orthopedics. Similar to previous strategies, physician employment and relocation incentives remain important. However, the perceived quality of care at our hospitals will become even more important to physicians. Similar to hospital reimbursement, plans are being developed to transform physician reimbursement to a pay for performance basis. In a hospital setting, many of the quality measures that apply to nursing care also apply to physician care. This interdependence aligns the quality of care focus of physicians and hospitals in order that both can receive equitable compensation for services provided.

We also face the risk of heightened physician reimbursement pressures that could cause physicians to seek to increase revenues by competing with hospitals for inpatient business. Additional competition from physician-owned specialty hospitals could adversely impact our future operating results. Again, we expect to mitigate this risk by achieving a competitive advantage with our quality of care initiatives that new specialty hospitals might not be equipped to implement.

These pressures may also result in our employing more physicians or pursuing additional opportunities to partner with physicians to provide healthcare services to the communities we serve.

#### *Nursing Salaries Pressures*

In order to demonstrate high quality services, we must hire and retain nurses who share our ideals and beliefs and who have access to the training necessary to implement our quality of care initiatives. Given the nationwide nursing shortage and the particular limited nursing availability in the Phoenix market, we expect continued pressure on nursing salaries and benefits. These pressures include higher than normal base wage increases, flexible working hours and other benefits and higher nurse to patient ratios necessary to improve quality of care. Quality of care initiatives also require additional nurse training programs that increase salaries and benefits costs. We will incur significant training costs as nurses learn to utilize our new information technology tools that allow us to monitor and report quality performance indicators. Becoming the employer of choice for nurses requires upfront human resource investments that could negatively affect operating results in the short-term. We may also be limited in our ability to adjust staffing levels in periods of lower than expected volumes. However, reducing turnover and improving the skill sets of our nurses will reduce our reliance on contract labor and result in improved quality of care and increased revenues in the long-term.

We expect to supplement our base of trained nursing professionals by expanding our comprehensive nurse recruiting and retention program. This program includes the following key components, among others:

- Nursing schools in San Antonio and Phoenix
- Foreign nurse recruiting initiatives
- Tuition reimbursement and internal training to promote career advancement opportunities, including specialization qualifications
- Extern programs and campus events to network with students
- Preceptor and other mentoring programs
- Expansion of orientation programs and employee involvement initiatives
- Performance leadership training for managers and directors
- Flexible work hours for nurses
- Employee safety initiatives
- Competitive pay and benefits and nursing recognition programs

We operate the Baptist Health System School of Health Professions (“SHP”) in San Antonio, which offers eight different programs with the greatest enrollment in the professional nursing program. The SHP trains approximately 440 students each year, the majority of which we expect to choose permanent employment with us. SHP experienced an enrollment growth of over 30% for fall 2006 compared to fall 2005 and expects enrollment to increase slightly in fall 2007. Plans are underway to transition SHP’s current diploma program to a degree granting program that will be more attractive to potential students. SHP enrollment includes approximately 80 students in our metropolitan Phoenix market that are trained using state of the art distance learning technology maximizing utilization of SHP instructors. Students are provided with company-funded scholarships that cover tuition, books and fees in return for a commitment to work at one of our hospitals for a defined period of time. Should we be unsuccessful in our attempts to maintain adequate nursing staff for our present and future needs, our future operating results could be materially adversely impacted.

#### *Competition for Outpatient Services*

With advances in medical technologies and pharmaceuticals, many services once provided in an inpatient setting are now available in an outpatient setting. The redirection of services to outpatient settings is also influenced by pressures from payers to reduce costs and by patients who seek convenience. Our hospitals and many other acute hospitals have struggled to retain or grow outpatient business resulting from this inpatient to outpatient shift. Competition for outpatient services has increased significantly with the proliferation of surgery centers, outpatient imaging centers and outpatient laboratories that are often viewed as more convenient to physicians and patients. While we remain at risk for further migration of outpatient services to non-hospital settings or to other hospitals, we expect to mitigate these risks with our quality of care initiatives, physician integration strategies and capital projects to improve the design of and access to outpatient service areas in our hospitals.

### *Implementation of our Quality Initiatives*

The previous paragraphs discuss the industry trends that are integral to our future success and how quality of care is the most important component in achieving success in those areas. While we are in the early stages of implementing our expanded quality of care initiatives, we believe that the following programs currently in place represent key building blocks to a successful strategy.

- Monthly review of the 21 quality indicators prescribed by CMS for federal fiscal year 2007
- Rapid response teams in place at all of our hospitals to provide more timely and efficient care
- Hourly nursing rounds in place at most of our hospitals
- Engagement of an external group to conduct unannounced mock JCAHO surveys
- Alignment of hospital management incentive compensation with quality performance indicators
- Additional staffing to collect and report quality information and to facilitate action plans to address areas for improvement
- Common information system in place at all hospitals to report quality indicators
- Common information system at departmental level to achieve efficiencies in delivering care and to feed data to the common reporting system (partially implemented, with all modules to be operational by the end of fiscal 2009)

### **Revenue/Volume Trends**

Our revenues depend upon inpatient occupancy levels, outpatient procedures performed at our facilities, the ancillary services and therapy programs ordered by physicians and provided to patients and our ability to successfully negotiate appropriate payment rates for these services with third party payers. During the nine months ended March 31, 2007, we experienced a 2.6% increase in discharges from continuing operations and a 1.4% increase in hospital adjusted discharges from continuing operations compared to the prior year period. The following table provides details of discharges from continuing operations by payer for the quarter and nine months ended March 31, 2007 compared to the prior year periods.

	Quarter ended March 31,				Nine months ended March 31,			
	2006		2007		2006		2007	
Medicare	12,456	29.3%	12,483	28.6%	36,309	29.0%	35,374	27.5%
Medicaid	5,343	12.6%	5,672	13.0%	16,276	13.0%	17,731	13.8%
Managed care	23,087	54.2%	23,430	53.7%	67,387	53.8%	69,549	54.1%
Self pay	1,282	3.0%	1,690	3.9%	4,122	3.3%	4,791	3.7%
Other	390	0.9%	351	0.8%	1,200	0.9%	1,091	0.9%
Total	42,558	100.0%	43,626	100.0%	125,294	100.0%	128,536	100.0%

We attribute the minimal growth in discharges from continuing operations to stagnant demand for inpatient healthcare services during the current year period. Additionally, decreases in certain subacute services as a result of regulatory changes and reduced demand for elective procedures as a result of changes in patient insurance coverage continue to weaken inpatient and outpatient volumes. We expect our volumes to improve over the long-term as a result of quality initiatives, service expansion initiatives and our market-driven management strategies. We also expect that as we fully implement our significant expansion projects, patient volumes will improve at those facilities where growth was previously constrained by physical plant limitations and patient throughput inefficiencies. However, the success of our growth initiatives is dependent upon maintaining the community's confidence in our services and staying ahead of the competition in the markets we serve. Continued weakened demand for hospital healthcare services could negate these growth initiatives in the short-term.

The majority of our patient service revenues are based on negotiated, per diem or pre-determined payment structures. Our facilities' gross charges typically do not reflect what the facilities are actually paid. In addition to volume

factors described above, patient mix, acuity factors and pricing trends affect our patient service revenues. Net patient revenues per adjusted hospital discharge from continuing operations increased 6.6% from \$7,347 during the nine months ended March 31, 2006 to \$7,832 during the nine months ended March 31, 2007. This increase reflects improved reimbursement for services provided under negotiated managed care contracts and improved Medicare reimbursements.

During the quarter ended March 31, 2007, we recorded \$15.6 million of revenues for payments received in April 2007 under the Bexar County, Texas upper payment limit ("UPL") Medicaid payment program that relate to services provided in previous quarters during fiscal years 2005, 2006 and 2007. The UPL payment also positively impacted pre-tax income by \$9.8 million during the quarter ended March 31, 2007 related to services provided in previous quarters during fiscal years 2005, 2006 and 2007. Approximately \$11.6 million of these revenues and \$5.9 million of the increase to pre-tax income are attributable to services provided during our fiscal years ended June 30, 2005 and 2006. The impact of continuing UPL payments under this Medicaid program through the currently approved expiration date of October 31, 2007 will not be material. The UPL revenues attributable to prior fiscal years represented 0.8% of the 6.6% period over period increase in net patient revenues per adjusted hospital discharge.

Increases in levels of charity care and negotiated self-pay discounts also impact net patient revenues per adjusted hospital discharge by decreasing revenues and decreasing the provision for doubtful accounts. We cannot assure you that future reimbursement rates, even if improved, will sufficiently cover potential increases in the cost of providing healthcare services to our patients.

We recognize premium revenues from our three health plans, PHP, AAHP and MHP. AAHP commenced operations on January 1, 2006 primarily to provide healthcare services (including Medicare Part D) to those individuals eligible for both Medicare and Medicaid benefits based on age and income levels. As of March 31, 2007, approximately 3,500 members were enrolled in this program, most of whom were previously enrolled in PHP. PHP's membership decreased to approximately 96,400 at March 31, 2007 compared to approximately 97,900 at March 31, 2006. Premium revenues from these three plans increased by \$21.9 million or 8.0% during the nine months ended March 31, 2007 compared to the prior year period. This increase resulted primarily from the increased per member per month reimbursement from AAHP. PHP also experienced period over period increased per member per month reimbursement as a result of a rate increase that went into effect on October 1, 2006. We do not anticipate a significant increase in membership for our health plan reporting segment during our fiscal year ending June 30, 2007 but could realize significant membership increases during future fiscal years. The Arizona Health Care Cost Containment System ("AHCCCS") exercised one of its two one-year renewal options under its contract with PHP that commenced on October 1, 2003, which extended the current contract through September 30, 2007. The Centers for Medicare and Medicaid Services ("CMS") renewed its contract with AAHP for a one-year period effective January 1, 2007. Should the PHP contract terminate, our future operating results and cash flows could be materially reduced.

## **General Trends**

The following paragraphs discuss recent trends that we believe are significant factors in our current and/or future operating results and cash flows. Many of these trends apply to the entire hospital industry while others may more specifically apply to us, and the trends could be relatively short-term in nature or could require our long-term focus. While these trends may involve certain factors that are outside of our control, the extent to which these trends affect us and our ability to manage the impact of these trends play vital roles in our current and future success. In many cases, we are unable to predict what impact these trends, if any, will have on us.

*Accounts Receivable Collection Risks Leading to Increased Bad Debts*

Similar to others in the hospital industry, the collectibility of our accounts receivable has deteriorated primarily due to an increase in self-pay receivables. The following table provides a summary of our accounts receivable by age since discharge date and payer class as of each respective period presented (in millions).

<b>March 31, 2006</b>	<b>0-90 days</b>	<b>91-180 days</b>	<b>Over 180 days</b>	<b>Total</b>
Medicare	\$ 97.2	\$ 4.5	\$ 3.0	\$ 104.7
Medicaid	46.4	8.8	6.3	61.5
Managed Care	217.0	21.4	11.1	249.5
Self Pay <sup>(1)</sup>	58.0	47.9	12.2	118.1
Other	16.0	4.7	2.6	23.3
Total <sup>(2)</sup>	\$ 434.6	\$ 87.3	\$ 35.2	\$ 557.1
<b>June 30, 2006</b>	<b>0-90 days</b>	<b>91-180 days</b>	<b>Over 180 days</b>	<b>Total</b>
Medicare	\$ 93.7	\$ 5.4	\$ 3.5	\$ 102.6
Medicaid	40.6	11.6	7.2	59.4
Managed Care	208.6	24.0	11.9	244.5
Self Pay <sup>(1)</sup>	58.8	51.7	11.9	122.4
Other	14.7	5.3	2.3	22.3
Total <sup>(2)</sup>	\$ 416.4	\$ 98.0	\$ 36.8	\$ 551.2
<b>March 31, 2007</b>	<b>0-90 days</b>	<b>91-180 days</b>	<b>Over 180 days</b>	<b>Total</b>
Medicare	\$ 92.2	\$ 2.9	\$ 3.3	\$ 98.4
Medicaid	40.6	7.0	4.9	52.5
Managed Care	218.8	20.5	17.9	257.2
Self Pay <sup>(1)</sup>	64.6	54.5	12.2	131.3
Other	10.7	3.5	2.7	16.9
Total <sup>(2)</sup>	\$ 426.9	\$ 88.4	\$ 41.0	\$ 556.3

(1) Includes uninsured patients and those patient co-insurance and deductible amounts for which payment has been received from the primary payer. If primary payment has not been received for an account, the patient co-insurance and deductible amounts remain classified in the primary payer category.

(2) The total accounts receivable balances reflected on these tables differ from the net accounts receivable balances as stated on the consolidated balance sheets for those respective periods because the balance sheet accounts receivable amounts are reduced by manual contractual allowances for unbilled patient accounts, certain billed patient accounts and for cash payments received but not posted to patient accounts, whereas those deductions are not reflected on the aging reports. The table below provides a reconciliation of these amounts.

	June 30, 2006	March 31, 2007
	(In millions)	
Accounts receivable per aging report	\$ 551.2	\$ 556.3
Less: Allowance for doubtful accounts	(103.5)	(109.9)
Less: Manual contractual allowances for unbilled patient accounts	(118.4)	(106.0)
Less: Manual contractual allowances for certain billed patient accounts	(22.5)	(25.2)
Less: Unposted cash receipts and other	(12.7)	(13.6)
Net accounts receivable reflected on the consolidated balance sheets	\$ 294.1	\$ 301.6

Our combined allowance for doubtful accounts and allowance for charity care covered 93.4% and 94.1% of self-pay accounts receivable as of June 30, 2006 and March 31, 2007, respectively.

The increase in self-pay accounts receivable has led to increased write-offs and older accounts receivable outstanding, resulting in the need for an increased allowance for doubtful accounts and charity care. The increase in self-pay accounts receivable results from a combination of factors including increased patient volumes, price increases, higher levels of patient deductibles and co-insurance under managed care programs and the increased difficulties of uninsured patients who do not qualify for charity care programs to pay for escalating healthcare costs. We have implemented policies and procedures designed to expedite upfront cash collections and promote repayment plans from our patients. Our upfront cash collections from continuing operations increased 11.1% during the nine months ended March 31, 2007 compared to the prior year period. However, we believe bad debts will remain sensitive to changes in payer mix, pricing and general economic conditions for the hospital industry during the foreseeable future.

#### *Expansion of Charity Care and Self-Pay Discount Programs*

We do not pursue collection of amounts due from uninsured patients that qualify for charity care under our guidelines (currently those uninsured patients whose incomes are equal to or less than 200% of the current federal poverty guidelines set forth by the Department of Health and Human Services). We exclude charity care accounts from revenues when we determine that the account meets our charity care guidelines. We deducted \$19.3 million, \$21.3 million, \$55.2 million and \$67.8 million of charity care from total revenues during the quarters ended March 31, 2006 and 2007 and the nine months ended March 31, 2006 and 2007, respectively. During fiscal 2006, we began tracking healthcare services provided to undocumented aliens that qualify for border funding reimbursement and recording those costs as charity care deductions. Until December 2006, border funding payments received were recorded as a decrease to charity deductions when received. In December 2006, we began recording a receivable representing estimated future border funding receipts based upon our historical ratio of payments received to claims filed. As of March 31, 2007, this receivable balance was \$2.0 million. Since the program's inception in May 2005, we have collected \$2.9 million in border-funding payments. We continually update the estimated receivable as new payment data is received. Revenue deductions for services provided to undocumented aliens, net of payments received and accrued, accounted for \$3.8 million, \$5.2 million, \$9.8 million and \$15.5 million of our charity care deductions during the quarters ended March 31, 2006 and 2007 and the nine months ended March 31, 2006 and 2007, respectively.

#### *Medicaid Funding Cuts*

Many states, including certain states in which we operate, have periodically reported budget deficits as a result of increased costs and lower than expected tax collections. Health and human service programs, including Medicaid and similar programs, represent a significant component of state spending. To address these budgetary concerns, certain states have decreased funding for these programs and other states may make similar funding cuts. These cuts may include tightened participant eligibility standards, reduction of benefits, enrollment caps or payment reductions. Additionally, pressure exists at the federal level to reduce Medicaid matching funds provided to states as evidenced by a budget resolution set forth by Congress in April 2005 calling for \$10.0 billion in cuts to federal funding of the Medicaid program over a five-year period. We are unable to assess the financial impact on our business of enacted or proposed state or federal funding cuts at this time.

### *Volatility of Professional Liability Costs*

We maintained professional and general liability insurance coverage through a wholly owned captive insurance subsidiary for individual claims incurred through May 31, 2006 up to \$10.0 million. For claims incurred subsequent to May 31, 2006, we self-insure the first \$9.0 million per occurrence, and the captive subsidiary insures the next \$1.0 million per occurrence. We maintain excess insurance coverage with independent third party carriers on a claims-made basis for individual claims exceeding \$10.0 million up to \$75.0 million, but limited to total annual payments of \$65.0 million in the aggregate. The total cost of our professional and general liability insurance is sensitive to the volume and severity of cases reported. Moreover, malpractice premiums have adversely affected the ability of physicians to obtain malpractice insurance at reasonable rates in certain markets, particularly in metropolitan Chicago, Illinois, resulting in physicians relocating to different geographic areas. In the event physicians practicing in our hospitals are unable to obtain adequate malpractice insurance coverage, our hospitals are likely to incur a greater percentage of the amounts paid to claimants. Our professional liability exposures also increase when we employ physicians. On the other hand, some states, including Texas and Illinois, have passed tort reform legislation to place limits on non-economic damages. While we have implemented multiple steps at our facilities to reduce our professional liability exposures, absent significant additional legislation to curb the size of malpractice judgments in other states in which we operate, our insurance costs may increase in the future.

### *Increased Cost of Compliance in a Heavily Regulated Industry*

We conduct business in a heavily regulated industry. Accordingly, we maintain a comprehensive, company-wide compliance program to address healthcare regulatory and other compliance requirements since if a determination were ever made that we were in material violation of any of the federal or state statutes regulating our healthcare operations, our operations and financial results could be materially adversely affected. This compliance program includes, among other things, initial and periodic ethics and compliance training, a toll-free reporting hotline for employees, annual fraud and abuse audits and annual coding audits. The organizational structure of our compliance program includes oversight by our board of directors and a high-level corporate management compliance committee. Our Senior Vice President of Compliance and Ethics reports jointly to our Chairman and Chief Executive Officer and to our board of directors, serves as Chief Compliance Officer and is charged with direct responsibility for the day-to-day management of our compliance program. During fiscal 2006, we established regional compliance officers in our markets and staffed the new positions with compliance professionals 100% dedicated to compliance duties. The financial resources necessary for program oversight, enforcement and periodic improvements to our program continue to grow, especially when we add new features to our program or engage external resources to assist with these highly complex matters.

### **Update of Critical Accounting Policies and Estimates**

The unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States. In preparing these financial statements, we make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses included in the financial statements. Management bases its estimates on historical experience and other available information, the results of which form the basis of the estimates and assumptions. We consider the following accounting policies to be critical accounting policies because they involve the most subjective and complex assumptions and assessments, are subject to a great degree of fluctuation period over period and are the most critical to our operating performance: revenues and revenue deductions, allowance for doubtful accounts and provision for doubtful accounts, insurance reserves, medical claims reserves, income taxes and impairment of long-lived assets and goodwill.

Other than the update provided below, there have been no changes in the nature or application of our critical accounting policies and estimates as discussed in Note 3 to our consolidated financial statements included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006.

### *Allowance for Doubtful Accounts and Provision for Doubtful Accounts*

Our ability to collect the self-pay portions of outstanding receivables is critical to our operating performance and cash flows. The primary collection risk relates to uninsured patient accounts and patient accounts for which primary insurance has paid but patient deductibles or co-insurance portions remain outstanding. We estimate the allowance for doubtful accounts using a standard policy that reserves 100% of all accounts aged greater than 180 days subsequent to discharge date plus a pre-determined percentage of accounts receivable due from self-pay patients less than 180 days old. We

adjust our estimate as necessary on a quarterly basis using a hindsight calculation that utilizes write-off data for all payer classes during the previous twelve-month period to estimate the allowance for doubtful accounts at a point in time. We also monitor cash collections and self-pay utilization. We believe that our standard policy is flexible to adapt to changing collection and self-pay utilization trends and our procedures for testing the standard policy provide timely and accurate information. Significant changes in payer mix, business office operations, general economic conditions or healthcare coverage provided by federal or state governments or private insurers may have a significant impact on our estimates and significantly affect its operations and cash flows.

We classify accounts pending Medicaid approval as Medicaid accounts in our accounts receivable aging report and record a manual contractual allowance for these accounts equal to the average Medicaid reimbursement rate for that specific state. We have historically been successful in qualifying approximately 50%-60% of submitted accounts for Medicaid coverage. As of March 31, 2007, we had approximately \$14.3 million of Medicaid pending accounts receivable from continuing operations (\$4.6 million of which was stated at gross charges with a manual contractual allowance and \$9.7 million of which was stated net of contractual discounts). In the event an account is not successfully qualified for Medicaid coverage and does not meet our charity guidelines, the previously recorded Medicaid contractual adjustment remains a revenue deduction (similar to a self-pay discount), and the remaining net account balance is reclassified to self-pay status and subjected to our allowance for doubtful accounts policy. During the nine months ended March 31, 2007, approximately \$11.4 million of net accounts receivable from continuing operations was reclassified from Medicaid pending status to self-pay status. If the account does not qualify for Medicaid coverage but does qualify as charity care, the contractual adjustment is reversed and the gross account balance is recorded as a charity deduction. During the nine months ended March 31, 2007, we recorded approximately \$4.8 million of charity deductions from continuing operations for the net balances of accounts previously classified as Medicaid pending that did not meet Medicaid eligibility requirements.

Because we require patient verification of coverage at the time of admission or service, reclassifications of Medicare or managed care accounts to self-pay, other than patient coinsurance or deductible amounts, occur infrequently and are not material to our financial statements. Additionally, the impact of these classification changes is further limited by our ability to identify any necessary classification changes prior to patient discharge or soon thereafter. Due to information system limitations and timing of claims or benefits adjudication, we are unable to quantify patient deductible and co-insurance receivables that are included in the primary payer classification in the accounts receivable aging report at any given point in time. Our self-pay financial class includes uninsured patients and those patient co-insurance and deductible amounts for which payment has been received from the primary payer. If primary payment has not been received for an account, the patient co-insurance and deductible amounts remain classified in the primary payer category. When classification changes occur, the account balance remains aged from the patient discharge date.

#### *Insurance Reserves*

Given the nature of our operating environment, we are subject to professional and general liability and workers compensation claims and related lawsuits in the ordinary course of business. For claims reported through May 31, 2006, our captive subsidiary insured our professional and general liability risks at a \$10.0 million retention level. For claims reported subsequent to May 31, 2006, we self-insure the first \$9.0 million per occurrence, and the captive subsidiary insures the next \$1.0 million per occurrence. We maintain excess coverage from independent third party insurers on a claims-made basis for individual claims exceeding \$10.0 million up to \$75.0 million, but limited to total annual payments of \$65.0 million in the aggregate. We self-insure our workers compensations claims up to \$1.0 million per claim and purchase excess insurance coverage for claims exceeding \$1.0 million.

We use an independent actuary to estimate our reserves for professional and general liability and workers compensation claims. Each reserve is comprised of estimated indemnity and expense payments related to: 1) reported events ("case reserves") and 2) incurred but not reported ("IBNR") events as of the end of the period. Management uses information from its risk managers and its best judgment to estimate case reserves. Actuarial IBNR estimates are dependent on multiple variables including our loss exposures, our self-insurance limits, geographic locations in which we operate, the severity of our historical losses compared to industry averages and the reporting pattern of our historical losses compared to industry averages, among others. Most of these variables require judgment by the independent actuary and changes in these variables could result in significant period over period fluctuations in our estimates. We adjust these reserves from time to time as we receive updated information. Due to changes in historical loss trends, we increased our professional and general liability reserve related to prior fiscal years by \$1.1 million during the quarter ended March 31, 2007 and decreased our professional and general liability reserve related to prior fiscal years by \$4.9 million during the quarter ended March 31, 2006. We

decreased our professional and general liability reserve related to prior fiscal years by \$6.9 million and \$4.3 million during the nine months ended March 31, 2006 and 2007, respectively. During the quarters ended March 31, 2006 and 2007, we decreased our workers compensation reserve related to prior fiscal years by \$1.0 million and \$1.1 million respectively. During the nine months ended March 31, 2006 and 2007, we increased our workers compensation reserve related to prior fiscal years by \$0.6 million and \$0.7 million, respectively. Given the fact that we have operated our hospitals for relatively short periods of time, we expect that additional adjustments to prior year estimates may occur as our reporting history and loss portfolio matures.

#### *Long-Lived Assets and Goodwill*

Long-lived assets, including property, plant and equipment and amortizable intangible assets, comprise a significant portion of our total assets. We evaluate the carrying value of long-lived assets when impairment indicators are present or when circumstances indicate that impairment may exist under the provisions of SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. When we believe impairment indicators may exist, we prepare projections of the undiscounted future cash flows associated with the use of and eventual disposition of long-lived assets held for use. If the projections indicate that the carrying values of the long-lived assets are not expected to be recoverable, we reduce the carrying values to fair value. For long-lived assets held for sale, we compare the carrying values to an estimate of fair value less selling costs to determine potential impairment. We test for impairment of long-lived assets at the lowest level for which cash flows are measurable. These impairment tests are heavily influenced by assumptions and estimates that are subject to change as additional information becomes available. Given the relatively few number of hospitals we own and the significant amounts of long-lived assets attributable to those hospitals, an impairment of the long-lived assets for even a single hospital could materially adversely impact our operating results or statement of position.

Goodwill represents a significant portion of our total assets. We review goodwill for impairment annually during our fourth fiscal quarter or more frequently if certain impairment indicators arise under the provisions of SFAS 142, *Goodwill and Other Intangible Assets*. We review goodwill at the reporting level unit, which is one level below an operating segment. We compare the carrying value of the net assets of each reporting unit to the net present value of estimated discounted future cash flows of the reporting unit. If the carrying value exceeds the net present value of estimated discounted future cash flows, an impairment indicator exists and an estimate of the impairment loss is calculated. The fair value calculation includes multiple assumptions and estimates, including the projected cash flows and discount rates applied. Changes in these assumptions and estimates could result in goodwill impairment that could materially adversely impact our results of operations or statement of position.

We have experienced gradual changes to the business climate at our Chicago hospitals, the most significant being payer mix shifts, which have resulted in weaker than expected operating results at those hospitals. We believe that these trends may not be temporary in nature and may not be sufficiently offset by various initiatives to improve operating results. Accordingly, we performed an impairment test of the long-lived assets of these hospitals under SFAS 144 and SFAS 142 effective December 31, 2006. Based upon an independent third party fair value estimate, we recorded a \$123.8 million (\$110.5 million, net of tax benefit) impairment charge during the quarter ended December 31, 2006. The independent third party fair value estimate was developed using a discounted net cash flows approach and two market-based approaches. As a result of the impairment charge, we reduced goodwill for our acute care services segment \$123.8 million in December 2006. Further reductions in the fair value of our hospitals could materially adversely impact our financial position and results of operations.

## Selected Operating Statistics

The following table sets forth certain operating statistics from continuing operations for each of the periods presented.

	(Unaudited) Quarter ended March 31,		(Unaudited) Nine months ended March 31,	
	2006	2007	2006	2007
Number of hospitals at end of period	16	16	16	16
Number of licensed beds at end of period	4,096	4,314	4,096	4,314
Discharges (a)	42,558	43,626	125,294	128,536
Adjusted discharges - hospitals (b)	65,860	68,136	200,248	203,093
Net revenue per adjusted discharge - hospitals (c)	\$ 7,711	\$ 8,177	\$ 7,347	\$ 7,832
Patient days (d)	190,401	192,444	542,522	555,928
Adjusted patient days - hospitals (e)	294,653	300,564	867,071	878,392
Average length of stay (days) (f)	4.47	4.41	4.33	4.33
Outpatient surgeries (g)	19,245	19,592	57,765	57,873
Emergency room visits (h)	143,505	155,291	434,821	450,582
Occupancy rate (j)	52.1 %	49.6 %	48.8 %	47.7 %
Average daily census (j)	2,116.0	2,138.0	1,980.0	2,029.0
Member lives (k)	147,200	143,800	147,200	143,800
Medical claims percentage (l)	75.3 %	74.4 %	71.7 %	74.4 %

- (a) Discharges represent the total number of patients discharged (in the facility for a period in excess of 23 hours) from our hospitals and is used by management and certain investors as a general measure of inpatient volume.
- (b) Adjusted discharges-hospitals is used by management and certain investors as a general measure of combined hospital inpatient and outpatient volume. Adjusted discharges-hospitals is computed by multiplying discharges by the sum of gross hospital inpatient and outpatient revenues and then dividing the result by gross hospital inpatient revenues. This computation enables management to assess hospital volume by a combined measure of inpatient and outpatient utilization.
- (c) Net revenue per adjusted discharge-hospitals is calculated by dividing net hospital patient revenues by hospital adjusted discharges and measures the average net payment expected to be received for a patient's stay in the hospital.
- (d) Patient days represent the number of days (calculated as overnight stays) our beds were occupied by patients during the periods.
- (e) Adjusted patient days-hospitals is calculated by multiplying patient days by the sum of gross hospital inpatient and outpatient revenues and then dividing the result by gross hospital inpatient revenues. This computation is an indicator of combined inpatient and outpatient volumes.
- (f) Average length of stay represents the average number of days an admitted patient stays in our hospitals.
- (g) Outpatient surgeries represent the number of surgeries performed at hospitals or ambulatory surgery centers on an outpatient basis (patient overnight stays not necessary).
- (h) Emergency room visits represent the number of patient visits to a hospital or freestanding emergency room where treatment is received, regardless of whether an overnight stay is subsequently required.
- (i) Occupancy rate represents the percentage of hospital licensed beds occupied by patients. Occupancy rate provides a measure of the utilization of inpatient rooms.
- (j) Average daily census represents the average number of patients in our hospitals each day during our ownership.
- (k) Member lives represent the total number of enrollees in our Arizona prepaid managed health plan and our Chicago managed care organization as of the end of the respective periods.
- (l) Medical claims percentage is calculated by dividing medical claims expense by premium revenues. Premium revenues include third party administrator ("TPA") revenues at MHP that do not have associated medical claims expense.

## Results of Operations

The following tables present summaries of our operating results for the quarters and nine months ended March 31, 2006 and 2007.

	(Unaudited) Quarter ended March 31,			
	2006		2007	
	Amount	%	Amount	%
<i>(In millions)</i>				
Patient service revenues	\$ 538.4	84.5%	\$ 586.3	85.7%
Premium revenues	98.7	15.5%	98.2	14.3%
Total revenues	637.1	100.0%	684.5	100.0%
Salaries and benefits (includes stock compensation of \$0.5 and \$(0.1), respectively)	261.1	41.0%	279.1	40.8%
Supplies	105.4	16.5%	109.7	16.0%
Medical claims expense	74.3	11.7%	73.1	10.7%
Provision for doubtful accounts	42.7	6.7%	47.2	6.9%
Other operating expenses	83.4	13.1%	103.2	15.1%
Depreciation and amortization	24.1	3.8%	29.5	4.3%
Interest, net	26.1	4.1%	31.6	4.6%
Minority interests and other expenses	1.1	0.2%	0.3	0.0%
Income from continuing operations before income taxes	18.9	2.9%	10.8	1.6%
Income tax expense	7.9	1.2%	4.2	0.6%
Income from continuing operations	11.0	1.7%	6.6	1.0%
Discontinued operations, net of taxes	4.6	0.7%	(3.3)	(0.5)%
Net income	\$ 15.6	2.4%	\$ 3.3	0.5%

**(Unaudited)**  
**Nine months ended**  
**March 31,**

	<b>2006</b>		<b>2007</b>	
	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>
<i>(In millions)</i>				
Patient service revenues	\$ 1,566.4	85.1%	\$ 1,676.2	85.0%
Premium revenues	274.2	14.9%	296.1	15.0%
Total revenues	1,840.6	100.0%	1,972.3	100.0%
Salaries and benefits (includes stock compensation of \$1.1 and \$0.7, respectively)	759.6	41.3%	821.1	41.6%
Supplies	301.4	16.4%	321.5	16.3%
Medical claims expense	196.7	10.7%	220.3	11.2%
Provision for doubtful accounts	125.0	6.8%	134.6	6.8%
Other operating expenses	261.8	14.2%	291.9	14.8%
Depreciation and amortization	70.7	3.8%	87.7	4.5%
Interest, net	77.2	4.2%	93.2	4.7%
Impairment loss	—	0.0%	123.8	6.3%
Minority interests and other expenses	4.6	0.2%	3.8	0.2%
Income (loss) from continuing operations before income taxes	43.6	2.4%	(125.6)	(6.4)%
Income tax expense (benefit)	18.0	1.0%	(13.1)	(0.7)%
Income (loss) from continuing operations	25.6	1.4%	(112.5)	(5.7)%
Discontinued operations, net of taxes	0.9	0.1	(10.6)	(0.5)%
Net income (loss)	\$ 26.5	1.5%	\$ (123.1)	(6.2)%

## Quarter ended March 31, 2007 compared to Quarter ended March 31, 2006

*Revenues.* Total revenues increased \$47.4 million during the quarter ended March 31, 2007 compared to the prior year quarter due to increased inpatient and outpatient volumes and improved reimbursement for services provided. Hospital adjusted discharges and emergency room visits from continuing operations increased 3.5% and 8.2%, respectively, quarter over quarter. Outpatient surgeries from continuing operations increased 1.8% quarter over quarter. Net revenue per adjusted hospital discharge from continuing operations increased 6.0% quarter over quarter, of which approximately 2.9% was attributable to the Texas UPL revenues previously discussed. The growth in net revenue per adjusted hospital discharge during the current year quarter was limited by an unfavorable payer mix relative to the prior year quarter. Net patient revenues from Medicaid and self-pay categories represented 19.6% of total net patient revenues during the current year quarter compared to 15.7% during the prior year quarter.

While demand for hospital services recovered slightly from recent quarters, we continue to experience soft demand in the markets we serve when considering the average population growth in those markets. We attribute this soft demand to multiple factors including patient wellness, greater competition from other hospitals in recruiting and retaining quality physicians and reduced elective procedures resulting from an increase in the number of uninsured patients or those insured patients with higher coinsurance and deductible limits, among others. We expect to overcome these market challenges by implementing our previously discussed quality initiatives, but these strategies are long-term in nature.

Premium revenues were flat quarter over quarter. Total health plan membership decreased by 2.3% from 147,200 at March 31, 2006 to 143,800 at March 31, 2007. This decrease was offset by higher per member per month reimbursement quarter over quarter. Per member per month reimbursement for PHP increased quarter over quarter as a result of an AHCCCS rate increase effective October 1, 2006.

Our ability to recognize future revenue growth, both from a reimbursement and volume perspective, is dependent on our ability to deliver a higher quality service than our competitors. We plan to supplement our quality initiatives with service line mix strategies, physician recruitment and retention initiatives, emergency department expansion and patient throughput design improvements, primary care expansion and specialty service expansion with particular emphasis on orthopedics, cardiology, neurology and endoscopy. We believe that these initiatives and the favorable demographic trends in most of our markets will position us to recapture patient volumes over the long-term as demand for hospital services strengthens.

*Costs and Expenses.* Total costs and expenses from continuing operations, exclusive of income taxes, were \$673.7 million or 98.4% of total revenues during the current year quarter, compared to 97.1% during the prior year quarter. Salaries and benefits, supplies, medical claims and provision for doubtful accounts represent the most significant of our normal costs and expenses or those subject to the greatest level of fluctuation period over period.

- **Salaries and benefits.** Salaries and benefits as a percentage of total revenues decreased slightly to 40.8% during the current year quarter from 41.0% during the prior year quarter. We have been successful in implementing staffing initiatives to limit the growth of salaries and benefits in certain of our hospitals. However, we continued to experience staffing mix challenges in our Arizona and San Antonio hospitals. During the current year quarter, we continued to incur staffing costs for our expansion projects in Arizona and San Antonio, which had not yet ramped up to full service levels. The national nursing shortage also continues to hinder our ability to fully manage salaries and benefits. Adjusting staff levels during periods of weakened demand for healthcare services is more difficult when constrained nursing resources limit our ability to re-adjust staff levels when demand recovers. We expect continued pressure to our salaries and benefits costs as the nursing shortage continues and our quality initiatives are implemented.
- **Supplies.** Supplies as a percentage of total revenues decreased to 16.0% during the current year quarter compared to 16.5% during the prior year quarter. We have increased our focus on supply chain management including efforts to increase utilization of our group purchasing organization to minimize the impact of supplies inflation and dedication of expanded corporate resources to manage supplies utilization. Because most of our growth strategies include expansion of high acuity services, we will continue to be exposed to increased pricing pressures for pharmaceuticals and expensive medical devices including those used in cardiac and orthopedic surgeries.

- **Medical claims.** Medical claims expense as a percentage of premium revenues decreased to 74.4% during the current year quarter compared to 75.3% during the prior year quarter. Our health plans in Arizona experienced a slight improvement in claims utilization quarter over quarter. Revenues and expenses between the health plans and our hospitals and related outpatient service providers of approximately \$8.4 million, or 10.3% of gross health plan medical claims expense, were eliminated in consolidation during the current year quarter consistent with the \$8.4 million eliminated in consolidation during the prior year quarter.
- **Provision for doubtful accounts.** The provision for doubtful accounts as a percentage of patient service revenues increased to 8.1% during the current year quarter from 7.9% during the prior year quarter. During the current year quarter, self-pay revenues as a percentage of net patient revenues increased to 9.7% from 8.4% during the prior year quarter. Self-pay discharges as a percentage of total discharges increased from 3.0% during the prior year quarter to 3.9% during the current year quarter. Our provision for doubtful accounts as a percentage of patient service revenues is reduced by our policy of deducting charity accounts from revenues at the time in which those accounts meet our charity care guidelines. On a combined basis, the provision for doubtful accounts and charity care deductions as a percentage of patient service revenues increased to 11.7% during the current year quarter compared to 11.5% during the prior year quarter. Collecting outstanding self-pay accounts remains difficult; however, we have experienced improved upfront cash collections and success in qualifying patients for coverage under Medicaid or similar programs.

*Other operating expenses.* Other operating expenses increased by \$19.8 million or 23.7% during the quarter ended March 31, 2007 compared to the quarter ended March 31, 2006. During the prior year quarter, we reduced our professional and general liability expense related to previous quarters by \$11.0 million based upon updated actuarial information that indicated an improvement in claims experience. Upon receipt of updated actuarial information during the current year quarter, we reduced our professional and general liability expense related to previous quarters by only \$1.1 million. Also, we experienced significant increases in physician fees for emergency room and other specialty program coverage and legal and consulting fees during the current year quarter compared to the prior year quarter.

*Income taxes.* Income tax expense was \$4.2 million during the quarter ended March 31, 2007, an effective tax rate of 38.9%, compared to \$7.9 million, an effective tax rate of 41.8%, during the prior year quarter.

*Net income.* Net income decreased to \$3.3 million during the quarter ended March 31, 2007 compared to \$15.6 million during the prior year quarter due primarily to the loss from discontinued operations, net of taxes, and the increased expenses discussed above.

#### **Nine months ended March 31, 2007 compared to nine months ended March 31, 2006**

*Revenues.* Total revenues increased \$131.7 million or 7.2% during the nine months ended March 31, 2007 compared to the prior year period primarily due to a 6.6% period over period increase in net revenue per adjusted hospital discharge from continuing operations. Hospital adjusted discharges from continuing operations increased 1.4% period over period, while emergency room visits from continuing operations increased 3.6% period over period. Outpatient surgeries from continuing operations were basically flat period over period.

Premium revenues increased by \$21.9 million or 8.0% during the nine months ended March 31, 2007 as a result of the start of AAHP's operations on January 1, 2006. Approximately 3,400 former PHP enrollees were enrolled in AAHP as of March 31, 2007. Per member per month reimbursement rates are significantly higher under AAHP than under the traditional AHCCCS Medicaid program. Per member per month reimbursement for PHP also increased period over period as a result of an AHCCCS rate increase effective October 1, 2006.

*Costs and Expenses.* Total costs and expenses from continuing operations, exclusive of income taxes, were \$2,097.9 million or 106.4% of total revenues during the nine months ended March 31, 2007 compared to \$1,797.0 million during the prior year period. The \$123.8 million impairment charge recorded during December 2006 represented the majority of the period over period increase in costs and expenses. Salaries and benefits, supplies, medical claims and provision for doubtful accounts represent the most significant of our normal costs and expenses or those subject to the greatest level of fluctuation period over period.

- **Salaries and Benefits.** Salaries and benefits as a percentage of total revenues increased to 41.6% during the nine months ended March 31, 2007 from 41.3% during the prior year period. Excluding the \$21.9 million period over period increase in premium revenues that did not result in a significant increase in salaries and benefits costs, salaries and benefits as a percentage of total revenues would have been 42.1% during the current year period. We continue to experience staffing mix challenges in our Arizona and San Antonio hospitals. During the current year period, portions of our expansion projects in Arizona and San Antonio had not yet ramped up to full service levels, and we continued to incur staffing costs for these service lines without the full revenue impact. The national nursing shortage also continues to hinder our ability to fully manage salaries and benefits. Adjusting staff levels during periods of weakened demand for healthcare services is more difficult when constrained nursing resources limit our ability to re-adjust staff levels when demand recovers.
- **Supplies.** Supplies as a percentage of total revenues were basically flat period over period. Advances in medical technologies and new medications continue to pressure our supplies costs. We have increased our focus on supply chain management including efforts to increase utilization of our group purchasing organization to minimize the impact of supplies inflation and dedication of expanded corporate resources to manage supplies utilization. Because most of our growth strategies include expansion of high acuity services, we will continue to be exposed to increased pricing pressures for pharmaceuticals and expensive medical devices including those used in cardiac and orthopedic surgeries.
- **Medical Claims.** Medical claims expense as a percentage of premium revenues increased to 74.4% during the nine months ended March 31, 2007 compared to 71.7% during the prior year period. The increase is primarily due to a \$3.0 million reduction in the accrued medical claims liability at PHP during the prior year period as a result of updated historical payment information and the start of AAHP operations on January 1, 2006. Medical claims expense represents the amounts paid by the health plans for healthcare services provided to their members, including an estimate of incurred but not reported claims that is determined based upon lag data and other actuarial assumptions. Revenues and expenses between the health plans and our hospitals and related outpatient service providers of approximately \$26.7 million, or 10.8% of gross health plan medical claims expense, were eliminated in consolidation during the nine months ended March 31, 2007 compared to \$27.7 million or 12.3% of gross health plan medical claims expense during the nine months ended March 31, 2006.
- **Provision for Doubtful Accounts.** During the nine months ended March 31, 2007, the provision for doubtful accounts as a percentage of patient service revenues was 8.0%, the same as the prior year period. Self pay revenues as a percentage of net patient revenues was relatively flat period over period. Self pay discharges from continuing operations increased slightly to 3.7% during the nine months ended March 31, 2007 compared to 3.3% during the prior year period. Our provision for doubtful accounts as a percentage of patient service revenues is reduced by our policy of deducting charity accounts from revenues at the time in which those accounts meet our charity care guidelines. On a combined basis, our provision for doubtful accounts and charity care deductions as a percentage of patient service revenues increased to 12.1% during the current year period compared to 11.5% during the prior year period. Collecting outstanding self-pay accounts remains difficult; however, we have experienced improved upfront cash collections and success in qualifying patients for coverage under Medicaid or similar programs.

*Other operating expenses.* Other operating expenses increased by \$30.1 million or 11.5% during the nine months ended March 31, 2007 compared to the nine months ended March 31, 2006. We experienced significant increases in physician fees for emergency room and other specialty program coverage and legal and consulting fees during the current year period compared to the prior year period.

*Income Taxes.* Income tax benefit was \$13.1 million during the nine months ended March 31, 2007, an effective rate of 10.4%, compared to income tax expense of \$18.0 million, an effective rate of 41.3%, during the prior year period. The significant decrease in the effective tax rate during the nine months ended March 31, 2007 resulted from the majority of the impairment charge recorded during the current year period being nondeductible for tax purposes.

*Net Income.* Net loss was \$123.1 million during the nine months ended March 31, 2007 compared to net income of \$26.5 million during the prior year period. The impairment charge and discontinued operations, net of taxes, significantly contributed to the current year net loss.

## Liquidity and Capital Resources

**Operating Activities.** At March 31, 2007, we had working capital of \$184.4 million, including cash and cash equivalents of \$122.8 million. Working capital at June 30, 2006 was \$193.0 million. Cash provided by operating activities decreased \$9.8 million during the nine months ended March 31, 2007 compared to the nine months ended March 31, 2006. The decrease in operating cash flows was primarily due to a buildup of prepaid expenses and other current assets during the current year period compared to the prior year period, much of which related to the Texas UPL payment received in April 2007.

**Investing Activities.** Cash used in investing activities decreased from \$143.3 million during the nine months ended March 31, 2006 to \$74.2 million during the nine months ended March 31, 2007, primarily as a result of a \$54.3 million period over period decrease in capital expenditures due to the completion of significant portions of our major expansion projects during the current year period.

We spent \$120.7 million for capital expenditures from continuing operations during the nine months ended March 31, 2007. In May 2004 and July 2005, our board of directors approved material new internal construction projects at six of our existing hospitals in San Antonio and metropolitan Phoenix. We have spent \$288.2 million for these projects since inception through March 31, 2007 and expect to spend an estimated additional \$50.0 million through fiscal year 2008. All of these projects will result in expanded capacity at each of the six hospitals. In addition, most of the projects will facilitate an expansion of clinical service capabilities.

The following table summarizes these major expansion projects as of May 1, 2007.

	Estimated Construction Period		Approximate Additional Licensed Bed Capacity	Approximate Additional Licensed Beds Completed	Additional Emergency Room Positions	Additional Operating Rooms	Additional Labor & Delivery Rooms
Hospital	Begin	Completed					
Phoenix							
Arrowhead Hospital	Q4 FY 04	Q2 FY 07	100	100	✓	✓	✓
Paradise Valley Hospital	Q1 FY 07	Q3 FY 09	22(4)	0	(2)	✓	✓
West Valley Hospital	Q1 FY 06	Q4 FY 07	57	32	✓	✓	(1)
San Antonio							
North Central Baptist Hospital	Q4 FY 04	Q2 FY 07	140	140	✓	✓	✓
Northeast Baptist Hospital	Q4 FY 04	Q2 FY 07	33(3)	33	✓	✓	✓
St. Luke’s Baptist Hospital	Q2 FY 06	Q4 FY 07	27	27			

- (1) Will increase post partum capacity to better utilize labor, delivery and recovery suites.
- (2) An expanded emergency room was opened in July 2004, expanding capacity from 16 to 28 bays.
- (3) In addition to increasing the number of licensed beds by 33, the expansion project allowed for the utilization of an additional 67 previously licensed beds.
- (4) In addition to increasing the number of licensed beds by 22, the expansion will allow for the utilization of an additional 18 previously licensed beds.

We anticipate spending a total of \$160.0 million to \$180.0 million in capital expenditures during fiscal 2007 including the \$120.7 million spent through March 31, 2007. This estimate includes the expansion projects mentioned above and all other renovation projects and technology upgrades at our facilities. These capital expenditures will be funded by cash on hand, cash flows from operations and availability under our revolving credit facility. We believe our capital expenditure program is sufficient to service, expand and improve our existing facilities to meet our quality objectives.

**Financing Activities.** Cash flows from financing activities decreased by \$149.9 million during the nine months ended March 31, 2007 compared to the nine months ended March 31, 2006, due to the \$175.0 million in term loan borrowings during September 2005.

As of March 31, 2007, we had outstanding \$1,526.1 million in aggregate indebtedness, with an additional \$210.0 million of available borrowing capacity under our revolving credit facility (\$250.0 million net of outstanding letters of credit of \$40.0 million). Our liquidity requirements are significant, primarily due to debt service requirements. The 9.0% Notes

require semi-annual interest payments. Prior to October 1, 2009, our interest expense on the 11.25% Notes will consist solely of non-cash accretions of principal.

Our previous senior secured credit facilities executed in September 2004 consisted of a revolving credit facility and the initial term loan facility. Our revolving credit facility provides for loans in a total principal amount of up to \$250.0 million, and matures in September 2010. The initial term loan facility, which was scheduled to mature in September 2011, provided for loans in a total principal amount of up to \$800.0 million as follows: (1) \$475.0 million borrowed on September 23, 2004 to finance the Blackstone merger, to refinance our then existing indebtedness and to pay fees and expenses relating thereto; (2) \$150.0 million borrowed on December 31, 2004 and February 18, 2005 to finance the acquisition of our Massachusetts hospitals and for other general corporate purposes and (3) \$175.0 million borrowed in September 2005 to fund capital expenditures and for other general corporate purposes.

On September 26, 2005, we refinanced and repriced all \$795.7 million of the outstanding term loans under the initial term loan facility by borrowing \$795.7 million of replacement term loans (the “2005 term loan facility”).

The 2005 term loan facility borrowings bear interest at a rate equal to, at our option, a base rate plus 1.25% per annum or LIBOR plus 2.25% per annum. These rates reflect a savings of 1.0% per annum over the interest rate options for our previous initial term loan facility. The borrowings under the revolving credit facility currently bear interest at a rate equal to, at our option, a base rate plus 1.00% per annum or LIBOR plus 2.00% per annum. These rates are subject to increase by up to 0.50% per annum should our leverage ratio exceed certain designated levels.

We are required to pay a commitment fee to the lenders under the revolving credit facility in respect of the unutilized commitments thereunder at a rate equal to 0.50% per annum. We also pay customary letter of credit fees.

The 2005 term loan facility and the revolving credit facility contain a number of covenants that, among other things, restrict, subject to certain exceptions, our ability, and the ability of our subsidiaries, to sell assets, incur additional indebtedness or issue preferred stock, repay other indebtedness (including the 9.0% Notes and 11.25% Notes), pay dividends and distributions or repurchase our capital stock, create liens on assets, make investments, loans or advances, make certain acquisitions, engage in mergers or consolidations, enter into sale and leaseback transactions, engage in certain transactions with affiliates, amend certain material agreements governing our indebtedness, including the 9.0% Notes and 11.25% Notes, change the business conducted by our subsidiaries and enter into hedging agreements. In addition, the senior credit facilities require us to maintain the following financial covenants: a maximum total leverage ratio, a maximum senior leverage ratio, a minimum interest coverage ratio and a maximum capital expenditures limitation.

As of March 31, 2007, we were in compliance with the debt covenant ratios as defined in our senior secured credit agreement, as follows.

	<b>Debt Covenant Ratio</b>	<b>Actual Ratio</b>
Interest coverage ratio requirement	2.00x	2.58x
Total leverage ratio limit	5.95x	4.66x
Senior leverage ratio limit	3.75x	2.27x

If we were to violate one or more of these covenants and not cure the violation, we could be required to immediately repay all principal amounts outstanding under our senior secured credit agreement, including accrued interest. Such repayment may materially adversely impact our financial position and cash flows.

The senior credit facilities and the indentures governing the 9.0% Notes and the 11.25% Notes limit our ability to:

- incur additional indebtedness or issue preferred stock;
- pay dividends on or make other distributions or repurchase our capital stock or make other restricted payments;
- make investments;
- enter into certain transactions with affiliates;

- pay dividends or other similar payments by our subsidiaries;
- create liens on *pari passu* or subordinated indebtedness without securing the Notes;
- designate the issuers' subsidiaries as unrestricted subsidiaries; and
- sell certain assets or merge with or into other companies or otherwise dispose of all or substantially all of their assets.

The table below summarizes our credit ratings as of the date of this filing.

	Standard & Poor's	Moody's
Corporate credit rating	B	B2
9% Senior Subordinated Notes	CCC+	Caa1
11¼% Senior Discount Notes	CCC+	Caa1
Senior credit facilities	B	Ba3

**Capital Resources.** We expect that cash generated from our operations and cash available to us under our revolving credit facility will be sufficient to meet our working capital needs, debt service requirements and planned capital expenditure programs that we consider necessary to continue our growth. However, we cannot assure you that our operations will generate sufficient cash or that future borrowings under our refinanced senior credit facilities will be available to enable us to meet these requirements and needs.

We also intend to continue to pursue acquisitions or partnering arrangements, either in existing markets or new markets, which fit our growth strategies. To finance such transactions, we might have to draw upon amounts available under our revolving credit facility or seek additional funding sources. We continually assess our capital needs and may seek additional financing, including debt or equity, as considered necessary to fund potential acquisitions, fund capital projects or for other corporate purposes. However, should our operating results and borrowing capacities not sufficiently support these capital projects or acquisition opportunities, our growth strategies may not be fully realized. Our future operating performance, ability to service or refinance our new debt and ability to draw upon other sources of capital will be subject to future economic conditions and other business factors, many of which are beyond our control.

#### **Guarantees and Off Balance Sheet Arrangements**

We are a party to certain rent shortfall agreements with certain unconsolidated entities and other guarantee arrangements, including parent-subsidiary guarantees, in the ordinary course of business. We have not engaged in any transaction or arrangement with an unconsolidated entity that is reasonably likely to materially affect liquidity.

## Obligations and Commitments

The following table reflects a summary of obligations and commitments outstanding, including both the principal and interest portions of long-term debt and capital leases, with payment dates as of March 31, 2007.

	Payments due by period				Total
	Within 1 year	During Years 2-3	During Years 4-5	After 5 years	
<b>Contractual Cash Obligations:</b>	<i>(In millions)</i>				
Long-term debt	\$ 119.1	\$ 236.3	\$ 954.4	\$ 1,140.6	\$ 2,450.4
Capital lease obligations	0.1	—	—	—	0.1
Operating leases	25.9	38.1	22.0	37.0	123.0
Purchase obligations	32.2	—	—	—	32.2
Health claims payable	57.9	—	—	—	57.9
Estimated self-insurance liabilities	21.1	37.8	18.9	6.3	84.1
Subtotal	\$ 256.3	\$ 312.2	\$ 995.3	\$ 1,183.9	\$ 2,747.7
<b>Other Commitments:</b>	<i>(In millions)</i>				
Construction and improvements commitments	\$ 39.9	\$ 17.8	\$ 0.5	\$ —	\$ 58.2
Guarantees of surety bonds	19.0	—	—	—	19.0
Letters of credit	—	—	40.0	—	40.0
Physician commitments	5.5	—	—	—	5.5
Minimum rent revenue commitments	0.1	—	—	—	0.1
Subtotal	\$ 64.5	\$ 17.8	\$ 40.5	\$ —	\$ 122.8
Total obligations and commitments	\$ 320.8	\$ 330.0	\$ 1,035.8	\$ 1,183.9	\$ 2,870.5

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

We are subject to market risk from exposure to changes in interest rates based on our financing, investing, and cash management activities. As of March 31, 2007, we had in place \$1,033.8 million of senior credit facilities bearing interest at variable rates at specified margins above either the agent bank's alternate base rate or its LIBOR rate. The senior credit facilities consist of \$783.8 million in term loans maturing in September 2011 and a \$250.0 million revolving credit facility maturing in September 2010 (of which \$40.0 million of capacity was utilized by outstanding letters of credit as of March 31, 2007). Although changes in the alternate base rate or the LIBOR rate would affect the cost of funds borrowed in the future, we believe the effect, if any, of reasonably possible near-term changes in interest rates would not be material to our results of operations or cash flows. Holding other variables constant, including levels of indebtedness, a 0.125% increase in interest rates would have an annual estimated impact on pre-tax income and cash flows of approximately \$1.0 million.

The \$250.0 million revolving credit facility bears interest at the alternate base rate plus a margin ranging from 1.00%-1.50% per annum or the LIBOR rate plus a margin ranging from 2.00%-2.50% per annum, in each case dependent upon our leverage ratio. The revolving credit facility matures in September 2010. The \$783.8 million in outstanding term loans bear interest at the alternate base rate plus a margin of 1.25% per annum or the LIBOR rate plus a margin of 2.25% per annum and mature in September 2011. The interest rate for the term loans was approximately 7.6% as of March 31, 2007.

From time to time, we use derivatives such as interest rate swaps to manage our market risk associated with variable rate debt or similar derivatives for fixed rate debt. We do not hold or issue derivative instruments for trading purposes and are not a party to any instruments with leverage features.

### **Item 4. Controls and Procedures.**

#### **Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this report, our management conducted an evaluation, with the participation of our chief executive officer and chief financial officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")). Based on this evaluation, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

#### **Changes in Internal Control Over Financial Reporting**

There were no changes in our internal control over financial reporting during our fiscal quarter ended March 31, 2007, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II OTHER INFORMATION

### Item 1A. Risk Factors.

There have not been any material changes to the risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006, as supplemented by the risk factor disclosed in our Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2006, other than as set forth below.

*Our hospitals face competition for staffing especially as a result of the national shortage of nurses and the increased imposition on us of nurse-staffing ratios, which has in the past and may in the future increase our labor costs and materially reduce our profitability.*

We compete with other healthcare providers in recruiting and retaining qualified management and staff personnel responsible for the day-to-day operations of each of our hospitals, including most significantly nurses and other non-physician healthcare professionals. In the healthcare industry generally, including in our markets, the national shortage of nurses and other medical support personnel has become a significant operating issue. This shortage has caused us in the past and may require us in the future to increase wages and benefits to recruit and retain nurses and other medical support personnel or to hire more expensive temporary personnel. We have voluntarily raised on several occasions in the past, and expect to raise in the future, wages for our nurses and other medical support personnel. In addition, union-mandated or state-mandated nurse-staffing ratios significantly affect not only labor costs, but if we are unable to hire the necessary number of nurses to meet the required ratios, these ratios may also cause us to limit patient admissions with a corresponding adverse effect on revenues. While we don't currently operate in any states with mandated nurse-staffing ratios, the states in which we operate could adopt mandatory nurse-staffing ratios at any time. In those instances where our nurses are unionized, it is our experience that new union contracts often impose significant new additional staffing ratios by contract on our hospitals, such as the increased staffing ratios imposed on us in our recently negotiated new union contract with our nurses at Saint Vincent Hospital in Worcester, Massachusetts (which contract obtained union member ratification on or about February 16, 2007 by a vote of 349 to 6). In addition, to the extent that a significant additional portion of our employee base unionizes, or attempts to unionize, our labor costs could increase materially, especially if the newly unionized employees are nurses. If our labor costs continue to increase, we may not be able to raise our payer reimbursement levels to offset these increased costs, including the significantly increased costs that we will incur for wage increases and nurse-staffing ratios under our new union contract with our nurses at Saint Vincent Hospital. Because substantially all of our net patient revenues consist of payments based on fixed or negotiated rates, our ability to pass along increased labor costs is materially constrained. Our failure to recruit and retain qualified management, nurses and other medical support personnel, or to control our labor costs, could have a material adverse effect on our profitability.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

(a) During the quarterly period ended March 31, 2007, we issued the securities described in the next paragraph below that were not registered under the Securities Act of 1933. The transactions described below were conducted in reliance upon the exemption from registration provided in Rule 701 of the Securities Act for a sale of securities under a written compensatory benefit plan established by the issuer for the participation of its current and former employees. These sales were made without the use of an underwriter, and the certificate evidencing the securities issued in connection with each such transaction bears a restrictive legend permitting transfer of the securities only upon registration under the Securities Act or pursuant to an exemption from registration.

On January 9, 2007, for an aggregate purchase price of \$36,000, we issued 36 shares of our common stock to a former employee upon her exercise of vested options which would have otherwise expired 90 days after her termination of employment. On January 16, 2007, for an aggregate purchase price of \$13,000, we issued 13 shares of our common stock to a former employee upon her exercise of vested options which would have otherwise expired 90 days after her termination of employment. On February 13, 2007, for an aggregate purchase price of \$13,000, we issued 13 shares of our common stock to a former employee upon her exercise of vested options which would have otherwise expired 90 days after her termination of employment. On March 7, 2007, for an aggregate purchase price of \$26,000, we issued 26 shares of our common stock to a former employee upon her exercise of vested options which would have otherwise expired 90 days after her termination of employment. On March 19, 2007, for an aggregate purchase price of \$71,000, we issued 71 shares of our common stock to a former employee upon her exercise of vested options which would have otherwise expired 90 days after her termination of employment.

**Item 6. Exhibits.**

The exhibits filed as part of this report are listed in the Index to Exhibits which is located at the end of this report.

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DATE: May 9, 2007

VANGUARD HEALTH SYSTEMS, INC.

BY: /s/ Phillip W. Roe  
*Phillip W. Roe*  
*Senior Vice President, Controller and*  
*Chief Accounting Officer*  
(Authorized Officer and Chief Accounting Officer)

## **INDEX TO EXHIBITS**

<b><u>Exhibit No.</u></b>	<b><u>Description</u></b>
<a href="#"><u>10.1</u></a>	Contract Amendment Number 16, executed on April 26, 2007, but effective as of October 1, 2006, to the Arizona Health Care Cost Containment System Administration Contract No. YH04-0001-06 between Phoenix Health Plan and the Arizona Health Care Cost Containment System.
<a href="#"><u>31.1</u></a>	Certification of CEO pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
<a href="#"><u>31.2</u></a>	Certification of CFO pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
<a href="#"><u>32.1</u></a>	Certification of CEO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
<a href="#"><u>32.2</u></a>	Certification of CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.