

Sutter Health and Affiliates

Combined Financial Statements

Years Ended December 31, 2001 and 2000

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Report of Independent Auditors

The Board of Directors
Sutter Health and Affiliates

We have audited the accompanying combined balance sheets of Sutter Health and Affiliates as of December 31, 2001 and 2000, and the related combined statements of operations and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of Sutter Health and Affiliates' management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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 combined financial position of Sutter Health and Affiliates at December 31, 2001 and 2000, and the combined results of their operations and changes in their net assets, and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

Ernst + Young LLP

March 25, 2002

Sutter Health and Affiliates

Combined Balance Sheets

(In Millions)

	December 31,	
	2001	2000
Assets		
Current assets:		
Cash and cash equivalents	\$ 220	\$ 233
Short-term investments	356	243
Patient accounts receivable (less allowance for doubtful accounts of \$127 in 2001 and \$125 in 2000)	626	600
Other receivables	68	92
Inventories	49	44
Other current assets	23	28
Total current assets	<u>1,342</u>	<u>1,240</u>
Non-current investments	650	681
Property, plant and equipment, net	1,704	1,625
Other assets	118	145
	<u>\$ 3,814</u>	<u>\$ 3,691</u>
Liabilities and net assets		
Current liabilities:		
Short-term borrowings	\$ 100	\$ 100
Current maturities of long-term obligations	28	23
Accounts payable and accrued expenses	623	538
Estimated third-party settlements	30	63
Total current liabilities	<u>781</u>	<u>724</u>
Non-current liabilities:		
Long-term obligations, less current maturities	1,129	1,176
Other	209	180
Net assets:		
Unrestricted	1,446	1,352
Temporarily restricted	190	200
Permanently restricted	59	59
	<u>1,695</u>	<u>1,611</u>
	<u>\$ 3,814</u>	<u>\$ 3,691</u>

See accompanying notes.

Sutter Health and Affiliates

Combined Statements of Operations and Changes in Net Assets

(In Millions)

	Years Ended December 31,	
	2001	2000
Unrestricted net assets:		
Unrestricted revenues, gains and other support:		
Patient service revenues	\$ 3,127	\$ 2,585
Capitation revenues	832	692
Investment income	48	60
Other revenues	209	209
Total revenues	4,216	3,546
Operating expenses:		
Salaries and employee benefits	1,785	1,564
Purchased services	787	614
Supplies	511	440
Capitated purchased services	301	214
Depreciation and amortization	207	191
Provision for bad debts	168	138
Rentals and leases	73	61
Interest	62	59
Insurance	14	10
Other	207	144
Total operating expenses	4,115	3,435
Income	101	111

Sutter Health and Affiliates

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

(In Millions)

	Years Ended December 31,	
	2001	2000
Unrestricted net assets (Continued):		
Income (page 3)	\$ 101	\$ 111
Change in net unrealized gains and losses on investments	(9)	(10)
Net assets released from restrictions for equipment acquisition	10	10
Donated long-lived assets, including contributions of long-lived assets in connection with St. Luke's Hospital affiliation in 2001	2	3
Other	(8)	5
Increase in unrestricted net assets before extraordinary item	96	119
Extraordinary loss from extinguishment of debt	(2)	-
Increase in unrestricted net assets	94	119
Temporarily restricted net assets:		
Contributions	55	56
Investment income	4	17
Change in net unrealized gains and losses on investments	(12)	(20)
Net assets released from restriction	(48)	(48)
Other, including impact of St. Luke's Hospital affiliation	(9)	-
(Decrease) increase in temporarily restricted net assets	(10)	5
Permanently restricted net assets:		
Contributions	-	2
Investment gains contributed to capital	-	3
Increase in permanently restricted net assets	-	5
Increase in net assets	84	129
Net assets, beginning of year	1,611	1,482
Net assets, end of year	\$ 1,695	\$ 1,611

See accompanying notes.

Sutter Health and Affiliates
 Combined Statements of Cash Flows

(In Millions)

	Years Ended December 31,	
	2001	2000
Operating activities		
Change in net assets	\$ 84	\$ 129
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Noncash impact of St. Luke's Hospital affiliation	(4)	-
Extraordinary loss from extinguishment of debt	2	-
Depreciation and amortization	207	191
Change in net unrealized gains and losses on investments	21	30
Provision for bad debts	168	138
Increase in professional liability reserves	10	9
Equity in earnings on investments in health care-related businesses	-	(1)
Increase in other non-current liabilities	29	8
Restricted contributions and investment income	(21)	(40)
Gain on sale of property	(2)	(21)
Other	2	3
Net changes in operating assets and liabilities:		
Patient accounts receivable and other receivables	(153)	(233)
Inventories and other assets	(2)	(14)
Accounts payable, accrued expenses and estimated third-party settlements	1	1
Net cash provided by operating activities	342	200
Investing activities		
Payments for business acquisitions, net of cash and cash equivalents acquired	(12)	-
Purchases of property, plant and equipment	(248)	(202)
Purchases and sales or maturities of investments, net	(97)	(30)
Proceeds from sale of property	21	43
Other	10	(2)
Net cash used in investing activities	(326)	(191)

Sutter Health and Affiliates

Combined Statements of Cash Flows (Continued)

(In Millions)

	Years Ended December 31,	
	2001	2000
Financing activities		
Increase in short-term borrowings	\$ —	\$ 7
Payments of long-term obligations	(26)	(38)
Payments for legal defeasance of bonds	(24)	—
Proceeds from long-term obligations	—	54
Proceeds from restricted contributions and investment income	21	40
Net cash (used in) provided by financing activities	(29)	63
Net (decrease) increase in cash and cash equivalents	(13)	72
Cash and cash equivalents at beginning of year	233	161
Cash and cash equivalents at end of year	\$ 220	\$ 233
 Supplementary disclosures of cash flow information and schedule of noncash investing and financing activities:		
Cash paid during the year for interest (net of capitalized interest costs of \$1 in 2001 and \$2 in 2000)	\$ 66	\$ 57
Noncash investing and financing activities:		
Assets acquired (\$48 in 2001 and none in 2000) in excess of liabilities assumed (\$46 in 2001 and none in 2000) in connection with business acquisitions accounted for as purchases, exchanges or contributions of long-lived assets, excluding cash and cash equivalents	\$ (2)	\$ —

See accompanying notes.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

1. ORGANIZATION

Organization: Sutter Health is a California nonprofit multi-provider integrated health care delivery system headquartered in Sacramento, California that includes a centralized support group and various health care-related businesses operating primarily in five service areas, principally in Northern California.

Sutter Health and its affiliates and subsidiaries provide the following services: health care, education, research and administration.

Affiliates in the five service areas include acute care and psychiatric hospitals, skilled nursing facilities, medical foundations, fundraising foundations and a variety of other specialized health care service providers. The acute care hospitals provide a full range of medical services (e.g., surgical, intensive care, emergency room, obstetrics). All emergency rooms provide emergency care, regardless of a patient's ability to pay. Sutter Health and its affiliates also serve their communities with programs including health education, health libraries, school-based clinics, home health care, hospice care, adult day care, prenatal clinics, community clinics and immunization services.

2. ACCOUNTING POLICIES

Basis of Combination: The combined financial statements include the accounts of Sutter Health and affiliated corporations and subsidiaries ("Sutter"). All significant intercompany accounts and transactions have been eliminated in combination.

Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Cash Equivalents: Cash equivalents represent all highly liquid investments with original maturities of 90 days or less, including money market accounts. Financial instruments that potentially subject Sutter to concentrations of credit risk include cash equivalents and investments. Sutter places certain of its cash in banks that are federally insured in limited amounts and in investment-grade debt instruments, many of which are backed by the U.S. Government or other government agencies. Cash equivalents are stated at fair market value.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

2. ACCOUNTING POLICIES (Continued)

Investments: Investments consist principally of corporate notes and stocks, and U.S. Government and agency securities, all of which are other-than-trading and carried at fair market value. Certain investments are designated as assets held in trust. These include assets held by trustees in accordance with the indentures relating to long-term obligations and assets reserved in accordance with self-insurance requirements. In addition, certain investments are designated by the appropriate governing boards for future capital improvements.

Patient Accounts Receivable: Sutter's primary concentration of credit risk is patient accounts receivable, which consist of amounts owed by various governmental agencies, insurance companies and private patients. Sutter manages the receivables by regularly reviewing its accounts and contracts and by providing appropriate allowances for uncollectible amounts. Significant concentrations of gross fee-for-service patient accounts receivable were as follows:

	December 31,	
	2001	2000
Medicare	20%	22%
Medi-Cal	16%	14%

Inventories: Inventories, which consist principally of medical and other supplies, are stated on the basis of cost determined by the first-in, first-out method, which is not in excess of market.

Property, Plant and Equipment: Property, plant and equipment are stated on the basis of cost, or in the case of donated items, on the basis of fair market value at the date of donation, less any impairment write-downs. Routine maintenance and repairs are charged to expense as incurred. Expenditures that increase values, change capacities or extend useful lives are capitalized, as is interest on amounts borrowed to finance such constructed assets.

Depreciation is computed by the straight-line method over the estimated useful lives of the assets, which range from 3 to 40 years for buildings and improvements and leasehold improvements, and from 3 to 20 years for equipment. Amortization of equipment under capital leases is included in depreciation expense.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

2. ACCOUNTING POLICIES (Continued)

Long-lived assets held for sale are stated at the lower of cost or estimated fair value less costs of disposal. The fair market values of these assets, and resultant impairment losses, which were recorded in other expenses in the Statement of Operations, were calculated based on discounted cash flow analyses or independent appraisals. As of December 31, 2001 and 2000, assets held for sale or to be disposed of are not material to Sutter's combined financial statements.

Other Assets: Goodwill represents the excess of purchase price over the fair market value of net assets acquired and is being amortized over periods ranging from 5 to 15 years using the straight-line method. Based on current estimates, management believes that the goodwill balance of \$13 as of December 31, 2001 will be realized. However, the amount of goodwill considered realizable could be revised in the near term if estimates of future operating cash flows are reduced. Unamortized financing costs associated with the issuance of long-term obligations are amortized ratably over the term of the respective obligations. Sutter has minority interests in various health care-related businesses. The majority of these investments are accounted for on the equity method and the assets, liabilities and results of operations of these unconsolidated investees are not material to Sutter's combined financial statements.

Risk Management: Sutter maintains several self-insured medical and other benefit plans for certain employees and is self-insured for workers' compensation for certain affiliates. Also, certain affiliates of Sutter participate in a wholly owned self-insured captive for professional liability claims and comprehensive general liability. In addition, certain affiliates of Sutter purchase (a) workers' compensation insurance coverage with nominal or no deductibles and (b) professional liability insurance coverage using both claims-made and modified occurrence-basis policies. For certain affiliates, the modified occurrence-basis policies include prepaid tail coverage for seven years. The provisions for estimated workers' compensation, professional liability and comprehensive general liability claims include estimates of the ultimate costs for both uninsured reported claims and claims incurred but not reported, in accordance with actuarial projections based on past experience. Such claim reserves are based on the best data available to Sutter; however, in some cases, because of the lack of historical experience, these estimates are subject to a significant degree of inherent variability. Accordingly, there is at least a reasonable possibility that a material change to the estimated reserves will occur in the future. Such estimates are continually monitored and reviewed, and as reserves

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

2. ACCOUNTING POLICIES (Continued)

are adjusted, the differences are reflected in current operations. While the ultimate number of workers' compensation, professional liability and comprehensive general liability claims is dependent on future developments, management is of the opinion that the associated liabilities recognized in the accompanying combined financial statements are adequate to cover such claims. Sutter has entered into reinsurance agreements with independent insurance companies to limit its losses on workers' compensation, professional liability and comprehensive general liability claims. Reserves for reported and incurred but not reported professional liability claims, which are discounted using a rate of 6%, amount to \$63 and \$49 as of December 31, 2001 and 2000, respectively. Management is aware of no potential professional liability claims whose settlement would have a material adverse effect on Sutter's combined financial position.

Other Liabilities: Other non-current liabilities consist of (a) insurance liabilities, including estimated liabilities for (i) professional liability losses and (ii) referral claims; (b) minority interests in net assets of subsidiaries; (c) obligations to return assets to local hospital districts, and (d) certain other liabilities.

Net Assets: All resources that are not restricted by donors are included in unrestricted net assets. Resources temporarily restricted by donors for specific purposes are reported as temporarily restricted net assets. When the specific purposes are achieved, either through passage of a stipulated time or the purpose for restriction is accomplished, they are reclassified to unrestricted net assets and reported as such in the combined statement of operations and changes in net assets. Resources temporarily restricted by donors for additions to property, plant and equipment are initially reported as temporarily restricted net assets and are transferred to unrestricted net assets when expended. Donor-imposed restrictions, which stipulate that the resources be maintained permanently are reported as permanently restricted net assets. Investment income related to these permanently restricted net assets is classified as either temporarily restricted or unrestricted based on the intent of the donor, or is added to the balance if required by the donor.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

2. ACCOUNTING POLICIES (Continued)

Temporarily and permanently restricted net assets were maintained for the following purposes as determined by management:

	December 31,	
	2001	2000
Temporarily restricted:		
Capital projects, medical equipment and services	\$ 67	\$ 96
Time restricted under trust agreements	23	26
Rehabilitation medicine	14	14
Community benefit	34	26
Research and education	52	38
	\$ 190	\$ 200
Permanently restricted -		
Endowment	\$ 59	\$ 59

Donor Gifts: Unconditional promises to give cash or other assets are reported at fair market value at the date the promises are received. Conditional promises to give and indications of intentions to give are reported at fair market value when the conditions are met; however, such amounts were not material at December 31, 2001 and 2000.

As of December 31, 2001, pledges receivable consisted of the following unconditional promises to give:

Pledges due in 2002	\$ 12
Pledges due 2003-2006	20
Pledges due after 2006	11
Less allowance for uncollectible pledges	(1)
Less discount on pledges receivable	(4)
	\$ 38

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

2. ACCOUNTING POLICIES (Continued)

Gifts of long-lived operating assets, such as property, plant or equipment, are reported as unrestricted support and excluded from income, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated long-lived assets are acquired and placed in service.

Patient Service Revenues: Patient service revenues are reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered, including estimated retroactive adjustments under reimbursement programs with third-party payors. Estimated settlements under third-party reimbursement programs are accrued in the period the related services are rendered and adjusted in future periods, primarily as a result of final settlements.

Capitation Revenues: Sutter has agreements with various Health Maintenance Organizations (“HMOs”) to provide medical services to subscribing participants. Under these agreements, Sutter receives monthly capitation payments based on the number of each HMOs’ participants covered by the contract, regardless of services actually performed by Sutter. Certain of these agreements also contain provisions whereby additional amounts may be due or paid.

Charity Care: Sutter provides medically necessary care to all patients who meet certain criteria under its charity care policy regardless of the patient’s ability to pay.

Performance Indicator: “Income,” as reflected in the accompanying combined statements of operations and changes in net assets, is a performance indicator. Income includes changes in unrestricted net assets other than contributions of long-lived assets, changes in net unrealized gains and losses on investments, investment returns restricted by donors, discontinued operations, cumulative effects of changes in accounting principles and extraordinary items. Impairment of long-lived assets is included in other operating expenses.

Income Taxes: Sutter Health and substantially all of its affiliates have been determined to be exempt organizations by the Internal Revenue Service, (pursuant to Internal Revenue Code Section 501(c)(3)), and the California Franchise Tax Board (pursuant to Revenue and Taxation Code 23701(d)) and, generally, are not subject to taxes on income.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

2. ACCOUNTING POLICIES (Continued)

Certain activities of Sutter are subject to income taxes; however, such activities are not significant to the combined financial statements. With respect to its for-profit subsidiaries and taxable activities, Sutter records income taxes using the liability method under which deferred tax assets and liabilities are determined based on the differences between the financial accounting and tax bases of assets and liabilities. Deferred tax assets or liabilities at the end of each period are determined using the currently enacted tax rate expected to apply to taxable income in the periods that the deferred tax asset or liability is expected to be realized or settled.

Fair Values of Financial Instruments: The methods and assumptions used by Sutter in estimating its financial instrument fair value disclosures, as well as the resultant amounts, are as indicated in Notes 4 and 7.

Adoption of New Accounting Pronouncements: Effective January 1, 2001, Sutter adopted Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS Nos. 137 and 138 ("SFAS No. 133"). SFAS No. 133 requires all derivative financial instruments, such as interest rate swaps, to be recognized as either assets or liabilities in the statement of financial position and measured at fair value. The adoption of SFAS No. 133 did not have a material effect on Sutter's financial position or results of operations.

In 2000, Sutter adopted SFAS No. 136, "Transfers of Assets to a Not-for-Profit Organization or Charitable Trust that Raises or Holds Contributions for Others." SFAS No. 136 establishes accounting guidance for certain charitable transactions where an entity makes a contribution by transferring assets to a not-for-profit organization or charitable trust that accepts the assets and agrees to transfer these assets to another entity specified by the donor. The adoption of SFAS No. 136 did not have a material impact on Sutter's combined financial position.

Adoption of Other New Accounting Pronouncements in the Future: In August 2001, the Financial Accounting Standards Board issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations for a disposal of a segment of a business."

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

2. ACCOUNTING POLICIES (Continued)

SFAS No. 144 is effective for fiscal years beginning after December 15, 2001, with earlier application encouraged. Sutter expects to adopt SFAS No. 144 in 2002 and does not expect the adoption to have a significant impact on its financial position or results of operations.

Reclassifications: Certain amounts in Sutter's 2000 combined financial statements have been reclassified to conform with the presentation of its 2001 combined financial statements.

3. BUSINESS COMBINATIONS

Effective July 17, 2001, Sutter and St. Luke's Hospital ("St. Luke's") consummated an affiliation agreement executed on March 21, 2001. On June 26, 2001, the Attorney General of the State of California approved the affiliation between Sutter and St. Luke's. Sutter is the sole corporate member of St. Luke's, pursuant to the terms of the affiliation agreement. Also, under the terms of the affiliation agreement, Sutter: (a) assumed certain bonds and other indebtedness of St. Luke's aggregating \$10 as of July 17, 2001, and (b) made a capital commitment to St. Luke's to fund capital of \$40, over a ten year period commencing on July 17, 2001. This affiliation has been accounted for partially as an exchange transaction and partially as a contribution of long-lived assets from St. Luke's to Sutter, to the extent that the estimated fair value of the assets received exceeded the liabilities assumed. Sutter has accounted for St. Luke's results of operations beginning July 17, 2001.

On February 1, 2001, Sutter acquired certain assets and liabilities from Warrack Corporation in a transaction accounted for as a purchase. The aggregate purchase price consisted of \$12 in cash. The acquired assets and liabilities have been adjusted to their estimated fair values as of the date of the acquisition.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

4. INVESTMENTS

Investments are held for the following uses:

	December 31,	
	2001	2000
Assets held in trust:		
Principal, interest and other reserves held in trust under bond indentures	\$ 87	\$ 120
Other	11	11
Internally designated funded depreciation and other designations	500	521
Investments	408	272
	1,006	924
Less current portion	(356)	(243)
	\$ 650	\$ 681

Investments consist of the following:

	December 31,			
	2001		2000	
	Cost	Fair Market Value	Cost	Fair Market Value
Money market funds and other cash equivalents	\$ 136	\$ 136	\$ 131	\$ 131
U.S. Government and agency securities	311	316	246	243
Corporate debt securities	298	306	277	277
Marketable equity securities	248	248	236	273
	\$ 993	\$ 1,006	\$ 890	\$ 924

The fair market values for investments are based on quoted market prices.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

4. INVESTMENTS (Continued)

Investment income is comprised of the following elements:

	Years Ended December 31,	
	2001	2000
Interest and dividends	\$ 50	\$ 63
Realized gains on sales of securities	2	17
	52	80
Less amounts included in changes in restricted net assets	(4)	(20)
Investment income	48	60
Less interest earned on unspent bond project funds	(5)	(5)
	\$ 43	\$ 55

Sutter uses the specific identification method to compute realized gains and losses on U.S. Government and agency securities and corporate debt securities. Sutter uses the average cost method to compute realized gains and losses on marketable equity securities. Marketable equity securities are primarily held for endowments and future capital improvements.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

5. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of the following:

	December 31,	
	2001	2000
Land improvements	\$ 52	\$ 45
Leasehold improvements	126	87
Buildings and improvements	1,348	1,394
Equipment	1,456	1,223
	2,982	2,749
Less accumulated depreciation and amortization	(1,597)	(1,438)
	1,385	1,311
Land	164	141
Construction-in-progress	155	173
	\$ 1,704	\$ 1,625

6. OTHER ASSETS

Other assets consist of the following:

	December 31,	
	2001	2000
Goodwill, net	\$ 13	\$ 25
Prepaid rent	17	18
Unamortized financing costs	25	26
Investments in health care-related businesses	6	11
Other	57	65
	\$ 118	\$ 145

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

7. LONG-TERM OBLIGATIONS

Long-term obligations consist of the following:

	December 31,	
	2001	2000
Hospital revenue bonds and Certificates of Participation under the Sutter Health Master Indenture of Trust, fixed interest at 4.3% to 6.4%, variable interest at .5% - 4.5%, due from 2012 to 2038 (net of discount of \$12 and \$13 at December 31, 2001 and 2000, respectively)	\$ 1,020	\$ 1,057
Hospital revenue bonds under the California Pacific Medical Center (“CPMC”) Master Indenture of Trust, fixed interest at 5.0% to 6.2%, due from 2014 to 2015 (net of discount of \$1 and \$1 at December 31, 2001 and 2000, respectively)	87	91
Hospital revenue bonds through the City of Modesto, fixed interest at 4.3% to 6.0%, variable interest based on daily rate (1.9% at December 31, 2001) due from 2012 to 2021	34	36
Hospital insured taxable revenue bond under St. Luke’s Hospital bond indenture of trust, fixed interest at 7.5%, due October 1, 2012	8	–
Various collateralized and unsecured obligations	5	12
Obligations under capital leases	3	3
	1,157	1,199
Less current maturities	(28)	(23)
	\$ 1,129	\$ 1,176

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

7. LONG-TERM OBLIGATIONS (Continued)

The aggregate estimated fair market values of Sutter's short-term borrowings and long-term obligations at December 31, 2001 and 2000 of \$1,382 and \$1,337, respectively, were established using discounted cash flow analyses based on (a) the current market yield to maturity for similar types of publicly traded debt issues and (b) Sutter's current incremental borrowing rates for all other debt instruments.

Certain affiliates of Sutter are members of the Obligated Groups of Sutter Health and CPMC. As a result, the assets of such affiliates of Sutter are subject to the indebtedness of the Obligated Groups of Sutter Health and CPMC.

The Obligated Groups of Sutter Health and CPMC are not legal entities. However, under the terms of the California Health Facilities Financing Authority ("CHFFA") and California Statewide Communities Development Authority ("CSCDA") bonds, members of the two Obligated Groups are jointly and severally liable for the bonds. The related financing documents and various other debt agreements contain certain restrictive covenants requiring compliance by all members, including pledges of gross revenues.

During 2001, St. Luke's and Sutter North Medical Foundation joined the Obligated Groups of Sutter Health and CPMC. During 2000, Summit Medical Center joined the Obligated Groups of Sutter Health and CPMC.

In May 2000, Sutter issued \$52 of 2000 Series A CHFFA fixed rate bonds. The proceeds of this borrowing were designated to finance certain capital expenditures.

Aggregate maturities of long-term obligations, excluding capital leases and bond discounts, are as follows as of December 31, 2001:

2002	\$	27
2003		28
2004		28
2005		29
2006		30
Thereafter		1,025
	\$	<u>1,167</u>

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

7. LONG-TERM OBLIGATIONS (Continued)

Sutter has a \$100 revolving line of credit with a syndicate of banks. At December 31, 2001 and 2000, \$100 has been borrowed and is recorded as short-term borrowings. \$100 and \$76 of such borrowings outstanding as of December 31, 2001 and 2000, respectively, were repaid using existing working capital in January 2002 and 2001, respectively.

8. DERIVATIVE FINANCIAL INSTRUMENTS

Sutter uses interest rate swap agreements to manage interest rate risk on future variable interest payments. As of December 31, 2001 and 2000, Sutter had one swap agreement with a financial institution. The agreement, which is based on a notional principal amount of \$43 at December 31, 2001 and 2000, commenced in July 1996 and expires in July 2002. Under the terms of the agreement, Sutter pays a fixed rate of 5.04% and receives the variable payment equal to the interest rate on one of its long-term obligations. The interest rate differential to be received or paid is recognized over the term of the swap agreement as an adjustment to interest expense. At December 31, 2001 and 2000, the aggregate fair market value of the swap was a net payable of \$1.

9. LEASES

Sutter leases various property, plant, office space and equipment. The leases expire at various times and contain certain contingent rental provisions, guarantees and various renewal options. These leases are classified as either capital leases, which are not material as of December 31, 2001 and 2000, or operating leases based on the terms of the respective agreements.

Certain operating leases relate to acute care facilities leased from various municipalities. Such operating lease agreements require Sutter to make specified capital improvements to the municipalities' facilities at various times.

Sutter has financed \$28 through three operating leases for medical office buildings that are commonly referred to as synthetic leases. A synthetic lease represents a form of off-balance sheet financing under which an unrelated third party finances the costs of the acquisition and/or construction of the property and leases the asset to a lessee. Upon termination or expiration of the synthetic leases, Sutter has the option to purchase

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

9. LEASES (Continued)

the property from the lessor at a predetermined amount, which does not constitute a bargain purchase, sell the property to a third party, or renew the lease arrangement. If the property is sold to a third party at an amount less than the amount financed by the lessor, Sutter has agreed, under residual value guarantees, to pay the lessor up to an agreed upon percentage of the amount financed by the lessor. Under the synthetic leases, there are no cash restrictions, however, the obligations are secured by the property.

Future minimum payments (net of income from subleases), by year and in the aggregate, under noncancellable operating leases with terms of one year or more consist of the following as of December 31, 2001:

2002	\$	41
2003		28
2004		23
2005		20
2006		16
Thereafter		61
	\$	<u>189</u>

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

10. PATIENT SERVICE AND CAPITATION REVENUES

Sutter has agreements with third-party payors that provide for payments to Sutter at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

- *Medicare* - Inpatient acute care services and outpatient services rendered to Medicare program beneficiaries are paid at prospectively determined rates per diagnosis. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Inpatient nonacute services and medical education costs related to Medicare beneficiaries are paid based on a cost reimbursement methodology. Sutter is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by Sutter and audits thereof by the Medicare fiscal intermediary. Sutter's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review. Sutter's Medicare cost reports have been audited by the Medicare fiscal intermediary generally through December 31, 1998.
- *Medi-Cal* - Inpatient and outpatient services rendered to Medi-Cal program beneficiaries are reimbursed either under contracted rates or reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by Sutter and audits thereof by Medi-Cal. Sutter's Medi-Cal cost reports have been audited generally through December 31, 1999.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

10. PATIENT SERVICE AND CAPITATION REVENUES (Continued)

Gross patient charges, including charges related to capitated patients, from the Medicare and Medi-Cal programs accounted for the following percentages of Sutter's gross patient service revenues:

	Years Ended December 31,	
	2001	2000
Medicare	36%	35%
Medi-Cal	12%	11%

Laws and regulations governing the Medicare and Medi-Cal programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Adjustments from finalization of prior-year cost reports from both Medicare and Medi-Cal resulted in increases (decreases) in patient service revenues of approximately \$4 and \$(2) for the years ended December 31, 2001 and 2000, respectively.

Sutter believes that it is in compliance with all applicable laws and regulations in all material respects and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing that would have a material adverse effect on Sutter's combined financial position. While no such significant 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 and Medi-Cal programs.

Sutter also has entered into payment agreements with certain commercial insurance carriers, HMOs and preferred provider organizations. The basis for payment to Sutter under these agreements includes capitated arrangements, prospectively determined rates per diagnosis, discounts from established charges and prospectively determined daily rates.

11. UNSPONSORED COMMUNITY BENEFIT EXPENSE (UNAUDITED)

Traditional Charity Care covers health care services provided to persons who meet certain criteria and cannot afford to pay. Sutter provided \$75 and \$57 of Charity Care Services to their patients in 2001 and 2000, respectively.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

11. UNSPONSORED COMMUNITY BENEFIT EXPENSE (UNAUDITED) **(Continued)**

The following is a summary of Sutter's estimated costs of providing services to the poor and broader community:

	Years Ended December 31,	
	2001	2000
Services for the poor and underserved	\$ 178	\$ 145
Benefits for the broader community	239	160
	<u>\$ 417</u>	<u>\$ 305</u>

Services for the poor and underserved include services provided to persons who cannot afford health care because of inadequate resources and/or are uninsured or underinsured. It also includes the unpaid costs of public programs treating Medi-Cal and indigent beneficiaries. Cost is computed based on a relationship of cost to charges.

Benefits for the broader community include unpaid costs of providing the following services: treating the elderly, health screenings and other health-related services, training health professionals, educating the community with various seminars and classes, the cost of performing medical research and the costs associated with providing free clinics and community services. Cash and in-kind donations made on behalf of the poor and needy, and contributions Sutter makes to community agencies to fund charitable activities are also included.

12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS

Sutter sponsors or participates in various employee benefit plans, including noncontributory defined benefit plans and several contributory defined contribution plans. Sutter's total retirement benefit expense was \$30 and \$25 for the years ended December 31, 2001 and 2000, respectively.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)

The changes in benefit obligations and plan assets for Sutter's three noncontributory defined benefit retirement plans are as follows:

	December 31,	
	2001	2000
Projected benefit obligation at beginning of year	\$ 461	\$ 435
Service cost	23	24
Interest cost	35	32
Amendments	5	3
Actuarial loss (gain)	17	(12)
Benefits paid	(24)	(21)
	517	461
Projected benefit obligation at end of year		
Fair value of plan assets at beginning of year	466	438
Actual return on plan assets	(19)	43
Employer contributions	3	6
Expenses paid	(4)	-
Benefits paid	(24)	(21)
	422	466
Fair value of plan assets at end of year		
Funded status of the plans	(95)	5
Unrecognized net actuarial loss (gain)	24	(61)
Unrecognized prior service cost	5	3
Minimum pension liability	(8)	-
Employer contributions	20	-
Net accrued retirement benefit cost at end of year	\$ (54)	\$ (53)

Sutter's measurement date for plan assets, pension obligations and net periodic pension cost associated with its primary noncontributory defined benefit retirement plan, is September 30.

Effective January 1, 2000, the Sutter Health Retirement Plan (the "Plan") was amended and restated to become a cash balance plan (the "CBP"). Each participant of the Plan has been given a one-time option to either (a) continue accruing benefits under the Plan (grandfather election) or (b) have his/her total accrued benefit converted to a beginning account balance under the CBP, and accrue future benefits under the CBP. The CBP provides each participant with a benefit initially based upon the participant's account

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)

balance under the Plan. Each participant's account balance will increase each year by the (a) additional benefit accrued by the participant for the year, if any, weighted by years of service and (b) interest credit. Distributions from the CBP will be made in the form of a single life annuity, a joint and 50% or 100% survivor annuity (for married participants only) or a lump sum. Management expects the impact of the aforementioned amendment on Sutter's combined financial position and results of operations to be immaterial.

Sutter's net accrued retirement benefit cost balances consist of the following elements:

	December 31,	
	2001	2000
Accrued retirement benefit cost	\$ (58)	\$ (58)
Prepaid retirement benefit cost	4	5
	\$ (54)	\$ (53)

Two of Sutter's three noncontributory defined benefit retirement plans have benefit obligations in excess of plan assets, as follows:

	December 31,	
	2001	2000
Projected benefit obligation	\$ 488	\$ 287
Fair value of plan assets	\$ 389	\$ 271

The weighted average assumptions used by Sutter's noncontributory defined benefit plans were as follows:

	December 31,	
	2001	2000
Discount rates	7.25-7.5%	7.5%
Rates of compensation increase	4.5%	4.0-4.5%
Expected long-term rates of return on plan assets	8.5-9.0%	8.5-9.0%

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)

The components of Sutter's net periodic benefit cost associated with its noncontributory defined benefit retirement plans are as follows:

	Years Ended December 31,	
	2001	2000
Service cost	\$ 23	\$ 24
Interest cost	35	32
Expected return on plan assets	(39)	(39)
Amortization of prior service cost	3	-
Transition asset recognition	-	(2)
Adjustment to actual pension cost	(1)	-
Recognized net actuarial gains	(6)	-
Benefit cost	\$ 15	\$ 15

The changes in benefit obligations and plan assets for Sutter's two noncontributory postretirement plans are as follows:

	December 31,	
	2001	2000
Benefit obligation at beginning of year	\$ 16	\$ 11
Service cost	1	2
Interest cost	1	2
Actuarial loss	1	2
Benefits paid	(1)	(1)
Benefit obligation at end of year	18	16
Fair value of plan assets at beginning of year	-	-
Employer contribution	1	1
Benefits paid	(1)	(1)
Fair value of plan assets at end of year	-	-
Funded status of the plans	(18)	(16)
Unrecognized net actuarial loss	1	-
Net accrued retirement benefit cost at end of year	\$ (17)	\$ (16)

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)

Sutter's noncontributory postretirement plans have projected benefit obligations of \$18 and \$16 in excess of plan assets as of December 31, 2001 and 2000, respectively:

	December 31,	
	2001	2000
Weighted-average assumptions as of December 31:		
Discount rate	7.25%	7.50%
	Years Ended December 31,	
	2001	2000
Components of net periodic benefit cost:		
Service cost	\$ 1	\$ 2
Interest cost	1	2
Benefit cost	\$ 2	\$ 4

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would not have a material effect on Sutter's combined financial statements.

Two Sutter affiliates are members of a multiemployer defined benefit retirement plan, which covers substantially all of their employees. For the multiemployer plan as a whole, the net assets available for benefits exceeded the actuarially computed value of vested benefits as of the most recent actuarial valuation (January 1, 2001). The funding policy of these affiliates is to contribute the minimum funding required by the Employee Retirement Income Security Act of 1974. Sutter's net pension expense associated with this multiemployer plan was \$7 and \$1 in 2001 and 2000, respectively.

Sutter maintains various defined contribution plans for eligible employees. Sutter's contributions to such plans were \$6 and \$5 in 2001 and 2000, respectively.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

13. INCOME TAXES

Deferred income taxes, which as of December 31, 2001 and 2000 have a net carrying value of \$0, reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting and the amounts used for income tax purposes. As of December 31, 2001 and 2000, Sutter had deferred tax assets of \$33 and \$31, respectively, relating principally to net operating loss carryovers. As of December 31, 2001 and 2000, such deferred tax assets were offset by a valuation allowance of \$33 and \$31, respectively. The valuation allowance increased by \$2 and decreased by \$3 during the year ended December 31, 2001 and 2000, respectively.

Federal net operating loss carryovers totaled \$91 at December 31, 2001 and will expire between 2004 and 2021. State net operating loss carryovers totaled \$26 at December 31, 2001 and will expire between 2002 and 2011.

14. ASSET DISPOSAL

In March 2001, Sutter sold certain assets of Sutter Merced Medical Center (“SMMC”), an acute-care hospital for cash. The proceeds received from the sale were used to legally defease SMMC’s portion of the 1997 Series A CHFFA bond. As a result of the defeasance transaction, Sutter was legally relieved of its obligation under the respective bond indentures. The legal defeasance resulted in an extraordinary loss of \$2 in 2001.

This transaction did not have a material effect on the results of operations for the twelve months ended December 31, 2001.

15. FUNCTIONAL CLASSIFICATION OF EXPENSES

The following is a summary of management’s functional classification of Sutter’s expenses:

	Years Ended December 31,	
	2001	2000
Health services	\$ 3,807	\$ 3,131
General and administrative	308	304
	<u>\$ 4,115</u>	<u>\$ 3,435</u>

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

16. CONTINGENCIES AND COMMITMENTS

Contingencies: Marin General Hospital (“MGH”) leases a hospital in Greenbrae, California from Marin Health Care District (the “Marin District”) pursuant to a lease between MGH and the Marin District (the “Marin Lease”). MGH, Marin Community Health, a Sutter affiliate, and Sutter are defendants in a lawsuit filed by the Marin District in 1997 that seeks, among other things, a judgment declaring that the Marin Lease and an Agreement for Transfer of Assets between the Marin District and MGH are void and that the Marin District is entitled to ownership and possession of the hospital and assets transferred and all proceeds and products of the hospital lease and assets transferred. On October 9, 1998, the Sacramento Superior Court granted motions of MGH and Sutter for partial summary adjudication. By its order, the Sacramento Superior Court ruled that the Marin District’s claims that the Marin Lease and asset transfer were void because of alleged violations of California Government Code Section 1090 were barred by applicable statutes of limitations. On October 14, 1999, judgment was entered for the defendants by the Sacramento Superior Court, and the Marin District filed and appealed the judgment insofar as it concluded that the claims based on Government Code Section 1090 were barred by applicable statutes of limitation. Briefing has been completed, but the Court of Appeal has not yet set the case for hearing.

Mills-Peninsula Health Services (“MPHS”) leases Mills-Peninsula Medical Center in Burlingame, California from Peninsula Health Care District (the “Peninsula District”) pursuant to a lease between MPHS and the Peninsula District (the “Peninsula Lease”). MPHS is a defendant in a lawsuit filed by the Peninsula District in 1997 that seeks, among other things, a declaration that certain contracts relating to the consolidation of the hospital and medical facilities and operations of the Peninsula District and MPHS are void and canceled, including the 1985 Agreement for Consolidation of Assets and Liability, the 1985 Lease of Peninsula Hospital, the 1997 Amended Lease of Peninsula Hospital, a 1985 cash donation from the Peninsula District to Mills-Peninsula Foundation, and certain 1985 donations of property from the Peninsula District to MPHS, and a declaration that the Peninsula District is entitled to ownership and possession of the assets transferred by the foregoing contracts and documents, including all the real property, improvements and personal property, both tangible and intangible, cash and liquid assets, all proceeds and products thereof, and all substitutions and replacements for the same. Subsequent to the filing of this lawsuit, the San Mateo Superior Court allowed both Sutter and the Mills-Peninsula Physicians Group, Inc. (“MPPG”) to intervene as defendants. On September 5, 1997, the San Mateo Superior Court heard arguments on a demurrer to the complaint filed by MPHS and joined in by Sutter and MPPG. On November 13, 1997, the San Mateo Superior Court sustained the demurrer without leave

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

16. CONTINGENCIES AND COMMITMENTS (Continued)

to amend the complaint. The Peninsula District has filed a motion requesting that the San Mateo Superior Court reconsider its decision. The motion asserts that the stipulated judgment that the San Mateo Superior Court relied on in sustaining the demurrer is invalid under California Government Code Section 1090 because certain parties who approved the stipulation had an interest in it. The Peninsula District and the District Attorney of San Mateo County, who was a party to the stipulated judgment, moved to vacate the stipulated judgment on the same grounds. On November 19, 1998, the San Mateo County Superior Court issued an order granting the motion to vacate. On June 28, 2000 the decision of the San Mateo County Superior Court was sustained. In November of 2000 the parties entered into a letter of intent, which provides that the litigation will be dismissed if several conditions are satisfied.

It is difficult to predict either the outcome of the MGH and MPHS litigation or the effect such litigation might have on Sutter's combined financial position and results of operations, but a negative outcome could be material.

Sutter is involved in other litigation, as both plaintiff and defendant, and other routine labor matters, tax examinations and regulatory examinations arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, these matters should be resolved without a material adverse effect on Sutter's combined financial position. However, there can be no assurance that this will be the case.

Sutter, in the ordinary course of business, enters into various incentive-based risk sharing agreements with managed care payors and other providers. These agreements require retroactive settlement based on data that may not be available or finalized until all claims are processed. Settlement amounts have been estimated for such risk-based incentives based on available information. However, it is reasonably possible that these estimates may change in the near term.

As of December 31, 2001, approximately 26% of Sutter's employees are represented by collective bargaining units. Employee strikes or other adverse labor actions may have a material adverse impact on Sutter's operations in the future.

As of December 31, 2001 and 2000, Sutter had irrevocable standby letters of credit aggregating \$118 and \$82, respectively, to collateralize certain long-term obligations aggregating \$122 and satisfy legal requirements for self-insured workers' compensation plans and for other purposes.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

16. CONTINGENCIES AND COMMITMENTS (Continued)

Commitments: Sutter's combined budgeted operations and master facility related projects, as approved or committed to by the Board of Directors as of December 31, 2001, for the period from January 1, 2002 to December 31, 2006 amount to approximately \$673. This excludes amounts estimated to bring facilities into compliance with seismic standards.

Seismic Standards (Unaudited): Sutter is assessing its earthquake retrofit requirements for healthcare facilities under a State of California law that requires compliance with certain seismic standards by 2008. Based on studies performed, the total cost of bringing facilities into compliance is estimated to be between \$361 and \$498 before inflation and not including costs due to disruption and loss of business. Planning measures are underway that may result in certain of the seismically noncompliant facilities being withdrawn from use or replaced.