COLES MYER LTD
Form 20-F
December 23, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 20-F

(Mark One)

¨ **REGISTRATION STATEMENT PURSUANT TO SECTION 12 (b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

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

FOR THE FISCAL YEAR ENDED JULY 31, 2005

OR

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

FOR THE TRANSITION PERIOD FROM __________ TO__________

¨ **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Date of event requiring this shell company report

Commission file number: 1-10083

COLES MYER LTD.

Australian Business Number 11 004 089 936

(Exact name of Registrant as specified in its charter)

VICTORIA, AUSTRALIA

(Jurisdiction of incorporation or organization)

800 TOORAK ROAD, TOORONGA, VICTORIA 3146 AUSTRALIA

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12 (b) of the Act.

Title of each class	Name of each exchange on which registered
Ordinary Shares	New York Stock Exchange*
American Depositary Shares**	New York Stock Exchange

* Not for trading but only in connection with the registration of American Depositary Shares, pursuant to the requirements of the Securities and Exchange Commission.

** Evidenced by American Depositary Receipts, each American Depositary Share representing eight Ordinary Shares.

Securities registered or to be registered pursuant to Section 12 (g) of the Act.

None

Securities for which there is a reporting obligation pursuant to Section 15 (d) of the Act.

None

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the Annual Report.

Fully Paid Ordinary Shares	1,237,160,686
Partly Paid Ordinary Shares paid up to A$0.01 per share	74,000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by 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 x No ¨

Indicate by check mark which financial statement item the registrant has elected to follow. Item 17 x Item 18 ¨

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No ¨

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes ¨ No x

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CERTAIN DEFINITIONS

The fiscal year of Coles Myer Ltd. (the Company , Coles Myer , CML or CML Group , which, unless the context otherwise requires, includes Coles Myer Ltd. and its consolidated entities) ends on the last Sunday in July each year. The fiscal year ended July 31, 2005 is referred to in the text of this Annual Report as 2005 , and other fiscal years are referred to in a corresponding manner. In the consolidated financial statements included in Item 17, the financial year 2004-05 is also referred to as 2005, and similarly for other years, except where otherwise stated. See also Glossary of Terms for descriptions of certain terms used in this Annual Report.

In this Annual Report, unless otherwise specified or the context otherwise requires, all dollar amounts are expressed in Australian dollars (A$).

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 20-F contains certain forward-looking statements, including statements regarding the expected outlook for the retail-trading environment in Australia, expectations as to the disposition of certain stores or lines of business, the implementation of strategies for growth in other businesses, and levels of anticipated capital expenditures. Coles Myer can give no assurances that the actual results will not differ materially from the statements contained herein. Such forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and other factors, many of which are beyond the control of Coles Myer, which may cause actual results to differ materially from those expressed in the statements contained herein. Any such forward-looking statements speak only as of the date of this Annual Report. In the absence of a specific legal obligation to the contrary, Coles Myer undertakes no responsibility to publicly announce the result of any revisions to any forward-looking statements contained herein to reflect future developments or events.

Risk factors, which may affect Coles Myer s future performance, are discussed in Item 3D.

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ITEM 1 IDENTITY OF DIRECTORS, SENIOR MANAGEMENT & ADVISERS

Not applicable.

ITEM 2 OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3 KEY INFORMATION

A. SELECTED FINANCIAL DATA

The selected income statement data for 2003 through 2005, and the selected balance sheet data at July 25, 2004 and July 31, 2005 set forth below (other than percentages) are derived from the audited consolidated financial statements of Coles Myer included in this Annual Report. They should be read in conjunction with, and are qualified in their entirety by reference to, those statements, including the Notes thereto. The selected income statement data for the years 2001 and 2002 and the selected balance sheet data at July 29, 2001, July 28, 2002 and July 25, 2003 set forth below (other than percentages) are derived from audited consolidated financial statements of Coles Myer, which are not included herein. Coles Myer s consolidated financial statements are prepared in accordance with accounting principles generally accepted in Australia (Australian GAAP), which vary in certain material respects from accounting principles generally accepted in the United States (U.S. GAAP). A reconciliation to U.S. GAAP is set out in Note 32 of the Notes to the Company s consolidated financial statements.

It should be noted that results for 2005 reflect 53 trading weeks compared to 52 trading weeks for the other fiscal years indicated. This is because the Company s fiscal year ends on the last Sunday in July each year and, as a result, approximately every six years an extra trading week is included in the Company s consolidated results for that fiscal year.

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Amounts in accordance with Australian GAAP

	2005(1)(2)	2005(2)	2004	2003	2002(3)	2001(3)
	US$	A$	A$	A$	A$	A$
	(In millions, except per share amounts)					
Income Statement Data:						
Sales (3)	27,479.0	36,185.2	32,082.2	26,875.8	25,688.7	23,779.6
Percent increase/(decrease) from prior year	n/a	12.8%	19.4%	4.6%	8.0%	(1.6)%
Profit from ordinary activities before income tax	670.2	882.5	866.2	608.8	482.2	208.2
Income tax expense	(202.3)	(266.4)	(258.1)	(187.7)	(137.2)	(68.0)
Net profit	467.9	616.1	608.1	421.1	345.0	140.2
Percent increase/(decrease) from prior year	n/a	1.3%	44.4%	22.1%	146.1%	(49.6)%
Dividends (4)	331.7	436.8	367.5	348.2	346.9	444.5
Per Ordinary Share:						
- Basic earnings	0.35	0.46	0.46	0.32	0.25	0.10
- Diluted earnings	0.36	0.47	0.47	0.33	0.27	0.11
- Cash Dividends (4) (5)	0.237	0.313	0.265	0.260	0.255	0.355
Balance Sheet Data: (at year end)						
Current assets	3,261.1	4,294.3	4,569.5	4,116.4	4,016.8	3,946.1
Total assets	7,102.2	9,352.4	9,051.7	8,452.8	8,320.6	8,317.8
Short-term debt	164.0	216.0	261.5	10.8	15.3	127.8
Long-term debt	921.4	1,213.3	713.4	1,143.3	1,552.8	1,671.4
Total debt	1,085.4	1,429.3	974.9	1,154.1	1,568.1	1,799.2
Net Assets/Shareholders equity	2,837.1	3,736.0	4,097.6	3,799.2	3,338.8	3,286.3

Refer page 4 for notes relating to above table.

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Amounts in accordance with U.S. GAAP

	2005[1][2] US$	2005 A$	2004 A$	2003 A$	2002[3] A$	2001[3] A$
	(In millions, except per share amounts)					
Income Statement Data:						
Sales [3]	27,479.0	36,185.2	32,082.2	26,875.8	25,688.7	23,779.6
Net profit from continuing operations	389.2	512.5	475.4	444.4	310.7	166.5
- Basic earnings per share	0.32	0.42	0.40	0.34	0.22	0.12
- Diluted earnings per share	0.31	0.41	0.39	0.33	0.22	0.12
Net profit	389.2	512.5	475.4	390.9	310.7	166.5
- Basic earnings per share	0.32	0.42	0.40	0.29	0.22	0.12
- Diluted earnings per share	0.31	0.41	0.39	0.29	0.22	0.12
Per Ordinary Share:						
- Cash dividends [4]	0.24	0.313	0.265	0.260	0.255	0.355
- Cash dividends in US$ [4] [5]	US$0.24	US$0.24	US$0.19	US$0.18	US$0.14	US$0.18
Balance Sheet Data: (at year end)						
Current assets	3,264.3	4,298.5	4,577.7	4,128.0	4,034.8	3,940.2
Total assets	6,93.7	9,170.9	9,109.9	8,422.4	8,218.8	8,181.9
Short-term debt	164.0	216.0	261.5	10.8	15.3	127.8
Long-term debt	921.4	1,213.3	1,397.5	1,143.3	1,552.8	1,671.4
Total debt	1,085.4	1,429.3	1,659.0	1,154.1	1,568.1	1,799.2
Net Assets/Shareholders equity	2,506.9	3,301.2	3,032.7	3,329.4	3,107.6	3,111.1
Issued capital - value	1,597.0	2,103.0	1,626.1	2,210.3	2,032.3	1,973.7
	Millions of shares					
Issued capital - number of outstanding shares [6]	1,237.2	1,237.2	1,225.5	1,212.5	1,184.7	1,176.8

(1) Merely for the convenience of the reader, certain selected financial data has been converted into US dollars at the Noon Buying Rate on July 29, 2005, the last trading day of the fiscal year, of A$1.00 = US$0.7594. These translations should not be construed as representations that the A$ amounts actually represent such US$ amounts or could be converted into US$ at the rate indicated. For a more recent A$/US$ exchange rate, refer below.

(2) Results for 2005 reflect 53 trading weeks compared to 52 trading weeks for other fiscal years shown.

(3) Sales exclude Goods and Services Tax (GST). Sales for 2002 and 2001 have not been adjusted for the concessional sales change of accounting policy.

(4) Dividends for 2001 and 2002 include the interim and final dividends relating to each respective fiscal year. As a result of the change in accounting policy for providing for dividends, since 2003 dividends for each year include the interim dividend of that year and the final dividend of the prior year (refer Note 7 of the consolidated financial statements included at Item 17).

(5) Based on the Noon Buying Rate for cable transfers in A$ as at each payment date as certified for customs purposes by the Federal Reserve Bank of New York. The actual rates of exchange used in determining the dollar payments to ADS holders were the exchange rates on the dates payments were made to the Depositary, being November 8, 2004 and May 9, 2005.

(6) Balance excludes number of Reset Convertible Preference Shares (ReCAPS) and includes partly paid shares.

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Exchange Rates

The following table sets forth, for the last five complete financial years, the average rate of exchange of A$ into United States dollars (US$) based on the noon buying rate in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate).

Fiscal Year	2005	2004	2003	2002	2001
	(all figures in US$ per A$)				
Average rate [1]	0.7564	0.7181	0.5884	0.5270	0.5262

[1] The average of the Noon Buying Rates on the last day of each full month during the period.

The high and low exchange rates for the previous six complete months are:

Months	High	Low
	(all figures in US$ per A$)	
June 2005	0.7792	0.7498
July 2005	0.7661	0.7403
August 2005	0.7739	0.7469
September 2005	0.7731	0.7537
October 2005	0.7630	0.7468
November 2005	0.7451	0.7267

The exchange rate at December 1, 2005 was A$1.00 = US$0.7410.

B. CAPITALIZATION AND INDEBTEDNESS

Not applicable.

C. REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

D. RISK FACTORS

This section describes some of the risks that could affect the Company s business. The factors below should be considered in connection with any forward-looking statements in this Annual Report. The risks below are not the only ones the Company faces some risks may not be known to the Company, and some, which are not currently considered to be material, could later turn out to be material.

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The major risk factors, which may impact Coles Myer, include:

Risks Related to Coles Myer

There is a risk that if the Company s strategic plan is not clearly defined and communicated, the Company will be unsuccessful in fulfilling its vision to be the market leader in all the markets it operates in.

The Company s vision is to be the market leader in all the markets it operates in. This strategy has to be clearly defined. Well-judged customer propositions and successful marketing programs influence the continued growth of retail profitability. Critical factors to Coles Myer maintaining its competitive position are: (i) the ability of Coles Myer to successfully gauge and satisfy consumer preferences, and to reward customer loyalty; (ii) merchandising skills to enable improvement in product range to better meet customer needs; (iii) ability to source products in a timely and efficient manner; and (iv) appropriate price positioning. The Company needs an appropriate framework of structures and processes that support the Group through the implementation of this strategy. If the appropriate structures and processes are not in place, the Company may miss or have inadequate responses to the market and new market opportunities.

There is a risk that the Company may not fully realize expected benefits and reduce costs from better leverage of the Group s operations.

The Group s future plans include expected benefits from greater efficiencies in areas that are common across the Group (in particular Supply Chain and Information Technology) and access to greater economies of scale. There is a risk that the Company may not leverage the benefits and reduce costs, available from the scale, depth and breadth of its retail capability. If the Company is not able to realize these benefits, its future ability to reduce costs and remain competitive may be reduced.

There is a risk that the Company may put too much focus on Group change.

The Company continues to have a significant agenda of implementing change across the Group, particularly in Retail Support areas such as Supply Chain and Information Technology. There is a risk that if the change agenda is not well managed, there may be a loss of focus with inadequate resources being directed to core retail activities. If these core retail activities do not perform in line with expectations, there is a risk that the Company s future financial performance may suffer.

There is a risk that the Company s customer proposition is unsuccessful, which may affect its future competitive position and growth opportunities.

Coles Myer s vision is to be the number one retailer in its brands, most of which operate in relatively mature retail markets. The Company must regularly evaluate its customer proposition for each of its brands in a dynamic and competitive marketplace. Growth initiatives are based on (i) expanding share within existing markets through differentiated product offers and competitive pricing or (ii) identifying new retail opportunities. In the Food and Liquor business, this includes successfully executing the planned expansion of house brands and increasing fresh food market shares. There is a risk that if the Company does not continue to innovate and improve its customer offer, its market share and future growth may be impacted.

If Coles Myer is unable to locate appropriate store sites, it may not be able to deliver expected store growth.

The Company s growth strategy includes the opening of new stores, together with the enhancement of existing stores. Coles Myer s ability to open new stores is dependent on identifying and entering into leases on commercially reasonable terms for properties that are suitable for its needs. If Coles Myer fails to identify and enter into leases at premium retail sites, the Company s growth may be impaired.

There is a risk that some of the Company s stores may underperform.

Individual stores may underperform for a number of reasons (eg poor positioning, poor execution, fluctuations in trends and markets, and the Company s failure or inability to swiftly respond to these). There is a risk that the cost of exiting such low returning sites may be prohibitive. If the Company fails to regularly monitor underperforming stores, and to take appropriate remedial action, such stores will adversely affect profitability.

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There is a risk that if the Company is unable to implement its new Information Technology (IT) systems and transform the Supply Chain the future performance of the Group may be affected.

The Company s growth strategy includes significant investment in new IT systems. Coles Myer has a large number of systems, and there is a risk that if CML does not adequately implement the IT strategy to support improvement and efficiency across the business, its future profitability may be affected.

The transformation of the Supply Chain is a major initiative for the Company, and is intended to result in doing business better for customers, simpler for stores and cheaper for Coles Myer. The initiative is complex, with risks including delays and interruptions. Presently, the Supply Chain is changing rapidly, and consequently the risk of interruption increases. These risks may result in the Company not achieving the expected benefits within expected timeframes.

There is a risk that the Company s growth strategy may be affected if there are insufficient skills across the Group to support its implementation.

There is a risk of the loss of key members of the senior management team, which may impede the implementation of the Group s strategies. The loss of key personnel, or insufficient management or leadership skills may mean that the Company s growth strategy does not meet expectations.

There is a risk that industrial action may affect the Company s operations impacting business and financial performance.

Coles Myer has traditionally had a stable industrial relations environment within its operations. However, there is a risk of industrial unrest or interruption particularly within distribution centers. Any industrial action may increase costs, impact operations and delay transformation initiatives.

There is a trend of increasing competition (from existing and new competitors) in the markets within which Coles Myer operates which may affect the results from its retail operations.

There is significant competition in the Australian and New Zealand markets in which Coles Myer s businesses operate. Retail chains generally compete on the basis of location, quality of products, service, price, product variety and store condition. Take-over activity amongst existing competitors intensifies competition. There is also the risk of new entrants into the Australian retail market, either by acquisition of an existing retailing company or through greenfields development. Regulatory authorities may constrain the Company from growing existing Brands, particularly within the food and liquor group. As Coles Myer operates in a broad range of retail sectors (food and liquor, discount stores, department stores, etc) it is exposed to competition in almost all retail sectors of the Australian market. These competitive conditions may adversely impact Coles Myer s market share and trading results.

Myer ownership options risk.

As part of the development of the Company s next strategic plan, the Company is considering ownership options for Myer. Amongst these is the option of selling, de-merging or retaining Myer. At this point in time the outcome of this process is unknown and consequently it is not possible to reasonably identify what risks, if any, may arise from the final ownership decision.

Coles Myer faces the risk of exposure to product liability claims and adverse publicity.

The packaging, marketing, distribution and sale of food products entail an inherent risk of product liability, product recall, adverse publicity and exposure to product liability claims. Such claims may have an adverse impact on the Company s financial performance.

The transition to International Financial Reporting Standards (IFRS) may affect the Company s operating results.

As described in Note 1 to the consolidated financial statements, CML complies with Accounting Standards, other authoritative pronouncements of the Australian Accounting Standards Board (AASB)**,** Urgent Issues Group Consensus Views and the Corporations Act 2001. The AASB is adopting International Financial Reporting Standards (IFRS) for application to reporting periods beginning on or after January 1, 2005. The AASB has issued Australian equivalents to IFRS (A-IFRS). The adoption of A-IFRS will be first reflected in the CML Group s financial statements for fiscal 2006, being the half year ending January 29, 2006 and the year ending July 30, 2006.

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The transitional rules for adoption of IFRS require the restatement of comparative financial statements using Australian equivalents of IFRS, except for AASB 132 Financial Instruments: Disclosure and Presentation and AASB 139 Financial Instruments: Recognition and Measurement . Most adjustments required on transition to IFRS will be made, retrospectively, against opening retained earnings as at July 26, 2004. The adoption of IFRS may increase the volatility of reported earnings in future periods, or negatively impact reported earnings.

Refer to note 1ae to our consolidated financial statements for further details regarding our adoption of IFRS.

There is a risk that if the Company is not able to improve its Health and Safety record, the associated costs may decrease profitability.

Continuing to improve the Health and Safety record is a major management focus through the Safety Right Now program. This program focuses on creating a safer environment for staff, customers and visitors to all business locations. There is a risk that if the Company is not able to maintain the improving Health and Safety record, the costs associated with workers compensation may increase and affect the future competitive position of the Company.

There is a risk that long-term exchange rate fluctuations may impact the costs of imports.

The Company sources merchandise both directly and indirectly from overseas denominated in either Australian dollars or foreign currency. All foreign exchange exposures arising from the importation of merchandise (including freight and customs), capital expenditure and other goods (for example back of house items, fees and expenses), and also foreign currency denominated borrowings, and offshore investments are fully hedged. There is a risk that long-term permanent depreciation of the Australian dollar may impact the Company s future sourcing costs.

There is a risk of non-compliance with governance, corporations law and other listed company obligations and expectations which may have a negative impact on the Company s performance.

Coles Myer is subject to many laws and regulations including, but not limited to, trade practices, corporations law, employment laws, workers compensation and rehabilitation, occupational health and safety, tax and accounting legislation including the Financial Services Act, State, Territory and local government legislation and regulations that govern property planning issues, liquor licensing, tobacco retailing, retail trading hours and other operational matters, environmental regulation and the Australian Competition and Consumer Commission. Compliance with, or changes in, these laws (which may be brought about by interest lobby groups) may reduce the sales and profitability of Coles Myer s operations and may otherwise adversely affect the Company s business, financial condition or results.

Risks Related to Australia

The Company s financial prospects, both in terms of sales and profits are primarily dependent on the Australian economic environment.

The retail trading environment is subject to general economic conditions in the Australian and global markets. Any adverse changes in such economic conditions can be expected to affect the retail-trading environment in general. Recent unexpected increases in energy costs have impacted the level of disposable income available to consumers to spend in the Company s stores. Adverse developments in economic conditions during the first half of the fiscal year of Coles Myer, particularly the Christmas trading period when its sales and profitability are typically strongest, may have a negative impact on Coles Myer s trading results.

The Company s future financial results, in terms of sales and borrowing costs, may be negatively impacted by higher interest rates.

Higher interest rates affect income available for spending, which can impact the level of retail sales. Higher interest rates also affect the Company s cost of borrowing and may reduce its profitability.

Acts of terrorism in Australia may affect the Company.

In the event of acts of local terrorism, the Company may experience business interruption.

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ITEM 4 INFORMATION ON THE COMPANY

The discussion below contains certain forward-looking information. See comments regarding Forward-Looking Statements on page 1 of this Annual Report.

A. HISTORY AND DEVELOPMENT

GENERAL

Coles Myer Ltd. is an Australian-based retailer, owning and operating stores in most sectors of the Australian retail market, in the general merchandise sector of the New Zealand retail market and on the Internet. The Company supplies a wide range of food and non-food items in supermarkets, discount stores, department stores, liquor stores, office supplies stores, automotive service centers, fuel outlets and online. Coles Myer Ltd. predominantly trades under the names of Coles , Bi-Lo , Coles Express , Coles Online , Liquorland , Vintage Cellars , 1st Choice Liquor Superstore , Theo s , Kmart , Kmart Garden Super Centre , Kmart Tyre & Auto , Tyremaster , Target , Target Country , Myer , Office and Harris Technology . In New Zealand, the Company trades as Kmart .

The Company commenced business in 1914, operating variety stores. After incorporation in 1921 as G.J. Coles & Coy. Limited (Coles), it continued to operate variety stores until the end of the 1950s, when it branched out into supermarket retailing. In 1969, Coles introduced the discount store concept into Australia through the establishment of the Kmart chain. In 1985, Coles acquired The Myer Emporium Limited, which was the largest department store business in Australia. In 1986, the Company changed its name to Coles Myer Ltd.

Further developments since that time have included purchases of specialty store chains, the development of niche market opportunities in growth categories such as office supplies and motor products, either by way of newly established brands such as Officeworks, or through existing brands extending their offering in specialized areas.

The Company is incorporated in the State of Victoria, Commonwealth of Australia, has its executive offices at 800 Toorak Road, Tooronga, Victoria, 3146 and its telephone number is (61) (3) 9829 3111.

Coles Myer Ltd. is the holding company. The number of subsidiaries/consolidated entities in the Coles Myer Group at July 31, 2005, was 87, all of which are incorporated in Australia and New Zealand, apart from one company, which is incorporated in Singapore.

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RECENT DEVELOPMENTS

1. Megamart

The Megamart brand experienced an extremely competitive environment during fiscal 2004. In mid-November 2004 a revised customer offer was developed to improve Megamart s performance. Whilst sales improved, the nine stores did not deliver the required profit improvement. Following a detailed review of the Megamart brand the Company decided to divest the nine Megamart stores. On November 9, 2005 the Company announced a conditional agreement to divest six Megamart stores to Harvey Norman, a listed Australian retailer of furniture and electrical goods, from November 23, 2005. The remaining three stores closed on November 13, 2005 and the Company is pursuing sub-letting of these properties. The Company expects that divestment and closure costs will be covered by the provision of A$56 million after tax previously announced on August 16, 2005.

2. Myer

As part of the development of Coles Myer s next five-year strategic plan, a process began in September 2005 to consider ownership options for Myer, including retention, de-merger and trade sale. The process will determine which is the best outcome for Myer, Coles Myer and its shareholders. No time frame has been set for the completion of this process.

On November 2, 2005 an Information Memorandum (IM) was provided to approximately 20 interested parties who, in responding to the call for formal expressions of interest, have demonstrated an ability to acquire the Myer brand. All parties receiving the IM have signed confidentiality agreements and have not been publicly identified by the Company.

The IM provides high-level information on Myer to enable prospective buyers to better understand the business, what it has achieved, where it is today and plans for the future. It includes background on the ownership review process, a detailed profile of Myer, its financial performance over recent years, its business strategy, including marketing, loyalty and sponsorship, and its store portfolio.

An integral part of the review process involves reviewing the ownership and development opportunities of the freehold property that the flagship store, Myer Melbourne (Australia s largest department store), is located on. It is in one of the most important and strategic retail locations in Australia. To ensure the Company maximizes the return for itself and Myer, the Company has decided to look at all options for this freehold property.

CML has commissioned consultants, including architects, quantity surveyors and property valuers, to begin exploring development opportunities for this freehold property. The development options will be presented to prospective buyers to assist them to understand the full value of Myer and the freehold property when they are preparing their bids.

At the same time, CML will approach major property developers and other parties to seek their interest in submitting proposals for developing the freehold property.

The parties had until early December 2005 to submit indicative bids for Myer. The Board met on December 12, 2005 to consider indicative bids submitted for the Myer business. The Board decided that several parties would be invited to participate in the next phase of the process. The parties will conduct due diligence on Myer to enable them to prepare and submit final bids during February 2006. The Board will then be in a position to compare potential shareholder value that could be created by divestment relative to that which would be generated by Myer s retention or de-merger. It is anticipated that a decision on the future ownership of Myer will be made in the first quarter of calendar year 2006.

At this stage, all ownership options for Myer, including sale, de-merger or retention, remain open.

3. Public Takeover Offers

Australian Leisure and Hospitality Group Limited (ALH)

In October 2004, the Company and Macquarie Bank Limited (MBL) undertook a public offer to acquire ALH, a hotel and liquor operator. Under the proposal, ALH would be acquired by CMM Hotel & Retail Investments Pty Limited (CMM), a joint venture vehicle with equity funding of 60 per cent from MBL and 40 per cent from CML. The offer price was A$3.35 a share.

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Another party, Bruandwo Pty. Ltd., had previously made an offer to acquire ALH and was continuing to raise the offer. As a result, the Company revised its original proposal to A$3.75 per share. At this time the other party made a further offer of A$3.76 a share. The Company and MBL decided not to further increase their offer, as it was not in the best interests of the Company s shareholders.

4. Financial Updates

1st Quarter Sales

On November 10, 2005, the Company announced 2006 first quarter sales (for the 13 weeks ended October 30, 2005) of A$9.0 billion, an increase of 5.6%. Specific sales results were:

	First Quarter (13 Weeks)		
	2006	**2005**	**Change**
	A$M	**A$M**	**%**
Food, Liquor & Fuel	6,360	5,917	7.5
Kmart	893	905	(1.4)
Officeworks	291	279	4.3
Myer	663	647	2.4
Megamart	59	61	(4.3)
Target	723	702	3.0
Total sales (1)	8,989	8,511	5.6

(1) Total sales include concession sales.

Earnings guidance

At the Company s 2005 Annual General Meeting on November 17, 2005, the Company reaffirmed that it remains committed to its 2006 full year s earnings goal of A$769 million (A$800 million pre-capital management refer below).

5. Management

CEO tenure

On February 11, 2005 the Company announced that Mr. John Fletcher will stay on as CEO after his current contract expires in September 2006. Mr. John Fletcher will continue his employment without a fixed term but subject to 12 months notice of termination by either the Board or himself.

Senior management changes

Appointments

Mr. Hani Zayadi (previously Managing Director Kmart) was appointed Group Managing Director Food, Liquor and Fuel from December 22, 2004, replacing Mr. Steven Cain who ceased employment with the Company on January 3, 2005.

On February 14, 2005 the Company announced that:

- Mr. Larry Davis was moving from his position as Managing Director Target to Managing Director Kmart;
- Ms. Launa Inman was moving from her position as Managing Director Officeworks to Managing Director Target;
- Mr. Joe Barberis was moving from his position as Managing Director, Coles Express to Managing Director Officeworks.

On March 8, 2005, the Company announced the appointment of Mr. Mick McMahon as Managing Director of Coles Express.

On January 31, 2005 Mr. Tom Lemke was appointed Group General Manager, Marketing and Customer Strategy.

In February 2005, Mr. Peter Merritt was appointed Managing Director, Strategy and Development, Food, Liquor and Fuel.

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On August 1, 2005 the Company announced the appointment of Ms. Fiona Bennett as Group General Manager, Risk and Internal Audit.

Departures

On December 22, 2004, the Company announced that Mr. Steven Cain, Managing Director Food, Liquor and Fuel would be leaving the Company. Mr. Hani Zayadi, then Managing Director Kmart, took over the Food, Liquor and Fuel leadership role.

Brand reorganizations

Restructure of Supermarket Brand (Coles and Bi-Lo) Support Structures

In September 2004, the Supermarkets brands support structures were reorganized to remove duplication and bring the management team closer (organizationally) to stores and customers. The Coles and Bi-Lo support structures were combined into one integrated supermarket team. Freed resources have been reinvested into the strategic areas of fresh food and housebrands.

Coles Myer Liquor Group relocation

The Coles Myer Liquor Group head office structure was reorganized to increase operational efficiencies. This included the relocation of the head office from Sydney to Melbourne in August 2004, enabling the Food and Liquor teams to work together more closely.

6. Capital management

Share buy-back

On May 27, 2005 the Company purchased and cancelled 70,433,916 fully paid ordinary shares under an off-market buy-back. The total cost of the off-market buy-back (including transaction costs) was A$589.0 million.

On May 23, 2005 the Company announced its intention to buy back up to 15 million ordinary shares on-market. Between June 7, 2005 and July 25, 2005 the Company purchased and cancelled 12,221,111 shares at a total cost of A$115.4 million.

In total, 82,655,027 shares were purchased and cancelled during the year. Refer Note 21 to the consolidated financial statements at Item 17.

On July 12, 2005 the Company converted 7,000,000 reset convertible preference shares (ReCAPS) into 79,282,822 million fully paid Coles Myer ordinary shares. Refer Note 21 to the consolidated financial statements at Item 17.

7. Other

MYER One

MYER One, a new loyalty card exclusive to Myer was launched on August 2, 2004. It is a strategic initiative to enhance relationships with customers. MYER One can be used in conjunction with FlyBuys™ and CML Source™ MasterCard.

Shareholder Discount Card Program

The Coles Myer Shareholder Discount Card Program ceased on July 31, 2004.

Dividend Reinvestment Plan (DRP)

The Company had a DRP under which holders of ordinary shares had previously been able to elect to have their dividend entitlements satisfied by the issue of new fully paid ordinary shares. The DRP was suspended effective from the final dividend for 2004 (paid in November 2004). All dividends are now paid in cash.

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Board Changes

At the Company s 2005 Annual General Meeting in Melbourne on November 17, 2005, Mr. Tony G. Hodgson, Ms. Sandra McPhee and Mr. Michael Wemms were re-elected Directors. Ms. Belinda Hutchinson having been appointed to the Board on September 23, 2005 was elected to the Board.

Capital expenditure

For 2005, capital expenditure was A$1,135 million in aggregate and was spread across the following areas:

A$ million	**2005**	**2004**	**2003**
New stores / replacements	343	184	236
Refits	213	205	172
Acquisitions	121	129	299
Technology	223	151	168
Property / Other	235	205	117
Total	1,135	874	992

Of this amount, 99.6% was spent on the Company s Australian operations, with the remainder spent in New Zealand.

The Company expects its cash flow from operating activities and available borrowings will be sufficient to meet its anticipated capital expenditure and investment requirements over the next twelve months.

Also see Consolidated Statements of Cash Flows and Note B Acquisitions/Disposals in the consolidated financial statements at Item 17.

B. BUSINESS OVERVIEW

Company Retail Operations

At July 31, 2005, Coles Myer operated 2,650 stores in Australia and New Zealand, and employed in excess of 180,000 people.

The Company operates businesses in Australia and New Zealand, all of which are serviced by a centralized corporate group. Each of these businesses is known as brands and is described below. The brands are primarily stand-alone but increasingly are being supported by a series of

Retail Support centers that all operate within policies determined by a centralized corporate group. The results of the operating brands are reported under six groups: Food, Liquor & Fuel, Kmart, Officeworks, Myer, Megamart and Target. Sales, segment result, and identifiable asset data are reported for each Coles Myer brand group, and are shown in Note 27 to the Coles Myer consolidated financial statements contained herein. The table on page 14 provides details of the stores that fall within each group and Item 5 Operating and Financial Review and Prospects , provides a discussion of the results of operations for each of Coles Myer s brands groups.

Coles Myer s sales and to a greater extent its profits, show a seasonal pattern. Myer, Kmart and Target typically experience stronger sales of higher margin merchandise during the Christmas trading period. Sales for Myer, Kmart and Target in the 27 weeks to January 31, 2005 accounted for 52.9% (2004: 53.0%) of their full year sales and 78.5 % (2004: 70.0%) of their full year profits. Aggregate sales of food and liquor through supermarkets, fuel and other outlets are not as subject to major seasonal influences.

The Company operates in all Australian States, the Northern Territory, the Australian Capital Territory, and New Zealand. The geographic spread of the Company s Australian operations corresponds closely to the distribution of population and retail spending, with the result that the Company s Australian revenues are not disproportionately exposed to economic conditions in any particular region or industry. In New Zealand the Company s stores are predominantly located in the North Island, which is the major population concentration.

The Company continually monitors the performance of its stores in all locations, and closes or re-develops stores which cease to provide acceptable levels of profitability on a continuing basis. The strong correlation between disposable income, retail sales and population across Australia is shown in the following table.

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The spread of the Company s sales and selling area across the Australian States and Territories, as shown in the following table, also reflects the geographic distribution of population, retail sales and disposable income. Accordingly the decisions taken by the Company in the opening, closure, or refurbishment of the large majority of its stores are typically not principally influenced by economic conditions in individual States.

	Share of National Aggregates as at July 2005			Share of Coles Myer as at July 2005	
	Population %	Retail Sales %	Disposable Income %	Sales %	Selling Area %
State/Territory					
New South Wales / Australian Capital Territory	35.0	35.6	37.3	33.0	32.0
Victoria	24.7	24.1	25.7	26.6	26.3
Queensland	19.4	19.8	17.3	18.9	20.1
South Australia / Northern Territory	8.6	8.3	8.0	8.8	8.6
Western Australia	9.9	10.1	9.7	10.8	11.0
Tasmania	2.4	2.1	2.0	1.9	2.0

Source: Company Records and Australian Bureau of Statistics.

As at July 31, 2005 (the end of the Company s last completed fiscal year), the number and location of stores trading were:

	Australia	New Zealand	Total
Food, Liquor & Fuel			
Coles	505		505
Bi-Lo	214		214
Coles Myer Liquor Group	669		669
Coles Express	597		597
Total Food, Liquor & Fuel	1,985		1,985
Kmart			
Kmart	167	13	180
Kmart Tyre & Auto	65		65
Total Kmart	232	13	245
Officeworks			
Officeworks	87		87
Harris Technology	8		8
Total Officeworks	95		95
Myer	61		61

Megamart	9		9
Target			
Target	142		142
Target Country	113		113
Total Target	255		255
Total	2,637	13	2,650

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The above store numbers include freestanding Kmart Tyre and Auto and Tyremaster stores. As at July 31, 2005, the Company operated a total of 2,650 stores, an increase of 72 stores on the 2,578 stores at July 25, 2004, which compared with 1,957 stores at July 27, 2003. The Company opened, acquired, closed and divested stores as follows:

	2005			2004			2003		
	Opened/ Acquired	Closed/ Divested	Net Increase/ (Decrease)	Opened/ Acquired	Closed/ Divested	Net Increase/ (Decrease)	Opened/ Acquired	Closed/ Divested	Net Increase/ (Decrease)
Food, Liquor & Fuel	84	42	42	652*	33	619	140	14	126
Kmart	21	1	20	5	2	3	10	1	9
Officeworks**	9	1	8	11	9	2	21		21
Myer				1	4	(3)		3	(3)
Megamart				1		1	3		3
Target	11	9	2	9	10	(1)	8	13	(5)
TOTAL	125	53	72	679	58	621	182	31	151

* Primarily acquisition of Shell fuel sites from multi-site franchisees (Coles Express)

** Includes Harris Technology

Strategy

History

Following the appointment of Mr. John Fletcher as CEO in September 2001, the Company announced a five-year growth strategy in March 2002. The strategy reflected the Company s goal of becoming Australia s number one retailer in all of its brands, by leveraging the strength of the Group and working as a unified team, with a shared desire to provide the best value to customers and grow shareholder value. The key planks of the strategy were:

Continuous brand improvement

Restoring operational excellence in the Kmart, Target and Myer brands

Growing the Food and Liquor brand

- Improving efficiencies
- Further strengthening the balance sheet

Sustainable growth

- Strong store network expansion 300+ new stores within the five year plan
- Rewarding loyalty for all customers
- Supply chain and information technology improvements building efficiencies and investing for the future

Group culture

- Recruiting and developing the best people
- Clear accountability management rewarded on Company-wide success
- Succession planning to identify future leaders
- Enhanced customer focus
- All brands working together to leverage Group scale

Safety

- Strong focus on occupational health and safety to prevent and reduce accidents, thereby boosting productivity, reducing costs and being responsible for the Company s staff and customers

On September 25, 2003, the Company announced a program of strategic whole-of-company initiatives to leverage the unique competitive advantage of the Group, to drive better value and service for customers, and better financial returns for shareholders. The initiatives encompass transformation of CML s supply chain, IT systems, organizational culture and loyalty offering.

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Supply Chain

The Company s initiatives to transform its supply chain involve significant one off, up front capital expenditure costs (up to A$600 million) in the five years to 2008. These costs will largely be incurred in the financial years 2005-2007.

Transformation of the supply chain is intended to result in doing business better for customers, simpler for stores and cheaper for Coles Myer Ltd.

Key features include:

Better systems to improve on-shelf availability of stock for customers;

Improved technology to simplify processes and reduce costs for suppliers and CML;

Streamlined deliveries into stores; and

More efficient distribution network, including the reduction of distribution centers to best practice levels.

Supply chain transformation expenses in 2005 were A$43.2 million.

The food and liquor brands - enabled by Supply Chain and Information Technology - continue to transform the way they do business to provide better outcomes for customers, shareholders and team members.

The changes across the food and liquor network are designed to deliver improved on-shelf availability, quality and value for customers and a simpler, cheaper and better model for stores.

In-store changes included the introduction of roll cages and the conversion of merchandise lines into shelf ready packaging, both enabling simpler and more efficient processes for store team members in the handling and replenishment of stock.

Roll cages were introduced into more than 250 supermarket and liquor stores across Victoria. The rollout will continue progressively over 2006.

Returnable plastic crates taking fresh produce from grower to the supermarket shelf with one touch - have been trialed, with strong feedback supporting the rollout across the network from October, 2005. The containers are used to improve productivity across the value chain, allowing for delivery of fresher product to customers.

Merchandise delivery is also being transformed as the Company continues to improve the overall effectiveness and costs of the food and liquor supply chain.

During 2005, direct-to-store deliveries from suppliers reduced by 25 deliveries per store per week. This means 15 million fewer cartons delivered directly to stores.

In January 2005, the factory gate pricing model went into operation, with over 2.5 million cartons per month purchased that way. By the end of 2006 the Company anticipates 40 percent of our food and liquor products will be purchased in this manner. The shift to central management of primary freight means more cost effective management of capacity and improved freight utilization within Australia s supply chain.

The food and liquor distribution network rollout commenced in 2005, with tenders being let for the construction of a number of new distribution centers. The new network is designed specifically to fulfill CML s future supply chain requirements. By separating fast and slow moving products into separate distribution centers the Company can ensure better, more efficient management and flow of products into stores.

New systems and processes are being installed in new and existing distribution centers to ensure more efficient stock management and picking, including a new warehouse management system, which is now operational in the network.

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IT Transformation

The IT transformation strategy focuses on removing complexity, duplication, effort and cost of systems, through the introduction of common technology across the brands. The strategy will see an increased emphasis on innovation to deliver IT business solutions to enable the brands to serve the customer better. The systems changes are a prerequisite to the transformation of the supply chain.

Loyalty

The new Coles Myer Loyalty program combines the Coles Express fuel discount offer, the enhanced FlyBuys™, the Coles Myer Source™ MasterCard and the MYER One Program.

The Coles Myer Source ™ MasterCard was re-launched in June 2005, with a range of new features designed to reward customers for their everyday shopping.

The MYER One customer program now has over 775,000 members.

Cultural change

Fostering the right culture is a critical part of achieving the Company s goals. The four elements of the strategy are recruiting and developing the best people, building leadership, aligning performance and reward with the strategic goals, and providing a safe working and shopping environment.

A number of further initiatives were introduced during the course of 2005, including the introduction of company-wide values and behaviors to underpin the Company s strategic goals and make Coles Myer a better place in which to work, shop and invest.

The Group has also initiated a new program to improve the diversity of our workforce to ensure that it better reflects the make-up of our customers and the communities in which we operate. This program is designed to build a working environment in which all team members feel valued, where difference is respected, and to equip us to continue to better understand our customers needs.

Outlook Strategic review

The CML Group has also begun developing the next five-year strategy so that there is some overlap between the current strategy and the one that will take the CML Group out to 2010. Refer Item 4A HISTORY AND DEVELOPMENT Recent Developments.

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RETAIL OPERATIONS

FOOD, LIQUOR & FUEL GROUP

These brands represent the largest grouping in Coles Myer in terms of sales. At July 31, 2005, the Food, Liquor & Fuel Group operated 1,985 stores. The roll out of our fuel and convenience brand commenced on July 28, 2003, from which point in time the Food & Liquor Group became known as the Food, Liquor & Fuel Group. The group comprises Supermarkets, Coles Myer Liquor Group, Coles Express and Coles Online.

The **Supermarkets** brand comprises the Coles and Bi-Lo brands, supported by a single cohesive team incorporating primarily centralized finance, administration, marketing and buying functions.

Coles supermarkets aim to delight customers with great value and convenience. Coles is committed to giving customers more for their money through competitive everyday prices, supported by strong and relevant promotions.

At July 31, 2005, the brand operated 505 stores across Australia, with 20 new supermarkets opened during the year. The network ranges from small metropolitan stores to large flagship sites, with selling area of approximately 20,000 to 50,000 square feet. The supermarkets offer customers a wide range of fresh food, groceries and general merchandise. Coles extensive offer includes both national and housebrand products. Coles Supermarkets operates an Internet shopping service called Coles Online.

During the year Coles launched its housebrand strategy, which is designed to optimize choice for customers. The strategy sees customers able to choose housebrand products from three distinct tiers being: $mart Buys , you ll love Coles and George J Coles .

Fresh produce departments with a market look are now a feature in most stores. Ongoing commitment to innovation and improved value has seen expansion of the fresh range. Product innovation in value-added ready-to-eat products offer customers better choice and convenience.

Bi-Lo

The Bi-Lo aim is to be Australia s leading discount supermarket, offering the cheapest weekly shopping basket of fresh food and groceries to value conscious customers.

Bi-Lo operated 214 stores at July 31, 2005, including 10 new supermarkets openings during the year. The average store size is smaller than Coles, with the network focused on local neighborhoods and regional areas.

Bi-Lo offers everyday grocery items, along with a housebrand range. Through the year Bi-Lo focused on enhancing the quality of fresh food and expanded the housebrand range by introducing or redesigning packaging for more than 400 Bi-Lo products.

Coles Myer Liquor Group

The Coles Myer Liquor Group (CMLG) operates four major brands Liquorland, Vintage Cellars, Theo s and 1ST Choice Liquor Superstore. The inaugural 1ST Choice Liquor Superstore opened in Melbourne in May 2005.

As at July 31, 2005 the brand operated 669 liquor sites, including 30 hotels, with representation in all states except Tasmania. Approximately one third of stores are located adjacent to a Coles Myer supermarket, with the majority being freestanding stores.

Liquor retailing and gaming is regulated in Australia, with each state and territory controlling liquor sale via liquor licensing and gaming via gaming licensing. State Government liquor and gaming authorities and in the case of liquor licensing, statewide police agencies execute the licensing regulations in their regions with each region s regulations reflecting their own unique regional issues. Consequently, the degree of regulation differs from State to State. The Company is not aware of any action or proposed action that would invalidate any of its liquor licenses.

The Coles Myer Liquor Group has expanded its liquor retailing over the past five years through a combination of acquisitions and organic store growth. A major growth driver over the next five years is expected to be via the rollout of its large format 1ST Choice Liquor Superstores.

Coles Express

During 2004, the Company acquired from Shell multi-site franchisees, the right to operate 585 fuel and convenience outlets and eight standalone convenience stores for A$103.7 million (including transaction costs).

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Currently the brand operates 597 fuel and convenience stores across Australia, making it the nation s largest fuel and convenience retail operation.

Coles Myer entered into a supply agreement with Shell for fuel and lubricant products, and operating leases for the service station sites. The sites are branded both Coles Express and Shell.

Coles, Bi-Lo and Liquorland customers who make purchases over a certain amount receive a cents per liter fuel discount when they present their receipts at a Coles Express service station.

KMART

Kmart

At July 31, 2005, Kmart operated 180 stores in Australia and New Zealand. Measured by sales, it is Australia s leading discount store business and sells a wide range of items, including sporting goods, toys, electrical appliances and apparel, with a mix of international and national brand names as well as private labels.

Kmart is positioned as a low cost, discount department store for the entire family. Kmart stores typically range in size from 47,500 to 75,000 square feet. They are mostly located in suburban shopping centers in major cities and in larger regional shopping centers, and cater for the needs of a wide range of customers by offering an extensive variety of goods at competitive prices.

Kmart s focus is a consistent offer, with low everyday prices supported by additional specials and seasonal sales events, backed by a lowest price guarantee.

The first Kmart in Australia was opened in Melbourne in 1969, and was a joint venture between Coles and the US based Kmart Corporation (KMC). The new business introduced the discount store concept to Australia. In 1978, Coles acquired full ownership of the joint venture.

In 1994, the Company renewed its License Agreement with KMC, pursuant to which Coles Myer has the exclusive right to use the Kmart name in Australia and New Zealand. Coles Myer does not believe that there is a significant risk of the License Agreement being terminated in a manner that would have a substantial adverse impact on the Company s operations. Besides the License Agreement, Coles Myer has no other affiliation or relationship with KMC.

In New Zealand, the business supplies similar product ranges to Australia. The Company opened its first Kmart store in New Zealand in October 1988, and the chain had 13 stores operating at July 31, 2005.

Kmart Automotive

Kmart Automotive consists of two automotive business units trading under the brand names Kmart Tyre & Auto Service and Tyremaster Wholesale . There are a total of 195 Kmart Tyre & Auto Service outlets of which 130 are either attached or in close proximity to a Kmart store and a further 65 located as stand-alone sites.

OFFICEWORKS

Officeworks

Officeworks is Australia s leading office supplies retailer for small to medium sized businesses, home offices and personal shoppers. Officeworks offers a range of over 10,000 products, including stationary, consumables, business machines, office furniture and printing services.

Officeworks is well represented in all major Australian cities, as well as many regional areas. The first store was opened in 1994, with 87 Officeworks operating at July 31, 2005. Officeworks operates 3 brands, Officeworks Superstores, Officeworks BusinessDirect and Harris Technology.

Harris Technology

Harris Technology is consolidating its brand after aggressive growth in the past several years. A strategic review was performed in early 2005, the aim of which was to identify where Harris could be most successful. As a result of that review, the brand is refocusing on its traditional customers the small business sector as well as technology professionals.

TARGET

Target

Target offers its customers apparel and soft homewares, underpinned by its strong housebrand strategy. Target is positioned in the market between department stores and discount department stores, competing largely with specialty stores.

Target s core product ranges include womenswear, intimate apparel, menswear, childrenswear, accessories, soft homewares, electrical, toys and other general merchandise. Apparel is predominantly Target-branded, with national brands and licenses used to complement the Target range, such as the popular Piping Hot and World Industries label in youth apparel.

Target stores are typically located in suburban and large regional shopping centers and precincts. Target operated 142 stores at July 31, 2005, with store selling areas ranging from approximately 21,000 to 73,000 square feet.

Target Country

A total of 113 stores trading as Target Country were operating at July 31, 2005. These stores are located primarily in rural and regional communities, and offer a smaller range of Target merchandise, predominantly apparel and soft homewares such as manchester and tableware.

MYER

Myer is Australia s largest department store group (measured by sales and store numbers) with stores operating in the states of Victoria, New South Wales, Queensland, South Australia, Tasmania, Western Australia and the Australian Capital Territory.

Myer operates full range department stores with selling areas ranging from around 130,000 square feet up to around 550,000 square feet in the Myer Melbourne (Victoria) flagship store.

Myer is positioned as a brand-focused, value-driven department store, providing a range of well-known national, international and private brands and good service in a pleasurable store environment. Myer operated 61 stores as at July 31, 2005. The larger Myer stores are situated in downtown locations, with other stores positioned mainly as anchor tenants in suburban shopping centers and in major regional towns.

In 2005, Myer expanded its merchandise offer by adding new national and international brands together with an ongoing focus on private brands.

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Customer service continued to improve with a strong ongoing focus on service levels and selling skills. All frontline team members received customer service training this year and many managers were further trained in advanced selling techniques. Strong marketing reflects the repositioning. The store environment is also improving, with more open layouts, clear aisle ways and strong visual merchandising.

As part of the development of Coles Myer s next strategic plan, a process began in September 2005 to consider ownership options for Myer, including retention, de-merger and trade sale. The process will determine which is the best outcome for Myer, Coles Myer and it shareholders. No timeframe has been set for the completion of this process. Also refer to Item 4A HISTORY AND DEVELOPMENT RECENT DEVELOPMENTS.

MEGAMART

An electronics and furniture format, Megamart, was launched during 1999. Megamart operated nine stores trading in Victoria, New South Wales, Queensland and Western Australia. The Megamart brand was re-launched in December 2004 with an increased focus on the latest technology and entertainment. While sales improved, the nine stores in four states did not provide the scale needed to deliver the required profit improvement. As a result, Coles Myer has announced that all nine Megamart stores will be divested in the 2006 financial year. Also refer to Item 4A HISTORY AND DEVELOPMENT RECENT DEVELOPMENTS.

RETAIL SUPPORT

Coles Myer has made a strategic shift from being an active portfolio manager of decentralized, autonomous business units to a Company that shares proprietary skills through its brand concept, and shares support activities through the creation of the Retail Support infrastructure.

Retail Support provides support functions to the retail brands and senior management. The aim is to reduce costs, improve efficiencies and provide leverage to the CML Group through the coordination and integration of joint services. Retail Support also has a corporate function and develops policy across the Coles Myer Group.

The main departments within Retail Support are Accounting Services, Treasury, Taxation, Supply Chain, Retail Property, Human Resources, Corporate Affairs, Information Technology, Legal, Risk Management and Compliance, and Customer Strategy and Financial Services.

Finance

Coles Myer Finance Limited (CMFL), a wholly owned subsidiary, is the entity responsible for all funding and funds management for the Company. CMFL is the centralized treasury for Coles Myer which provides an integrated cash, debt and financial risk management service to Coles Myer, and operates in accordance with policies and authorities approved by the Board. CMFL operates as a managerial division of the Company, and not as a profit center.

At July 31, 2005, the Company had no secured liabilities, other than a controlled entity having issued a floating charge over assets, capped at A$80.0 million as security for payment obligations to a trade creditor. The Company s borrowing structure is flexible and consistent, based on the acceptance by financial institutions of the Standard Coles Myer Negative Pledge (the Negative Pledge) and the Common Provisions Deed Poll (CPDP). The Negative Pledge is in the process of being replaced by the CPDP, which better reflects current market practice for credit support.

The CPDP is the basis of the Company s unsecured borrowing structure providing the following financial undertakings (terms have the meanings defined in the CPDP):

(1) Limitation on Total Liabilities: The CML Group will at all times maintain Consolidated Total Liabilities at no greater than 80% of Consolidated Total Tangible Assets;

(2) Limitation on Secured Debt: The CML Group will at all times maintain Secured Debt (excluding Indebtedness secured by any encumbrance created or extended in accordance with the CPDP) at no greater than 20% of Consolidated Total Tangible Assets; and

(3) Fixed Charges Cover: The CML Group will at all times ensure that the ratio of the aggregate of EBITDA and Rental Expense to Total Fixed Charges exceeds 1.65 times.

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In addition, an undertaking is given not to provide security over CML Group assets to parties with the benefit of the CPDP, without providing security to all parties of the CPDP.

The Negative Pledge continues as the basis of an unsecured borrowing structure for certain unmatured debt, providing financial ratio restrictions of total liabilities to total tangible assets at 80%, and the ratio of secured liabilities to total tangible assets at 40%. In addition, a pledge is given not to provide security over Company assets, in contravention of the terms of the Negative Pledge, without providing equivalent security to parties to the Negative Pledge. Similar ratio restrictions are included in Trust Deeds to provide a standard borrowing structure.

The CML Group has been in compliance with its financial covenants contained within the Negative Pledge and CPDP during 2005.

The CPDP has been attached as an Exhibit at Item 19.

At July 31, 2005, all foreign currency borrowings were hedged to cover exposure to adverse exchange rate movements. Coles Myer s interest rate risk management strategy is to have approximately 50% of core debt hedged at fixed interest rates beyond 12 months in maturity. Core debt represents the Company s long term, non-seasonal debt. See also Item 11 Quantitative and Qualitative Disclosures about Market Risk for a description of the Company s hedging activities.

Credit Cards

The Coles Myer Source™ MasterCard is a general-purpose credit card for use within all the Coles Myer brands as well as externally wherever a MasterCard is accepted.

The Coles Myer credit card portfolio includes two other credit card products, namely the Coles Myer Store Card and the Coles Myer Source™ MasterCard with FlyBuys**™** Points EXTRA FAST, which has an annual fee. There are in excess of 1.5 million Coles Myer Branded credit cards issued.

GE Capital Finance Australasia Pty Ltd (GE), a subsidiary of General Electric Capital Corporation of the U.S., provides credit facilities to customers of various Coles Myer brands, and for other retailers. Under the contractual arrangements between Coles Myer and GE, GE has certain exclusive rights to provide credit facilities to customers of the CML Group and Coles Myer and GE conduct joint marketing programs to promote both the Coles Myer Source™ MasterCard and Coles Myer Card**™**.

PURCHASING AND SUPPLIERS

All Coles Myer brands have embraced the concept of developing a partnership approach with their suppliers to ensure customers have access to the quality, range and value they demand. The brands are focused on developing mutually beneficial relationships with approximately 32,000 active suppliers.

While the Company generally does not enter into long-term purchasing agreements, it has entered into a ten-year supply agreement in relation to petroleum products from the Shell Company of Australia.

Orders are generally placed with suppliers depending on the sales and stock levels of the product. With the exception of direct sourcing from overseas which is still a small part of the Company s overall purchasing, this method in general allows the Company to retain maximum flexibility to adjust to changes in retail markets.

The Company is not substantially dependent on a single supplier or purchasing contract. Coles Myer purchases substantial lines of Australian-made goods, but supplements its ranges with imported goods.

In recent years Coles Myer through each of its brands has moved to increase its purchases of goods on a direct sourcing basis from overseas.

The Company hedges against adverse foreign currency movements for directly imported goods.

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COMPETITION

Coles Myer s supermarkets (Coles and Bi-Lo) operate in a competitive retail sector. Coles and Bi-Lo compete against the large national Woolworths supermarket chain (operating as Safeway in Victoria). Independent operators, regional chains, and convenience and specialty stores provide further competition. During 2001, the German-based international supermarket chain ALDI commenced operations in Australia by opening its first supermarket in New South Wales, and has since opened stores in other states and territories.

Coles Myer Liquor Group through its major brands, Liquorland, Vintage Cellars, 1ST Choice Liquor Superstore and Theo s also competes nationally against the Woolworths chain, which during 2005 acquired ALH (see Item 4A HISTORY AND DEVELOPMENT RECENT DEVELOPMENTS), a large hotel and liquor operator and recently acquired the Taverner Hotel Group. In addition there is competition from independent retail chains, sole-traders and hotels that sell packaged liquor.

Coles Express competes against other retailers in the fuel and convenience industry including Mobil, BP, Caltex, Woolworths Petrol+ (a retail venture between Woolworths and Caltex) and 7-Eleven. From the perspective of a food and liquor promotional scheme using fuel, the primary competitor is Woolworths Petrol+ and Woolworths/Caltex co-branded service stations.

The Company has a strong position in Australia in the discount store market through Kmart and the Target and Target Country chains. These chains compete against other chains such as Woolworths Big W and Millers Retail for apparel, and against numerous operators of small chains or single specialty stores.

The department store Myer faces national competition from David Jones, Harvey Norman and Harris Scarfe, as well as a number of largely regional competitors. General competition is also provided by specialty store operators and discount stores.

Competition between the Group s general merchandise and apparel brands is minimized by clear and distinct strategic positioning of each brand.

Officeworks has a strong position in Office Products. A wide range of brands compete on a category basis, however, no one competitor has a comparable offer across all categories.

For Harris Technology, competition differs depending on sales channels. In the retail sector, Harvey Norman, Dick Smith Electronics, Domayne are major competitors. In the direct sector (on line and contact centre), e-store, Dell, City Software are the key players.

ADVERTISING AND PROMOTION

Coles Myer and its brands continue to be amongst the largest advertisers in Australia. Advertising expenditure in 2005 was A$474.5 million, which compares with A$431.7 million in 2004 reflecting new business initiatives, sales growth and increased competitive activity in our major markets.

Coles Myer uses the media agency Universal McCann, to plan and buy television, radio, cinema, press, magazines and on-line media in all metropolitan and regional media markets on behalf of all brands.

Each of the brands selects their own advertising agencies and together they develop their own marketing strategy, develop the creative concept and utilize various media to accommodate the range of marketing programs across the Company.

Coles appointed a new strategic and creative agency, Solomon Partnership, and evolved the Save Everyday campaign to focus on the brand s core value and convenience proposition. Coles also successfully trialed a new store visual identity scheme that improved in-store communication to customers and better promoted the value and quality of the merchandise offer. This new scheme will become the store standard in 2006.

Bi-Lo launched a new campaign cementing its discount position in the market and further improving price perceptions of the brand.

A new strategy to grow our liquor brands was developed and launched in March 2005. A major marketing review was completed during 2005, culminating in the definition of key customer behavioral segments, ensuring clear positioning and differentiation for our core liquor brands - Liquorland, Vintage Cellars, Theo s and 1st Choice Liquor Superstore.

Target received a number of national awards for catalogue effectiveness, as well as Young Australian Designer of the Year. Under the award-winning 100% Happy campaign, Target implemented campaigns to further strengthen core brands, including Womenswear, Underwear and Homewares.

Target launched a major denim advertising campaign reinforcing Target as a destination for denim for all the family. This campaign helped reinforce perception that Target offers on-trend, fashionable denim apparel.

Kmart continues to evolve and refresh its marketing communication whilst reinforcing its core price / value driven platform. A new creative advertising agency, Cummins & Partners, was appointed in February 2005. The purpose of this appointment was to create new ideas and campaigns that build customers perception that Kmart has a portfolio of desirable, known brands**.**

In February 2005 a new sub-brand for Officeworks was launched in the market. Officeworks BusinessDirect was created through the integration of Officeworks Direct and Viking Office Products. Over the past two years the focus has been on bringing the two brands together and the launch marked a significant step in the Officeworks journey. As a result of the integration, Officeworks BusinessDirect is Australia s largest direct marketer of office supplies and the growth of the direct brand will continue to be a key strategic priority for the brand moving forward. Marketing campaigns throughout the year included the regular Christmas, Tax Time, The Works and Back to School promotions. Officeworks marked its tenth birthday with a sales celebration campaign.

Myer once again produced a multi-channel integrated marketing campaign. Myer continued with the My Store, Myer branding throughout its marketing activity.

Highlights for the year included successful and widely acclaimed seasonal fashion launches, the use of the actor Carson Kressley as the face of its Spring Racing Sponsorship and the launch of MYER One (see below).

Loyalty Programs

Myer continued its focus on loyalty programs by introducing the MYER One program in August 2004. The MYER One program is targeted to high value Myer customers and rewards them for shopping and treats them to special events, previews and offers. It is complementary to the existing Coles Myer loyalty programs such as CML Source™ Master Card and Fly Buys™ - as both have mass-market appeal. Since launch, MYER One has attracted over 775,000 members, the majority of whom shop at least monthly.

FlyBuys is the customer loyalty program for the majority of Coles Myer brands. Membership of FlyBuys is free to customers, with members issued a card to present at point of sale when shopping. Each customer holds a discrete account and points are automatically credited to the account, based on eligible expenditure. When enough points have been accumulated, they can be exchanged for free air travel, Coles Myer shopping vouchers or other benefits. Points expire after three years.

The FlyBuys program was re-launched in September 2003 and continues to have very high penetration within Australia with over 2.6 million active member households (average 2.2 cards per household).

FlyBuys is a joint venture between Coles Myer and National Australia Bank, and other major participating companies include Best Western Australia, Budget Rental Cars, Michael Hill Jewellers and Ezibuy.

Under the terms of a service agreement between Coles Myer and the FlyBuys partnership, Coles Myer (and other participants) pay the partnership for points allocated as a result of eligible purchases. The partnership uses this revenue to pay for the air travel and other awards. See also Item 7B - RELATED PARTY TRANSACTIONS - Transactions with other related parties, for details of Coles Myer s cost of participation.

On June 3, 2005, the Company launched a revamped Coles Myer Source™ MasterCard with a free loyalty offer. The Coles Myer Source™ MasterCard is a general purpose credit card for use within all the Coles Myer brands as well as externally wherever a MasterCard is accepted.

Existing Coles Myer Source™ MasterCard customers have been offered the new credit card product that has no annual fee and offers an additional fuel discount of 2 cents off per litre for a minimum spend of A$30 at participating Coles Myer Food and Liquor stores. Customers use the additional 2 cents voucher together with the standard (Food & Liquor) 4 cents discount receipt to save 6 cents per litre on fuel at Coles Express. Customers also receive 2 FlyBuys™ points for every A$5 spent on the Coles Myer Source™ MasterCard at participating

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Coles Myer stores. This means that customers shopping within a participating Coles Myer brand, who present their FlyBuys™ card with their Coles Myer Source™ MasterCard when paying for the purchase will receive up to 4 FlyBuys™ points for each A$5 of spend. The addition of free petrol discounts and FlyBuys™ points to the Coles Myer Source™ MasterCard is designed to encourage enhanced customer loyalty and drive increased sales on the credit card across all Coles Myer Brands.

RESEARCH & ANALYSIS

The Company provides its brands with access to information concerning the retail environment including customer insights, economic, social, and demographic trends, and competitor intelligence through a centralized research and analysis unit. This unit accesses and shares information, knowledge and expertise across the group, leveraging our buying power and return on investment in information.

The Company strives to understand consumers and their current and future needs and to identify appropriate opportunities to meet these needs in our stores. The research unit utilizes a wide variety of research methods to identify consumer needs including qualitative methods such as focus groups, accompanied shopping trips, ethnography, immersions, and quantitative studies such as brand, advertising and satisfaction tracking. Increasingly the Company utilizes customer data from the point of sale to understand buying patterns and preferences, and thereby modifying assortments to deliver to customer needs.

TRADING HOURS

Coles Myer and other large retail chains are generally permitted to trade seven days a week in all state capitals except Perth, Western Australia.

Restrictions on Sunday trading affect the following number of stores in Perth:

Coles	55
Kmart	13
Target	10
Myer	4
Officeworks	6
Liquor Stores	96 - Most of the stores are affected

Stores located in Perth (central business districts and tourist areas) and other regional areas of Australia are permitted to engage in limited Sunday trading for seasonal events (summer, Christmas holiday period).

REGULATION

The Australian Government has a pro-market competition policy. Due to its size and the fact that it operates in important markets like grocery and fuel, Coles Myer is subject to political and regulatory scrutiny. However, the current Government is not proposing legislative or policy changes that would materially or disproportionately impact Coles Myer.

The Australian federal political system, unlike the United States, does not have fixed election dates. Rather, the calling of an election is a matter of political judgment and timing, in accordance with the constitutional and legislative framework that governs the electoral timetables and processes.

The Australian Constitution requires periodic elections for both federal Houses of Parliament, with separate provisions reflecting the different constitutional status of each House. The Commonwealth Electoral Act of 1918 implements the Constitutional scheme.

A general election in Australia was held on October 9, 2004. The Australian Liberal Party in coalition with the National Party was re-elected. The term of the next (the 41st) Federal Parliament of Australia will expire no later than three years after its first sitting after the election. The following election for the House of Representatives must be held on a Saturday, not more than 68 days after the expiry of the parliament s term.

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Government Regulation

Due to its size and the markets in which it operates, including fuel, grocery and liquor, Coles Myer is subject to a range of laws and regulations in Australia and New Zealand.

Australian Regulation

As a listed public company, Coles Myer is subject to many business laws and regulations including, but not limited to:

- the listing and disclosure rules of the Australian Stock Exchange;
- the Australian Corporations Act 2001; and
- Australian accounting and taxation laws and regulations.

Due to the nature of the Company s retail businesses, the Company is required to operate in compliance with many Australian Federal, State, Territory and local laws and regulations including, but not limited to:

- the Trade Practices Act 1974, including the areas of product liability, restrictive trade practices, unconscionable conduct, consumer protection, the Retail Industry Code of Conduct, and various State and Territory Fair Trading Acts;
- the standards developed by Food Standards Australia New Zealand (FSANZ) and the Therapeutic Goods Administration;
- the sale of alcohol and tobacco, the operation of hotels and gaming machines, both at the Federal and State level;
- the enforcement of health and safety standards by State and local health authorities;
- local planning laws covering zoning, environmental and building regulations;
- State and local laws governing trading hours, as discussed in item 4.B.; and
- legislative provisions relating to privacy matters such as restrictions in the use of personal data (for example, in the use of customer data for, and obtained in the context of, customer loyalty programs or in direct marketing activities).

Coles Myer is subject to Federal and State laws and regulations covering, but not limited to:

- employment practice standards for workers;
- discrimination and equal opportunities in employment; and
- workers compensation, workers compensation self-insurance and relevant Occupational Health and Safety regulations.

The Trade Practices Act 1974 (the Act) is the Australian Federal legislation which impacts most directly and widely on the retail and operational activities of Coles Myer, including the following areas:

Restrictive Trade Practices

In 1993, the Act was amended to prohibit acquisitions of shares or assets, which have the effect of substantially reducing competition, unless such acquisitions are authorized by the Australian Competition and Consumer Commission utilizing public benefit criteria.

A further amendment was an increase in penalties for contravention of Part IV (the Restrictive Trade Practices) of the Trade Practices Act. The penalties increased to a maximum of A$10 million for a body corporate, per offense, and a maximum of A$500,000 per offense for individuals.

Unconscionable Conduct

In 1998, the Act was further amended to introduce a specific prohibition against unconscionable conduct in business transactions . This amendment was introduced to provide small businesses with further protection in their commercial dealings with large corporations. This provision sets out several factors, which a Court must consider in determining whether unconscionable conduct has occurred. The provision originally only applied to transactions under A$1 million. However, in July 2001 the transactional limit was increased to A$3 million, which extends the coverage considerably.

Product Liability

Strict product liability exists in Australia. This regime is substantially based on the European Community Product Liability Directive and provides that a person who is injured, or whose property is damaged as a result of defective or unsafe goods, has a right to compensation from the manufacturer without the need to prove negligence or breach of contract. The Act provides that this regime cannot be excluded, restricted or modified by

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contract. This regime also substantially widens the classes of persons who might sue, and extends the definition of manufacturer to include importer as well as supplier in some circumstances.

Consumer Protection

In July 2001, the maximum penalty for a contravention of Part V (Consumer Protection Provisions) of the Act was increased to A$1.1 million for corporations (from A$200,000) and A$220,000 for individuals (from A$40,000).

Retail Grocery Industry Code of Conduct

Following a parliamentary inquiry into retailing, a voluntary retail grocery industry code of conduct (RGI Code) was established in August 2000, to apply to vertical relationships in the retail grocery industry. Coles Myer supports the introduction and application of this Code and is a signatory. RGI Code has recently had its first independent triennial review and some recommendations for improvement have been accepted by the Government and are currently being implemented by the Code Administration Committee. It is not anticipated that there will be any additional impact on CML Supermarkets.

New Zealand Regulation

In New Zealand, the Company is subject to various legislative provisions relating, but not limited, to the sale of products, management of facilities, employment practices and health and safety of employees, privacy matters, and taxation of foreign earnings.

The New Zealand Commerce Act 1986 is the primary trade practice legislation in New Zealand and Coles Myer s New Zealand operations are also subject to the taxation and accounting legislation in that country.

Changes to Business Taxation

The Company has implemented the tax consolidation legislation as of July 29, 2002 with no material impact on the consolidated financial statements. The primary impact of the new legislation for Coles Myer is that the Company now files a consolidated income tax return with the Australian Tax Office with respect to subsidiaries in the tax consolidated group, instead of filing separate income tax returns for all subsidiary companies. The transition to the tax consolidation legislation provided Australian companies with the opportunity to reset tax bases of assets and liabilities, however no material impacts were recorded. See also Note 6 to the consolidated financial statements included in Item 17.

Under tax consolidation rules, franking credits currently held within wholly owned Australian resident subsidiaries will be pooled and will be available to frank Coles Myer Ltd. s dividends. All franking credits that arise after tax consolidation will belong to Coles Myer Ltd. and will be available to frank its dividends.

Changes have been made to the imputation system, and subject to certain conditions, Coles Myer Ltd. is now able to determine the amount of franking credits that it will allocate to its dividends. Previously, dividends had to be franked to the maximum extent possible.

In practice, it is expected that Coles Myer Ltd. will continue to frank its dividends to the maximum extent possible.

See also Item 10E. Taxation for further information on the dividend imputation system.

INSURANCE

All brands in the Company are covered for material losses by insurance policies, including but not limited to workers compensation, marine transit (to cover directly imported merchandise whilst it is being transported), property, public and product liability. All insurances are in excess of self-insured retentions.

The Company has a risk management program in place to assess appropriate levels of self-insurance. The material levels of self-insurance maintained by the Company are:

- public and products liability where up to A$500,000 per claim is self-insured,
- workers compensation in most Australian states where the Company self-insures up to A$1 million per event,
- property insurance where the Company self-insures up to A$4 million in any one year.

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As part of the risk management program, insurance that is procured externally is sourced from a portfolio of providers, which is monitored based on a minimum A- Standard and Poors credit rating.

TRADEMARKS AND LICENSES

Trademarks

The Company is entitled, by virtue of a License Agreement with Kmart Corporation (KMC), to the exclusive right to use the Kmart name, service marks, and trade-marks in Australia and New Zealand. The license extends until 2018 with unlimited further renewals for five years at a time at the Company s election. In consideration for the license, the Company pays an annual fee to KMC based on gross sales revenue per fiscal year, but not exceeding A$5 million for Australia and NZ$1 million for New Zealand. The two License Agreements with KMC (one with Kmart Australia Ltd and one with Kmart New Zealand) have been attached as Exhibits at Item 19.

The Company has no other relationship with Kmart Corporation, nor does it receive from, nor share with, Kmart Corporation any other services, strategies nor combined purchasing programs.

Coles Myer does not have any relationship or agreement with Target in the US. Coles Myer registered the trademark Target name and symbol in Australia in 1973.

Coles Myer has the right to exclusive use of all material trademarks and brand names of its businesses referred to in this Annual Report in all its trading jurisdictions. Coles Myer is a licensee of the FlyBuys™ trademark. The licensor of FlyBuys™ is Loyalty Pacific Pty. Ltd. The Company holds a 50% share in Loyalty Pacific Pty. Ltd. and the National Australia Bank owns the remaining 50% shareholding.

Licenses

Liquor retailing, gaming and the operation of hotels in Australia are regulated by the respective State and Territory Governments. Strict licensing regimes operate in each state and territory, which require CMLG to hold liquor licenses and in the case of Liquorland Hotels, gaming licenses, for each of their locations.

The Company is not aware of any action or proposed action that would invalidate any of its liquor licenses.

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C. ORGANIZATIONAL STRUCTURE

The Coles Myer Group consists of Coles Myer and its subsidiaries, which conduct business in Australia and New Zealand. A complete list of subsidiaries and their details can be found at Note 34 to the consolidated financial statements included in Item 17. Of these subsidiaries, the following were significant subsidiaries of Coles Myer at July 31, 2005:

Coles Supermarkets Australia Pty. Ltd.

Kmart Australia Ltd.

All the significant subsidiaries are wholly owned and incorporated in Australia.

D. PROPERTY, PLANT AND EQUIPMENT

At July 31, 2005, the Company operated a total of 2,650 stores in Australia and New Zealand, with total selling area of approximately 48 million square feet. Properties include locations in downtown shopping areas, regional and minor shopping centers, strip retail locations, and freestanding stores.

Coles Myer is constantly engaged in new store development and refurbishment of existing stores. This process has resulted in an upgrading of the network of retail sites.

Leases entered into by the Company generally comprise a base rental together with a rental payment related to a percentage of sales turnover. Leases generally range for terms of 10 to 25 years, and usually provide options for the Company to extend the lease terms. The vast majority of the premises occupied are leased, as distinct from freehold (owned).

At July 31, 2005, the Company s owned property portfolio was recorded at A$740.2 million (2004: A$425.4 million), held either directly, or indirectly through investments in property joint ventures.

It is the Company s policy to undertake revaluations of freehold and investment properties with sufficient regularity to ensure that the carrying amount of property does not differ materially from its fair value at balance date. This is in accordance with Australian Accounting Standards. The latest valuation, undertaken during 2005, resulted in a net increase in the aggregate book value of properties and investments in property trusts by A$56.1 million. See also Notes 1(i), 1(j), and 11 to the consolidated financial statements included in Item 17.

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ITEM 5 OPERATING AND FINANCIAL REVIEW AND PROSPECTS

A. OPERATING RESULTS

The discussion below contains certain forward-looking information. See comments regarding Forward-Looking Statements on page 1 of this Annual Report. Comparative amounts for 2004 and 2003 have been reclassified to ensure comparability with the current reporting period, and where significant this has been noted.

RETAIL TRADING ENVIRONMENT

2004/2005

In 2004/05, Australia s economic growth for the year to June 2005 was recorded at 2.6%[1]. Although solid, it was down on the 3.3% growth recorded in 2003/04[2].

Over the past year, the driver of Australia s economic growth has shifted away from consumer spending to business investment. High commodity prices have stimulated investment in the mining sector and in resource related industries[3]. This is expected to support an increase in the rate of Australia s economic growth into 2006 and 2007[4].

However, the retail environment remains more subdued reflecting high petrol prices and an end to house price growth. Despite strong income supports via jobs and wage growth, as well as recent tax cuts, real retail turnover is forecast to be 1.8% in 2005/06, down from 3.5% in 2004/05[5].

After sales growth over the past three years, non-food retailing is expected to moderate. Food retail is expected to continue to grow at rates broadly experienced over the last two to three years.

In 2004/05, non-food retail sales grew by 4.5%, down from 9.0% in 2003/04. Non-food retail sales may trough in mid 2006 before rising again in 2007 as domestic demand picks up and the housing cycle enters its next forecast upswing. The value of food retail sales grew by 4.2% in 2004/05, down from 6.9% growth in 2003/04. In the short-term food sales are expected to remain sluggish but there may not be much more downside and 4.3% growth is forecast in 2005/06[6].

2003/2004

Australia s economy enjoyed solid growth over the year. Real GDP growth over the year to September 2004 was 3.0%, a solid rate, though down on the 4%+ annual growth recorded earlier in 2004.

While the rate of output growth slowed, the unemployment rate which averaged 5.8% over 2004, hit a low of 5.2%, inflation remained contained, and official interest rates have been steady at 5.25% since late 2003.

Australia s economic growth through 2004 was supported by the strong performance of the global economy, high levels of activity in Australia s housing sector, strong growth in consumer spending, and a high rate of business investment.

Some of those economic supports started to lose momentum. After a period of strong growth, investment in housing fell in the September quarter of 2004, while growth in consumer and retail spending also slowed.

Growth in retail turnover remained well above trend, at 5.9% over the year to September 2004 in real (inflation-adjusted) terms, though that was down from the record annual growth rate seen over the year to June 2004. Non-food retailing performed particularly well, with growth in real non-food retail turnover of 8.5% over the year to September 2004, compared with 4.8% growth for real food retail turnover.

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[1] Reserve Bank of Australia (November 2005) Statement on Monetary Policy .

[2] ANZ (December quarter 2005) ANZ Economic Outlook .

[3] Reserve Bank of Australia (November 2005) Statement on Monetary Policy .

[4] ANZ (December quarter 2005) ANZ Economic Outlook .

[5] Access Economics (August 2005) Economic and Market Planning Guidelines .

[6] Access Economics (August 2005) Economic and Market Planning Guidelines .

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CRITICAL ACCOUNTING POLICIES

Critical accounting policies, means those that require application of management s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and that may change in subsequent periods.

The Company s significant accounting policies are described in Note 1 to the consolidated financial statements. Not all of these significant policies require management to make difficult, subjective or complex judgments or estimates. The following disclosure is intended to provide an enhanced level of understanding of the policies that could be deemed to be critical, and their impact on Coles Myer s consolidated financial statements. These judgments involve assumptions or estimates in respect of future events, which can vary from what is forecast. However, the Company believes that its consolidated financial statements and its ongoing review of the estimates and assumptions utilized in preparing those consolidated financial statements, is appropriate to provide a true and fair view of Coles Myer s financial performance and position over the relevant period.

The following are considered critical accounting policies of Coles Myer:

Accounting for provisions

Employee entitlements

The provision for employee entitlements is determined based on various assumptions, including but not limited to, future increases in wage and salary rates, employee retention rates, and the timing of future payments.

Onerous contracts

A provision for onerous contracts is recognized when the expected benefits to be derived from a contract are less than the unavoidable costs of meeting the obligations under that contract, and only after any impairment losses to assets dedicated to that contract have been recognized. The provision for onerous contracts is determined based on the excess of estimated cash flows to meet the unavoidable costs under the contract over the estimated cash flows to be received in relation to the contract.

Workers compensation and self-insurance

The provisions for workers compensation and self-insurance are determined based on various assumptions, actuarial assessments, including but not limited to, future inflation, investment return, average claim size and claim administration expenses.

The Company s estimated cash flows for employee entitlements, onerous contracts, workers compensation and self-insurance are based on historical experience and knowledge of the market in which it is operating. These estimates, however, project several years into the future and are affected by variable economic and demographic factors that are outside the control of the Company. It is possible that the final settlement of these provisions may vary from the Company s estimate.

Net realizable value of inventory

All stock of finished goods on hand or in transit is valued at the lower of cost or net realizable value. Net realizable value is determined after a detailed review by management, taking into consideration amongst other factors, stock levels, stock turnover, marketing programs and current margins. The Company considers the assumptions used in the calculation to be reasonable and supportable in the existing economic environment.

Supplier promotional rebates

Accounting for all forms of rebates is reflective of guidance given by the Emerging Issues Task Force in the U.S. (EITF Issue No. 02-16, Accounting by a Customer (including a Reseller) for Certain Consideration Received from a Vendor). Refer Note 1(g) to the consolidated financial statements included in Item 17.

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Carrying value of non-current assets

The carrying value of non-current assets does not exceed their recoverable amount. Recoverable amount is determined by reference to the amount expected to be recovered from the discounted net cash flows arising from the assets continued use and subsequent disposal. Each reporting period, the Company reviews the non-current assets for possible impairment issues. If impairment issues are found, the Company is required to make an assessment as to whether the carrying amount of the asset identified remains fully recoverable. In making this assessment, the Company compares the current carrying value to the market value where available or the value in use. Determination of the value in use requires the Company to make assumptions and use estimates. The Company considers the assumptions used in the calculation to be reasonable and supportable in the existing economic environment.

Pensions and other post-retirement benefit plans

The CML Group contributes to both defined benefit and defined contribution plans for employees. Monthly paid professional and managerial employees are offered membership of Coles Myer Super Plan (CMSP) (a part of Mercer Super Trust). Store based service assistants and other employees whose employment conditions are determined by an award or agreement are offered membership of the industry fund Retail Employees Superannuation Trust (REST) or in another fund as specified by the relevant award or agreement.

The CML Group is obliged to ensure that contributions are made to the defined benefit plan at the rate assessed by an actuary, subject to its rights to reduce, suspend or terminate contributions as specified in the relevant trust deed. The obligation of the CML Group to make contributions to the fund at the actuarially determined rate is legally enforceable up to the date on which the CML Group gives notice to suspend or terminate contributions as provided in the agreement governing the plan. Under Australian GAAP, the CML Group expenses contributions to the defined benefit plan as they become due and payable and there is no present obligation with respect to future contributions. Accordingly, a liability is not recorded where there is a deficiency of fund assets over accrued benefits.

In respect of all other superannuation funds, the CML Group is obliged to contribute at fixed rates or amounts as set out in the relevant trust deeds, or in accordance with industrial awards, agreements and relevant legislation.

Employer contributions to this defined benefit fund during 2005 amounted to A$20.3 million (2004 A$18.2 million). Vested benefits are benefits, which are not conditional upon continued membership of the fund or any factor, other than resignation from the fund.

For U.S. reporting, the company has applied the principles of FASB Statement No. 87 *Employers Accounting for Pensions* (FAS 87). As a result, a reconciling item from Australian GAAP to U.S. GAAP is recorded at Note 32(g).

The defined benefit pension plan pays benefits to employees at retirement using formulae based on participants years of service and compensation. The defined benefit plan has been closed to new members since 1996. All new employees since that date must become members of the defined contribution plans. At balance date the defined benefit plan had approximately 3,000 remaining members.

Contributions to the defined benefit plan are based on rates determined by the actuary as being necessary and sufficient to ensure the stability and financial soundness of the plan. The funding objectives are: to target assets of 100% of total actuarial reserves; and for assets to exceed total vested benefits by a margin sufficient to reduce the likelihood of assets falling below vested benefits to an acceptable level.

The contribution rate is formally reviewed every three years as part of the triennial actuarial investigation of the Plan. As a result of the last triennial investigation in July 2003, the actuary recommended the contribution rate increase to 9.5% of salaries, from 8.9%, in respect of all members. This increase took effect from August 1, 2004. This movement is not expected to have any material impact on the Company s liquidity. The net periodic pension cost has increased income from operations over the 2005 fiscal year by A$1.2 million in respect of defined benefit members.

The assets of the defined benefit plan are invested in a variety of both domestic and international shares, securities, bonds and properties as determined by professional investment managers appointed by the trustees.

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The asset allocation at the reporting date of the Plan, being July 31, 2005 is as follows:

	Actual	Benchmark
Australian Shares	35.7%	35.0%
Overseas Shares (hedged)	11.1%	11.0%
Overseas Shares (unhedged)	16.3%	16.0%
Property	7.8%	8.0%
Australian Fixed Interest	14.6%	15.0%
Overseas Fixed Interest	9.7%	10.0%
Cash	4.8%	5.0%

The in-house rule under Superannuation law in Australia restricts a Superannuation Plan from holding more than 5% in total assets of the sponsoring company s shares. Plan assets include fully paid ordinary shares in CML of A$1.6 million (2004 A$NIL million, 2003: A$NIL million).

For the 2005 fiscal year expense, the expected return on assets used by the actuary is 6.5%, which is unchanged from the prior year.

Recent experience between the expected and actual returns for assets backing defined benefits is as follows:

Period	Expected Return	Actual Return
2005 fiscal year	6.5%	13.1%
2004 fiscal year	6.5%	15.3%

The Company does not smooth the effects of changes in actual returns. Only the actual market value of assets is used. The expected return assumption is based on the geometric average return of each sectors anticipated future return.

The plan determines its discount rate assumption by reference to the 10 year AA rated corporate bond rate in the Australian market. A deduction for income tax on Plan earnings at 15% has also been made. The assumed average future service of members expected to receive benefits is 7.3 years. Further disclosures on the retirement plans are included in Note 24 to the consolidated financial statements.

International Financial Reporting Standards (IFRS)

The Australian Accounting Standards Board (AASB) is adopting IFRS for application to reporting beginning on or after January 1, 2005. The AASB has issued Australian equivalents to IFRS (A-IFRS). The adoption of A-IFRS will be first reflected in the CML Group s financial statements for fiscal 2006. Further disclosures on the impact of A-IFRS are included in Note 1 to the consolidated financial statements included at Item 17.

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CONSOLIDATED RESULT

Comparative amounts for 2004 and 2003 have been reclassified to ensure comparability with the current reporting period.

	2005 53 weeks A$M	2004 52 weeks A$M	2003 52 weeks A$M
Sales	36,185.2	32,082.2	26,875.8
Cost of goods sold	(27,286.8)	(23,914.6)	(19,508.9)
Gross profit	8,898.4	8,167.6	7,366.9
Other revenue from operating activities	97.3	66.8	48.8
Cumulative effect of change in accounting policy for supplier promotional rebates			(76.5)
Other revenue from non-operating activities	304.2	309.2	275.3
Proceeds from sale of property, plant and equipment, investments and businesses and controlled entities	20.6	131.0	392.5
Net book value of property, plant and equipment, investments and businesses and controlled entities disposed	(68.1)	(146.5)	(416.8)
Borrowing costs	(74.0)	(71.1)	(86.9)
Advertising expenses	(474.5)	(431.7)	(383.8)
Selling and occupancy expenses	(6,308.1)	(5,801.7)	(5,327.5)
Administrative expenses [1]	(1,513.3)	(1,357.4)	(1,183.2)
Profit from ordinary activities before income tax	882.5	866.2	608.8
Income tax expense	(266.4)	(258.1)	(187.7)
Net profit	616.1	608.1	421.1

1 Includes the Megamart A$81.5 million divestment charge.

2005 compared with 2004

Sales

Retail sales for 2005 were A$36,185.2 million, an increase of 12.8% compared to 2004. Sales increased predominately due to increased volume as a result of key promotional sales, such as the Toy Sale and the Massive Home Sale in general merchandise and apparel, an increase in store numbers, particularly in supermarkets and Coles Express first full year of sales. Major increases in sales were recorded in the segments of Food, Liquor & Fuel (16.7%), Kmart (6.0%), Officeworks (12.4%) and Target (8.8%).

The Coles Express brand commenced operations during 2004 with stores acquired in tranches, with the rollout of outlets completed during 2005. Excluding Coles Express sales of A$5,559.5 million for 2005 and A$3,176.9 million for 2004, retail sales would have been A$30,625.7 million and A$28,905.3 million respectively.

Gross Profit

Gross profit increased by 8.9% to A$8,898.4 million in 2005. This was achieved through continued focus on streamlining the cost of doing business across all segments. Direct sourcing in general merchandise and apparel have delivered greater cost efficiencies and speed to the market.

Other revenue from operating activities

This revenue represents commissions generated by the hotels acquired by the Coles Myer Liquor Group and concession sales. The increase of A$30.5 million is primarily the result of an increase in concession sales. Refer Note 2 Change in Accounting Policy of the consolidated financial statements at Item 17.

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Other revenue from non-operating activities

	2005 A$M	2004 A$M
Other revenue from non-operating activities	304.2	309.2

Other non-operating revenue mainly comprises of interest income, property income and other income, which is predominately advertising income. Non-operating revenue decreased by A$5.0 million. The material movements relate to a decrease of A$24.9 million in interest income and an increase of A$15.6 million of other income.

Interest income decreased from A$57.6 million to A$32.7 million due to the receipt of interest from the Coles Myer Employee Share Plan Trust of A$38.0 million in 2004, as a result of the restructuring of the Trust by the trustees, compared to interest received from the Trust of A$3.6 million in 2005.

For U.S. GAAP reporting purposes this interest income from the Trust has been eliminated from net profit to correspond with the reclassification of the loan (relating to income) to shareholders equity. Refer Note 32 (f) of the consolidated financial statements at Item 17.

Sale of property, plant and equipment, investments and businesses and controlled entities

	2005 A$M	2004 A$M
Proceeds from sale of property, plant and equipment, investments and businesses and controlled entities	20.6	131.0
Net book value of property, plant and equipment, investments and businesses and controlled entities disposed	(68.1)	(146.5)

During 2005, there were no disposals of businesses and controlled entities. The 2005 sale predominately relates to the disposal of plant and equipment. In 2004, the CML Group disposed of five Newmart supermarket stores and seven Sands & McDougall stationery stores for A$31.9 million.

Borrowing costs

Borrowing costs increased by A$2.9 million to A$74.0 million, which is a reflection of higher average debt levels. Borrowing costs were also affected by an increase in the average finance rate from 6.5% in 2004 to 6.7% in 2005.

Advertising expenses

U.S. GAAP requires the advertising income (provided by suppliers to offset advertising costs) and expenses to be netted and disclosed as one item. This is expressly prohibited under Australian GAAP reporting and each item must be disclosed on a gross basis.

The reconciliation at Note 32 between Australian and U.S. GAAP is performed at the net income level, at which point there are no differences between the two regulations.

Advertising expenses predominantly relate to all production costs and fees relating to press, radio, television, and catalogue advertising of merchandise. The Company aims to maintain market share in all its trading businesses, whilst at the same time seeking out opportunities to centralize components of the advertising process where possible to take advantage of economies of scale and technological developments.

Overall, advertising expenses have increased from 2004 to 2005 as sales have increased, competition in major markets has increased and the Company has undertaken new business initiatives such as the fuel offer and upgrading of the loyalty offer (enhanced FlyBuys™ and Coles Myer Source MasterCard). Refer to page 24 for additional information.

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Selling and occupancy expenses

	2005 A$M	2004 A$M
Selling and occupancy expenses	(6,308.1)	(5,801.7)

Selling and occupancy expenses are necessarily incurred to operate the Company s stores and other offices and sites.

Total selling and occupancy costs increased by 8.7%. This was primarily the result of an increase in employee costs and external rent. Salaries, wages, payroll tax, superannuation and other selling staff costs increased 9.6% from A$3,510.7 million in 2004 to A$3,849.2 million in 2005, as a result of wage and salary rate increases and an additional 6,230 staff employed during the year.

External rent and outgoings increased by 9.2% from A$1,322.8 million in 2004 to A$1,444.0 million in 2005. This was principally due to an overall net increase of 72 new stores across the segments during 2005.

Administrative expenses

	2005 A$M	2004 A$M
Administrative expenses	(1,513.3)	(1,357.4)

Total administrative expenses increased by 11.5%.

Costs of administrative staff (salaries, wages, payroll tax, superannuation and Fringe Benefits Tax (FBT)) increased by 8.3% from A$734.3 million in 2004 to A$795.4 million in 2005. Of the additional 6,230 staff employed during the year, 333 were in the Property and Unallocated segment, which includes head office employees.

Travel, general and other administrative expenses increased by A$52.1 million or 9.2%, from A$528.8 million in 2004 to A$620.6 million in 2005. The major movement relates to costs of A$81.5 million for the Megamart divestment. Included in this category is depreciation of plant and equipment located in offices, which has remained steady.

Legal, consultants and audit fees increased by 78.2% from A$54.6 million in 2004 to A$97.3 million in 2005. This is primarily attributable to transformational activity, in particular various Information Technology initiatives.

Income tax expense

The effective tax rate for 2005 was 30.2% (2004: 29.8%). The differences from the statutory rate of 30% are explained in Note 6 to the consolidated financial statements included at Item 17.

Net profit

The Company s Australian GAAP net profit increased by 1.3% from A$608.1 million in 2004 to A$616.1 million in 2005. Segments that primarily contributed to this improvement were the Food, Liquor & Fuel, Officeworks and Target, offsetting decreases in Myer and Megamart.

The Company s U.S. GAAP net profit increased from A$475.4 million in 2004 to A$512.5 million in 2005. The difference between the 2005 Australian GAAP net profit and U.S. GAAP net profit is detailed in Note 32 to the consolidated financial statements included at Item 17.

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Dividend

A fully franked final dividend of A$0.17 per share was declared on all fully paid ordinary shares registered at October 21, 2005 and paid on November 14, 2005. The final dividend, combined with the interim dividend of A$0.1625 per share, represented an annual dividend of A$0.3325 per share. This represents an increase of A$0.0425 per share over the 2004 annual dividend.

2004 compared with 2003

Sales

Retail sales in 2004 increased 19.4% to A$32,082.2 million from A$26,875.8 million in 2003.

Sales increases were predominantly driven by increased volume. The Company continued to drive value for customers through reinvesting in price (i.e. operating costs savings used to maintain or decrease selling prices), underpinned by our ongoing efficiencies.

Major increases were recorded in the segments of Food, Liquor & Fuel (27.7%), Kmart (4.2%), Officeworks (22.8%) and Target (7.7%) whilst Myer sales remained steady. Coles Express contributed A$3,176.9 million in sales to the Food, Liquor & Fuel segment. Excluding Coles Express, the Food and Liquor segment recorded a sales increase of 8.5%.

Gross Profit

Gross profit increased 10.9% for the year ended July 25, 2004. The Food, Liquor & Fuel segment achieved higher gross profit and reflected sales leverage relative to costs, reductions in shrinkage and waste, continued streamlining of costs and strong growth of the higher margin house-branded goods in the supermarkets.

Another area of improvement for the Company in 2004 was in the Target segment. Target s better management of product sourcing and promotional programs during 2004 combined with strong inventory control had a positive impact on gross profit. Myer also made significant progress against its rebuild program of combining a focus on enhancing the merchandise offer, with a strong customer focus and strategic marketing to drive higher quality sales and results. Kmart continued its rebuild through improving its product offer, competitive pricing and improved marketing.

Other revenue from operating activities

This revenue represented commissions generated by the hotels acquired by the Coles Myer Liquor Group. The A$18.0 million increase primarily resulted from a full year s contribution from the late in the 2003 acquisition of Theo s.

Other revenue from non-operating activities

	2004 A$M	2003 A$M
Other revenue from non-operating activities	309.2	275.3

Other non-operating revenue mainly comprised of interest income, property income and other income, which was mainly comprised of advertising income. The increase in non-operating income of 12.3% was primarily due to an increase in interest income.

Interest income increased from A$23.7 million to A$57.6 million due to the receipt of interest from the Coles Myer Employee Share Plan Trust of A$38.0 million (2003 A$3.7 million), comprising A$2.7 million received in the first half of the financial year, and A$35.3 million received in the second half of the financial year as a result of the restructuring of the Trust by its trustees. For U.S. GAAP reporting purposes this interest was eliminated from net profit to correspond with the reclassification of the loan (the income relates to) to shareholders equity. Refer Note 32 (e) of the consolidated financial statements at Item 17.

Rental income decreased from A$30.8 million to A$25.9 million as a result of the disposal in 2003 of Sydney Central Plaza, a major retail property that contributed rental income to the CML Group.

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Sale of property, plant and equipment, investments and businesses and controlled entities

	2004 A$M	2003 A$M
Proceeds from sale of property, plant and equipment, investments and businesses and controlled entities	131.0	392.5
Net book value of property, plant and equipment, investments and businesses and controlled entities disposed	(146.5)	(416.8)

During 2004, the CML Group disposed of five Newmart supermarket stores and seven Sands and McDougall stationery stores for A$31.9 million.

In 2003, the CML Group sold Sydney Central Plaza for A$372.8 million, additional proceeds of A$9.9 million were received during 2004.

Borrowing costs

Borrowing costs decreased from A$86.9 million in 2003 to A$71.1 million in 2004 as the Company benefited from reduced average net debt levels. This was partially offset by the average finance rate increasing from 6.4% in 2003 to 6.5% in 2004.

Advertising expenses

U.S. GAAP requires the advertising income (provided by suppliers to offset advertising costs) and expenses to be netted and disclosed as one item. This is expressly prohibited under Australian GAAP reporting and each item must be disclosed on a gross basis.

The reconciliation at Note 32 between Australian and U.S. GAAP is performed at the net income level, at which point there are no differences between the two regulations.

Advertising expenses predominantly related to all production costs and fees relating to press, radio, television, and catalogue advertising of merchandise. The increase from 2003 was in line with the Company s aim of maintaining market share in all its trading businesses in an increasingly competitive environment. Other factors contributing to the increase are sales increases and new business initiatives.

Selling and occupancy expenses

	2004 A$M	2003 A$M
Selling and occupancy expenses	(5,801.7)	(5,327.5)

Selling and occupancy expenses are necessarily incurred to operate the Company s stores and other offices and sites.

Total selling and occupancy costs increased by 8.9%. If Coles Express were excluded from the 2004 numbers the increase would be 5.3%. Major items that contributed to the movement were external rent and employee costs.

External rent and outgoings increased by 9.8% from A$1,204.7 million in 2003 to A$1,322.8 million in 2004. This was principally due to the addition of 598 Coles Express outlets and a net 29 new stores opened by the Company in 2004.

Salaries, wages, payroll tax, superannuation and other selling staff costs increased 9.2% from A$3,215.5 million in 2003 to A$3,510.7 million in 2004. Wages and salary rates increased and an additional 13,694 staff were employed during the year. The majority of staff were in the Food, Liquor & Fuel segment. This was principally due to the addition of 598 Coles Express outlets and a net 29 new stores opened by the Company in 2004.

This line item includes depreciation of plant and equipment in stores, which increased by 5.0% from 2003 to 2004.

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Administrative expenses

	2004 A$M	2003 A$M
Administrative expenses	(1,357.4)	(1,183.2)

Total administrative expenses increased by 14.7%.

Costs of administrative staff (salaries, wages, payroll tax, superannuation and FBT) increased by 6.8% from A$687.8 million in 2003 to A$734.3 million in 2004. Of the additional 13,694 staff employed during the year, approximately 1,000 were in the Property and Unallocated segment, which included head office employees.

Travel, general and other administrative expenses increased by 25.8% from A$495.4 million in 2003 to A$623.1 million in 2004. Included in 2004 were the costs of relocating the Coles Myer Liquor Group head office from Sydney to Melbourne, and the Mt Druitt restructure costs, being costs of closing CML Group stores in the Mt Druitt (NSW) shopping centre. This line item included depreciation of plant and equipment located in offices, which remained steady from 2003 to 2004.

Income tax expense

The effective tax rate for 2004 was 29.8% (2003: 30.8%). The differences from the statutory rate of 30% are explained in Note 6 to the consolidated financial statements included at Item 17.

Net profit

The Company s Australian GAAP net profit increased from A$421.1 million in 2003 to A$608.1 million in 2004 (44.4% increase). Areas within the Company that primarily contributed to this improvement were the Food, Liquor & Fuel segment, Kmart, Officeworks and Target.

The Company s U.S. GAAP net profit (before policy changes) increased from A$390.9 million in 2003 to A$475.4 million in 2004. The difference between the 2004 Australian GAAP net profit and U.S. GAAP net profit is detailed in Note 32 to the consolidated financial statements included at Item 17.

Dividend

A fully franked final dividend of A$0.15 per share was declared on all fully paid ordinary shares registered at October 15, 2004, and paid on November 8, 2004. The final dividend, combined with the interim dividend of A$0.14 per share, represented an annual dividend of A$0.29 per share. This represented an increase of A$0.03 per share over the 2003 annual dividend.

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RETAIL RESULT

Food, Liquor & Fuel Group

2005 compared with 2004

	2005	2004	Change
Sales (A$M)	24,670.2	21,146.8	16.7%
Segment result[1] (A$M)	743.4	647.4	14.8%
Stores	1,985	1,943	42.0
Selling area[2] (M.sq.ft)	17.230	16.695	3.2%

1. Profit from ordinary activities before income tax and interest

2. Excludes Coles Express locations

At July 31, 2005, Food, Liquor & Fuel comprised Supermarkets (Coles and Bi-Lo), the Coles Myer Liquor Group and Coles Express which collectively accounted for 68.2% of the Company s total sales in 2005 (2004: 65.9%).

Segment sales for this group increased by 16.7% to A$24,670.2 million (2004: A$21,146.3 million). The results for Food, Liquor & Fuel includes Coles Express. The Coles Express brand was launched in Victoria in July 2003, with sites acquired in tranches during the 2004 financial year. Excluding Coles Express, segment sales increased by 6.4%, from A$17,969.9 million to A$19,110.7 million.

The segment result increased by 14.8% from A$647.4 million to A$743.4 million. After adjusting for segment restructuring costs of A$22.5 million, the segment result was A$765.9 million for 2005. The 2004 segment result was A$667.0 million after adjusting for the Coles Myer Liquor Group head office relocation costs and the Bi-Lo Mt Druitt store restructuring costs, representing an increase in 2005 of A$98.9 million or 14.8% over 2004. Further excluding Coles Express result of A$36.8 million for 2005 and A$20.1 million for 2004, this would have resulted in a 12.7% increase for the segment from A$646.9 million to A$729.1 million.

Sales momentum in the Food and Liquor group continued to increase, with growth initiatives focused on ongoing commitment to innovation and improved value in the fresh departments and expansion of the range across poultry and seafood. Volumes in fresh continue to grow, with a strong result in both the fresh produce and meat department. There is also focus on value added ready-to-eat products, offering customers better choice and convenience.

The increase in the Food and Liquor result reflects sales leverage, reduced shrinkage and waste, and continued streamlining of costs through investment in the supply chain transformation.

The store expansion program continued to plan, with 30 supermarkets and 47 liquor outlets opened during the year.

Coles Express has established the largest, most efficient fuel and convenience network across Australia, with 597 sites, and one of the country s best known and well established fuel offers. The two-year cycle of rolling out the new Coles Express fuel offer was completed this fiscal year. Coles Express contributed A$36.8 million to the Food, Liquor and Fuel group s 2005 segment result in its first full year of operation.

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2004 compared with 2003

	2004	2003	Change
Sales (A$M)	21,146.8	16,565.4	27.7%
Segment result[1] (A$M)	647.4	555.5	16.5%
Stores	1,943	1,325	618
Selling area[2] (M.sq.ft)	16.695	16.235	2.8%

1. Profit from ordinary activities before income tax and interest

2. Excludes Coles Express locations

Retail sales for this group increased by 27.7% to A$21,146.8 million (2003: A$16,565.4 million). After adjusting for sales relating to Coles Express (brand commenced operations in 2004), sales increased from A$16,565.4 million to A$17,969.9 million, an increase of A$1,404.5 million or 8.5 %.

The segment result increased by 16.5% to A$647.4 million (2003: A$555.5 million). After adjusting for the Coles Myer Liquor Group head office relocation costs of A$14.6 million in 2004 and the Mt Druitt restructure costs of A$5.0 million in 2004, and accounting policy changes of A$34.0 million and losses from exited businesses of A$2.5 million in 2003, the segment result would have been A$667.0 million in 2004 and A$592.0 million in 2003, representing a 12.7% increase. After further adjusting for the result of Coles Express of A$20.1 million, the result of the Food and Liquor operations would have increased by A$54.9 million or 9.3% to A$646.9 million.

Sales momentum in the Food and Liquor group increased over the year, with fourth quarter Food and Liquor growth of 9.4%. This was a reflection of the new fuel and fresh food offers. New fresh produce departments with their market look were a feature in the majority of Coles stores, supported by better product quality. Fresh food improvements have also benefited customer traffic and assisted sales growth across the store. Fuel discounts are a key part of the Group s loyalty program and were used in different and innovative ways to delight customers. This recently included the FlyBuys for fuel offer, where Coles Myer Source™ MasterCard holders could redeem FlyBuys™ points for Coles Express fuel.

The increase in the Food and Liquor result reflected sales leverage relative to costs, reduced shrinkage and waste, and continued streamlining of costs. The margin increases occurred despite the short-term impact of double loyalty costs incurred in the second half - both shareholder discount and fuel discount.

The Coles Myer Liquor Group head office was relocated from Sydney to Melbourne ahead of schedule in August 2004, which enabled our Food and Liquor teams to work more closely and benefit from cross-brand career development opportunities.

The store expansion program continued during the year, with 29 new supermarkets and 21 new liquor outlets.

Kmart

2005 compared with 2004

	2005	2004	Change
Sales (A$M)	4,025.7	3,799.1	6.0%
Segment result[1] (A$M)	96.0	100.8	(4.8%)
Stores	245	225	20
Selling area (M.sq.ft)	10.667	10.439	2.2%

1. Profit from ordinary activities before income tax and interest

Segment sales increased by 6.0% from A$3,799.1 million to A$4,025.7 million. Segment results decreased by A$4.8 million or 4.8%, from A$100.8 million to A$96.0 million. Included in these results are benefits relating to the re-measurement of the Kmart New Zealand onerous lease provision, which has resulted from improved trading conditions in New Zealand. After adjusting for the impact of this re-measurement, the segment result would have increased by A$7.1 million or 8.3%, from A$85.4 million to A$92.5 million.

Kmart experienced weaker sales in May and June, following a slowing of consumer spending and reduced sales of winter-related merchandise due to unseasonably warm weather conditions. Categories most impacted included

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electrical and apparel. Given the considerable external challenges, Kmart maintained margin growth and produced a solid earnings increase for the year.

Kmart had an excellent customer reaction to several key initiatives, in particular the Toy Sale in July and the spring season launch. Customers are also responding positively to the improved marketing, and key national brands such as Now, Girl Xpress in young women s, Exchange in menswear, Living with Deborah Hutton in home, World for Kids in toys and Jackeroo in outdoor.

Kmart opened five new stores during the year. Kmart s current network includes 180 stores across Australia and New Zealand with an expected eight new stores in 2006.

2004 compared with 2003

	2004	2003	Change
Sales (A$M)	3,799.1	3,644.5	4.2%
Segment result[1] (A$M)	100.8	67.8	48.7%
Stores	225	222	3
Selling area (M.sq.ft)	10.439	10.349	0.9%

1. Profit from ordinary activities before income tax and interest

Sales for this group increased from A$3,644.5 million to A$3,799.1 million.

Increased sales have been achieved at the same time as improvements in gross margins. This combined with the ability to contain costs led to the improved segment result.

The segment result increased by 48.7% to A$100.8 million. Included in these results was a credit of A$15.4 million relating to a re-measurement of the Kmart New Zealand onerous lease provision in 2004.

The improved result was evidence that customers have responded to Kmart s product offer, competitive prices and improved marketing in both general merchandise and apparel. Highlights in general merchandise were new ranges in the home offer and sustained growth in toys, leisure and entertainment. In apparel, new brands included Hilary Duff and Sista, and house brands such as Girl Xpress, Now and Solutions were solid performers.

The success of the Easter, Stocktake and Mother s Day Sales, along with the Mega Electrical and Toy Sales also contributed to the improved results.

Kmart opened five new stores during the year, which brought the network to 175 stores. The store refurbishment plan continued with lower fixtures and wider aisles, to improve the shopping experience for customers and make it easier for them to move through the store.

Officeworks

2005 compared with 2004

	2005	2004	Change
Sales (A$M)	1,236.3	1,100.1	12.4%
Segment result[1] (A$M)	67.1	51.7	29.8%
Stores	95	87	8
Selling area (M.sq.ft)	1.421	1.275	11.5%

1. Profit from ordinary activities before income tax and interest

Sales increased by 12.4% from A$1,100.1 million to A$1,236.3 million. Segment results increased from A$51.7 million to A$67.1 million or 29.8%.

Officeworks delivered another strong performance as a result of ongoing business efficiencies and strong sales growth.

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Officeworks continued to strengthen its position as the leading supplier for quality office and technology products for home offices, students and small to medium size businesses by offering a great range, convenience and low prices.

Nine new stores were opened during the year, increasing the network to 87 Officeworks superstores and 8 Harris Technology Business centers.

2004 compared with 2003

	2004	2003	Change
Sales (A$M)	1,100.1	896.1	22.8%
Segment result[1] (A$M)	51.7	41.2	25.5%
Stores	87	85	2
Selling area (M.sq.ft)	1.275	1.153	10.6%

1. Profit from ordinary activities before income tax and interest

Sales increased from A$896.1 million to A$1,100.1 million. Segment results also increased accordingly, from A$41.2 million to A$51.7 million or 25.5%. During the year, the Officeworks branded businesses delivered on the long-term goal of passing A$1.0 billion in sales.

Officeworks delivered another strong performance. The result reflected good sales growth, improved merchandise mix and ongoing business efficiencies. A new focus on housebrands was also initiated, and resulted in new packaging and clearer price points.

Officeworks opened nine new stores in the year, increasing the network to 78. Another 20 stores were updated with major refurbishments. Twelve new in-store technology centers were opened, bringing the total to 22, while the rollout of the digital printing program neared completion with 66 stores offering the service.

Myer

2005 compared with 2004

	2005	2004	Change
Sales[1] (A$M)	2,882.0	2,895.6	(0.5%)
Segment result[2] (A$M)	35.0	54.0	(35.2%)
Stores	61	61	
Selling area (M.sq.ft)	7.893	7.942	(0.6%)

1. Excludes concession sales

2. Profit from ordinary activities before income tax and interest

Sales, excluding concessions, have decreased by A$13.6 million or 0.5% to A$2,882.0 million. Including concessions, sales have increased by A$65.1 million to A$3,095.8 million or 2.1%.

Segment results decreased by 35.2% or A$19.0 million to A$35.0 million. The 2004 result included Mt Druitt store restructuring costs of A$14.2 million. After adjusting for this, the segment result would have decreased by A$33.2 million or 48.7%, from A$68.2 million to A$35.0 million.

A softening in discretionary spending, an unseasonably warm winter and the sales spike in the eight weeks prior to the July 2004 removal of the Shareholder Discount Card all impacted comparative sales performance in the second half of 2005, relative to the second half of 2004.

Although the brand was impacted by tough trading conditions in the second half, Myer continued to deliver solid growth in key categories across women s apparel, including Australian and international designer, Miss Shop, accessories, intimate apparel, cosmetics and footwear as well as menswear.

Also refer to Item 4A HISTORY AND DEVELOPMENT RECENT DEVELOPMENTS.

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2004 compared with 2003

	2004	2003	Change
Sales(2)De Novo internally developed location that has been in service with the Company for 12 months or less.			

(3) Organic combination of same store and de novo.
(4) Acquired purchased location that has been in service with the Company for 12 months or less.

	Year Ending December 31, 2008						
	Same Store(1)	De Novo(2)	Organic(3)	Organic Growth %	Acquired(4)	Total	Total Growth %
Revenue	$ 286,342	$ 2,879	$ 289,221	18.5%	$ 36,820	$ 326,041	33.6%
Revenue Medicare	$ 239,627	$ 2,431	$ 242,058	21.9%	$ 31,375	$ 273,433	37.7%
Average Census	17,228	341	17,569	5.6%	3,950	21,519	29.4%
Average Medicare Census	14,099	277	14,376	14.5%	2,979	17,355	38.2%
Admissions	47,150	689	47,839	9.4%	8,791	56,630	29.5%
Medicare Admissions	34,502	495	34,997	13.8%	6,714	41,711	35.6%
Episodes	105,712	1,323	107,035	34.4%	10,412	117,447	47.4%

(1) Same store location that has been in service with the Company for greater than 12 months.
(2) De Novo internally developed location that has been in service with the Company for 12 months or less.
(3) Organic combination of same store and de novo.
(4) Acquired purchased location that has been in service with the Company for 12 months or less.

Facility-Based Services. Net service revenue from facility-based services for the year ended December 31, 2009 was $62.5 million, an increase of $5.9 million, or 10.4%, compared with $56.6 million for the year ended December 31, 2008. The increase in net service revenue primarily relates to the additional revenue from our LTACH acquired in 2009.

Cost of Service Revenue

Our cost of service revenue consists of expenses incurred by our clinical and clerical personnel in our agencies and facilities. Cost of service revenue for the year ended December 31, 2009 was $270.5 million, an increase of

$84.2 million, or 45.2%, from $186.3 million for the year ended December 31, 2008. Cost of service revenue represented approximately 50.9% and 48.7% of our net service revenue for the years ended December 31, 2009 and 2008, respectively.

Home-Based Services. Cost of service revenue from home-based services for the year ended December 31, 2009 was $234.1 million, an increase of $79.7 million, or 51.6%, from $154.4 million for the year ended December 31, 2008. The following table summarizes cost of service revenue (amounts in thousands).

	Year Ended December 31,			
	2009		2008	
Salaries, wages and benefits	$ 200,401	42.7%(1)	$ 131,452	40.3%(1)
Transportation, primarily mileage reimbursement	16,441	3.5	11,803	3.6
Supplies and services	17,289	3.7	11,121	3.4
Total	$ 234,131	49.9%	$ 154,376	47.3%

(1) Percentage of Home-Based net service revenue

The increase in salaries, wages and benefits as a percentage of net service revenue for the year ended December 31, 2009 compared to the same period in 2008 relates to an increase in visits per episode for both registered nurses and physical therapists.

Facility-Based Services. Cost of service revenue from facility-based services for the year ended December 31, 2009 was $36.4 million, an increase of $4.5 million, or 14.1%, from $31.9 million for the year ended December 31, 2008, as detailed in the following table (amounts in thousands).

	Year Ended December 31,			
	2009		2008	
Salaries, wages and benefits	$ 22,488	36.0%(1)	$ 20,131	35.6%(1)
Transportation	150	0.2	260	0.5
Supplies and services	13,746	22.0	11,487	20.3
Total	$ 36,384	58.2%	$ 31,878	56.4%

(1) Percentage of Facility-Based net service revenue

The increase in facility-based cost of service revenue relates primarily to the increase in supplies and services as a percentage of net service revenue. The increase in supplies and services relates to an increase in patient acuity throughout 2009 compared to 2008.

Provision for Bad Debts

Provision for bad debts for the year ended December 31, 2009 was $4.7 million compared to $11.8 million for the year ended December 31, 2008. For the years ended December 31, 2009 and 2008, the provision for bad debts was approximately 0.9% and 3.1% of net service revenue, respectively. Throughout 2009, we increased collection efforts, including those related to commercial claims, which increased cash collections and reduced overall receivables and days sales outstanding at year end and resulted in lower bad debt expense as a percentage of net service revenue.

General and Administrative Expenses

General and administrative expenses consist primarily of the following expenses incurred by our home office and administrative field personnel:

Home office and field administration:

- salaries and related benefits;
- insurance;
- costs associated with advertising and other marketing activities; and
- rent and utilities.

Supplies and services:

- accounting, legal and other professional services; and
- office supplies.

Depreciation;

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Other:

- advertising and marketing expenses;
- recruitment;
- operating locations rent; and
- taxes.

General and administrative expenses for the year ended December 31, 2009 were $171.7 million, an increase of $47.6 million, or 38.4%, from $124.1 million for the year ended December 31, 2008. General and administrative expenses represented approximately 32.3% and 32.4% of our net service revenue for the years ended December 31, 2009 and 2008, respectively.

Home-Based Services. General and administrative expenses from the home-based services for the year ended December 31, 2009 were $155.7 million, an increase of $45.8 million, or 41.7%, from $109.9 million for the year ended December 31, 2008. General and administrative expenses remained relatively consistent at 33.2% and 33.7% of our net service revenue during the years ended December 31, 2009 and 2008, respectively.

Facility-Based Services. General and administrative expenses from facility-based services for the year ended December 31, 2009 were $16.0 million, an increase of $1.8 million, or 12.7%, from $14.2 million for the year ended December 31, 2008. General and administrative expenses in the facility-based segment were 25.6% and 25.0% of net service revenue for the years ended December 31, 2009 and December 31, 2008, respectively.

Gain (loss) on the sale of assets and entities and Non-operating income

For the year ended December 31, 2009, we had a non-operating loss of $261,000 compared to non-operating income of $1.4 million for the year ended December 31, 2008. The loss during 2009 primarily relates to a $542,000 impairment expense on two provider numbers which were purchased in 2008. In February 2009, CMS denied the Company s change of ownership for the provider numbers because the agency locations had been moved outside of the allowed service area. The Company has since received new provider numbers for these home health agencies. However, the purchased provider numbers no longer have value and were written off in 2009.

The non-operating income for the year ended December 31, 2008 primarily consists of a gain of $624,000 for the exchange of a minority ownership in two of the Company s entities for a majority ownership in an acquired entity and a $315,000 gain on the sale of the Company s aircraft.

Income Tax Expense

The effective tax rates for the years ended December 31, 2009 and 2008 were 37.8% of income from continuing operations attributable to LHC Group, Inc.

Net Income Attributable to Noncontrolling Interest

Net income attributable to noncontrolling interest was $14.0 million and $11.7 million for the years ended December 31, 2009 and 2008, respectively. Noncontrolling interest represented 2.6% and 3.1% of net service revenue for the years ended December 31, 2009 and 2008, respectively.

Discontinued Operations

The following table provides financial results of discontinued operations for the years ended December 31, 2009 and 2008 (amounts in thousands):

	2009	2008
Net service revenue	$ 402	$ 756
Costs of services and G&A expenses	(543)	(1,722)
Loss from discontinued operations before noncontrolling interest and income taxes	(141)	(966)
Income tax benefit	55	190
Loss from discontinued operations net of income tax benefit	(86)	(776)
Less loss from discontinued operations attributable to noncontrolling interest		(123)
Loss from discontinued operations attributable to LHC Group Inc. s common stockholders	$ (86)	$ (653)

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In September 2009, the Company sold its outpatient rehabilitation clinic and recognized a loss of $22,000. The results of operations related to the clinic and the loss are included in discontinued operations in the Company s consolidated statements of income for the years ended December 31, 2009 and 2008.

Discontinued operations for the year ended December 31, 2008 also includes a home health pharmacy, which was closed on September 30, 2007 and a critical access hospital, which was sold on July 1, 2007. There is no activity related to these two locations for the year ended December 31, 2009.

Year Ended December 31, 2008 Compared to Year Ended December 31, 2007

Net Service Revenue

Net service revenue for the year ended December 31, 2008 was $382.6 million, an increase of $85.6 million or 28.8%, from $297.0 million for the same period ending December 31, 2007. The growth in the home-based services net service revenue contributed $81.9 million of the increase in consolidated net service revenue between December 31, 2008 and 2007. Net service revenue was comprised of the following for the periods ending December 31:

	2008	2007
Home-based services	85.2%	82.2%
Facility-based services	14.8	17.8
	100.0%	100.0%

Revenue derived from Medicare represented 83.2% and 81.7% of consolidated net service revenue for the years ended December 31, 2008 and 2007, respectively.

Home-Based Services. Net service revenue from home-based services for the year ended December 31, 2008 was $326.0 million, an increase of $81.9 million, or 33.6%, from $244.1 million for the year ended December 31, 2007. Total admissions increased 29.5% to 56,630 during 2008, versus 43,736 for the same period in 2007. Average home-based patient census for the year ended December 31, 2008 increased 29.4% to 21,519 patients as compared with 16,635 patients for the year ended December 31, 2007.

As detailed in the table below, the increase in revenue in 2008 is explained by both organic growth and the growth from our acquisitions during the year ended December 31, 2008.

The following table details the home-based services revenue growth and percentages for organic and total growth (amounts in thousands, except statistical data):

	Year Ending December 31, 2008						
	Same Store(1)	De Novo(2)	Organic(3)	Organic Growth %	Acquired(4)	Total	Total Growth %
Revenue	$ 286,342	$ 2,879	$ 289,221	18.5%	$ 36,820	$ 326,041	33.6%
Revenue Medicare	$ 239,627	$ 2,431	$ 242,058	21.9%	$ 31,375	$ 273,433	37.7%
Average Census	17,228	341	17,569	5.6%	3,950	21,519	29.4%
Average Medicare Census	14,099	277	14,376	14.5%	2,979	17,355	38.2%
Admissions	47,150	689	47,839	9.4%	8,791	56,630	29.5%
Medicare Admissions	34,502	495	34,997	13.8%	6,714	41,711	35.6%
Episodes	105,712	1,323	107,035	34.4%	10,412	117,447	47.4%

(1) Same store location that has been in service with the Company for greater than 12 months.
(2) De Novo internally developed location that has been in service with the Company for 12 months or less.
(3) Organic combination of same store and de novo.
(4) Acquired purchased location that has been in service with the Company for 12 months or less.

Facility-Based Services. Net service revenue from facility-based services for the year ended December 31, 2008 was $56.6 million, an increase of $3.7 million, or 7.0%, compared with $52.9 million for the year ended December 31, 2007. Organic growth made up the total growth in this service sector during 2008. The increase in net service revenue primarily relates to an increase in patient acuity throughout the year. Patient days increased to 46,190 in the year ended December 31, 2008, from 45,818 in the year ended December 31, 2007.

Cost of Service Revenue

Cost of service revenue for the year ended December 31, 2008 was $186.3 million, an increase of $36.3 million, or 24.2%, from $150.0 million for the year ended December 31, 2007. Cost of service revenue represented approximately 48.7% and 50.5% of our net service revenue for the years ended December 31, 2008 and 2007, respectively.

Home-Based Services. Cost of service revenue from home-based services for the year ended December 31, 2008 was $154.4 million, an increase of $37.4 million, or 32.0%, from $117.0 million for the year ended December 31, 2007. The following table summarizes cost of service revenue (amounts in thousands):

	Year Ended December 31,			
	2008		2007	
Salaries, wages and benefits	$ 131,452	40.3%(1)	$ 99,446	40.7%(1)
Transportation, primarily mileage reimbursement	11,803	3.6	8,589	3.5
Supplies and services	11,121	3.4	8,927	3.7
Total	$ 154,376	47.3%	$ 116,962	47.9%

(1) Percentage of Home-Based net service revenue

Facility-Based Services. Cost of service revenue from facility-based services for the year ended December 31, 2008 was $31.9 million, a decrease of $1.2 million, or 3.6%, from $33.1 million for the year ended December 31, 2007, as detailed in the following table (amounts in thousands);

	Year Ended December 31,			
	2008		2007	
Salaries, wages and benefits	$ 20,131	35.6%[(1)]	$ 20,266	38.3%[(1)]
Transportation	260	0.5	325	0.6
Supplies and services	11,487	20.3	12,485	23.6
Total	$ 31,878	56.4%	$ 33,076	62.5%

(1) Percentage of Facility-Based net service revenue

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The decrease in cost of facility-based service revenue as a percentage of facility-based net service revenue for the year ended December 31, 2008 relates primarily to a decrease in salary, wages and benefits as a percentage of net service revenue. The decrease is the result of cost management at the facilities and increased acuity of the patients receiving treatment, resulting in higher net service revenue without increased patient days. Additionally during 2008, management renegotiated several contracts with its major suppliers. As a result of the renegotiations, the Company saw reductions in the dollar amount of cost of supplies and as a percentage of net service revenue, throughout the year.

Provision for Bad Debts

Provision for bad debts for the year ended December 31, 2008 was $11.8 million compared to $12.2 million for the year ended December 31, 2007. For the years ended December 31, 2008 and 2007, the provision for bad debts was approximately 3.1% and 4.1% of net service revenue, respectively. In the fourth quarter of 2007, we increased bad debt expense by $3.9 million to reflect collection difficulties, primarily with commercial claims. Prior to that increase, we had been recording bad debt expense of approximately 2.9% of net service revenue. During 2008, we increased collection efforts, including those related to commercial claims, increased cash collections and reduced overall receivables and days sales outstanding at year end, which resulted in lower bad debt expense as a percentage of net service revenue.

General and Administrative Expenses

General and administrative expenses for the year ended December 31, 2008 were $124.1 million, an increase of $28.1 million, or 29.3%, from $96.0 million for the year ended December 31, 2007. General and administrative expenses represented approximately 32.4% and 32.3% of our net service revenue for the years ended December 31, 2008 and 2007, respectively.

Home-Based Services. General and administrative expenses from home-based services for the year ended December 31, 2008 were $109.9 million, an increase of $29.3 million, or 36.4%, from $80.6 million for the year ended December 31, 2007. General and administrative expenses were 33.7% and 33.0% of our net service revenue during the year ended December 31, 2008 and 2007, respectively. This increase as a percentage of net service revenue was in part caused by higher general and administrative expenses in agencies acquired in 2008. In addition, investment in our billing and collections department and growth and development in other departments which support the Company s growth increased these costs throughout 2008.

Facility-Based Services. General and administrative expenses from the facility-based services for the year ended December 31, 2008 were $14.2 million, a decrease of $1.2 million, or 7.8%, from $15.4 million for the year ended December 31, 2007.

General and administrative expenses in the facility-based segment for the year ended December 31, 2008 represented 25.0% of our net service revenue compared to 29.0% during the year ended December 31, 2007.

Gain (loss) on the sale of assets and entities and Non-operating income

Non-operating income for the year ended December 31, 2008 was $1.4 million compared to $1.1 million for the year ended December 31, 2007. During 2008, the Company recorded a gain of $624,000 for the exchange of a minority ownership in two of the Company s entities for a majority ownership in an acquired entity. Also, during 2008, the Company recognized a gain of $315,000 related to the sale of the Company s aircraft.

Income Tax Expense

The effective tax rates for the years ended December 31, 2008 and 2007 were 37.8% and 35.7%, of income from continuing operations attributable to LHC Group, Inc., respectively. The increase is related to the effect of higher state tax rates and the related mix of taxable income in those states and a lower credit in 2008 related to the Gulf Opportunity Act.

Net Income Attributable to Noncontrolling Interest

Net income attributable to noncontrolling interest was $11.7 million for the year ended December 31, 2008, or 3.1% of net service revenue, an increase of $6.4 million, compared to $5.3 million, or 1.8% of net service revenue

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for the year ended December 31, 2007. Between June 30, 2007 and December 31, 2007, the Company entered into seven joint venture agreements. These joint ventures contributed to noncontrolling interest expense for a 12 month period ending December 31, 2008 versus only a few months of the preceding year. Further, during 2008, the Company entered into 13 additional joint venture agreements. These new joint venture acquisitions contributed $3.7 million to the increase in noncontrolling interest for the year ended December 31, 2008. The remaining increase relates to the increase in income from operations related to all of our joint ventures.

Discontinued Operations

The following table provides financial results of discontinued operations for the years ended December 31, 2008 and 2007 (amounts in thousands):

	2008	2007
Net service revenue	$ 756	$ 3,994
Costs of services and G&A expenses	(1,722)	(6,699)
Loss from discontinued operations before noncontrolling interest and income taxes	(966)	(2,705)
Income tax benefit	190	289
Loss from discontinued operations net of income tax benefit	(776)	(2,416)
Less loss from discontinued operations attributable to noncontrolling interest	(123)	(672)
Loss from discontinued operations attributable to LHC Group Inc. s common stockholders	$ (653)	$ (1,744)

In September 2009, the Company sold its outpatient rehabilitation clinic and recognized a loss of $22,000. The results of operations related to the clinic and the loss are included in discontinued operations in the Company s consolidated statements of income for the years ended December 31, 2008 and 2007.

Discontinued operations for the year ended December 31, 2008 and 2007 also include a home health pharmacy, which was closed on September 30, 2007, and a critical access hospital, which was sold on July 1, 2007.

Liquidity and Capital Resources

Cash at December 31, 2009 decreased by $3.1 million, to $394,000 from $3.5 million at December 31, 2008. Based on our current plan of operations, including acquisitions, we believe this amount, when combined with expected cash flows from operations and amounts available under our revolving line of credit, will be sufficient to fund our growth strategy to meet our anticipated operating expenses, capital expenditures and debt service obligations for at least the next 12 months.

Liquidity

Our principal source of liquidity for our operating activities is the collection of our accounts receivable, most of which are collected from governmental and third-party commercial payors. Our reported cash flows from operating activities are impacted by various external and internal factors, including the following:

Operating Results Our net income has a significant impact on our operating cash flows. Any significant increase or decrease in our net income could have a material impact on our operating cash flows.

Timing of Acquisitions We use our operating cash flows to purchase home health and hospice agencies. When the acquisitions occur at or near the end of a period, our cash outflows significantly increase.

Start-Up Costs Following the completion of an acquisition, we suspend billing Medicare and Medicaid claims until we receive the change of ownership and electronic funds transfer approvals. We also generally incur substantial start-up costs in order to implement our business strategy. There is generally a delay between our expenditure start-up costs and the increase in net service revenue and subsequent cash collections, which adversely affects our cash flows from operating activities.

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Timing of Payroll Our employees are paid bi-weekly on Fridays; therefore, operating cash flows decline in reporting periods that end on a Friday. Conversely, for those reporting periods ending on a day other than Friday, our cash flows are higher because we have not yet paid our payroll.

Medical Insurance Plan Funding We are self-funded for medical insurance purposes. Any significant changes in the amount of insurance claims submitted could have a direct impact on our operating cash flows.

Medical Supplies A significant expense associated with our business is the cost of medical supplies. Any increase in the cost of medical supplies, or in the use of medical supplies by our patients, could have a material impact on our operating cash flows.

Cash used in investing activities is primarily for acquisitions of home nursing and hospice agencies, while cash used by financing activities relates to payments on outstanding debt agreements and payments to our noncontrolling interest partners.

The following table summarizes changes in cash flows (amounts in thousands):

	Year Ended December 31,	
	2009	**2008**
Cash provided by operating activities	$ 49,192	$ 85,504
Cash used in investing activities	(41,663)	(75,876)
Cash used in financing activities	(10,646)	(7,272)
Change in cash	(3,117)	2,356
Cash and cash equivalents at beginning of period	3,511	1,155
Cash and cash equivalents at end of period	$ 394	$ 3,511

Operating activities during the year ended December 31, 2009 provided $49.2 million in cash compared to $85.5 million for year ended December 31, 2008. Net income provided $57.8 million of operating cash flow in 2009. At December 31, 2009, working capital was $48.4 million compared to $32.1 million at December 31, 2008, an increase of $16.3 million. The decrease in cash provided by operating activities and the change in working capital in 2009 primarily relates to tax payments. As a result of Hurricanes Ike and Gustav, estimated 2008 federal tax payments, as well as those for most states, including Louisiana, were deferred until January 2009. The Company paid $8.5 million on January 3, 2009 related to these deferred payments which reduced operating cash flows in 2009.

Investing activities used $41.7 million and $75.9 million in cash for the years ended December 31, 2009 and 2008, respectively. Cash outflows for the year ending December 31, 2009 included $33.4 million for acquisitions, compared to $69.9 million for acquisitions for the year ending December 31, 2008.

Financing activities used $10.6 million and $7.3 million in cash in the years ended December 31, 2009 and 2008, respectively. During 2008, noncontrolling interest distributions increased $4.6 million. This increase was offset by the $5.7 million outstanding on the line of credit as of December 31, 2009.

Days sales outstanding (DSO) for the year ended December 31, 2009 was 48 days compared to 51 days for the same period in 2008.

Indebtedness

Our total long-term indebtedness was $10.2 million at December 31, 2009 and $5.1 million at December 31, 2008, including the current portions of $415,000 and $583,000, respectively. At December 31, 2009, long-term debt included $5.7 million outstanding on the revolving line of credit.

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Credit Facility

The Company s Credit Facility with Capital One, National Association, which was amended on June 15, 2009, provides for a maximum aggregate principal borrowing of $75.0 million. The Credit Facility, which is scheduled to expire on June 15, 2011, is unsecured and has a letter of credit sublimit of $2.5 million. In September 2009, the company issued a $700,000 letter of credit as collateral on the Company s workers compensation insurance. The annual facility fee is 0.25% of the total availability. The interest rate for borrowings under the Credit Facility is a function of the prime rate (Base Rate) subject to a floor or the Eurodollar rate (Eurodollar) subject to a floor, as elected by the Company, plus the applicable margin based on the Leverage Ratio as defined in the Credit Facility. At December 31, 2009, $5.7 million and the letter of credit were outstanding under the Credit Facility. At December 31, 2008, no amounts were outstanding under the Credit Facility.

The interest rate for borrowings under the Credit Facility is a function of the prime rate (Base Rate) or the Eurodollar rate (Eurodollar), as elected by the Company, plus the applicable margin as set forth below:

Leverage Ration	**Eurodollar Margin**	**Base Rate Margin**
< 1.00:1.00	2.25%	0.50%
³ 1.00:1.00 < 1.50:100	2.50%	0.75%
³ 1.50:1.00 < 2.00:1.00	2.75%	1.00%
³ 2.00:1.00	3.00%	1.25%

The Company s Credit Facility contains customary affirmative, negative and financial covenants. For example, the Company is restricted in incurring additional debt, disposing of assets, making investments, allowing fundamental changes to the Company s business or organization, and making certain payments in respect of stock or other ownership interests, such as dividends and stock repurchases. Under the Credit Facility, the Company is also required to meet certain financial covenants with respect to minimum fixed charge coverage, consolidated net worth, leverage and minimum asset coverage ratios. At December 31, 2009, the Company was in compliance with all covenants and we expect to be in compliance with all covenants throughout 2010.

The Company s Credit Facility also contains customary events of default, including bankruptcy and other insolvency events, cross-defaults to other debt agreements, a change in control involving the Company or any subsidiary guarantor, and the failure to comply with certain covenants.

Long-Term Debt

On February 28, 2008, the Company paid its promissory note with Bancorp Equipment Finance, Inc. in full. The note was collateralized by the Company s previous aircraft, which was sold in February 2008 for $3.1 million. The sale resulted in a gain of $315,000.

In February 2008, the Company entered into a loan agreement with Capital One for a term note in the amount of $5.1 million for the purchase of a 1999 Cessna 560 aircraft. The aircraft serves as collateral for the term note, which is payable in 83 monthly installments of principal plus interest commencing on March 6, 2008 followed by one balloon installment of $2.7 million on February 6, 2015. The term note bears interest at the LIBOR rate (adjusted monthly) plus the Applicable Margin (as defined in the term note) of 1.9% (2.14% at December 31, 2009).

Commitments

The following table discloses aggregate information about our contractual obligations and the periods in which payments are due as of December 31, 2009:

		Payment due by period			
Contractual Cash Obligation	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
			(In thousands)		
Long-term debt	$ 4,483	$ 387	$ 1,010	$ 1,010	$ 2,076
Capital lease obligations	45	28	17		
Operating leases	29,380	11,062	15,925	2,120	273
Total contractual cash obligations	$ 33,908	$ 11,477	$ 16,952	$ 3,130	$ 2,349

Off-Balance Sheet Arrangements

We do not currently have any off-balance sheet arrangements with unconsolidated entities, financial partnerships or entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not engage in trading activities involving non-exchange traded contracts. As such, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in these relationships.

The following discussions describe our critical accounting policies, which we believe require the most significant judgments and estimates used in the preparation of our consolidated financial statements.

Critical Accounting Policies

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported revenue and expenses during the reported period. Actual results could differ from those estimates. Changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ materially from our estimates. To the extent that there are material differences between these estimates and actual results, our financial condition or results of operations will be affected. We base our estimates on past experience and other assumptions that we believe are reasonable under the circumstances and we evaluate these estimates on an ongoing basis.

The following discussions describe our critical accounting policies, which we believe require the most significant judgments and estimates used in the preparation of our consolidated financial statements.

Principles of Consolidation

The consolidated financial statements include all subsidiaries and entities controlled by the Company. We define control as ownership of a majority of the voting interest of an entity. The consolidated financial statements include entities in which the Company has the obligation to absorb losses of the entities or the right to receive benefits from the entities and has voting control over the entities or both, as a result of ownership, contractual or other financial interests in the entities.

The following table summarizes the percentage of net service revenue earned by type of ownership or relationship the Company had with the operating entity:

	2009	2008	2007
Equity joint ventures	51.4%	49.6%	43.7%
Wholly owned subsidiaries	44.6	46.6	46.4

License leasing arrangements	2.5	2.1	7.8
Management services	1.5	1.7	2.1
	100.0%	100.0%	100.0%

The change in the percentage of revenue earned by license leasing arrangements and the equity joint ventures relates, in part, to the conversion of one of the Company s license leasing arrangements to a joint venture on October 1, 2007.

All significant inter-company accounts and transactions have been eliminated in consolidation. Business combinations accounted for as purchases have been included in the consolidated financial statements from the respective dates of acquisition.

The following describes the Company s consolidation policy with respect to its various ventures excluding wholly owned subsidiaries:

Equity Joint Ventures

The Company s joint ventures are structured as limited liability companies in which the Company typically owns a majority equity interest ranging from 51% to 99%. Each member of all but one of the Company s equity joint ventures participates in profits and losses in proportion to their equity interests. The Company has one joint venture partner whose participation in losses is limited. The Company consolidates these entities as the Company has the obligation to absorb losses of the entities and the right to receive benefits from the entities and has voting control over the entities.

License Leasing Arrangements

The Company, through wholly owned subsidiaries, leases home health licenses necessary to operate certain of its home nursing agencies. As with wholly owned subsidiaries, the Company owns 100% of the equity of these entities and consolidates them based on such ownership, as well as the Company s obligation to absorb losses of the entities and the right to receive benefits from the entities.

Management Services

The Company has various management services agreements under which the Company manages certain operations of agencies and facilities. The Company does not consolidate these agencies or facilities, as the Company does not have an ownership interest and does not have an obligation to absorb losses of the entities or the right to receive the benefits from the entities.

Revenue Recognition

The Company reports net service revenue at the estimated net realizable amount due from Medicare, Medicaid, commercial insurance, managed care payors, patients and others for services rendered. All payors contribute to both the home-based services and facility-based services.

The following table sets forth the percentage of net service revenue earned by category of payor for the years ending December 31:

	2009	2008	2007
Payor:			
Medicare	81.7%	83.2%	81.7%
Medicaid	3.5	4.6	5.5
Other	14.8	12.2	12.8
	100.0%	100.0%	100.0%

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The percentage of net service revenue contributed from each reporting segment was as follows for the years ending December 31:

	2009	2008	2007
Home-based services	88.2%	85.2%	82.2%
Facility-based services	11.8	14.8	17.8
	100.0%	100.0%	100.0%

Medicare

Home-Based Services

Home Nursing Services. The Company s home nursing Medicare patients are classified into one of 153 home health resource groups prior to receiving services. Based on this home health resource group, the Company is entitled to receive a standard prospective Medicare payment for delivering care over a 60-day period referred to as an episode. The Company recognizes revenue based on the number of days elapsed during an episode of care within the reporting period.

Final payments from Medicare may reflect one of four retroactive adjustments to ensure the adequacy and effectiveness of the total reimbursement: (a) an outlier payment if the patient s care was unusually costly; (b) a low utilization adjustment if the number of visits totaled fewer than five; (c) a partial payment if the patient transferred to another provider before completing the episode; or (d) a payment adjustment based upon the level of therapy services required in the population base. Management estimates the impact of these payment adjustments based on historical experience and records this estimate during the period the services are rendered. The Company s payment is also adjusted for differences in local prices using the hospital wage index. In calculating the Company s reported net service revenue from home nursing services, the Company adjusts the prospective Medicare payments by an estimate of the adjustments. The adjustments are calculated using a historical average of prior adjustments.

Hospice Services. The Company is paid by Medicare under a per diem payment system. The Company receives one of four predetermined daily or hourly rates based upon the level of care the Company furnished. The Company records net service revenue from hospice services based on the daily or hourly rate and recognizes revenue as hospice services are provided.

Hospice payments are also subject to two caps. One relates to individual programs receiving more than 20% of its total Medicare reimbursement from inpatient care services and the second relates to individual programs receiving reimbursements in excess of a cap amount calculated by multiplying the number of beneficiaries during the period by a statutory amount indexed for inflation. The determination for each cap is made annually based on the 12-month period ending on October 31 of each year. This limit is computed on a program-by-program basis. We have not received notification that any of our hospices have exceeded the cap on inpatient care services during 2009. None of the Company s hospices exceeded either cap during the years ended December 31, 2008, or 2007.

Facility-Based Services

Long-Term Acute Care Services. The Company is reimbursed by Medicare for services provided under the LTACH prospective payment system, which was implemented on October 1, 2002. Each patient is assigned a long-term care diagnosis-related group. The Company is paid a predetermined fixed amount applicable to that particular group. This payment is intended to reflect the average cost of treating a Medicare patient classified in that particular long-term care diagnosis-related group. For selected patients, the amount may be further adjusted based on length of stay and facility-specific costs, as well as in instances where a patient is discharged and subsequently readmitted, among other factors. The Company calculates the adjustment based on a historical average of these types of adjustments for claims paid. Similar to other Medicare prospective payment systems, the rate is also adjusted for geographic wage differences. Revenue is recognized as services are provided for the Company s LTACHs.

Medicaid, managed care and other payors

The Company s Medicaid reimbursement is based on a predetermined fee schedule applied to each service provided. Therefore, revenue is recognized for Medicaid services as services are provided based on this fee

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schedule. The Company s managed care payors reimburse the Company in a manner similar to either Medicare or Medicaid. Accordingly, the Company recognizes revenue from managed care payors in the same manner as the Company recognizes revenue from Medicare or Medicaid.

Management Services

The Company records management services revenue as services are provided in accordance with the various management services agreements to which the Company is a party. As described in the agreements, the Company provides billing, management and other consulting services suited to and designed for the efficient operation of the applicable home nursing agency or inpatient rehabilitation facility. The Company is responsible for the costs associated with the locations and personnel required for the provision of services. The Company is compensated based on a percentage of cash collections, a flat fee or is reimbursed for operating expenses and compensated based on a percentage of operating net income.

Accounts Receivable and Allowances for Uncollectible Accounts

The Company reports accounts receivable net of estimated allowances for uncollectible accounts and adjustments. Accounts receivable are uncollateralized and primarily consist of amounts due from third-party payors and patients. To provide for accounts receivable that could become uncollectible in the future, the Company establishes an allowance for uncollectible accounts to reduce the carrying amount of such receivables to their estimated net realizable value. The credit risk for other concentrations of receivables is limited due to the significance of Medicare as the primary payor. The Company does not believe that there are any other significant concentrations of receivables from any particular payor that would subject it to any significant credit risk in the collection of accounts receivable.

The amount of the provision for bad debts is based upon the Company s assessment of historical and expected net collections, business and economic conditions, trends in government reimbursement and other collection indicators. Uncollectible accounts are written off when the Company has determined the account will not be collected.

A portion of the estimated Medicare prospective payment system reimbursement from each submitted home nursing episode is received in the form of a request for accelerated payment (RAP). The Company submits a RAP for 60% of the estimated reimbursement for the initial episode at the start of care. The full amount of the episode is billed after the episode has been completed. The RAP received for that particular episode is deducted from the final payment. If a final bill is not submitted within the greater of 120 days from the start of the episode, or 60 days from the date the RAP was paid, any RAPs received for that episode will be recouped by Medicare from any other Medicare claims in process for that particular provider. The RAP and final claim must then be resubmitted. For subsequent episodes of care contiguous with the first episode for a particular patient, the Company submits a RAP for 50% instead of 60% of the estimated reimbursement. The remaining 50% reimbursement is requested upon completion of the episode. The Company has earned net service revenue in excess of billings rendered to Medicare.

Our Medicare population is paid at a prospectively set amount that can be determined at the time services are rendered. Our Medicaid reimbursement is based on a predetermined fee schedule applied to each individual service we provide. Our managed care contracts are structured similar to either the Medicare or Medicaid payment methodologies. Because of our payor mix, we are able to calculate our actual amount due at the patient level and adjust the gross charges down to the actual amount at the time of billing. This negates the need for an estimated contractual allowance to be booked at the time we report net service revenue for each reporting period.

At December 31, 2009, our allowance for uncollectible accounts, as a percentage of patient accounts receivable, was approximately 10.1%, or \$8.3 million, compared to 14.0%, or \$10.0 million, at December 31, 2008.

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The following table sets forth, as of December 31, 2009, the aging of accounts receivable (based on the billing date) and the total allowance for uncollectible accounts, expressed as a percentage of the related aged accounts receivable (amounts in thousands):

Payor	0-90	91-180	180-365	Over 365	Total
Medicare	$ 40,228	$ 9,404	$ 6,853	$ 1,238	$ 57,723
Medicaid	2,861	767	942	163	4,733
Other	14,121	3,162	2,150	24	19,457
Total	$ 57,210	$ 13,333	$ 9,945	$ 1,425	$ 81,913
Allowance as a percentage of receivables	3.4%	9.9%	27.0%	97.2%	10.1%

For home-based services, we calculate the allowance for uncollectible accounts as a percentage of total patient receivables. The percentage changes depending on the payor and increases as the patient receivables age. For facility-based services, we calculate the allowance for uncollectible accounts based on a claim by claim review. As a result, the allowance percentages presented in the table above vary between the aging categories because of the mix of claims in each category.

The following table sets forth as of December 31, 2008, the aging of accounts receivable (based on the billing date) and the total allowance for uncollectible accounts expressed as a percentage of the related aged accounts receivable (amounts in thousands):

Payor	0-90	91-180	180-365	Over 365	Total
Medicare	$ 41,772	$ 6,806	$ 2,678	$ 1,305	$ 52,561
Medicaid	2,807	1,081	1,108	946	5,942
Other	7,656	3,239	1,219	883	12,997
Total	$ 52,235	$ 11,126	$ 5,005	$ 3,134	$ 71,500
Allowance as a percentage of receivables	6.9%	15.8%	33.0%	94.3%	14.0%

The following table summarizes the activity and ending balances in the allowance for uncollectible accounts (amounts in thousands):

	Beginning of Year Balance	Additions and Expenses	Deductions	End of Year Balance
Year ended December 31:				
2009	$ 9,976	$ 4,724	$ 6,438	$ 8,262
2008	8,953	12,463	11,440	9,976
2007	5,769	13,817	10,633	8,953

Goodwill and Intangible Assets

Goodwill and other intangible assets with indefinite lives are reviewed annually for impairment or more frequently if circumstances indicate impairment may have occurred. If the carrying value of goodwill or an indefinite-lived intangible asset exceeds its fair value, an impairment loss is recognized. The evaluation of impairment involves comparing the current fair value of each of the Company s reporting units to their recorded value, including goodwill. Components of the Company s home-based segment are generally represented by individual subsidiaries or joint ventures with individual licenses to conduct specific operations within geographic markets as limited by the terms of each license. Components of the Company s facility-based services are represented by individual operating entities. Management aggregates the components of these two segments into two reporting units for purposes of evaluating impairment.

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The Company estimates the fair value of its identified reporting units using the discounted cash flow method and the market multiple analysis method. These valuations require management to make estimates and assumptions regarding industry economic factors and the profitability of future business strategies. Management considers historical experience and all available information at the time the fair values of its reporting units are estimated. For each of the reporting units, the estimated fair value is determined based on a formula that considers 50% of the estimated value based on a multiple of earnings before interest, taxes, depreciation and amortization plus 50% of the estimated value using recent sales of comparable facilities. A change in the weight assigned to each methodology would not have changed the conclusion that no impairment charge is necessary during the year ending December 31, 2009. The Company has not recognized goodwill impairment charges in 2009, 2008 or 2007.

Included in intangible assets, net are definite-lived assets subject to amortization such as software licenses and non-compete agreements. Amortization of the definite-lived intangible assets is calculated on a straight-line basis over the estimated useful lives of the related assets. Software licenses are amortized over a three year period and non-compete agreements are amortized over the life of the agreement, usually ranging from three to five years.

The Company also has indefinite-lived assets that are not subject to amortization expense such as trade names and certificates of need. The Company has concluded that trade names and certificates of need have indefinite lives, as management has determined that there are no legal, regulatory, contractual, economic or other factors that would limit the useful life of these intangible assets and the Company intends to renew and operate the licenses and use these trade names indefinitely. The Company performs an annual impairment test on the trade names using the relief-from royalty method. Under this method, the fair value of the intangible asset is determined by calculating the present value of the after-tax cost savings associated with owning the trade names and therefore not having to pay royalties for its use for the remainder of its estimated useful lives. The certificates of need are tested annually for impairment using the cost approach. Under this method, assumptions are made about the cost to replace the certificates of need.

In 2008, the Company purchased two home health agency provider numbers in Ohio for $542,000 and obtained approval from the State of Ohio to move the provider numbers to a new service area. In February 2009, the CMS denied the Company s change of ownership for the provider numbers because the agency locations were moved outside of the allowed service area. Although the Company has re-applied for and received the new provider numbers for these home health agencies, the purchased provider numbers no longer have value. Therefore, the Company recognized a $542,000 impairment expense on the Home-Health segment in other non-operating (loss) income on the Company s Condensed Consolidated Statements of Income for the year ended December 31, 2009.

Adoption of New Accounting Standards

In June 2009, the Financial Accounting Standards Board (the FASB) issued authoritative guidance that replaced the previous hierarchy of GAAP and established the FASB Codification as the single source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. Its primary purpose is to improve clarity and use of existing standards by grouping authoritative literature under common topics. The FASB will no longer issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standards Updates which will serve to update the Codification, provide background information about the guidance and provide the basis for conclusions on the changes to the Codification. The Codification is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Codification does not change or alter existing GAAP and did not have a material effect on the Company s condensed financial condition, results of operations, or cash flows.

In April 2009, the FASB issued authoritative guidance requiring publicly-traded entities to disclose in the body or in the accompanying notes of its summarized financial information for interim reporting periods and in its financial statements for annual reporting periods, the fair value of all financial instruments for which it is practicable to estimate that value, whether recognized or not recognized in the statement of financial position, as required by other authoritative guidance. The guidance is effective for interim and annual reporting periods ending after June 15, 2009. The adoption of the new disclosure requirements did not have a material effect on the Company s condensed financial condition, results of operations, or cash flows.

In May 2009, the FASB issued authoritative guidance establishing general standards of accounting for and disclosing subsequent events that occur after the balance sheet date but before financial statements are issued or are available to be issued. In particular, the guidance sets forth the period after the balance sheet date during which management of the Company should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which the Company should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that the Company should make about events or transactions that occurred after the balance sheet date. Because the guidance only introduces the concept of financial statements being *available to be issued,* the adoption of this guidance did not result in significant changes in the subsequent events that the Company reports, either through recognition or disclosure, in its consolidated financial statements.

On January 1, 2009, the Company prospectively adopted the FASB s guidance on business combinations. The authoritative guidance changes the accounting treatment and disclosure for certain specific items in a business combination. According to the guidance, an acquiring entity is required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. This includes the fair values of the noncontrolling interest acquired. Under previous guidance, the noncontrolling interest (minority interest) was recorded at the minority owner s historical balance. Contingent consideration arrangements are also now measured and recorded at fair value at the acquisition date. Under previous guidance contingent consideration was not recognized until paid or settled. Other changes include the treatment of acquisition-related costs, which, with the exception of debt or equity issuance costs, are to be recognized as an expense in the period that the costs are incurred and the services are received. The Company capitalized acquisition-related costs under previous guidance. Further, any adjustments during the measurement period to the provisional amounts recognized as part of the purchase price allocation are treated retrospectively as of the acquisition date.

In April 2009, the FASB further issued an update on accounting for assets acquired and liabilities assumed in a business combination that arise from contingencies. The update addresses application issues on initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in a business combination. The update required that all contractual contingencies and all noncontractual contingencies that are more likely than not to give rise to an asset or liability be recognized at their acquisition date fair value. All noncontractual contingencies that do not meet the more-likely-than not criterion as of the acquisition date would be accounted for in accordance with other U.S. GAAP. The guidance requires that when new information is obtained, a liability be measured at the higher of its acquisition-date fair value and the amount that would be recognized under other authoritative guidance. Further, an acquirer shall recognize at fair value, at the acquisition date, an asset acquired or a liability assumed in a business combination that arises from a contingency if the acquisition-date fair value of that asset or liability can be determined during the measurement period. The Company has adopted the provisions of this guidance effective January 1, 2009.

The Company also adopted the FASB s guidance on noncontrolling interests in consolidated financial statements on January 1, 2009. The guidance establishes new accounting and reporting standards for the noncontrolling interest, previously known as minority interest. Noncontrolling interest in consolidated subsidiaries is presented in the consolidated balance sheet within stockholders equity as a separate component from the parent s equity. Consolidated net income includes earnings attributable to both the parent and the noncontrolling interest. Earnings per share, which is not affected by the guidance, is based on earnings attributable only to the parent company. The guidance explains the accounting for changes in the parent s ownership interest in a subsidiary, including transactions where control is retained and where control is relinquished. The guidance requires additional disclosure information related to amounts attributable to the parent for income from continuing operations, discontinued operations and extraordinary items and reconciliations of the parent and noncontrolling interests equity in subsidiaries.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk.

As of December 31, 2009, we had $394,000 in cash. Cash in excess of requirements are deposited in highly liquid money market instruments with maturities less than 90 days. Because of the short maturities of these instruments, we would not expect our operating results or cash flows to be materially affected by the effect of a sudden change in market interest rates on our portfolio. At times, the Company s cash in banks exceeds the Federal Insurance Deposit Corporation (FDIC) insurance limit. The Company has not experienced any loss as a result of those deposits and does not expect any in the future.

Our exposure to market risk relates to changes in interest rates for borrowings under the Credit Facility we entered into in February 2008 and amended on June 19, 2009. A hypothetical 100 basis point increase in interest rates on the average daily amounts outstanding under the Credit Facility would have increased interest expense by $10,000 for the year ended December 31, 2009.

Item 8. Financial Statements and Supplementary Data.

The consolidated financial statements and financial statement schedules in Part IV, Item 15 of this Annual Report on Form 10-K are incorporated by reference into this Item 8.

Item 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure.

On August 20, 2008, the Audit Committee of the Company s Board of Directors dismissed Ernst & Young LLP (Ernst & Young) as our independent registered public accounting firm. The reports of Ernst & Young on the financial statements of the Company for the past two fiscal years contained no adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles.

During our two most recent fiscal years and subsequent interim period through August 20, 2008, there were no disagreements with Ernst & Young on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements if not resolved to the satisfaction of Ernst & Young would have caused it to make reference to the subject matter of such disagreements in their reports on the financial statements for such years.

Item 9A. Controls and Procedures.

Evaluation of Disclosure Control and Procedures

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed by the company in the reports it files or submits under the Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to the Company s management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Under the supervision and with the participation of the Company s management, including its Chief Executive Officer and Chief Financial Officer, management evaluated the effectiveness of the Company s disclosure controls and procedures as of December 31, 2009. Based on that evaluation, the Company s Chief Executive Officer and its Chief Financial Officer concluded that the Company s disclosure controls and procedures (as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended) were effective as of December 31, 2009.

Management s Report on Internal Control Over Financial Reporting

The Company s management is responsible for establishing and maintaining adequate internal control over financial reporting, as that term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of the Company s management, including the Chief Executive Officer and Chief Financial Officer, the Company conducted an evaluation of its internal control over financial reporting based on the framework in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Based on management s testing and evaluation under the framework in Internal Control-Integrated Framework, management concluded that our internal control over financial reporting was effective as of December 31, 2009.

The attestation report of KPMG, the independent registered public accounting firm, is included herein.

Changes in Internal Control Over Financial Reporting

There have not been any changes in the Company s internal control over financial reporting, as such term is defined in Rule 13a-15(f) under the Exchange Act, during the Company s fiscal quarter ended December 31, 2009 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

LHC Group, Inc.

We have audited LHC Group, Inc. s internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). LHC Group, Inc. s (the Company) management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, LHC Group, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of LHC Group, Inc. and subsidiaries as of December 31, 2009, and the related consolidated statements of income, changes in equity, and cash flows for the year then ended, and our report dated March 15, 2010 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Baton Rouge, Louisiana

March 15, 2010

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Item 9B. Other Information.
None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance.
The information required by this Item with respect to directors and executive officers is incorporated by reference from the information contained under the headings Directors and Executive Officers and Corporate Governance in our definitive Proxy Statement relating to the Company s 2010 Annual Meeting of Stockholders.

The information required by this Item regarding compliance with Section 16(a) of the Exchange Act is incorporated by reference from the section entitled Directors and Executive Officers in the definitive Proxy Statement relating to the Company s 2010 Annual Meeting of Stockholders.

The information required by this Item with respect to corporate governance is incorporated by reference from the information contained under the heading The Board of Directors and Corporate Governance in the definitive Proxy Statement for the Company s 2010 Annual Meeting of Stockholders.

Code of Conduct and Ethics

We have adopted a code of ethics that applies to all of our directors, officers and employees. This code is publicly available in the investor relations area of our website at www.lhcgroup.com. This code of ethics is not incorporated in this report by reference. Copies of our code of ethics may also be requested in print by writing to Investor Relations at LHC Group, Inc., 420 West Pinhook Road, Suite A, Lafayette, Louisiana, 70503.

Item 11. Executive Compensation.
The information required by this Item is incorporated by reference from the section entitled Executive Compensation in the definitive Proxy Statement relating to the Company s 2010 Annual Meeting of Stockholders.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.
The information required by this Item is incorporated by reference to the sections entitled Security Ownership of Certain Beneficial Owners and Management in the definitive Proxy Statement relating to the Company s 2010 Annual Meeting of Stockholders.

Equity Compensation Plan Information

Plan Category	(a) Number of Shares to be Issued Upon Exercise of Outstanding Options, Warrants, and Rights	(b) Weighted-Average Exercise Price of Outstanding Price of Outstanding Rights	(c) Number of Shares Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a))
Equity compensation plans approved by Stockholders:	19,000	$ 17.20	415,723
Equity compensation plans not approved by Stockholders:			

Total	19,000	$	17.20	415,723

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Item 13. Certain Relationships and Related Transactions, and Director Independence.

The information required by this Item is incorporated by reference from the section entitled Certain Relationships and Related Transactions in the definitive Proxy Statement relating to the Company s 2010 Annual Meeting of Stockholders.

Item 14. Principal Accounting Fees and Services.

The information required by this Item is incorporated by reference from the section entitled Principal Accounting Fees and Services in the definitive Proxy Statement relating to the Company s 2010 Annual Meeting of Stockholders.

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PART IV

Item 15. Exhibits, Financial Statement Schedules.

(a) Documents to be filed with Form 10-K:

(1) Financial Statements

Reports of Independent Registered Public Accounting Firms	F-1
Consolidated Balance Sheets as of December 31, 2009 and 2008	F-3
For each of the three years in the period ended December 31, 2009, 2008 and 2007	
Consolidated Statements of Income	F-4
Consolidated Statements of Changes in Equity	F-5
Consolidated Statements of Cash Flows	F-6
Notes to the Consolidated Financial Statements	F-7

(2) Financial Statement Schedules

There are no financial statement schedules included in this report.

(3) Exhibits

The Exhibits are listed in the Index of Exhibits required by Item 601 of Regulation S-K included herewith, which is incorporated by reference

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

LHC Group, Inc.:

We have audited the accompanying consolidated balance sheets of LHC Group, Inc. and subsidiaries (the Company) as of December 31, 2009 and 2008, and the related consolidated statements of income, changes in equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of LHC Group, Inc. and subsidiaries as of December 31, 2009 and 2008, and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), LHC Group, Inc. s internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 15, 2010 expressed an unqualified opinion on the effectiveness of the LHC Group, Inc. s internal control over financial reporting.

/s/ KPMG LLP

Baton Rouge, Louisiana

March 15, 2010

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders

LHC Group, Inc. and subsidiaries

We have audited the accompanying consolidated statements of income, changes in equity, and cash flows of LHC Group, Inc. and subsidiaries (the Company) for the year ended December 31, 2007. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated results of operations and cash flows of LHC Group, Inc. and subsidiaries for the year ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, effective January 1, 2007 the Company adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109* .

/s/ Ernst & Young LLP

New Orleans, Louisiana

March 14, 2008,

except for Notes 2 and 3, as to which the date is

March 15, 2010

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LHC GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Amounts in thousands, except share data)

	As of December 31, 2009	2008
ASSETS		
Current assets:		
Cash	$ 394	$ 3,511
Receivables:		
Patient accounts receivable, less allowance for uncollectible accounts of $8,262 and $9,976, respectively	73,651	61,524
Other receivables	3,850	2,317
Amounts due from governmental entities	1,184	2,434
Total receivables, net	78,685	66,275
Deferred income taxes	4,370	4,959
Prepaid income taxes	3,131	
Prepaid expenses and other current assets	8,798	6,464
Total current assets	95,378	81,209
Property, building and equipment, net	21,361	16,348
Goodwill	139,474	112,572
Intangible assets, net	46,851	29,975
Other assets	3,169	3,296
Total assets	$ 306,233	$ 243,400
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and other accrued liabilities	$ 20,873	$ 15,497
Salaries, wages and benefits payable	22,521	16,400
Amounts due to governmental entities	3,208	6,023
Income taxes payable		10,682
Current portion of long-term debt	387	508
Total current liabilities	46,989	49,110
Deferred income taxes	12,475	5,718
Revolving Credit Facility	5,723	
Long-term debt, less current portion	4,096	4,483
Other long-term obligations	1,567	145
Noncontrolling interest-redeemable	13,823	6,682
Stockholders equity:		
Common stock $0.01 par value: 40,000,000 shares authorized; 20,967,418 and 20,853,463 shares issued and 17,990,685 and 17,895,832 shares outstanding, respectively	179	179
Treasury stock 2,976,733 and 2,957,631 shares at cost, respectively	(3,513)	(3,072)
Additional paid-in capital	86,310	85,404
Retained earnings	138,196	94,310
Total LHC Group, Inc. stockholders equity	221,172	176,821
Noncontrolling interest non-redeemable	388	441
Total equity	221,560	177,262

Total liabilities and stockholders equity	$ 306,233	$ 243,400

See accompanying Notes to the Consolidated Financial Statements

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LHC GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Amounts in thousands, except share and per share data)

	For the Year Ended of December 31, 2009	2008	2007
Net service revenue	$ 531,980	$ 382,591	$ 297,017
Cost of service revenue	270,515	186,254	150,038
Gross margin	261,465	196,337	146,979
Provision for bad debts	4,724	11,771	12,248
General and administrative expenses	171,695	124,074	95,950
Operating income	85,046	60,492	38,781
Interest expense	(142)	(458)	(357)
Gain (loss) on the sale of assets and entities	(22)	967	(108)
Non-operating (loss) income	(239)	461	1,167
Income from continuing operations before income taxes and noncontrolling interest	84,643	61,462	39,483
Income tax expense	26,743	18,808	12,197
Income from continuing operations	57,900	42,654	27,286
Loss from discontinued operations (net of income tax benefit of $55, $190 and $289, respectively)	(86)	(776)	(2,416)
Gain on sale of discontinued operations (net of income taxes of $20)			31
Net income	57,814	41,878	24,901
Less net income attributable to noncontrolling interest	13,973	11,676	5,312
Net income attributable to LHC Group, Inc.	43,841	30,202	19,589
Redeemable noncontrolling interests	45	31	193
Net income available to LHC Group, Inc. s common stockholders	$ 43,886	$ 30,233	$ 19,782
Earnings per share basic:			
Income from continuing operations attributable to LHC Group, Inc.	$ 2.44	$ 1.73	$ 1.24
Loss from discontinued operations attributable to LHC Group, Inc.		(0.04)	(0.14)
Net income attributable to LHC Group, Inc.	2.44	1.69	1.10
Redeemable noncontrolling interest			0.01
Net income attributable to LHC Group, Inc. s common stockholders	$ 2.44	$ 1.69	$ 1.11
Earnings per share diluted:			
Income from continuing operations attributable to LHC Group, Inc.	$ 2.43	$ 1.73	$ 1.23
Loss from discontinued operations attributable to LHC Group, Inc.		(0.04)	(0.13)
Net income attributable to LHC Group, Inc.	2.43	1.69	1.10
Redeemable noncontrolling interest			0.01
Net income attributable to LHC Group, Inc. s common stockholders	$ 2.43	$ 1.69	$ 1.11

Weighted average shares outstanding:			
Basic	17,960,376	17,855,634	17,760,432
Diluted	18,069,897	17,899,087	17,827,444

See accompanying Notes to the Consolidated Financial Statements

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LHC GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

(Amounts in thousands, except share data)

	LHC Group, Inc. Common Stock									
	Issued		Treasury		Additional		Noncontrolling		Non-Controlling	
	Amount	Shares	Amount	Shares	Paid-In Capital	Retained Earnings	Interest - Non-redeemable	Total Equity	Interest - Redeemable	Net Income
Balance at December 31, 2006	$ 177	20,682,317	$ (2,856)	2,950,059	$ 80,273	$ 44,295	$ 387	$ 122,276	3,243	
Net income						19,589	1,131	20,720	4,181	24,901
Noncontrolling interest distributions							(1,045)	(1,045)	(4,509)	
Exercise of stock options		527								
Nonvested stock compensation					1,125			1,125		
Issuance of vested restricted stock		25,976			62			62		
Treasury shares redeemed to pay income tax			(10)	370				(10)		
Excess tax benefit vesting of nonvested stock					104			104		
Issuance of common stock under Employee Stock Purchase Plan		16,893			419			419		
Recording noncontrolling interest in joint venture at redemption value						193		193		
Balances at December 31, 2007	$ 177	20,725,713	$ (2,866)	2,950,429	$ 81,983	$ 64,077	$ 473	$ 143,844	$ 2,915	
Net income						30,202	1,463	31,665	10,213	41,878
Noncontrolling interest distributions							(1,495)	(1,495)	(8,307)	
Purchase of additional noncontrolling interest									1,861	
Issuance of common stock to joint venture partners in exchange for a portion of their minority ownership	1	51,736			1,033			1,034		
Nonvested stock compensation					1,935			1,935		
Issuance of vested restricted stock		53,026								
Treasury shares redeemed to pay income tax			(206)	7,202				(206)		
Tax shortfall from issuance of vesting stock					(39)			(39)		
Issuance of common stock under Employee Stock Purchase Plan	1	22,988			492			493		
Recording noncontrolling interest in joint venture at redemption value						31		31		
Balances at December 31, 2008	$ 179	20,853,463	$ (3,072)	2,957,631	$ 85,404	$ 94,310	$ 441	$ 177,262	$ 6,682	
Net income						43,841	1,554	45,395	12,419	57,814

Transfer of noncontrolling interest					181			181	1,228
Purchase of additional controlling interest					(2,286)			(2,286)	
Acquired noncontrolling interest									5,858
Noncontrolling interest distributions							(1,607)	(1,607)	(12,364)
Nonvested stock compensation					2,393			2,393	
Issuance of vested restricted stock		89,163							
Treasury shares redeemed to pay income tax			(441)	19,102				(441)	
Issuance of common stock under Employee Stock Purchase Plan		24,792			618			618	
Recording noncontrolling interest in joint venture at redemption value						45		45	
Balances at December 31, 2009	$ 179	20,967,418	$ (3,513)	2,976,733	$ 86,310	$ 138,196	$ 388	$ 221,560	$ 13,823

See accompanying Notes to the Consolidated Financial Statements

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LHC GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in thousands)

	For the Year Ended December 31, 2009	2008	2007
Operating activities			
Net income	$ 57,814	$ 41,878	$ 24,901
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization expense	4,831	3,740	3,026
Provision for bad debts	4,724	12,463	13,817
Stock based compensation expense	2,393	1,935	1,187
Deferred income taxes	4,646	462	129
Loss on impairment of intangible assets	542		
Gain on sale of assets and partial sale of entity		(967)	
Changes in operating assets and liabilities, net of acquisitions:			
Receivables	(17,896)	(597)	(31,109)
Prepaid expenses, other assets	(4,747)	4,155	(1,446)
Accounts payable and accrued expenses	(1,550)	20,549	1,570
Net amounts due from governmental entities	(1,565)	1,886	(61)
Net cash provided by operating activities	49,192	85,504	12,014
Investing activities			
Cash paid for acquisitions, primarily goodwill, intangible assets and advance payment on acquisitions	(33,427)	(69,898)	(28,935)
Purchases of property, building and equipment	(8,236)	(8,550)	(3,346)
Proceeds from sale of property and equipment		3,094	
Purchase of certificate of deposit		(522)	
Net cash used in investing activities	(41,663)	(75,876)	(32,281)
Financing activities			
Proceeds from line of credit	69,206	32,850	
Payments on line of credit	(63,483)	(32,850)	
Proceeds from debt issuance		5,050	
Principal payments on debt	(508)	(3,339)	(199)
Payment of deferred financing fees	(263)	(75)	
Payments on capital leases	(80)	(101)	(207)
Excess tax benefits from vesting of restricted stock	121	91	104
Proceeds from issuance of common stock under ESPP	618	493	419
Purchase of additional controlling interest	(2,286)		
Noncontrolling interest distributions	(13,971)	(9,391)	(5,572)
Net cash used in financing activities	(10,646)	(7,272)	(5,455)
Change in cash	(3,117)	2,356	(25,722)
Cash at beginning of period	3,511	1,155	26,877
Cash at end of period	$ 394	$ 3,511	$ 1,155
Supplemental disclosures of cash flow information			
Interest paid	$ 142	$ 456	$ 376

Income taxes paid	$ 35,869	$ 8,937	$ 12,052

Supplemental disclosure of non-cash transactions:

In February 2009, the Company acquired a 75% interest in Southeast Louisiana HomeCare, LLC in exchange for $7.5 million of cash and a noncontrolling interest in three of the Company s home health agencies. Also, during 2009, the Company acquired a majority ownership in 11 entities and recorded $7.1 million of noncontrolling interest related to the acquisitions.

During the year ended December 31, 2008, the Company issued common stock valued at $1.0 million to several joint venture partners upon the acquisition of a portion of their noncontrolling interest. Also, in October 2008, the Company sold a minority ownership interest in two of its entities as consideration to purchase a majority ownership in an entity. The Company recognized a gain of $624,000 on the partial acquisition.

See accompanying Notes to the Consolidated Financial Statements

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LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization

LHC Group, Inc. (the Company) is a health care provider specializing in the post-acute continuum of care primarily for Medicare beneficiaries. The Company provides home-based services, primarily through home nursing agencies and hospices and facility-based services, primarily through long-term acute care hospitals. The Company, through its wholly and majority-owned subsidiaries, equity joint ventures and controlled affiliates, currently operates in Louisiana, Mississippi, Arkansas, Alabama, Texas, Kentucky, Florida, Tennessee, Georgia, Virginia, West Virginia, Ohio, Missouri, Maryland, Washington, Oklahoma, Oregon and North Carolina.

2. Summary of Significant Accounting Policies

Immaterial Correction of an Error

During the fourth quarter of 2009, the Company identified an immaterial error in the accounting for and presentation of noncontrolling interest-redeemable. Previously, all noncontrolling interest was presented in equity in the consolidated balance sheet and statement of changes in equity. Noncontrolling interest is generally required to be classified as equity. However, some of the Company s noncontrolling interest agreements have certain redemption features that are not solely within the control of the Company. Classification of these noncontrolling interests outside of permanent equity is required. Therefore, the Company corrected the classification by presenting certain noncontrolling interest which contains a redemption feature, outside of permanent equity.

The unaudited balance sheets included in the Company s 2009 interim financial statements presented noncontrolling interest - redeemable as a component of stockholders equity, rather than outside of permanent equity. In accordance with authoritative guidance, the Company evaluated the materiality of the error from both a qualitative and quantitative perspective, and concluded the error was immaterial to the current and prior periods. This immaterial error had no effect on our income statement or statement of cash flows for the years ending December 31, 2009, 2008 or 2007, including, no impact on earnings per share, net service revenue or in the manner in which we determine net income attributable to non-controlling interests. Noncontrolling interest - redeemable as of December 31, 2008, March 31, 2009, June 30, 2009 and September 31, 2009 should have been \$6.7 million, \$11.6 million, \$13.2 million, and \$13.5 million, respectively.

Use of Estimates

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

Principles of Consolidation

The consolidated financial statements include all subsidiaries and entities controlled by the Company. Control is defined by the Company as ownership of a majority of the voting interest of an entity. The consolidated financial statements include entities in which the Company has the obligation to absorb losses of the entities or the right to receive benefits from the entities and generally has voting control over the entities or both, as a result of ownership, contractual or other financial interests in the entities. Third party equity interests in the consolidated joint ventures are reflected as noncontrolling interests in the Company s consolidated financial statements.

The following table summarizes the percentage of net service revenue earned by type of ownership or relationship the Company had with the operating entity for the periods presented:

	2009	2008	2007
Equity joint ventures	51.4%	49.6%	43.7%
Wholly owned subsidiaries	44.6	46.6	46.4
License leasing arrangements	2.5	2.1	7.8

Management services	1.5	1.7	2.1
	100.0%	100.0%	100.0%

The changes in the percentages of revenue earned by license leasing arrangements and by the equity joint ventures relate, in part, to the conversion of one of the Company s license leasing arrangements to a joint venture on October 1, 2007.

All significant inter-company accounts and transactions have been eliminated in consolidation. Business combinations accounted for as purchases have been included in the consolidated financial statements from the respective dates of acquisition.

The following discussion describes the Company s consolidation policy with respect to its various ventures excluding wholly owned subsidiaries:

Equity Joint Ventures

The Company s joint ventures are structured as limited liability companies in which the Company typically owns a majority equity interest ranging from 51% to 99%. Each member of all but one of the Company s equity joint ventures participates in profits and losses in proportion to their equity interests. The Company has one joint venture partner whose participation in losses is limited. The Company consolidates these entities as the Company has the obligation to absorb losses of the entities and the right to receive benefits from the entities and generally has voting control over the entities.

LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

License Leasing Arrangements

The Company, through wholly owned subsidiaries, leases home health licenses necessary to operate certain of its home nursing agencies. As with wholly owned subsidiaries, the Company owns 100% of the equity of these entities and consolidates them based on such ownership, as well as the Company s obligation to absorb losses of the entities and the right to receive benefits from the entities.

Management Services

The Company has various management services agreements under which the Company manages certain operations of agencies and facilities. The Company does not consolidate these agencies or facilities, as the Company does not have an ownership interest and does not have an obligation to absorb losses of the entities or the right to receive the benefits from the entities.

Revenue Recognition

The Company reports net service revenue at the estimated net realizable amount due from Medicare, Medicaid, commercial insurance, managed care payors, patients and others for services rendered. All payors contribute to both the home-based services and facility-based services.

The following table sets forth the percentage of net service revenue earned by category of payor for the years ending December 31:

	2009	2008	2007
Payor:			
Medicare	81.7%	83.2%	81.7%
Medicaid	3.5	4.6	5.5
Other	14.8	12.2	12.8
	100.0%	100.0%	100.0%

The percentage of net service revenue contributed from each reporting segment was as follows for the years ending December 31:

	2009	2008	2007
Home-based services	88.2%	85.2%	82.2%
Facility-based services	11.8	14.8	17.8
	100.0%	100.0%	100.0%

Medicare

Home-Based Services

Home Nursing Services. The Company s home nursing Medicare patients are classified into one of 153 home health resource groups prior to receiving services. Based on this home health resource group, the Company is entitled to receive a standard prospective Medicare payment for delivering care over a 60-day period, referred to as an episode. The Company recognizes revenue based on the number of days elapsed during an episode of care within the reporting period.

Final payments from Medicare may reflect one of four retroactive adjustments to ensure the adequacy and effectiveness of the total reimbursement: (a) an outlier payment if the patient s care was unusually costly; (b) a low utilization adjustment if the number of visits totaled fewer than five; (c) a partial payment if the patient transferred to another provider before completing the episode; or (d) a payment adjustment based upon the level of therapy services required in the population base. Management estimates the impact of these payment adjustments based on historical experience and records this estimate during the period the services are rendered. The Company s payment is also adjusted for differences in local prices using the hospital wage index. In calculating the Company s reported net service revenue from home nursing services, the Company adjusts the prospective Medicare payments by an estimate of the adjustments. The adjustments are calculated using a historical average of prior adjustments.

Hospice Services. The Company is paid by Medicare under a per diem payment system. The Company receives one of four predetermined daily or hourly rates based upon the level of care the Company furnished. The Company records net service revenue from hospice services based on the daily or hourly rate and recognizes revenue as hospice services are provided.

LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Hospice payments are also subject to two caps. One relates to individual programs receiving more than 20% of its total Medicare reimbursement from inpatient care services and the second relates to individual programs receiving reimbursements in excess of a cap amount, calculated by multiplying the number of beneficiaries during the period by a statutory amount that is indexed for inflation. The determination for each cap is made annually based on the 12-month period ending on October 31 of each year. This limit is computed on a program-by-program basis. The Company has not received notification that any of its hospices have exceeded the cap on inpatient care services during 2009. None of the Company s hospices exceeded either cap during the years ended December 31, 2008, or 2007.

Facility-Based Services

Long-Term Acute Care Services (LTACHs). The Company is reimbursed by Medicare for services provided under LTACH prospective payment system, which was implemented on October 1, 2002. Each patient is assigned a long-term care diagnosis-related group, and the Company is paid a predetermined fixed amount applicable to that particular group. This payment is intended to reflect the average cost of treating a Medicare patient classified in that particular long-term care diagnosis-related group. For selected patients, the amount may be further adjusted based on length of stay and facility-specific costs, as well as in instances where a patient is discharged and subsequently readmitted, among other factors. Similar to other Medicare prospective payment systems, the rate is also adjusted for geographic wage differences. Revenue is recognized as services are provided for the Company s LTACHs.

Medicaid, managed care and other payors

The Company s Medicaid reimbursement is based on a predetermined fee schedule applied to each service provided. Therefore, revenue is recognized for Medicaid services as services are provided based on this fee schedule.

The Company s managed care payors reimburse the Company in a manner similar to either Medicare or Medicaid. Accordingly, the Company recognizes revenue from managed care payors in the same manner as the Company recognizes revenue from Medicare or Medicaid.

Management Services

The Company records management services revenue as services are provided in accordance with the various management services agreements to which the Company is a party. As described in the agreements, the Company provides billing, management and other consulting services suited to and designed for the efficient operation of the applicable home nursing agency or inpatient rehabilitation facility. The Company is responsible for the costs associated with the locations and personnel required for the provision of services. The Company is compensated based on a percentage of cash collections, a flat fee or is reimbursed for operating expenses and compensated based on a percentage of operating net income.

Accounts Receivable and Allowances for Uncollectible Accounts

The Company reports accounts receivable net of estimated allowances for uncollectible accounts and adjustments. Accounts receivable are uncollateralized and primarily consist of amounts due from third-party payors and patients. To provide for accounts receivable that could become uncollectible in the future, the Company establishes an allowance for uncollectible accounts to reduce the carrying amount of such receivables to their estimated net realizable value. The credit risk for other concentrations of receivables is limited due to the significance of Medicare as the primary payor. The Company does not believe that there are any other significant concentrations of receivables from any particular payor that would subject it to any significant credit risk in the collection of accounts receivable.

The amount of the provision for bad debts is based upon the Company s assessment of historical and expected net collections, business and economic conditions and trends in government reimbursement. Uncollectible accounts are written off when the Company has determined the account will not be collected.

A portion of the estimated Medicare prospective payment system reimbursement from each submitted home nursing episode is received in the form of a request for accelerated payment (RAP). The Company receives a RAP payment for 60% of the estimated reimbursement for the initial episode at the start of care. The full amount of the episode is billed after the episode has been completed. The RAP received for that particular episode is deducted from the final payment. If a final bill is not submitted within the greater of 120 days from the start of the episode, or 60 days from the date the RAP was paid, any RAPs received for that episode will be recouped by Medicare from any other Medicare claims in process for that particular provider. The RAP and final claim must then be resubmitted. For subsequent episodes of care contiguous with the first episode for a particular patient, the Company submits a RAP for 50% instead of 60% of the estimated reimbursement. The remaining 50% reimbursement is requested upon completion of the episode. The Company has earned net service revenue in excess of billings rendered to Medicare.

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LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company s Medicare population is paid at a prospectively set amount that can be determined at the time services are rendered. The Company s Medicaid reimbursement is based on a predetermined fee schedule applied to each individual service the Company provides. The Company s managed care contracts are structured similar to either the Medicare or Medicaid payment methodologies. Because of the Company s payor mix, it is able to calculate actual amounts due at the patient level and adjust the gross charges down to the actual amount at the time of billing. This negates the need for an estimated contractual allowance to be booked at the time it reports net service revenue for each reporting period.

Business Combination

The Company accounts for business combinations using the acquisition method. The assets acquired in the Company s acquisition consist primarily of a Medicare license, certificate or need and/or a noncompete agreement. The assets acquired and liabilities assumed, if any, are measured at fair value on the acquisition date using the appropriate valuation method. The noncontrolling interest associated with joint venture acquisitions is also measured and recorded at fair value as of the acquisition date. The residual purchase price is recorded as goodwill. The operations are the acquisitions are included in the consolidated financial statements from their respective dates of acquisition.

Goodwill and Intangible Assets

Goodwill and other intangible assets with indefinite lives are reviewed annually for impairment or more frequently if circumstances indicate impairment may have occurred. An impairment loss is recognized if the carrying value of goodwill or an indefinite-lived intangible asset exceeds its fair value. The evaluation of impairment involves comparing the current fair value of each of the Company s reporting units to their recorded value, including goodwill. Components of the Company s home -based services segment are generally represented by individual subsidiaries or joint ventures with individual licenses to conduct specific operations within geographic markets as limited by the terms of each license. Components of the Company s facility-based services are represented by individual operating entities. Management aggregates the components of these two segments into two reporting units for purposes of evaluating impairment.

The Company estimates the fair value of its identified reporting units using the discounted cash flow method and the market multiple analysis method. These valuations require management to make estimates and assumptions regarding industry economic factors and the profitability of future business strategies. Management considers historical experience and all available information at the time the fair values of its reporting units are estimated. For each of the reporting units, the estimated fair value is determined based on a formula that considers 50% of the estimated value based on a multiple of earnings before interest, taxes, depreciation and amortization plus 50% of the estimated value using recent sales of comparable facilities. A change in the weight assigned to each methodology would not have changed the conclusion that no impairment charge is necessary during the year ending December 31, 2009. The Company has not recognized goodwill impairment charges in 2009, 2008 or 2007.

Included in intangible assets, net, are definite-lived assets subject to amortization such as non-compete agreements. Amortization of definite-lived intangible assets is calculated on a straight-line basis over the estimated useful lives of the related assets.

The Company also has indefinite-lived assets that are not subject to amortization expense such as trade names and certificates of need. The Company has concluded that trade names and certificates of need have indefinite lives, as management has determined that there are no legal, regulatory, contractual, economic or other factors that would limit the useful life of these intangible assets and the Company intends to renew and operate the licenses and use these trade names indefinitely. The Company performs an annual impairment test on the trade names using the relief-from royalty method. Under this method, the fair value of the intangible asset is determined by calculating the present value of the after-tax cost savings associated with owning the trade names and, therefore, not having to pay royalties for its use for the remainder of its estimated useful lives. The certificates of need are tested annually for impairment using the cost approach. Under this method assumptions are made about the cost to replace the certificates of need.

Due to/from Governmental Entities

The Company s LTACHs are reimbursed for certain activities based on tentative rates. The amounts recorded in *due to/from governmental entities* on the Company s consolidated balance sheet relate to settled and open cost reports that are subject to the completion of audits and the issuance of final assessments. Final reimbursement is determined based on submission of annual cost reports and audits by the fiscal intermediary. Adjustments are accrued on an estimated basis in the period the related services were rendered and further adjusted as final settlements are determined. These adjustments are accounted for as changes in estimates. There have been no significant changes in estimates during the years ended December 31, 2009 and 2008.

Property, Building and Equipment

Property, building and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the individual assets. Estimated useful lives for buildings is 39 years and ranges from 3 to 10 years for transportation equipment and furniture and other equipment. The useful life for leasehold improvements is the lesser of the lease term or the expected life of the leasehold improvement. Routine repairs and maintenance are expensed when incurred.

Property, building and equipment is reviewed whenever events or changes in circumstances occur that indicate possible impairment. There were no impairments recognized during the periods ended December 31, 2009, 2008 or 2007.

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LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table describes the Company s components of property, building and equipment:

	December 31, 2009	December 31, 2008
	(In thousands)	
Land	$ 667	$ 342
Building and improvements	4,385	3,719
Transportation equipment and major moveables	5,697	5,496
Furniture and other equipment	25,643	17,695
	36,392	27,252
Less accumulated depreciation and amortization	15,031	10,904
	$ 21,361	$ 16,348

Depreciation expense for the years ended December 31, 2009, 2008 and 2007 was $4.8 million, $3.7 million and $3.0 million, respectively.

Noncontrolling Interest

The nonredeemable interest held by third parties in subsidiaries owned or controlled by the Company is reported on the consolidated balance sheets as noncontrolling interest as a component of stockholders equity. Redeemable interest held by third parties in subsidiaries owned or controlled by the Company is reported on the consolidated balance sheets outside permanent equity. All noncontrolling interest reported in the consolidated statements of income reflects the respective interests in the income or loss after income taxes of the subsidiaries attributable to the other parties, the effect of which is removed from the net income available to LHC Group, Inc.

Stock-Based Employee Compensation

The Company grants restricted stock or restricted stock units to employees and members of its Board of Directors as a form of compensation. The expense for such awards is based on the grant date fair value of the award and is recognized on a straight-line basis over the requisite service period. See Note 7 to these consolidated financial statements.

Earnings Per Share

Basic per share information is computed by dividing the item by the weighted-average number of shares outstanding during the period, under the treasury stock method. Diluted per share information is computed by dividing the item by the weighted-average number of shares outstanding plus dilutive potential shares. The dilutive share calculation at December 31, 2009 included 29,043 contingent shares related to one of the Company s acquisitions. See Note 3 to these consolidated financial statements.

The following table sets forth shares used in the computation of basic and diluted per share information for the years ended December 31, 2009, 2008 and 2007:

	2009	2008	2007
Weighted average number of shares outstanding for basic per share calculation	17,960,376	17,855,634	17,760,432
Effect of dilutive potential shares:			

Options	6,158	5,705	6,461
Nonvested restricted stock	74,320	37,748	60,551
Contingent shares	29,043		
Adjusted weighted average shares for diluted per share calculation	18,069,897	17,899,087	17,827,444

Subsequent Events

The Company evaluated all events or transactions that occurred from December 31, 2009 through the date the financial statements were issued. During this period, the Company did not have any material recognizable subsequent events.

LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Adoption of New Accounting Standards

In June 2009, the Financial Accounting Standards Board (the FASB) issued authoritative guidance that replaced the previous hierarchy of GAAP and established the FASB Codification as the single source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. Its primary purpose is to improve clarity and use of existing standards by grouping authoritative literature under common topics. The FASB will no longer issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standards Updates which will serve to update the Codification, provide background information about the guidance and provide the basis for conclusions on the changes to the Codification. The Codification is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Codification does not change or alter existing GAAP and did not have a material effect on the Company s condensed financial condition, results of operations, or cash flows.

In April 2009, the FASB issued authoritative guidance requiring publicly-traded entities to disclose in the body or in the accompanying notes of its summarized financial information for interim reporting periods and in its financial statements for annual reporting periods, the fair value of all financial instruments for which it is practicable to estimate that value, whether recognized or not recognized in the statement of financial position, as required by other authoritative guidance. The guidance is effective for interim and annual reporting periods ending after June 15, 2009. The adoption of the new disclosure requirements did not have a material effect on the Company s financial condition, results of operations, or cash flows.

In 2009, the Company adopted the FASB authoritative guidance establishing general standards of accounting for and disclosing subsequent events that occur after the balance sheet date but before financial statements are issued or are available to be issued. In particular, the guidance sets forth the period after the balance sheet date during which management should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which the Company should recognize events or transactions occurring after the balance sheet date in its financial statements, and the disclosures that the Company should make about events or transactions that occurred after the balance sheet date. Because the guidance only introduces the concept of financial statements being *available to be issued,* adoption of this guidance did not result in significant changes in the subsequent events that the Company reports, either through recognition or disclosure, in its consolidated financial statements.

On January 1, 2009, the Company prospectively adopted FASB s guidance on business combinations. The authoritative guidance changes the accounting treatment and disclosure for certain specific items in a business combination. According to the guidance, an acquiring entity is required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. This includes the fair values of the noncontrolling interest acquired. Under previous guidance, the noncontrolling interest (minority interest) was recorded at the minority owner s historical balance. Contingent consideration arrangements are also now measured and recorded at fair value at the acquisition date. Under previous guidance contingent consideration was not recognized until paid or settled. Other changes include the treatment of acquisition-related costs, which, with the exception of debt or equity issuance costs, are to be recognized as an expense in the period that the costs are incurred and the services are received. The Company capitalized acquisition-related costs under previous guidance. Further, any adjustments during the measurement period to the provisional amounts recognized as part of the purchase price allocation are treated retrospectively as of the acquisition date.

In April 2009, the FASB further issued an update on accounting for assets acquired and liabilities assumed in a business combination that arise from contingencies. The update addresses application issues on initial recognition and measurement, subsequent measurement and accounting, and disclosure of assets and liabilities arising from contingencies in a business combination. The update required that all contractual contingencies and all noncontractual contingencies that are more likely than not to give rise to an asset or liability be recognized at their acquisition date fair value. All noncontractual contingencies that do not meet the more-likely-than not criterion as of the acquisition date would be accounted for in accordance with other U.S. GAAP. The guidance requires that when new information is obtained, a liability be measured at the higher of its acquisition-date fair value or the amount that would be recognized under other authoritative guidance. Further, an acquirer shall recognize at fair value, at the acquisition date, an asset acquired or a liability assumed in a business combination that arises from a contingency if the acquisition-date fair value of that asset or liability can be determined during the measurement period. The Company has adopted the provisions of this guidance effective January 1, 2009, which did not have a material effect on the operating results, financial position, or liquidity of the Company.

The Company also adopted the FASB s guidance on noncontrolling interests in consolidated financial statements on January 1, 2009. The guidance establishes new accounting and reporting standards for the noncontrolling interest, previously known as minority interest. Noncontrolling interest in consolidated subsidiaries is presented in the consolidated balance sheet within stockholders equity as a separate component from the parent s equity. Consolidated net income includes earnings attributable to both the parent and the noncontrolling interest. Earnings per share, which is not affected by the guidance, is based on earnings attributable only to the parent

LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

company. The guidance explains the accounting for changes in the parent s ownership interest in a subsidiary, including transactions where control is retained and where control is relinquished. The guidance requires additional disclosure information related to amounts attributable to the parent for income from continuing operations, discontinued operations and extraordinary items and reconciliations of the parent and noncontrolling interests equity in subsidiaries.

3. Acquisitions and Divestitures

Pursuant to the Company s strategy of becoming the leading provider of post-acute health care services in the United States, the Company acquired one LTACH, 13 homecare entities and two hospice entities during 2009. As a result of these acquisitions, the Company maintains an ownership interest in the entities set forth below.

Acquired Entity	Ownership Percentage	State of Operations	Acquisition Date
Southeast Louisiana HomeCare, LLC	75%	Louisiana	February 1, 2009
Hospice of Central Arkansas, LLC	67%	Arkansas	April 1, 2009
Marion Regional HomeCare, LLC	67%	Alabama	April 1, 2009
Louisiana Extended Care Hospital of Kenner, LLC	75%	Louisiana	May 1, 2009
Central Basin HomeCare and Hospice, LLC	100%	Washington	May 1, 2009
East Alabama Medical Center HomeCare, LLC	75%	Alabama	June 1, 2009
Kentucky HomeCare of Henderson, LLC	67%	Kentucky	June 1, 2009
Coosa Valley HomeCare, LLC	75%	Alabama	August 1, 2009
Northeast Washington Home Health, Inc.	80.1%	Washington	August 1, 2009
LHCG XV, LLC	100%	Louisiana	September 1, 2009
Three Rivers HomeCare, LLC	75%	Oregon	September 1, 2009
Camden HomeCare, LLC	100%	Alabama	October 1, 2009
Feliciana Home Health, LLC	100%	Louisiana	November 1,2009
Twin Lakes Home Health Agency, LLC	75%	Kentucky	November 1, 2009
Woods Memorial Home Health, LLC	75%	Tennessee	December 1, 2009

Each of the acquisitions was accounted for under the acquisition method of accounting, and, accordingly, the accompanying consolidated financial statements include the results of operations of each acquired entity from the date of acquisition.

2009 Acquisitions

Home-Based

The total purchase price of home-based acquisitions was $33.2 million, which was paid primarily in cash. The purchase prices were determined based on the Company s analysis of comparable acquisitions and the target market s potential future cash flows. The purchase price for Southeast Louisiana HomeCare, LLC included a transfer of a 25% noncontrolling interest in three of the Company s wholly owned home health agencies. The transfer of the noncontrolling interest in the Company s existing home health agencies was accounted for as an equity transaction, resulting in the Company recognizing additional paid in capital of $181,000.

The purchase price for Feliciana Home Health, LLC provided for up to $2.5 million in contingent consideration to be paid to the seller if certain financial measurements are achieved. The fair value of the contingent consideration recognized on the acquisition date was $1.7 million. The fair value of the contingent consideration was estimated using an income approach based on financial projections for the acquired company. The projected cash flows were discounted using a discount rate of LIBOR plus 100 basis points, which the Company believes is appropriate and is representative of a market participant assumption. The fair value measurement is based on significant inputs not observable in the market and thus represents a Level 3 fair value measurement.

The Company recognized goodwill of $22.0 million, including $3.2 million of goodwill attributable to noncontrolling interests, related to acquisitions made in 2009. The Company expects its portion of goodwill to be fully tax deductible.

During 2009, the Company purchased additional ownership interests in five of its joint ventures. The total purchase price for the additional ownership interests was $2.3 million and was accounted for as an equity transaction, resulting in the Company recognizing additional paid in capital of $2.3 million.

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LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In 2008, one of the Company s acquisitions contained contingent consideration to the seller, a portion of which may be settled in shares of the Company s stock one year after the acquisition date. The number of shares that may be issued is contingent upon the acquired company achieving certain financial measurements in the year after the acquisition. During the three months ended September 30, 2009, the Company recorded $1.9 million of additional purchase price related to the contingent consideration as the acquired company achieved the required financial measurements. Of the contingent consideration, $950,000 was paid in cash during 2009. The remaining $950,000 is recorded as a liability as of December 31, 2009, however the number of the shares to be issued was not determinable beyond a reasonable doubt.

During 2009, the Company settled the working capital amounts acquired on several 2008 acquisitions. An additional $349,000 was paid in cash in 2009 related to the settlements. An additional $2.7 million was recognized as goodwill and a deferred tax liability related to the finalization of acquisition accounting.

On December 31, 2009, the Company paid $1.2 million in cash for two acquisitions with January 1, 2010 acquisition dates. Control was not assumed until January 1, 2010; therefore, the $1.2 million cash payment is recorded in other assets on the balance sheet as of December 31, 2009.

Facility-Based

The total purchase price of the facility-based acquisitions was $1.2 million, which was paid primarily in cash. The purchase price was determined based on the Company s analysis of comparable acquisitions and the target market s potential future cash flows.

The Company recognized goodwill of $86,000, including $22,000 of noncontrolling goodwill, related to the acquisitions. The Company expects its portion of goodwill to be fully tax deductible.

In conjunction with the redemption by certain noncontrolling interest holders of their interest in one of the Company s joint ventures, $15,000 of goodwill, which is not deductible for income tax purposes, was recognized in the facility-based services segment.

The following table summarizes the consideration paid for the 2009 acquisitions and the amounts of the assets acquired and liabilities assumed at the acquisition dates, as well as the fair value at the acquisition dates of the noncontrolling interest acquired for both the home-based and facility-based acquisitions.

	2009
Consideration (in thousands)	
Cash	$ 30,905
Contingent consideration	1,726
Equity instruments (the Company exchanged a noncontrolling ownership interest in three of its entities)	1,409
Working capital adjustment	337
Fair value of total consideration transferred	$ 34,377
Acquisition-related costs (included in general and administrative expenses in the Company s statement of income.)	$ 672
Recognized amounts of identifiable assets acquired and liabilities assumed	
Property, plant and equipment	$ 888
Trade name	12,949

Certificate of need/License	3,532
Other identifiable intangible assets	797
Total identifiable assets	$ 18,166
Noncontrolling interest	$ 5,858
Goodwill, including noncontrolling interest of ($3.3 million)	$ 22,069

Trade names and certificates of need are indefinite-lived assets and, therefore, not subject to amortization. The other identifiable assets include non-compete agreements and other contracts that are amortized over the life of the agreements or contracts, ranging from two to five years. The fair value of the acquired intangible assets is preliminary pending the final valuation of those assets.

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LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The acquisitions during the year, individually, were immaterial to the Company s consolidated financial statements; however, when aggregated, total acquisitions were material. The following table contains unaudited pro forma consolidated income statement information assuming the acquisitions closed January 1, 2008 for 2009 acquisitions (amounts in thousands):

	2009	2008
Net service revenue	$ 553,315	$ 427,127
Operating income	86,833	29,670
Net income	45,222	29,590
Basic earnings per share	2.52	1.67
Diluted earnings per share	2.50	1.66

To provide financial information that is more representative of the combined results of the Company as if the acquisitions had occurred January 1, 2008, the pro forma disclosure in the table above includes adjustments for depreciation expense, amortization of intangible assets, income tax expense and an estimate of additional costs to provide administrative services for these locations. This pro forma information is presented for illustrative purposes only and may not be indicative of the results of operations that would have actually occurred. In addition, future results may vary significantly from the results reflected in the pro forma information.

2008 Acquisitions

Home-Based

During the year ended December 31, 2008, the Company acquired the existing operations of 11 entities operating a total of 43 agencies and a majority ownership in 12 entities operating a total of 17 agencies. The total purchase price for the acquisitions was $63.7 million, including $2.0 million of acquisition-related costs. Goodwill of $47.2 million and other intangibles of $14.9 million were assigned to the home-based services segment related to the acquisitions. Goodwill of $23.5 million is not deductible for income tax purposes.

In October 2008, the Company purchased a majority ownership in an entity with three agencies in exchange for a minority ownership interest in two of the Company s entities. Noncontrolling interest of $1.9 million was recorded in the Company s consolidated balance sheet as of December 31, 2008 related to the noncontrolling ownership transferred as consideration. The Company recognized a gain of $624,000 on the purchase. Goodwill of $2.4 million and other intangibles of $485,000 were assigned to the home-based services segment related to the acquisition.

Facility-Based

In 2008, the Company also acquired an additional ownership interest in one of its majority-owned hospitals for $1.0 million, paid by issuing 51,736 shares of its common stock. Goodwill of $1.0 million related to this acquisition, which is nondeductible for income tax purposes, was assigned to the facility-based services segment.

In conjunction with the redemption by certain noncontrolling interest holders of their interest in one of the Company s joint ventures, $89,000 of goodwill, which is not deductible for income tax purposes, was recognized in the facility-based services segment.

2007 Acquisitions

During the year ended December 31, 2007, the Company acquired the existing operations of 11 locations and a majority ownership interest in the existing operations of 12 locations for $26.0 million in cash, and $2.4 million in acquisition costs. Goodwill of $21.9 million and other intangibles of $5.8 million were assigned to the home-based services segment.

2009 Divestitures

In September 2009, the Company sold its outpatient rehabilitation clinic. The sale generated a loss of $22,000, which was recognized in the third quarter of 2009. The results of operations related to the clinic are included in discontinued operations in the Company s condensed consolidated statements of income for the years ending December 31, 2009, 2008 and 2007.

2007 Divestitures

During the year ended December 31, 2007, the Company sold its critical access hospital for $180,000 and recognized a gain of $31,000, net of tax of $20,000. There was no goodwill related to this hospital. Additionally, the Company closed a home health pharmacy location in the year ended December 31, 2007. The assets related to the home health pharmacy are classified as assets held for sale on the balance sheet. The Company retired goodwill of $48,000 related to the termination of its private duty business.

LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table provides financial results of discontinued operations for the years ending December 31, 2009, 2008 and 2007 (amounts in thousands):

	2009	2008	2007
Net service revenue	$ 402	$ 756	$ 3,994
Costs of services and general and administrative expenses	(543)	(1,722)	(6,699)
Loss from discontinued operations before noncontrolling interest and income taxes	(141)	(966)	(2,705)
Income tax benefit	55	190	289
Loss from discontinued operations net of income tax benefit	(86)	(776)	(2,416)
Less loss from discontinued operations attributable to noncontrolling interest		(123)	(672)
Loss from discontinued operations attributable to LHC Group Inc. s common stockholders	$ (86)	$ (653)	$ (1,744)

4. Goodwill and Other Intangibles, Net

The following table summarizes the changes in goodwill by segment:

	2009	2008
	(In Thousands)	
Home-based services segment:		
Balances at beginning of period	$ 107,108	$ 57,885
Goodwill from acquisitions	18,735	49,223
Goodwill related to noncontrolling interest	3,248	
2008 acquisition adjustments	(654)	
Deferred tax liability on 2008 acquisitions	2,700	
Consideration settlement of 2008 acquisition	2,772	
Home-based balance at end of period	133,909	107,108
Facility-based services segment:		
Balances at beginning of period	$ 5,464	$ 4,342
Goodwill from acquisitions	64	
Goodwill related to noncontrolling interest	22	
Goodwill acquired during the period from redemption of noncontrolling interest	15	1,122
Facility-based balance at end of period	5,565	5,464
Consolidated balance at end of period	$ 139,474	$ 112,572

In 2008, the Company purchased two home health agency provider numbers in Ohio for $542,000 and obtained approval from the State of Ohio to move the provider numbers to a new service area. In February 2009, the Centers for Medicare and Medicaid Services (CMS) denied the

Company s change of ownership for the provider numbers because the agency locations were moved outside of the allowed service area. Although the Company has re-applied for and received the new provider numbers for these home health agencies, the purchased provider numbers no longer have value. Therefore, the Company has recognized a $542,000 impairment expense on the home-based services segment in other non-operating (loss) income on the Company s condensed consolidated statements of income for the year ended December 31, 2009.

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LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the changes in other intangibles, net during 2009, which all related to the home-based services segment (amounts in thousands):

	Trade Names	License and Certificates of Need	Other Intangibles	Total
Balance at December 31, 2008	$ 27,233	$ 2,001	$ 741	$ 29,975
Additions	12,949	3,532	797	17,278
2008 acquisition adjustments	123	542		665
License impairment		(542)		(542)
Amortization			(525)	(525)
Balance at December 31, 2009	$ 40,305	$ 5,533	$ 1,013	$ 46,851

Other intangible assets of $45.9 million, net of accumulated amortization, related to the home-based services segment and $992,000 related to the facility-based services segment as of December 31, 2009.

5. Income Taxes

The Company accounts for income taxes using the liability method. Under the liability method, deferred taxes are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using the enacted tax laws that will be in effect when the differences are expected to reverse. Management provides a valuation allowance for any net deferred tax assets when it is more likely than not that a portion of such net deferred tax assets will not be recovered.

As discussed in Note 3 to these consolidated financial statements, during 2009, the Company finalized the acquisition accounting for three of the Company s 2008 acquisitions and recorded a $2.7 million net deferred tax liability. Significant components of the Company s deferred tax assets and liabilities as of December 31, 2009 and 2008 were as follows:

	2009	2008
	(In Thousands)	
Deferred tax assets:		
Allowance for uncollectible accounts	$ 2,746	$ 3,503
Accrued employee benefits	2,293	1,679
Stock compensation	897	742
Accrued self-insurance	1,185	796
Acquisition Costs	372	
Book losses not deductible for taxes	76	
Net operating loss carry forward	652	644
Valuation allowance	(652)	(689)
Deferred tax assets	$ 7,569	$ 6,675
Deferred tax liabilities:		
Amortization of intangible assets	(10,247)	(4,733)

Tax depreciation in excess of book depreciation	(3,005)	(1,683)
Prepaid expenses	(866)	(364)
Non-accrual experience accounting method	(918)	(654)
Conversion from cash basis accounting	(638)	
Deferred tax liabilities	(15,674)	(7,434)
Net deferred tax liability	$ (8,105)	$ (759)

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LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Based on the Company s historical pattern of taxable income, the Company believes it will produce sufficient income in the future to realize its deferred income tax assets. A valuation allowance is established for any portion of a deferred income tax asset for which the Company believes it is more likely than not that the Company will not be able to realize the benefits or portions of a deferred income tax asset. At December 31, 2008 management had a valuation allowance primarily related to the tax net operating losses and deferred tax assets on the Company s home health pharmacy, which was included in discontinued operations for the years ending December 31, 2008 and 2007. During 2009, the net operating losses were fully utilized; therefore, management released the valuation allowance. Management established a valuation allowance during purchase accounting related to the tax net operating losses acquired during 2008 in one the Company s stock acquisitions.

The components of the Company s income tax expense from continuing operations, less noncontrolling interest, were as follows:

	2009	2008	2007
		(In Thousands)	
Current:			
Federal	$ 19,026	$ 15,928	$ 10,585
State	3,071	2,418	1,483
	22,097	18,346	12,068
Deferred:			
Federal	4,001	401	111
State	645	61	18
	4,646	462	129
Total provision for income taxes	$ 26,743	$ 18,808	$ 12,197

A reconciliation of the differences between income taxes expense, computed at the federal statutory rate and provisions for income taxes for each period is as follows:

	2009	2008	2007
		(In Thousands)	
Income taxes computed at federal statutory tax rate	$ 24,734	$ 17,270	$ 11,730
State income taxes, net of federal benefit	2,480	1,730	1,001
Work Opportunity Act tax credit	(525)	(518)	(662)
Valuation allowance reduction	(689)		
Nondeductible expenses	743	326	128
Total provision for income taxes	$ 26,743	$ 18,808	$ 12,197

As of December 31, 2009, the Company has no unrecognized tax benefits. The Company recognizes interest and penalties related to uncertain tax positions, if applicable, in interest expense and general and administrative expenses, respectively. During the years ended December 31, 2009, 2008 and 2007, the Company did not recognize any interest or penalties in its consolidated financial statements, nor has it recorded an accrued liability of interest or penalty payments related to uncertain tax positions.

The Company is subject to both federal and state income tax for jurisdictions within which it operates. Within these jurisdictions, the Company is open to examination for tax years ended after December 31, 2006.

LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Credit Arrangements

Long-Term Debt

Long-term debt consisted of the following:

	December 31, 2009	December 31, 2008
	(In thousands)	
Due in monthly installments of $28,056 through February 2015 at LIBOR plus 1.90% (2.14% at December 31,2009) plus a balloon payment of $2.7 million	$ 4,433	$ 4,769
Due in August 2010 at 6.25%	50	100
Due in November 2009 at 5.78%		122
	4,483	4,991
Less current portion of long-term debt	387	508
	$ 4,096	$ 4,483

In February 2008, the Company entered into a loan agreement with Capital One, National Association (Capital One) for a term note in the amount of $5.1 million for the purchase of a 1999 Cessna 560 aircraft. The aircraft serves as collateral for the term note, which is payable in 83 monthly installments of principal plus interest followed by one balloon installment on February 6, 2015 of $2.7 million. The term note bears interest at the LIBOR Rate (adjusted monthly) plus the Applicable Margin of 1.9%.

Certain of the Company s loan agreements contain restrictive covenants, including limitations on indebtedness and the maintenance of certain financial ratios. The Company was in compliance with all covenants at December 31, 2009 and 2008.

The scheduled principal payments on long-term debt are as follows for each of the next five years following December 31, 2009 (in thousands):

2010	$ 387
2011	337
2012	337
2013	337
2014	337
Thereafter	2,748
	$ 4,483

Credit Facility

The Company s Credit Facility with Capital One, which was amended on June 15, 2009, provides for a maximum aggregate principal borrowing of $75.0 million. The Credit Facility, which is scheduled to expire on June 15, 2011, is unsecured and has a letter of credit sublimit of $2.5 million. In September 2009, the company issued a $700,000 letter of credit as collateral on the Company s workers compensation insurance. The annual facility fee is 0.25% of the total availability. The interest rate for borrowings under the Credit Facility is a function of the prime rate (Base Rate) subject to a floor or the Eurodollar rate (Eurodollar) subject to a floor, as elected by the Company, plus the applicable margin based on the Leverage Ratio as defined in the Credit Facility. The Company paid $477,000 of credit fees on the Credit Facility during 2009. At December 31, 2009, $5.7 million and the letter of credit were outstanding under the Credit Facility. At December 31, 2008 no amounts were outstanding under the Credit Facility.

The Company s Credit Facility contains customary affirmative, negative and financial covenants. For example, the Company is restricted in incurring additional debt, disposing of assets, making investments, allowing fundamental changes to the Company s business or organization, and making certain payments in respect of stock or other ownership interests, such as dividends and stock repurchases. Under the Credit Facility, the Company is also required to meet certain financial covenants with respect to minimum fixed charge coverage, consolidated net worth, leverage and minimum asset coverage ratios. At December 31, 2009, the Company was in compliance with all covenants.

The Company s Credit Facility also contains customary events of default. These include bankruptcy and other insolvency events, cross-defaults to other debt agreements, a change in control involving the Company or any subsidiary guarantor, and the failure to comply with certain covenants.

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LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Stockholders Equity

Equity Based Awards

On January 20, 2005, the Board of Directors and stockholders of the Company approved the 2005 Long Term Incentive Plan (the Incentive Plan). The Incentive Plan, which is administered by the Compensation Committee of the Company s Board of Directors, provides for 1,000,000 shares of common stock that may be issued or transferred pursuant to awards made under the plan. A variety of discretionary awards for employees, officers, directors and consultants are authorized under the Incentive Plan, including restricted stock and incentive or non-qualified statutory stock options. All awards must be evidenced by a written award certificate that will include the provisions specified by the Compensation Committee of the Board of Directors. The Incentive Plan provides that shares of common stock subject to awards granted become available again for issuance if such awards are canceled or forfeited.

The Compensation Committee determines the exercise price for non-statutory stock options. The exercise price for any option cannot be less than the fair market value of the Company s common stock as of the date of grant.

In the event of a change of control as defined in the Incentive Plan, all restricted periods and restrictions imposed on non-performance based restricted stock awards will lapse and outstanding options will become immediately exercisable in full.

Share Based Compensation

Stock Options

The following table represents stock options activity for the year ended December 31, 2009:

	Number of Shares	Weighted Average Exercise Price	Average Remaining Contractual Term	Aggregate Instrinsic Value
Options outstanding at January 1, 2009	19,000	$ 17.20	7.0 years	$ 357,275
Options granted				
Options exercised				
Options forfeited or expired				
Options outstanding at December 31, 2009	19,000	$ 17.20	6.0 years	$ 311,865
Options exercisable at December 31, 2009	19,000	$ 17.20	6.0 years	$ 311,865

All options are fully vested and exercisable at December 31, 2009. No options were exercised in the year ended December 31, 2009 or 2008. There were 2,000 options exercised in the year ended December 31, 2007 with a total intrinsic value of $14,120. There were no options granted during 2009, 2008 or 2007. No compensation expense related to stock option grants was recorded in the years ended December 31, 2009, 2008 or 2007.

Non-vested Stock

The Company issues stock-based compensation to employees in the form of restricted stock, which is an award of common stock subject to certain restrictions. The awards, which the Company calls nonvested shares, generally vest over a five year period, conditioned on continued employment for the full incentive period. Compensation expense for the restricted stock is recognized for the awards that are expected to vest. The expense is based on the fair value of the awards on the date of grant recognized on a straight-line basis over the requisite service period, which generally relates to the vesting period.

During 2009, 2008 and 2007, respectively, 238,028, 149,095 and 181,071 non-vested shares were granted to employees pursuant to the 2005 Long-Term Incentive Plan. These shares vest over a five year period.

The Company also issues restricted stock to its non-employee members of the Company s Board of Directors. During 2009, 2008 and 2007, respectively, 14,000, 16,100 and 16,100 non-vested shares of stock were granted to the Company s independent directors under the 2005 Director Compensation Plan. New non-employee directors receive an initial grant of non-vested shares in which one third of these shares vest immediately and the remaining vest over the two year period following the grant date. Additionally, the 2005 Director Compensation Plan provides for annual grants of non-vested shares to non-employee directors in which the full amount of shares vests at the one year anniversary of the grant date.

The fair value of non-vested shares is determined based on the closing trading price of the Company s shares on the grant date. The weighted average grant date fair values of non-vested shares granted during the years ended December 31, 2009, 2008 and 2007 were $20.49, $18.67 and $27.83, respectively.

LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table represents the non-vested stock activity for the year ended December 31, 2009:

	Number of Shares	Weighted Average Grant Date Fair Value
Non-vested shares outstanding at January 1, 2009	306,406	$ 22.56
Granted	252,028	$ 20.40
Vested	(89,163)	$ 21.62
Forfeited	(3,138)	$ 19.60
Non-vested shares outstanding at December 31, 2009	466,133	$ 21.88

As of December 31, 2009, there was $8.1 million of total unrecognized compensation cost related to non-vested shares granted. That cost is expected to be recognized over the weighted average period of 3.4 years. The total fair value of shares vested in the years ended December 31, 2009, 2008 and 2007 were $1.9 million, $1.3 million and $468,000, respectively. The Company records compensation expense related to non-vested share awards at the grant date for shares that are awarded fully vested and over the vesting term on a straight line basis for shares that vest over time. The Company has recorded $2.4 million, $1.9 million and $1.2 million in compensation expense related to non-vested stock grants in the years ended December 31, 2009, 2008 and 2007, respectively.

Employee Stock Purchase Plan

In 2006, the Company adopted the Employee Stock Purchase Plan allowing eligible employees to purchase the Company s common stock at 95% of the market price on the last day of each calendar quarter. There were 250,000 shares reserved for the plan. During 2008 and 2007, the Company issued 22,988 shares and 16,893 shares, respectively. The Company issued 24,792 shares of common stock under the plan at a weighted average per share price of $24.97 during the year ended December 31, 2009. At December 31, 2009 there were 178,231 shares available for future issuance.

Treasury Stock

In conjunction with the vesting of the non-vested shares of stock, recipients incur withholding tax liabilities. The Company allows the holders to turn in shares of common stock to satisfy those tax obligations. The Company redeemed 19,102, 7,202 and 370 shares of common stock related to these tax obligations at December 31, 2009, 2008 and 2007, respectively.

Issuance of Common Stock

As discussed in Note 3 to these consolidated financial statements, during 2008, the Company issued 51,736 shares of common stock to purchase an additional ownership percentage in one of its majority-owned hospitals. The stock was valued as of May 14, 2008, the effective date of the acquisition.

8. Leases

In certain instances, state laws may prohibit the sale of a home nursing agency or hospitals may be reluctant to sell their home health agencies. In these instances, the Company, through its wholly owned subsidiaries, enters into a lease agreement for a Medicare and Medicaid license, as well as the associated provider number to provide home health or hospice services. As of December 31, 2009, the Company had four license lease arrangements to operate five home nursing agencies and three hospice agencies.

Two of the leases were entered into in 2007 and expire in 2017. Expense related to these leases was $260,000 in 2009 and 2008. Payments due under these leases are $270,000 in 2010.

Two of the leases were entered into in 2005 and expire in 2010. Expense related to these leases was $215,123 in 2009 and $186,000 in 2008. The lease payments associated with these leases are based on a percentage of net quarterly profits; therefore, the future payments will vary with the future profits.

The Company leases office space and equipment at its various locations. Many of the leases contain renewal options with varying terms and conditions. Management expects that in the normal course of business, expiring leases will be renewed or, upon making a decision to relocate, replaced by leases for new locations. Operating lease terms range from three to ten years. Rent expense includes

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LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

insurance, maintenance, and other costs as required by the lease. Total rental expense was approximately $13.8 million in 2009, $10.6 million in 2008 and $8.1 million in 2007. Future minimum rental commitments under non-cancelable operating leases are as follows (in thousands):

2010	$ 11,062
2011	7,223
2012	5,152
2013	3,550
2014	1,406
Thereafter	987
	$ 29,380

As of December 31, 2009, future minimum payments by year and in the aggregate, under non-cancelable capital leases with initial terms of one year or more, consisted of the following (in thousands):

2010	$ 28
2011	17
2012	
2013	
2014	
Thereafter	
Total minimum lease payments	45
Current portion of capital lease obligations	28
Capital lease obligations, long-term	$ 17

The cost of assets held under capital leases was $531,000 at both December 31, 2009 and 2008. The related accumulated amortization was $456,000 at December 31, 2009 and 2008.

9. Employee Benefit Plan

Defined Contribution Plan

The Company sponsors a 401(k) plan to all eligible full-time employees. The plan allows participants to contribute up to 15% of their compensation and allows discretionary Company contributions as determined by the Company s Board of Directors. Effective January 1, 2006, the Company implemented a discretionary match of up to two percent of participating employee contributions. The employer contribution will vest 20% after two years and 20% each additional year until it is fully vested in year six. Contribution expense to the Company was $2.2 million, $1.4 million and $1.1 million in 2009, 2008 and 2007.

10. Commitments and Contingencies

Contingencies

The Company is involved in various legal proceedings arising in the ordinary course of business. Although the results of litigation cannot be predicted with certainty, management believes the outcome of pending litigation will not have a material adverse effect, after considering the effect of the Company s insurance coverage, on the Company s consolidated financial statements.

Joint Venture Buy/Sell Provisions

Several of the Company s joint ventures include a buy/sell option that grants to the Company and its joint venture partners the right to require the other joint venture party to either purchase all of the exercising member s membership interests or sell to the exercising member all of the non-exercising member s membership interest, at the non-exercising member s option, within 30 days of the receipt of notice of the exercise of the buy/sell option. In some instances, the purchase price is based on a multiple of the historical or future earnings before income taxes and depreciation and amortization of the equity joint venture at the time the buy/sell option is exercised. In other instances, the buy/sell purchase price will be negotiated by the partners and subject to a fair market valuation process. The Company has not received notice from any joint venture partners of their intent to exercise the terms of the buy/sell agreement nor has the Company notified any joint venture partners of its intent to exercise the terms of the buy/sell agreement.

Noncontrolling Interest- Redeemable

A majority of the Company s joint venture agreements include a provision that requires the Company to purchase the noncontrolling partner s interest upon the occurrence of certain triggering events, such as death or bankruptcy of the partner or the partner s exclusion from the Medicare or Medicaid programs. These triggering events and the related repurchase provisions are specific to each individual joint venture; if the repurchase provision is triggered in any one joint venture, the remaining joint ventures would not be impacted. Upon the occurrence of a triggering event, the Company would be required to purchase the noncontrolling partner s interest at either the fair value or the book value at the time of purchase as stated in the agreement. Historically, no triggering event has occurred, and we believe the likelihood of a triggering event occurring is remote. The Company has never been required to purchase the noncontrolling interest of any of its joint venture partners. According to authoritative guidance, redeemable noncontrolling interests must be reported outside of permanent equity on the consolidated balance sheet in instances where there is a repurchase provision with a triggering event that is outside the control of the Company. The Company had 51 joint venture agreements with these repurchase provisions resulting in total noncontrolling interests - redeemable of $13.8 million and $6.7 million at December 31, 2009 and 2008, respectively.

Compliance

The laws and regulations governing the Company s operations, along with the terms of participation in various government programs, regulate how the Company does business, the services offered and interactions with patients and the public. These laws and regulations and their interpretations are subject to frequent change. Changes in existing laws or regulations, or their interpretations, or the enactment of new laws or regulations could materially and adversely affect the Company s operations and financial condition.

LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company is subject to various routine and non-routine governmental reviews, audits and investigations. In recent years, federal and state civil and criminal enforcement agencies have heightened and coordinated their oversight efforts related to the health care industry, including with respect to referral practices, cost reporting, billing practices, joint ventures and other financial relationships among health care providers. Violation of the laws governing the Company s operations, or changes in the interpretation of those laws, could result in the imposition of fines, civil or criminal penalties, the termination of the Company s rights to participate in federal and state-sponsored programs and the suspension or revocation of the Company s licenses.

If the Company s LTACHs fail to meet or maintain the standards for Medicare certification as LTACHs, such as average minimum length of patient stay, they will receive payments under the prospective payment system applicable to general acute care hospitals rather than payment under the system applicable to LTACHs. Payments at rates applicable to general acute care hospitals would likely result in the Company receiving less Medicare reimbursement than currently received for patient services. Moreover, all but one of the Company s long-term acute care hospitals are subject to additional Medicare criteria because they operate as separate hospitals located in space leased from and located in, a general acute care hospital, known as a host hospital. This is known as a hospital within a hospital model. These additional criteria include requirements concerning financial and operational separateness from the host hospital.

The Company anticipates there may be changes to the standard episode-of-care payment from Medicare in the future. Due to the uncertainty of the revised payment amount, the Company cannot estimate the impact that changes in the payment rate, if any, will have on its future financial statements.

The Company believes that it is in material compliance with all applicable laws and regulations. As previously reported, the Company received an administrative subpoena from the Inspector General of the Office of Personnel Management (OPM). OPM is an administrative agency responsible for overseeing the Federal Employees Health Benefit Program (FEHBP). Although the subpoena was issued by OPM, the Company learned on July 9, 2009 that the scope of the review is not limited to the FEHBP, but also extends to services provided to Medicare beneficiaries. The focus of the review is on third-party quality improvement audits performed on the Company s behalf by a third party consultant from 2005 to present. The Company will continue to cooperate and provide responsive information for the OPM review.

As previously reported, the Company has a qui tam lawsuit filed in Tennessee entitled United States of America ex rel Sally Christine Summers v. LHC Group, Inc. which alleged a violation of the False Claims Act at a single agency. The Company has received the district court s order dismissing the case. The plaintiff is now appealing the court s dismissal, and the Company continues to respond as necessary and appropriate.

Except as discussed in the preceding paragraphs, the Company is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. While no such regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action, including fines, penalties and exclusion from the Medicare program.

11. Segment Information

The Company s segments consist of (a) home-based services and (b) facility-based services. Home-based services include home nursing services and hospice services. Facility-based services include long-term acute care services. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

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LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Year Ended December 31, 2009		
	Home-Based Services	Facility-Based Services (In thousands)	Total
Net service revenue	$ 469,470	$ 62,510	$ 531,980
Cost of service revenue	234,131	36,384	270,515
Provision for bad debts	4,199	525	4,724
General and administrative expenses	155,670	16,025	171,695
Operating income	75,470	9,576	85,046
Interest expense	(126)	(16)	(142)
Non operating (loss) income, including gain on sale of assets	(299)	38	(261)
Income from continuing operations before income taxes and noncontrolling interest	75,045	9,598	84,643
Income tax expense	24,082	2,661	26,743
Income from continuing operations	50,963	6,937	57,900
Noncontrolling interest	12,527	1,446	13,973
Total assets	$ 279,416	$ 26,817	$ 306,233

	Year Ended December 31, 2008		
	Home-Based Services	Facility-Based Services (In thousands)	Total
Net service revenue	$ 326,041	$ 56,550	$ 382,591
Cost of service revenue	154,376	31,878	186,254
Provision for bad debts	10,208	1,563	11,771
General and administrative expenses	109,917	14,157	124,074
Operating income	51,540	8,952	60,492
Interest expense	(377)	(81)	(458)
Non operating income, including gain on sale of assets	1,246	182	1,428
Income from continuing operations before income taxes and noncontrolling interest	52,409	9,053	61,462
Income tax expense	16,029	2,779	18,808
Income from continuing operations	36,380	6,274	42,654
Noncontrolling interest	10,219	1,457	11,676
Total assets	$ 220,822	$ 22,578	$ 243,400

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LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Year Ended December 31, 2007		
	Home-Based Services	Facility-Based Services	Total
		(In thousands)	
Net service revenue	$ 244,107	$ 52,910	$ 297,017
Cost of service revenue	116,962	33,076	150,038
Provision for bad debts	9,426	2,822	12,248
General and administrative expenses	80,595	15,355	95,950
Operating income	37,124	1,657	38,781
Interest expense	(250)	(107)	(357)
Non operating income, including gain on sale of assets	746	313	1,059
Income from continuing operations before income taxes and noncontrolling interest	37,620	1,863	39,483
Income tax expense	8,219	3,978	12,197
Income from continuing operations	29,401	(2,115)	27,286
Noncontrolling interest	5,177	135	5,312
Total assets	$ 151,540	$ 23,445	$ 174,985

12. Fair Value of Financial Instruments

The carrying value of the Company s long-term debt is based on the current interest rates on the Company s variable debt and approximates its fair value. The carrying amounts of the Company s cash, receivables, accounts payable and accrued liabilities approximate their fair values because of their short maturity.

13. Allowance for Uncollectible Accounts

The following table summarizes the activity and ending balances in the allowance for uncollectible accounts:

	Beginning of Year Balance	Additions and Expenses	Deductions	End of Year Balance
		(In thousands)		
Year ended December 31:				
2009	$ 9,976	$ 4,724	$ 6,438	$ 8,262
2008	8,953	12,463	11,440	9,976
2007	5,769	13,817	10,633	8,953

14. Concentration of Risk

The Company s Louisiana facilities accounted for approximately 34.0%, 41.9% and 50.9% of net service revenue during the years ended December 31, 2009, 2008 and 2007 respectively. Any material change in the current economic or competitive conditions in Louisiana could have a disproportionate effect on the Company s overall business results.

LHC GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

15. Unaudited Summarized Quarterly Financial Information

The following table presents the Company s audited quarterly results of operations (amounts in thousands, except share data):

	First Quarter 2009	Second Quarter 2009	Third Quarter 2009	Fourth Quarter 2009
		(In thousands)		
Net service revenue	$ 124,457	$ 133,175	$ 132,856	$ 141,492
Gross margin	62,362	66,136	63,331	69,636
Net income attributable to LHC Group, Inc.	11,081	10,262	9,832	12,666
Net income available to common stockholders	11,109	10,282	9,829	12,666
Basic earnings per share				
Net income attributable to LHC Group, Inc.	$ 0.62	$ 0.57	$ 0.55	$ 0.70
Diluted earnings per share				
Net income attributable to LHC Group, Inc.	$ 0.62	$ 0.57	$ 0.54	$ 0.70
Weighted average shares outstanding				
Basic	17,924,238	17,959,823	17,971,352	17,985,169
Diluted	17,991,618	18,030,373	18,116,984	18,169,052

	First Quarter 2008	Second Quarter 2008	Third Quarter 2008	Fourth Quarter 2008
		(In thousands)		
Net service revenue	$ 83,281	$ 89,934	$ 97,990	$ 111,386
Gross margin	42,162	45,159	50,783	58,233
Net income attributable to LHC Group, Inc.	5,338	6,334	8,032	10,498
Net income available to common stockholders	5,439	6,298	8,003	10,493
Basic and Diluted earnings per share				
Net income attributable to LHC Group, Inc.	$ 0.30	$ 0.35	$ 0.45	$ 0.58
Net income available to common shareholders	$ 0.31	$ 0.35	$ 0.45	$ 0.58
Weighted average shares outstanding				
Basic	17,800,066	17,849,820	17,881,228	17,891,426
Diluted	17,813,967	17,883,964	17,976,305	17,993,815

Because of the method used to calculate per share amounts, quarterly per share amounts may not necessarily total to the per share amounts for the entire year.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) 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.

LHC GROUP, INC.

/s/ Keith G. Myers
Keith G. Myers
President and Chief Executive Officer

Date March 15, 2010

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Keith G. Myers and Peter J. Roman and either of them (with full power in each to act alone) as true and lawful attorneys-in-fact with full power of substitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K and to file the same, with all exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that said attorneys-in-fact, or their substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Keith G. Myers **Keith G. Myers**	Chief Executive Officer, President and Chairman of the Board of Directors	March 15, 2010
/s/ Peter J. Roman **Peter J. Roman**	Executive Vice President, Chief Financial Officer	March 15, 2010
/s/ John L. Indest **John L. Indest**	Director	March 15, 2010
/s/ Dan S. Wilford **Dan S. Wilford**	Director	March 15, 2010
/s/ Ronald T. Nixon **Ronald T. Nixon**	Director	March 15, 2010
/s/ Ted W. Hoyt **Ted W. Hoyt**	Director	March 15, 2010
/s/ George A. Lewis **George A. Lewis**	Director	March 15, 2010
/s/ John B. Breaux **John B. Breaux**	Director	March 15, 2010
/s/ Monica F. Azare	Director	March 15, 2010

Monica F. Azare

/s/ W.J. Billy Tauzin **W.J. Billy Tauzin**	Director	March 15, 2010
/s/ Kenneth E. Thorpe **Kenneth E. Thorpe**	Director	March 15, 2010

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EXHIBIT INDEX

Exhibit Number	Description of Exhibits
3.1	Certificate of Incorporation of LHC Group, Inc. (previously filed as an exhibit to the Form S-1/A (File No. 333-120792) on February 14, 2005).
3.2	Bylaws of LHC Group, Inc., as amended on December 3, 2007 (previously filed as Exhibit 3.2 to the Form 10-Q on May 9, 2008)
3.3	Certificate of Designations (previously filed as Exhibit B to Exhibit 4.1 to the Form 8-A12B on March 11, 2008).
4.1	Specimen Stock Certificate of LHC s Common Stock, par value $0.01 per share (previously filed as an exhibit to the Form S-1/A (File No. 333-120792) on February 14, 2005).
4.2	Reference is made to Exhibits 3.1 and 3.2 (previously filed as an exhibit to the Form S-1/A (File No. 333-120792) on February 14, 2005 and May 9, 2005, respectively).
4.3	Stockholder Protection Rights Agreement, Dated March 10, 2008 by and between LHC Group, Inc. and Computershare Trust Company, N.A., as rights agent (previously filed as Exhibit 4.1 to the Form 8-A12B on March 11, 2008).
10.1	LHC 2003 Key Employee Equity Participation Plan (previously filed as an exhibit to the Form S-1/A (File No. 333-120792) on November 26, 2004).+
10.2	LHC Group, Inc. 2005 Long-Term Incentive Plan (previously filed as an exhibit to the Form S-1/A (File No. 333-120792) on February 14, 2005). +
10.3	Form of Award under LHC Group, Inc. 2005 Director Compensation Plan. (previously filed as an exhibit to the Form S-1/A (File No. 333-120792) on February 14, 2005). +
10.4	Form of Indemnity Agreement between LHC Group and directors and certain officers (previously filed as an exhibit to the Form S-1/A (File No. 333-120792) on February 14, 2005). +
10.5	LHC Group, Inc. 2005 Director Compensation Plan (previously filed as an exhibit to the Form S-1/A (File No. 333-120792) on February 14, 2005). +
10.6	Amendment to LHC Group, Inc. 2005 Director Compensation Plan (previously filed as Exhibit 99.1 to the Form 8-K on June 12, 2006).
10.7	LHC Group, Inc. 2006 Employee Stock Purchase Plan (previously filed as Exhibit 99.2 to the Form 8-K on June 12, 2006). +
10.8	Severance and Consulting Agreement by and between LHC Group, Inc. and Barry E. Stewart, dated August 15, 2007 (previously filed as Exhibit 10.1 to the Form 8-K on August 15, 2007).
10.9	Employment Agreement by and between LHC Group, Inc. and Don Stelly, dated October 22, 2007 (previously filed as Exhibit 10.1 to the Form 8-K on October 30, 2007). +
10.10	Employment Agreement between LHC Group, Inc. and Keith G. Myers dated January 1, 2008 (previously filed as Exhibit 10.1 to the Form 8-K on January 4, 2008). +
10.11	Employment Agreement between LHC Group, Inc. and John L. Indest dated January 1, 2008 (previously filed as Exhibit 10.2 to the Form 8-K on January 4, 2008). +
10.12	Employment Agreement by and between LHC Group, Inc. and Peter Roman, dated January 1, 2008 (previously filed as Exhibit 10.3 to the Form 8-K on January 4, 2008). +

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Exhibit Number	Description of Exhibits
10.13	Employment Agreement between LHC Group, Inc. and Daryl Doise dated January 1, 2008 (previously filed as Exhibit 10.4 to the Form 8-K on January 4, 2008). +
10.14	Loan Agreement by and between LHC Group, Inc., Palmetto Express, L.L.C. and Capital One, National Association dated February 6, 2008 (previously filed as Exhibit 10.1 to the Form 8-K on February 13, 2008).
10.15	Amended and Restated Credit Agreement by and among LHC Group, Inc., Capital One, National Association, First Tennessee Bank, N.A. and Brand Banking and Trust Company, dated June 12, 2008 (previously filed as Exhibit 10.1 to the Form 8-K on June 17, 2008).
10.16	First Amendment to Amended and Restated Credit Agreement by and among LHC Group, Inc., Capital One, National Association, Capital One Corporation, First Tennessee Bank, N.A. and Brand Banking and Trust Company, dated June 15, 2009 (previously filed as Exhibit 10.1 to the Form 8-K on June 18, 2009).
10.17	Employment Agreement by and between LHC Group, Inc. and John L. Indest dated September 14, 2009 (previously filed as Exhibit 10.1 to the Form 10-Q on November 4, 2009).+
10.18	Employment Agreement by and between LHC Group, Inc. and Pete C. November dated July 25, 2008. +
10.19	Amendment to the LHC Group, Inc. 2005 Non-Employee Directors Compensation Plan dated January 1, 2010. +
21.1	Subsidiaries of the Registrant.
23.1	Consent of Ernst & Young LLP.
23.2	Consent of KPMG LLP.
31.1	Certification of Keith G. Myers, Chief Executive Officer pursuant to Rule 13a- 14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Peter J. Roman, Chief Financial Officer pursuant to Rule 13a- 14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* This exhibit is furnished to the SEC as an accompanying document and is not deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that Section, and the document will not be deemed incorporated by reference into any filing under the Securities Act of 1933.

\+ Indicates a management contract or compensatory plan.