

Sutter Health and Affiliates

Combined Financial Statements

Years Ended December 31, 2002 and 2001

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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, 2002 and 2001, 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, 2002 and 2001, 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 7, 2003

# Sutter Health and Affiliates

## Combined Balance Sheets

(In Millions)

	<b>December 31,</b>	
	<b>2002</b>	<b>2001</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 237	\$ 220
Short-term investments	767	356
Patient accounts receivable (less allowance for doubtful accounts of \$115 in 2002 and \$127 in 2001)	653	626
Other receivables	73	68
Inventories	54	49
Other current assets	27	23
Total current assets	<u>1,811</u>	<u>1,342</u>
Non-current investments	686	650
Property, plant and equipment, net	1,785	1,704
Other assets	124	118
	<u>\$ 4,406</u>	<u>\$ 3,814</u>
<b>Liabilities and net assets</b>		
Current liabilities:		
Short-term borrowings	\$ 95	\$ 100
Current maturities of long-term obligations	27	28
Accounts payable and accrued expenses	766	623
Current portion of estimated third-party settlements	12	15
Total current liabilities	<u>900</u>	<u>766</u>
Non-current liabilities:		
Long-term obligations, less current maturities	1,271	1,129
Other	276	224
Net assets:		
Unrestricted	1,708	1,435
Temporarily restricted	184	196
Permanently restricted	67	64
	<u>1,959</u>	<u>1,695</u>
	<u>\$ 4,406</u>	<u>\$ 3,814</u>

See accompanying notes.

## Sutter Health and Affiliates

### Combined Statements of Operations and Changes in Net Assets

*(In Millions)*

	<b>Years Ended December 31,</b>	
	<b>2002</b>	<b>2001</b>
<b>Unrestricted net assets:</b>		
Unrestricted revenues, gains and other support:		
Patient service revenues	\$ 3,846	\$ 3,127
Capitation revenues	839	832
Investment income	19	48
Other revenues	227	209
Total revenues	4,931	4,216
Operating expenses:		
Salaries and employee benefits	2,047	1,787
Purchased services	910	813
Supplies	554	511
Capitated purchased services	307	301
Depreciation and amortization	244	207
Provision for bad debts	210	168
Rentals and leases	77	73
Interest	59	62
Insurance	18	14
Other	221	181
Total operating expenses	4,647	4,117
Income	284	99

## Sutter Health and Affiliates

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

*(In Millions)*

	<b>Years Ended December 31,</b>	
	<b>2002</b>	<b>2001</b>
<b>Unrestricted net assets (Continued):</b>		
Income (page 3)	\$ 284	\$ 99
Change in net unrealized gains and losses on investments	7	(9)
Net assets released from restrictions for equipment acquisition	11	10
Donated long-lived assets, including contributions in connection with business combinations	2	(9)
Additional minimum pension liability	(33)	(8)
Other	2	—
Increase in unrestricted net assets	273	83
<b>Temporarily restricted net assets:</b>		
Contributions	38	55
Investment (loss) income	(2)	4
Change in net unrealized gains and losses on investments	(13)	(12)
Net assets released from restriction	(50)	(48)
Other, including impact of business combinations	15	(3)
Decrease in temporarily restricted net assets	(12)	(4)
<b>Permanently restricted net assets:</b>		
Contributions	4	—
Change in net unrealized gains and losses on investments	(1)	—
Other, including impact of business combinations	—	5
Increase in permanently restricted net assets	3	5
Increase in net assets	264	84
Net assets, beginning of year	1,695	1,611
Net assets, end of year	\$ 1,959	\$ 1,695

*See accompanying notes.*

Sutter Health and Affiliates  
 Combined Statements of Cash Flows

*(In Millions)*

	<b>Years Ended December 31,</b>	
	<b>2002</b>	<b>2001</b>
<b>Operating activities</b>		
Change in net assets	\$ 264	\$ 84
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Noncash impact of business combinations	(7)	(4)
Loss from extinguishment of debt	4	2
Depreciation and amortization	244	207
Change in net unrealized gains and losses on investments	7	21
Provision for bad debts	210	168
Increase in professional liability reserves	13	10
Decrease in equity in earnings on investments in health care-related businesses	(3)	–
Increase in other non-current liabilities	53	44
Restricted contributions and investment income	(7)	(21)
Loss (gain) on sale of property	1	(2)
Other	1	2
Net changes in operating assets and liabilities:		
Patient accounts receivable and other receivables	(236)	(153)
Inventories and other assets	(9)	(2)
Accounts payable, accrued expenses and current portion of estimated third-party settlements	117	(14)
Net cash provided by operating activities	<b>652</b>	<b>342</b>
<b>Investing activities</b>		
Payments for business acquisitions, net of cash and cash equivalents acquired	–	(12)
Purchases of property, plant and equipment	(323)	(253)
Proceeds from sale of equipment	2	5
Purchases and sales or maturities of investments, net	(453)	(97)
Proceeds from sale of property	–	21
Other	(5)	10
Net cash used in investing activities	<b>(779)</b>	<b>(326)</b>

Sutter Health and Affiliates

Combined Statements of Cash Flows (Continued)

(In Millions)

	<b>Years Ended December 31,</b>	
	<b>2002</b>	<b>2001</b>
<b>Financing activities</b>		
Net decrease in short-term borrowings	\$ (5)	\$ —
Payments of long-term obligations	(25)	(26)
Payments for legal defeasance of bonds	(53)	(24)
Proceeds from issuance of long-term obligations	229	—
Bond issuance costs and discount	(9)	—
Proceeds from restricted contributions and investment income	7	21
Net cash provided by (used in) financing activities	<u>144</u>	<u>(29)</u>
Net increase (decrease) in cash and cash equivalents	17	(13)
Cash and cash equivalents at beginning of year	220	233
Cash and cash equivalents at end of year	<u>\$ 237</u>	<u>\$ 220</u>

**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 \$3 in 2002 and \$1 in 2001)	\$ 58	\$ 66
Noncash investing and financing activities:		
Assets acquired (\$16 in 2002 and \$48 in 2001) in excess of liabilities assumed (\$9 in 2002 and \$46 in 2001) in connection with business acquisitions accounted for as purchases, exchanges or contributions of long-lived assets, excluding cash and cash equivalents	\$ (7)	\$ (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 accounting principles generally accepted in the United States 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 with limited market risk. 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:

	<b>December 31,</b>	
	<b>2002</b>	<b>2001</b>
Medicare	<b>22%</b>	20%
Medi-Cal	<b>17%</b>	16%

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 and amortization 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, 2002 and 2001, 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 \$12 as of December 31, 2002 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 workers' compensation claims, which are discounted using a rate of 5.5% and 6.0%, amount to \$82 and \$47 as of December 31, 2002 and 2001, respectively. Reserves for reported and incurred but not reported professional liability claims, which are discounted using a rate of 5.5% and 6.0%, amount to \$76 and \$63 as of December 31, 2002 and 2001, 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; (d) portion of estimated third-party settlements not expected to be settled within a year; and (e) 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 a specified time or 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 released to other revenue 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 temporarily or permanently restricted net assets is classified as either temporarily restricted or unrestricted based on the intent of the donor, or is added to permanently restricted net assets 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:

	<b>December 31,</b>	
	<b>2002</b>	<b>2001</b>
Temporarily restricted:		
Capital projects, medical equipment and services	\$ 63	\$ 69
Time restricted under trust agreements	23	24
Rehabilitation medicine	14	14
Community benefit	31	35
Research and education	53	54
	\$ 184	\$ 196
Permanently restricted - Endowment	\$ 67	\$ 64

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, 2002 and 2001.

As of December 31, 2002, pledges receivable consisted of the following unconditional promises to give:

Pledges due in 2003	\$ 17
Pledges due 2004-2007	25
Pledges due after 2007	3
Less allowance for uncollectible pledges	(1)
Less discount on pledges receivable	(4)
	\$ 40

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

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### **2. ACCOUNTING POLICIES (Continued)**

used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about the period for which 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.

Capitated Services: 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 provided by Sutter. Certain of these agreements also contain provisions whereby additional amounts may be due or paid. Sutter accrues costs when services are rendered under these contracts, including estimates of incurred but not reported (“IBNR”) claims and amounts receivable/payable under risk-sharing arrangements. The IBNR accrual is an estimate of cost of services for which Sutter is responsible.

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, additional minimum pension liability, 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

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### **2. ACCOUNTING POLICIES (Continued)**

and Taxation Code 23701(d)) and, generally, are not subject to taxes on income. 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 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.

Effective January 1, 2002, 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.” The adoption of SFAS No. 144 did not have a significant impact on Sutter’s financial position or results of operations.

In April 2002, the Financial Accounting Standards Board issued SFAS No. 145 “Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections.” This Statement rescinds SFAS No. 4, “Reporting Gains and Losses from Extinguishment of Debt,” SFAS No. 64, “Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements” and SFAS No. 44, “Accounting for Intangible Assets of Motor Carriers.” This statement also amends SFAS No. 13,

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### **2. ACCOUNTING POLICIES (Continued)**

“Accounting for Leases.” The adoption of FAS 145 has resulted in a reclassification of \$2 from Extraordinary Loss to Other Expenses in the 2001 Combined Statements of Operations and Changes in Net Assets.

In November 2002, the Financial Accounting Standards Board issued FASB Interpretation No. 45 (“FIN 45”), “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,” which among other things addresses disclosures to be made by a guarantor in its financial statements about its obligations under certain guarantees that it has issued. The adoption of FIN 45 did not have an impact on Sutter’s financial position or results of operations.

Reclassifications: Certain amounts in Sutter’s 2001 combined financial statements have been reclassified to conform with the presentation of its 2002 combined financial statements.

### **3. BUSINESS COMBINATIONS**

On July 1, 2002, Sutter received certain assets and became responsible for liabilities from California College of Podiatric Medicine in a transaction accounted for as a contribution. The acquired assets and liabilities have been adjusted to their estimated fair market values as of the date of the acquisition.

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,	
	2002	2001
Assets held in trust:		
Principal, interest and other reserves held in trust under bond indentures	\$ 204	\$ 87
Other	8	11
Internally designated funded depreciation and other designations	712	500
Investments	529	408
	1,453	1,006
Less current portion	(767)	(356)
	\$ 686	\$ 650

Investments consist of the following:

	December 31,			
	2002		2001	
	Cost	Fair Market Value	Cost	Fair Market Value
Money market funds and other cash equivalents	\$ 213	\$ 213	\$ 136	\$ 136
U.S. Government and agency securities	358	375	311	316
Foreign Government and Corporate debt securities	58	62	—	—
Corporate debt securities	410	421	298	306
Marketable equity securities	408	382	248	248
	\$ 1,447	\$ 1,453	\$ 993	\$ 1,006

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:

	<b>Years Ended December 31,</b>	
	<b>2002</b>	<b>2001</b>
Interest and dividends	\$ 43	\$ 50
Realized (loss) gain on sales of securities, including other than temporary impairments	(26)	2
	17	52
Amounts included in changes in restricted net assets	2	(4)
Investment income	19	48
Less interest earned on unspent bond project funds	(4)	(5)
	\$ 15	\$ 43

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:

	<b>December 31,</b>	
	<b>2002</b>	<b>2001</b>
Land improvements	\$ 53	\$ 52
Leasehold improvements	102	74
Buildings and improvements	1,640	1,549
Equipment	1,312	1,307
	3,107	2,982
Less accumulated depreciation and amortization	(1,681)	(1,597)
	1,426	1,385
Land	165	164
Construction-in-progress	194	155
	\$ 1,785	\$ 1,704

#### 6. OTHER ASSETS

Other assets consist of the following:

	<b>December 31,</b>	
	<b>2002</b>	<b>2001</b>
Goodwill, net	\$ 12	\$ 13
Prepaid rent	15	17
Unamortized financing costs	26	25
Investments in health care-related businesses	6	6
Non-current portion of notes receivable	15	13
Non-current portion of pledges receivable	24	26
Other	26	18
	\$ 124	\$ 118

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### 7. LONG-TERM OBLIGATIONS

Long-term obligations consist of the following:

	<b>December 31,</b>	
	<b>2002</b>	<b>2001</b>
Hospital revenue bonds and Certificates of Participation under the Sutter Health Master Indenture of Trust, fixed interest at 4.4% to 6.3%, variable interest at .6% - 1.9%, due from 2012 to 2042 (net of discount of \$15 and \$12 at December 31, 2002 and 2001, respectively)	<b>\$ 1,152</b>	\$ 1,020
Hospital revenue bonds under the California Pacific Medical Center (“CPMC”) Master Indenture of Trust, fixed interest at 5.1% to 5.9%, due from 2014 to 2015 (net of discount of \$1 at December 31, 2002 and 2001)	<b>83</b>	87
Hospital revenue bonds through the City of Modesto, fixed interest at 4.4% to 6.0%, variable interest based on daily rate (1.8% at December 31, 2002) due from 2012 to 2021	<b>33</b>	34
Hospital insured taxable revenue bond under St. Luke’s Hospital bond indenture of trust, fixed interest at 7.5%, due October 1, 2012	<b>8</b>	8
Various collateralized and unsecured obligations	<b>20</b>	5
Obligations under capital leases	<b>2</b>	3
	<b>1,298</b>	1,157
Less current maturities	<b>(27)</b>	(28)
	<b>\$ 1,271</b>	\$ 1,129

# 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, 2002 and 2001 of \$1,444 and \$1,282, 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 Sutter Health Obligated Group and the California Pacific Medical Center Obligated Group ("the Obligated Groups"). As a result, the assets of such affiliates of Sutter are subject to the indebtedness of the Obligated Groups.

The Obligated Groups 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 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.

In May 2002, Sutter issued \$56 and \$156 of 2002 Series A and B CSCDA variable and fixed rate bonds, respectively. The proceeds of these borrowings were designated to legally defease the 1992 Certificates of Participation and to finance certain capital expenditures. The legal defeasance resulted in a loss of \$4 in 2002.

During 2001, St. Luke's and Sutter North Medical Foundation joined the Obligated Groups.

Aggregate maturities of long-term obligations, excluding capital leases and bond discounts, are as follows as of December 31, 2002:

2003	\$	26
2004		26
2005		27
2006		29
2007		61
Thereafter		1,143
	\$	<u>1,312</u>

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### **7. LONG-TERM OBLIGATIONS (Continued)**

As of December 31, 2002 and 2001, Sutter had \$110 and \$100, respectively, of a revolving line of credit with a syndicate of banks. At December 31, 2002, \$110 had been borrowed, of which \$95 has been repaid using existing working capital in January 2003 and is recorded as short-term borrowings. The remaining \$15 has been recorded as long-term borrowings since it has been refinanced in conjunction with the 2003 bond issuance. At December 31, 2001, all line of credit borrowings were recorded as short-term and were repaid using existing working capital in January 2002.

#### **8. DERIVATIVE FINANCIAL INSTRUMENTS**

In 2002, Sutter entered into forward currency contracts, principally to diversify its investment portfolio to include foreign currencies. At December 31, 2002, Sutter's investments in forward currency contracts are immaterial to the combined statement of financial position. Gains and losses with a no hedge designation are recognized in the accompanying combined statements of operations as gains and losses and included in investment income. Certain of Sutter's forward currency contracts are subject to foreign currency exchange volatility.

In 2001, Sutter used an interest rate swap agreement to manage interest rate risk on future variable interest payments. As of December 31, 2001, 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, commenced in July 1996 and expired in July 2002. The interest rate differential received and paid was recognized over the term of the swap agreement as an adjustment to interest expense. At December 31, 2001, the aggregate fair market value of the swap was a net payable of \$1. As of December 31, 2002 Sutter had no interest rate swap agreements.

#### **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, 2002 and 2001, or operating leases based on the terms of the respective agreements.

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### **9. LEASES (Continued)**

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.

As of December 31, 2002 and 2001, Sutter has financed \$14 and \$28, respectively, through 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 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. In 2002, two of Sutter's three synthetic leases terminated. At termination, Sutter purchased both facilities for \$15.

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 at inception consist of the following as of December 31, 2002:

2003	\$	40
2004		34
2005		28
2006		26
2007		23
Thereafter		91
	\$	<u>242</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. Certain 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, 1999.
- *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, 2000.

## 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:

	<b>Years Ended December 31,</b>	
	<b>2002</b>	<b>2001</b>
Medicare	<b>38%</b>	36%
Medi-Cal	<b>13%</b>	12%

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 the finalization of prior-year cost reports from both Medicare and Medi-Cal resulted in increases in patient service revenues of approximately \$9 and \$4 for the years ended December 31, 2002 and 2001, 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.

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### 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 \$87 and \$75 of Charity Care Services to their patients in 2002 and 2001, respectively.

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

	Years Ended December 31,	
	2002	2001
Services for the poor and underserved	\$ 204	\$ 178
Benefits for the broader community	262	239
	<u>\$ 466</u>	<u>\$ 417</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 \$49 and \$30 for the years ended December 31, 2002 and 2001, 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:

	<b>December 31,</b>	
	<b>2002</b>	<b>2001</b>
Projected benefit obligation at beginning of year	\$ 517	\$ 461
Service cost	23	23
Interest cost	39	35
Amendments	-	5
Actuarial loss	45	17
Benefits paid	<b>(26)</b>	<b>(24)</b>
Projected benefit obligation at end of year	<b>598</b>	517
Fair value of plan assets at beginning of year	422	466
Actual return on plan assets	<b>(16)</b>	(19)
Employer contributions	33	3
Expenses paid	<b>(4)</b>	(4)
Benefits paid	<b>(26)</b>	<b>(24)</b>
Fair value of plan assets at end of year	<b>409</b>	422
Funded status of the plans	<b>(189)</b>	(95)
Unrecognized net actuarial loss	<b>125</b>	24
Unrecognized prior service cost	5	5
Minimum pension liability	<b>(46)</b>	(8)
Employer contributions	3	20
Net accrued retirement benefit cost at end of year	<b>\$ (102)</b>	<b>\$ (54)</b>

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.

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### 12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)

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

	<b>December 31,</b>	
	<b>2002</b>	<b>2001</b>
Accrued retirement benefit cost	\$ (106)	\$ (58)
Prepaid retirement benefit cost	4	4
	<b>\$ (102)</b>	<b>\$ (54)</b>

As of December 31, 2002 all of Sutter's noncontributory defined benefit retirement plans have benefit obligations in excess of plan assets. At December 31, 2001 two of Sutter's three noncontributory defined benefit retirement plans have benefit obligations in excess of plan assets. The projected benefit obligations and fair value of plan assets for these plans are as follows:

	<b>December 31,</b>	
	<b>2002</b>	<b>2001</b>
Projected benefit obligation	\$ 598	\$ 488
Fair value of plan assets	\$ 409	\$ 389

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### 12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)

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

	<b>December 31,</b>	
	<b>2002</b>	<b>2001</b>
Discount rates	<b>6.75%</b>	7.25-7.5%
Rates of compensation increase	<b>4.5-5.0%</b>	4.5%
Expected long-term rates of return on plan assets	<b>8.5%</b>	8.5-9.0%

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

	<b>Years Ended December 31,</b>	
	<b>2002</b>	<b>2001</b>
Service cost	<b>\$ 23</b>	\$ 23
Interest cost	<b>39</b>	35
Expected return on plan assets	<b>(37)</b>	(39)
Amortization of prior service cost	<b>1</b>	3
Adjustment to actual pension cost	<b>—</b>	(1)
Recognized net actuarial loss (gain)	<b>1</b>	(6)
Benefit cost	<b>\$ 27</b>	\$ 15

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 two noncontributory postretirement health benefit plans are as follows:

	<b>December 31,</b>	
	<b>2002</b>	<b>2001</b>
Benefit obligation at beginning of year	\$ 18	\$ 16
Service cost	1	1
Interest cost	1	1
Actuarial loss	1	1
Benefits paid	(1)	(1)
Benefit obligation at end of year	<u>20</u>	<u>18</u>
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	<u>-</u>	<u>-</u>
Funded status of the plans	(20)	(18)
Unrecognized net actuarial loss	1	1
Unrecognized prior service cost	1	-
Net accrued retirement benefit cost at end of year	<u>\$ (18)</u>	<u>\$ (17)</u>

Sutter's noncontributory postretirement health benefit plans have projected benefit obligations of \$20 and \$18 in excess of plan assets as of December 31, 2002 and 2001, respectively.

	<b>December 31,</b>	
	<b>2002</b>	<b>2001</b>
Weighted-average assumption as of December 31:		
Discount rate	6.75%	7.25%
	<b>Years Ended December 31,</b>	
	<b>2002</b>	<b>2001</b>
Components of net periodic benefit cost:		
Service cost	\$ 1	\$ 1
Interest cost	1	1
Benefit cost	<u>\$ 2</u>	<u>\$ 2</u>

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. Sutter's projected medical cost trend rate related to its two noncontributory postretirement health benefit plans in 2003 range from 10-11%. The

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### **12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)**

assumed medical cost trend rate is expected to gradually decrease in subsequent years to 5-6% in 2009 and thereafter. 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 that 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, 2002). 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 \$6 and \$7 in 2002 and 2001, respectively.

Sutter maintains various defined contribution plans for eligible employees. Sutter's contributions to such plans were \$14 and \$6 in 2002 and 2001, respectively.

#### **13. INCOME TAXES**

Deferred income taxes, which as of December 31, 2002 and 2001 have no net carrying value, 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, 2002 and 2001, Sutter had deferred tax assets of \$35 and \$33, respectively, relating principally to net operating loss carryovers. As of December 31, 2002 and 2001, such deferred tax assets were offset by a valuation allowance of \$35 and \$33, respectively. The valuation allowance increased by \$2 during the years ended December 31, 2002 and 2001.

Federal net operating loss carryovers totaled \$88 at December 31, 2002 and will expire between 2004 and 2022. State of California net operating loss carryovers totaled \$18 at December 31, 2002 and will expire between 2003 and 2012.

#### **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 a 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.

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### 15. FUNCTIONAL CLASSIFICATION OF EXPENSES

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

	Years Ended December 31,	
	2002	2001
Health services	\$ 4,302	\$ 3,807
General and administrative	345	310
	<u>\$ 4,647</u>	<u>\$ 4,117</u>

### 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 were defendants in a lawsuit filed by the Marin District in 1997 seeking, among other things, a judgment declaring that the Marin Lease and an Agreement for Transfer of Assets between the Marin District and MGH were void and that the Marin District was 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 to the Third District Court of Appeal insofar as it concluded that the claims based on Government Code Section 1090 were barred by applicable statutes of limitation. On November 14, 2002, the Court of Appeal issued a published decision affirming the trial court judgment. The District filed a petition requesting that the California Supreme Court review the decision, but the California Supreme Court denied the petition. The decision of the Supreme Court will become final on March 22, 2003.

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

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### **16. CONTINGENCIES AND COMMITMENTS (Continued)**

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 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. Both MPHS and Sutter Health appealed the granting of the motion, but the decision of the trial court was sustained on appeal on June 28, 2000. 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. There have been no further proceedings in the trial court since the execution of the letter of intent.

The parties have agreed to extend the time for the District to bring the case to trial by one year, until June 20, 2003. The case raises the same statute of limitations issue described in the summary above regarding Marin General Hospital. Based on the decision of the Supreme Court, management believes this case is likely to be dismissed and not proceed to trial. However, it is difficult to predict either the outcome of the litigation or the effect the litigation might have on MPHS, its facilities, the Corporation or the Obligated Group, 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 Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### **16. CONTINGENCIES AND COMMITMENTS (Continued)**

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, 2002, approximately 27% 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, 2002 and 2001, Sutter had irrevocable standby letters of credit and surety bonds aggregating \$184, to collateralize certain long-term obligations aggregating \$119 and \$122, respectively, and satisfy legal requirements for self-insured workers' compensation plans and for other purposes.

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, 2002 for the period from January 1, 2003 to December 31, 2007 amount to approximately \$1,092. 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.

#### **17. SUBSEQUENT EVENT**

In January 2003, Sutter issued \$101 of Series A and B CSCDA variable rate bonds. The proceeds of these borrowings were designated to retire certain short-term borrowings and finance certain capital expenditures.