

2003 Annual Report



Exceptional care at Fairview

Exceptional care starts with me.

I am committed to clinical excellence and improved care delivery for children.

I live our mission by improving the health of communities worldwide.

I live our values by leading with dignity, integrity, service and compassion.



Cyndy Mellgren, R.N.
*Fairview-University
Children's Hospital*

Minnesota Hospital
Association's
Caregiver of the Year



Shirley Graf, R.N.
*Fairview Lakes Regional
Medical Center*

Fairview Cares Award
recipient



Judy Wedebrand
Fairview Finance

Fairview Courageous
Leadership Award
recipient

I am Fairview.

Dear Friends:

Clinical excellence. Patient care. Patient safety. During 2003, we focused on these three critical issues to redefine how we deliver health care. Our understanding of and respect for our patients have driven much of our work this year. We continued to monitor and streamline our clinical and business processes, reducing variation and focusing on results. That concentrated effort is making a difference for our patients.

Fairview took a leadership role in reporting our quality outcomes on five high-profile clinical conditions: acute myocardial infarction, heart failure, community-acquired pneumonia, coronary artery bypass graft, and hip and knee replacement. Only 250 hospitals nationwide, and only two other Minnesota hospitals, joined this Centers for Medicare and Medicaid and Premier effort. Monitoring quality of outcomes leads to improved health for our patients.

In addition, Fairview ranked 19th among integrated health care systems nationwide in Modern Healthcare and Verispan's analysis of 568 systems—well above the two other Minnesota groups in the top 100. This level of integration means providing our patients the level of care they need throughout our care system.

Together with our partners at University of Minnesota Physicians and the University of Minnesota's Academic Health Center, we are delivering superior health outcomes. The focus on research and innovation that is part of the state's largest teaching hospital, Fairview-University Medical Center, leads us to breakthrough medical solutions for our sickest patients.

Our employee engagement scores again pointed upward—over the past three years our scores have risen from the 42nd percentile to the 66th percentile. Individual work groups scored within the top percentiles in this national ranking. Our retention rates are up and our open clinical positions are down, increasing continuity of care for our patients.

Our goals for 2004 are to continue to focus on new ways of delivering care that meet our patients' needs, delivering superior health outcomes and serving our patients and their families.



David R. Page
*President and Chief
Executive Officer, Fairview*

A handwritten signature in black ink that reads "D. R. Page".



Rodney Burwell
*Chair, Fairview
Board of Directors*

A handwritten signature in black ink that reads "Rodney Burwell".

Driving Clinical Excellence



Heart attack survival rates at Fairview Southdale Hospital rank in the top 1% nationally

Designed to meet the health care needs of today's aging population, the Minnesota Heart and Vascular Center at Fairview Southdale Hospital is a nationally-

recognized facility. Its conception was based on clinical collaboration, innovative care delivery models and highly-skilled cardiovascular experts.

Just three years after opening, the Center was ranked in the top one percent in the nation for heart attack survival rates.

Long recognized as one of the



brought to the cardiac catheterization lab, where a skilled team of cardiologists and health care professionals open the blocked artery within 90 minutes, stopping the heart attack and getting the patient on the road to recovery. In 2002, every patient who came through our primary angioplasty program was saved—every single one.

“We collaborate with primary care physicians and specialists within the hospital to deliver a thorough vascular evaluation of each patient. By doing this, we’re able to better understand the health of that patient’s [cardiovascular] system and develop a customized treatment approach,” said Stephen Battista, M.D., cardiologist with the Minnesota Heart Clinic.

Minnesota Heart and Vascular Center physicians and surgeons educate patients about the linkages between heart and vascular disease. They spend time with patients, helping them understand their conditions and future risks. Our exceptional, compassionate care providers make sure that heart attack patients know they face a greater risk of a second heart attack or a stroke because of the connectivity of heart and vascular disease. For each individual, physicians develop a customized plan to reduce the risk of future events, helping patients to remain healthy and active.

Commitment to clinical excellence, superior health outcomes and teamwork make the Minnesota Heart and Vascular Center at Fairview Southdale Hospital one of the best heart hospitals in the country.

best in the state, our primary angioplasty program achieved a unique distinction according to 2002 data (the most recent data available). With primary angioplasty, a patient suffering a heart attack is assessed in Fairview Southdale’s emergency department and then quickly

More excellence in action

Fairview Home Care and Hospice and Fairview Lakes HomeCaring and Hospice both ranked above local and national averages by the Centers for Medicare and Medicaid

University of Minnesota Physicians marked the 40th anniversary of the transplant program, including 25 years of heart transplantation (A)

Fairview named one of six national Palliative Care Leadership Centers with a three-year, \$750,000 grant from the Robert Wood Johnson Foundation

Fairview Range rated highest in the state for diabetic care by the Healthcare Evaluation and Research Foundation

Fairview Red Wing inpatient satisfaction scores rank among the top 75 percent nationally (B)

Fairview Lakes and Fairview Northland celebrated their 5- and 10-year anniversaries, respectively, of providing integrated, comprehensive care to their local communities (C)

Fairview adopted community-wide surgical site-marking policy with Safest in America consortium members



Redefining Care Delivery



Innovative anticoagulation clinic improves care and service for patients

For patients on long-term anticoagulation therapy, regular medication adjustments, routine blood tests, multiple clinic appointments and an

interdisciplinary care team are important to managing their complex medical conditions.

That's why Fairview Oxboro Clinic and Fairview Pharmacy

Services staff teamed up to improve care delivery for the clinic's nearly 300 long-term therapy patients. The staff believed they could deliver



clinic appointments and more comprehensive education for patients. In a single appointment, patients have their blood levels checked, are assessed and given new medication instructions.

“After a patient has a blood sample taken from a finger stick, lab staff perform the blood-clotting test while the nurse reviews the patient’s medications and any concerns. Most patients are in and out of the office in 20 minutes with their instructions in hand. No need to wait for a phone call from the doctor later in the day,” says Stephanie Meredith, administrator, Fairview Oxboro Clinic.

During their appointments, patients also have the opportunity to meet one-on-one with a pharmaceutical care pharmacist to more fully understand their disease and its management. Since many patients have multiple and complex medical conditions, this personalized and specialized approach to education can be critical to achieving desired clinical outcomes.

Most importantly, within just 10 months, nearly 85 percent of the identified patients are in their therapeutic ranges. This is above the national average of a mid-70 percent range, and significantly above the initial 55 percent rate.

Better care and better service through clinical collaboration and innovation—that’s what redefining care is all about at Fairview.

more convenient care while decreasing physician workload and improving clinical outcomes for this complex patient population.

Launched in April 2003, the Anticoagulation Clinic uses a streamlined care delivery process, resulting in fewer

Redefining care across our organization

Ebenezer’s Intergenerational Day Program uses best practice knowledge to provide exceptional care to both toddlers and seniors (A)



The University of Minnesota and Fairview-University Medical Center teamed up to open the Center for Minimally Invasive Surgery (B)



Innovative employee health management program earned Fairview the C. Everett Koop National Health Award

Fairview and the University of Minnesota jointly received a three-year, \$750,000 telemedicine grant to improve access to health care services in rural and remote areas



Fairview Ridges Hospital’s new chest pain evaluation unit ensures appropriate and efficient care for cardiology patients admitted through the emergency department

Partnership with Century College trains medical interpreters helping Fairview meet the changing needs of our diverse communities (C)

Fairview clinics implemented new care delivery and operational models to maximize clinical quality, customer satisfaction and financial performance

Improving Our Communities' Health



Fairview recognized as a national leader in integrated health care

Fairview Health Services is redefining health care delivery through an integrated health network (IHN) providing care from prevention and disease

management to the most complex of life-threatening injuries and illnesses. A leader in health care delivery, Fairview ranks 19th in Modern

Healthcare and Verispan's 2004 IHN 100 ranking of 568 systems nationwide and is the only Minnesota system in the Midwest's top 10 rankings.



In 2003, Fairview's charity care and community benefit totaled more than \$140 million. Health screenings, subsidized clinics, transportation services, medical care without charge and more help improve the health of our communities.

Minnesota's Academic Health Center and University of Minnesota Physicians partner to educate and train two-thirds of Minnesota's health care professionals and provide medical services to citizens from across the state. Superior health outcomes are delivered through a seamless continuum of services bridging community and academic medicine.

Headquartered in Minneapolis, Minn., the Fairview system includes seven hospitals with 2,567 licensed beds including an academic teaching hospital, six community hospitals, comprehensive children's services, more than 50 primary care and specialty clinics, and home care and hospice services. Senior services are provided through Ebenezer, a division of Fairview. Fairview is home to the Minnesota Heart and Vascular Center, the Brain Tumor Center of Minnesota and designated a Palliative Care Leadership Center by the Robert Wood Johnson Foundation. Services extend throughout the State of Minnesota.

Fairview is also a recipient, with the University of Minnesota's Academic Health Center, of a telecommunications grant to extend medical services to remote parts of Minnesota. In addition, Fairview, the state's largest provider of behavioral services, received a one-year \$750,000 grant from the Minnesota Community Foundation to expand adolescent behavioral services.

Verispan's survey recognizes use of integration to excel clinically and financially. In addition, Fairview is ranked 11th in Healthcare and Medical Industry within Information Week's Top 500 technology companies. Fairview, the University of



Fairview's Service Areas

Fairview Health Services

- + 18,900 Employees
- + 7 Hospitals
- + 31 Primary care clinics
- + 28 Specialty clinics
- + 5 Urgent care centers
- + 24 Institute for Athletic Medicine locations
- + 5 Fairview Hand Center locations
- + 8 Orthotics & prosthetics clinics
- + 8 Fairview Counseling Centers
- + 4 Adult day program locations
- + Intergenerational day program
- + 20 Senior housing facilities
- + 5 Long-term care facilities
- + 24 Retail pharmacies
- + 2 Fairview Home Medical Equipment locations
- + 4 Home care & hospice agencies
- + Fairview Diagnostic Laboratories
- + Fairview Pain Management Center
- + Fairview Partners
- + Fairview Foundation
- + Ebenezer Foundation
- + Fairview Press

Affiliated Physician Organizations

- + Behavioral Healthcare Providers
- + Fairview Physician Associates
- + University of Minnesota Physicians

Our Values

Fairview's values are dignity, integrity, service and compassion.

Our Mission

Fairview's mission is to improve the health of the communities we serve. We commit our skills and resources to the benefit of the whole person by providing the finest in health care, while addressing the physical, emotional and spiritual needs of individuals and their families. We further pledge to support the research and education efforts of our partner, the University of Minnesota, and its tradition of excellence.

Our Vision

You will know us for our continuum of healing care, our responsiveness and for setting national standards for clinical excellence, innovation and safety.

Executive Summary

For an organization like Fairview—one committed to service—revenue and expense figures, ratios and graphs may seem out of place. On a practical level, they remind us of our need to operate the organization in a fiscally responsible way, so that we enhance our ability to take care of more people tomorrow than we are taking care of today.

Fairview's 2003 financial results furthered our ability to provide superior health outcomes in the communities we serve. Achieving a record high for the second consecutive year, Fairview reported a net operating income of \$49.1 million—60.2 percent higher than 2002. Revenues grew to \$1.7 billion, also a high mark for the company.

We've been able to achieve these results despite a highly competitive market, increasing medical cost inflation, a complex regulatory environment and concerns about patient safety. In doing so, our commitment to serving those in need has not wavered. The cost of providing charity care, services furnished for community benefit programs, and the unpaid costs of public program payments amounted to \$140 million in 2003.

Fairview is also benefiting from the implementation of our Performance Excellence program, which is designed to improve outcomes and business results by increasing responsiveness to our patients and customers, improving clinical processes, setting standards for performance and measuring results.

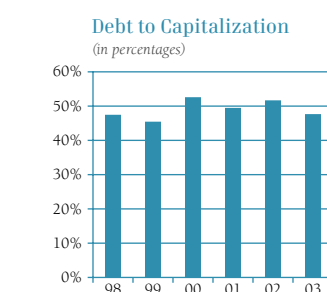
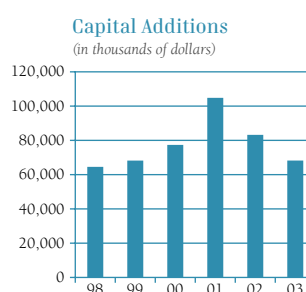
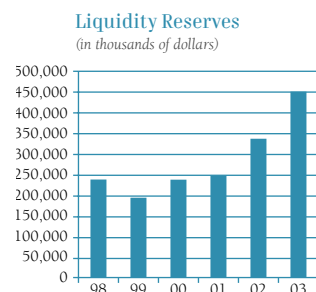
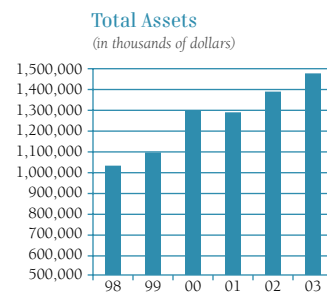
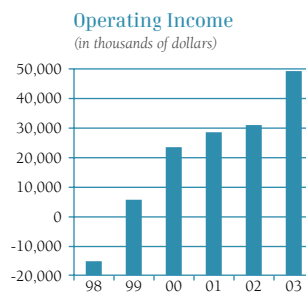
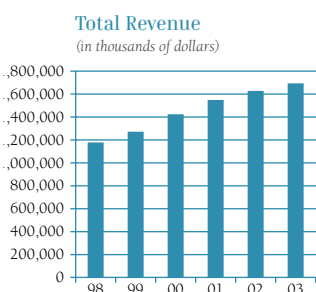
In 2004, we anticipate committing \$90 million of capital. When added to amounts committed to in previous years to be spent in 2004, our total capital budget is \$201.4 million. This includes an expansion of Fairview Northland, and an increase in routine spending by 50 percent to \$75 million, as well as capital for physician initiatives and information services.

Because Fairview has been diligent in improving its operating margin, decreasing our leverage ratios and increasing our cash, we are in a stronger financial position to invest in our people, our services and our communities.

Statements of Financial Position for the Years Ended December 31

(Dollars in Thousands)	2003	2002	% Change
Total Revenue	\$1,685,017	\$1,623,367	4%
Operating Income	\$ 49,089	\$ 30,638	60%
Net Operating Margin	2.9%	1.9%	
Total Assets	\$1,470,883	\$1,389,352	6%
Liquidity Reserves*	\$ 450,288	\$ 333,035	35%

* Liquidity Reserves consist of cash, short term investments, and investments



Customers Served

	For the Years Ended December 31					
	2003	2002	2001	2000	1999	1998
Ambulatory care						
Hospitals	1,089,725	1,070,404	1,034,399	933,701	889,663	787,656
Clinics	925,985	936,425	948,634	963,076	933,733	925,127
Institute for Athletic Medicine	186,673	183,480	189,442	176,204	168,801	174,993
Hospital home care	234,557	240,873	237,983	245,423	310,881	363,189
Orthopedics laboratories (procedures)	25,153	23,879	20,464	19,510	18,863	19,500
Retail pharmacy	1,436,383	1,318,544	1,269,410	1,210,014	1,074,621	975,295
FPA care system						
Members served	54,937	44,470	71,540	62,185	62,189	61,589
Inpatient admissions						
Acute care	70,089	68,237	68,558	68,891	68,774	68,003
Behavioral services	9,574	9,421	9,148	8,766	8,285	8,821
<i>Total inpatient admissions</i>	79,663	77,658	77,706	77,657	77,059	76,824
Patient days						
Acute care	268,574	273,022	283,708	290,314	285,395	284,741
Behavioral services	70,405	69,410	69,273	68,376	63,350	71,385
Long-term care	193,161	199,530	208,832	229,163	240,573	294,478
<i>Total patient days</i>	532,140	541,962	561,813	587,853	589,318	650,604
Average length of stay						
Acute care	3.8	4.0	4.1	4.2	4.1	4.2
Behavioral services	7.4	7.4	7.6	7.8	7.6	8.1

Consolidated Statements of Operations and Changes in Net Assets

(Dollars in Thousands)	Year Ended December 31		
	2003	2002	2001
Unrestricted revenue:			
Net patient revenue	\$1,536,929	\$1,447,171	\$1,301,680
Other revenue	147,081	174,165	234,275
Net assets released from restrictions	1,007	2,031	1,589
<i>Total unrestricted revenue</i>	1,685,017	1,623,367	1,537,544
Expenses:			
Salaries and benefits	891,957	879,984	809,149
Supplies	318,934	301,434	263,771
Purchased services	147,830	141,012	168,252
Depreciation and amortization	69,981	68,473	56,232
Interest	27,978	23,703	20,423
Provision for bad debts	23,447	26,691	42,465
Other operating expenses	155,801	151,432	148,548
<i>Total expenses</i>	1,635,928	1,592,729	1,508,840
Operating income	49,089	30,638	28,704
Nonoperating gains (losses):			
Investment income	8,558	4,915	12,272
Gain (loss) on interest and basis rate swaps, net	2,478	(4,615)	(1,616)
Loss on early extinguishment of debt	–	(2,450)	–
<i>Total nonoperating gains (losses), net</i>	11,036	(2,150)	10,656
<i>Excess of revenue over expenses</i>	60,125	28,488	39,360
Other changes in unrestricted net assets:			
Excess of revenue over expenses	60,125	28,488	39,360
Changes in unrealized gains and losses	25,940	(5,224)	(8,903)
Cumulative effect of adopting new accounting principle	–	–	5,375
Decrease (increase) in additional minimum liability relating to defined benefit plan	237	(666)	–
Contributions of long-lived assets	4,457	1,274	1,231
<i>Increase in unrestricted net assets</i>	90,759	23,872	37,063
Temporarily restricted net assets:			
Contributions and other changes	4,600	2,394	2,895
Net assets released from restrictions	(3,899)	(3,305)	(2,820)
<i>Increase (decrease) in temporarily restricted net assets</i>	701	(911)	75
Total increase in net assets	91,460	22,961	37,138
Net assets at beginning of year	532,542	509,581	472,443
<i>Net assets at end of year</i>	\$ 624,002	\$ 532,542	\$ 509,581

See accompanying notes.

Consolidated Balance Sheets

(Dollars in Thousands)

	Year Ended December 31		
	2003	2002	2001
Assets			
Current assets:			
Cash and cash equivalents	\$ 51,568	\$ 55,748	\$ 51,137
Short-term investments	52,337	49,605	5,502
Patient accounts receivable, less allowance for doubtful accounts of \$45,756 in 2003, \$56,834 in 2002, and \$64,816 in 2001	261,134	257,968	300,090
Receivable under third-party reimbursement contracts	-	7,994	-
Inventories	32,893	33,561	32,785
Other current assets	45,518	59,884	60,248
<i>Total current assets</i>	443,450	464,760	449,762
Investments	346,383	227,682	193,226
Assets whose use is limited:			
Debt service reserve fund investments	28,851	30,203	24,366
Construction fund investments	30,466	54,353	49,863
Investments held by insurance subsidiaries	40,770	38,464	39,616
Investments pledged under workers' compensation program	15,672	13,591	13,591
Restricted fund investments	11,514	10,277	12,551
<i>Total assets whose use is limited</i>	127,273	146,888	139,987
Other long-term assets:			
Deferred debt acquisition costs	10,313	10,425	8,743
Other assets	46,352	45,193	22,715
<i>Total other long-term assets</i>	56,665	55,618	31,458
Property, plant, and equipment, net	497,112	494,404	478,485
<i>Total assets</i>	\$1,470,883	\$1,389,352	\$1,292,918
Liabilities and net assets			
Current liabilities:			
Checks outstanding	\$ 14,591	\$ 15,789	\$ 14,826
Notes and accounts payable	62,061	74,069	80,174
Accrued liabilities	139,006	129,761	123,131
Payable under third-party reimbursement contracts	6,873	-	11,635
Current maturities of long-term debt	8,496	8,363	8,566
Current portion of insurance subsidiaries claims reserves	6,712	7,919	7,307
Current portion of workers' compensation reserves	4,276	4,475	4,145
<i>Total current liabilities</i>	242,015	240,376	249,784
Other liabilities:			
Insurance subsidiaries claims reserves, less current portion	17,289	15,747	11,933
Workers' compensation reserves, less current portion	19,452	17,185	15,915
Other long-term liabilities	14,479	24,117	11,979
<i>Total other liabilities</i>	51,220	57,049	39,827
Long-term debt, less current maturities	553,646	559,385	493,726
Net assets:			
Unrestricted	612,023	521,264	497,392
Temporarily restricted	11,979	11,278	12,189
<i>Total net assets</i>	624,002	532,542	509,581
<i>Total liabilities and net assets</i>	\$1,470,883	\$1,389,352	\$1,292,918

See accompanying notes.

Consolidated Statements of Cash Flows

(Dollars in Thousands)	Year Ended December 31		
	2003	2002	2001
Operating activities			
Increase in net assets	\$ 91,460	\$ 22,961	\$ 37,138
Adjustments to reconcile increase in net assets to net cash provided by operating activities:			
Depreciation and amortization	69,981	68,473	56,232
Provision for bad debts	23,447	26,691	42,465
Changes in unrealized gains and losses	(25,940)	5,224	8,903
Cumulative effect of adopting new accounting principle	–	–	(5,375)
(Decrease) increase in additional minimum liability relating to defined benefit plan	(237)	666	–
Contributions of long-lived assets	(4,457)	(1,274)	(1,231)
Loss on early extinguishment of debt	–	2,450	–
(Gain) loss on interest and basis rate swaps, net	(2,478)	4,615	1,616
Changes in assets and liabilities:			
Patient accounts receivable	(26,613)	15,431	(34,903)
Inventories and other current assets	13,273	(8,406)	(11,328)
Notes and accounts payable, accrued and other current liabilities	9,121	(10,147)	(29,160)
Other, net	6,929	(10,423)	(673)
<i>Net cash provided by operating activities</i>	154,486	116,261	63,684
Investing activities			
Additions to property, plant, and equipment	(68,655)	(82,546)	(107,485)
Investment purchases	(274,474)	(239,766)	(115,313)
Investment sales	190,020	149,082	179,714
Other, net	372	698	5,487
<i>Net cash used in investing activities</i>	(152,737)	(172,532)	(37,597)
Financing activities			
Proceeds from long-term debt	2,767	114,410	800
Payment for defeasance of long-term debt	–	(42,565)	–
Payments on long-term debt	(8,373)	(8,839)	(6,954)
Deferred debt acquisition costs	(323)	(2,124)	–
<i>Net cash (used in) provided by financing activities</i>	(5,929)	60,882	(6,154)
(Decrease) increase in cash and cash equivalents	(4,180)	4,611	19,933
Cash and cash equivalents at beginning of year	55,748	51,137	31,204
<i>Cash and cash equivalents at end of year</i>	\$ 51,568	\$ 55,748	\$ 51,137

See accompanying notes.

Notes to Consolidated Financial Statements

(Dollars in Thousands)

December 31, 2003, 2002, and 2001

Note 1. Organization and Basis of Presentation

Fairview Health Services is a nonprofit corporation incorporated and headquartered in Minnesota. Fairview Health Services and its wholly controlled affiliates and wholly owned subsidiaries (collectively referred to as Fairview) are a regionally integrated network of physicians, hospitals, ambulatory care and pharmacy services, and health care management enterprises.

The consolidated financial statements include the accounts of Fairview, which include both tax-exempt and taxable entities. All significant interaffiliate and intercompany balances and transactions have been eliminated in consolidation.

Note 2. Summary of Significant Accounting Policies

Use of Estimates — The preparation of consolidated 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 these consolidated financial statements and accompanying notes. Although estimates are considered to be fairly stated at the time the estimates are made, actual results could differ from those estimates.

Cash and Cash Equivalents — Cash and cash equivalents include currency on hand, demand deposits with banks or other financial institutions, and short-term investments with maturities of 90 days or less from the date of purchase.

Fairview places its temporary cash investments with high-quality financial institutions which have a bond rating of AA or higher and, by policy, limits the amount of credit exposure to any one financial institution. However, Fairview has cash balances at financial institutions that may exceed federal depository insurance limits.

Inventories — Inventories include drugs and supplies and are recorded at the lower of cost or market on a first-in, first-out (FIFO) basis.

Investments — Investments are recorded at fair value based on quoted market prices (Note 6). When quoted market prices are not available, Fairview uses pricing models for various types of financial instruments that take into account the present value of estimated future cash flows. Realized gains and losses and changes in unrealized gains and losses are included in the consolidated statements of operations and changes in net assets. Investments are exposed to various risks, such as interest rate, credit, and overall market volatility.

Fairview continually reviews its investments for impairment conditions, which would indicate that an other-than-temporary loss has occurred. In conducting this review, numerous factors are considered, including specific information pertaining to an individual company or a particular industry and general market conditions that reflect prospects for the economy as a whole. Based on this review, no other-than-temporary losses were recorded during 2003, 2002, and 2001.

Interest Rate and Basis Rate Swaps — Effective January 1, 2001, Fairview adopted Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*. SFAS Nos. 133 and 138 establish accounting and reporting standards for derivative instruments and for hedging activities. They require that all derivatives, including those embedded in other contracts, be recognized as either assets or liabilities and that those financial instruments are measured at fair value. Gains or losses resulting from changes in the fair values of derivatives are reflected in the consolidated statements of operations and changes in net assets.

Deferred Debt Acquisition Costs — Costs of bond issuance are deferred and amortized on a straight-line basis over the term of the related indebtedness.

Property, Plant, and Equipment — Property, plant, and equipment are recorded at cost and depreciated over estimated useful lives using the straight-line method. Noncancelable financing leases are capitalized at the present value of future minimum lease payments and amortized on a straight-line basis over the estimated useful lives of the related assets. The following estimated useful lives are used in computing depreciation:

Land improvements	5–10 years
Buildings	30–40 years
Equipment	2–20 years

During 2003, 2002, and 2001, capitalized interest relating to construction in progress was \$1,609, \$1,844, and \$300, respectively.

Professional and General Liability Claims — Fairview is insured with an external insurance carrier for professional and general liability claims in excess of amounts insured through its insurance subsidiaries. Fairview offsets amounts due from the insurance carrier against the corresponding claims liability.

Unrestricted and Temporarily Restricted Net Assets — Unrestricted net assets are used to account for all transactions related to patient care and other operating activities. Unrestricted net assets include assets whose use is limited through designation by the Board of Directors and requirements of bond indentures. Temporarily restricted net assets are those assets whose use by Fairview has been limited by donors or grantors to a specific purpose or time period.

Net Patient Revenue — Fairview has agreements with third-party payors, which provide for payments to Fairview at amounts different from its established rates. Net patient revenue is reported at estimated net amounts due from patients and third-party payors for services rendered.

Contractual adjustments arising from various reimbursement arrangements with third-party payors are accrued on an estimated basis in the period in which the services are rendered. Certain reimbursement arrangements are subject to retroactive audit and adjustment. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Differences between amounts originally recorded and finally settled are included in operations in the year in which the differences become known.

Fairview utilizes a process to identify and appeal settlements on cost reports and claims by Medicare and other intermediaries. Routine appeals, cost report settlements, and adjustments to estimated amounts due from patients for prior years' patient care amounted to approximately 1% of net patient revenue in each of the years 2003, 2002, and 2001. In addition, during 2003 and 2002, Fairview recorded \$8,100 and \$23,300, respectively, relating to additional Medicare disproportionate share reimbursement for the period from 1993 to 2001.

Charity Care — Fairview provides health care services to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Since collection of these amounts is not pursued, they are excluded from net patient revenue.

Loss on Extinguishment of Debt — Effective January 1, 2002, Fairview adopted SFAS No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*. As a result, Fairview reported in 2002 the loss on early extinguishment of debt as a nonoperating loss in the statements of operations and changes in net assets.

Excess of Revenue Over Expenses — The consolidated statements of operations and changes in net assets include excess of revenue over expenses. Changes in unrestricted net assets that are excluded from excess of revenue over expenses include changes in net unrealized gains and losses on investments, cumulative effect of adopting new accounting principle, contributions of long-lived assets, and a change in the additional minimum liability relating to a defined benefit plan.

Reclassifications — Certain reclassifications were made to the 2001 and 2002 consolidated financial statements to conform to the 2003 presentation. The reclassifications had no effect on the increase in net assets or on net assets as previously reported.

Note 3. Affiliations

Effective January 1, 1997, certain assets and liabilities related to clinical care at University of Minnesota Hospital and Clinic were transferred to Fairview. In addition, the University of Minnesota (the University) transferred to Fairview its membership rights in certain health-related affiliates, including Fairview Red Wing Clinic and Range Regional Health Services. Fairview and the University also entered into various other agreements, including an affiliation between Fairview and the Academic Health Center (the AHC) of the University, a lease of space at the University campus to Fairview, and a purchase services agreement whereby each party purchases certain core infrastructure services from the other.

Through December 31, 2003, Fairview's bylaws authorized a board of directors of up to 21 members. Three members of Fairview's Board of Directors, which consisted of 18 members as of December 31, 2003, were either appointed by and/or held positions at the University.

Under the terms of the academic affiliation agreement (the Agreement) with the AHC, Fairview and the University have agreed to jointly support the research, education, and patient care missions of Fairview and the AHC. The Agreement expires on December 31, 2026 and renews automatically for six additional terms of ten years unless terminated in accordance with its provisions. The Agreement provides for the sharing of certain revenue and expenses related to medical research and education at Fairview-University Medical Center, which was formed as a result of a merger of the former Fairview Riverside Hospital and the former University of Minnesota Hospital and Clinic. Fairview has committed to supporting the AHC through an annual grant to the University equal to the greater of 25% of Fairview's net operating margin, as defined in the Agreement, in excess of 3.5% or \$1,000 through December 31, 2026, which can be fully offset against lease payments made by Fairview to the University over the same period.

Revenue and expenses recorded by Fairview under all of its agreements with the University were \$20,676 and \$36,381, respectively, for 2003; \$25,642 and \$35,007, respectively, for 2002; and \$28,084 and \$33,232, respectively, for 2001. Amounts receivable from and payable to the University were \$25,019 and \$7,223, respectively, at December 31, 2003; \$44,281 and \$11,469, respectively, at December 31, 2002; and \$37,080 and \$9,346, respectively, at December 31, 2001. At December 31, 2003 and 2002, the effect of discounting certain long-term receivables to their net present value was approximately \$1,100 and \$2,000, respectively.

Note 4. Net Patient Revenue and Contractual Agreements With Third-Party Payors

Fairview provides care to patients under the Medicare and Medicaid programs and through contractual arrangements with other managed care payors, consisting primarily of various health maintenance organizations (HMOs) and preferred provider organizations (PPOs).

The Medicare program pays primarily all inpatient and most outpatient services at predetermined rates. Services provided to patients covered by managed care organizations and the Medicaid program are paid for on the basis of negotiated or contractual payment rates or, in some cases, on the basis of allowable cost of providing such services. Changes in the Medicare and Medicaid programs or certain managed care contracts could have a material adverse effect on Fairview.

The revenue mix from patients and third-party payors, based on gross patient charges, is summarized below:

	2003	2002	2001
Medicare	28%	27%	27%
Medicaid	7	7	7
Managed care	59	59	58
Commercial and other	6	7	8
	100%	100%	100%

One managed care payor accounted for approximately 17% of gross patient charges for each of 2003 and 2002 and 16% for 2001.

Fairview grants credit without collateral to its patients, most of whom are residents in the communities that Fairview serves and are insured under third-party payor agreements. The mix of amounts receivable from third-party payors and patients at December 31 consists of the following:

	2003	2002	2001
Medicare	23%	24%	21%
Medicaid	13	14	16
Managed care	44	41	42
Commercial and other	20	21	21
	100%	100%	100%

Amounts due from one managed care payor accounted for approximately 16% of patient accounts receivable at December 31, 2003 and 14% at each of December 31, 2002 and 2001.

Note 5. Charity Care and Community Benefits (Unaudited)

Fairview provides medical care without charge or at reduced cost to residents of the communities it serves by providing services to patients who are uninsured or underinsured and by absorbing the difference between public program payments (primarily Medicare and Medicaid) and the related costs of providing such services. In addition, Fairview pays a provider tax on certain revenue to help fund the Minnesota Care program for the State's uninsured patients.

In furtherance of its charitable purpose, Fairview also provides a wide variety of benefits to the community, including various community-based social service programs, such as subsidized clinics, health screenings, interpreter services, social service and support counseling for patients and families, transportation to and from the hospitals, and the donation of space for use by community groups. Fairview donates cash, supplies, and equipment to various organizations that support the underserved. Additionally, a large number of health-related educational programs and research projects are provided by Fairview for the benefit of the community, including health and wellness, classes on specific medical conditions, medical education, telephone information services, and programs designed to improve the general health of the community.

The cost of providing charity care, including services and supplies furnished for community benefit programs, and deficits in public program payments, retroactively adjusted for appeals and settlements, are summarized below:

	2003	2002	2001
Cost of providing community services	\$ 21,755	\$ 23,203	\$ 23,167
Cost of providing charity care	1,480	937	1,116
Unpaid costs of public programs:			
Medicare	73,362	71,166	54,275
Medicaid	18,709	14,486	4,051
Medicaid surcharge	12,845	11,198	9,955
MinnesotaCare tax	11,396	11,438	11,637
Total	\$139,547	\$132,428	\$104,201

Note 6. Investments and Other Financial Instruments

The composition of Fairview's investments at December 31 is summarized as follows:

	2003	2002	2001
Cash and cash equivalents	\$154,593	\$141,038	\$ 93,496
Fixed income securities	222,351	188,433	164,527
Mutual funds	134,107	70,301	60,414
Equity securities	14,942	24,403	20,278
	<u>\$525,993</u>	<u>\$424,175</u>	<u>\$338,715</u>

Investment return is summarized and is reported in the consolidated statements of operations and changes in net assets as follows:

	2003	2002	2001
Dividends and interest	\$ 7,513	\$6,245	\$ 7,532
Net realized gains (losses)	1,045	(1,330)	4,740
	8,558	4,915	12,272
Changes in unrealized gains and losses	25,940	(5,224)	(8,903)
	<u>\$34,498</u>	<u>\$ (309)</u>	<u>\$ 3,369</u>

The carrying values of cash and cash equivalents, patient accounts receivable, and accounts payable are reasonable estimates of their fair value due to the short-term nature of these financial instruments. The estimated fair value of long-term debt, based on quoted market prices for the same or similar issues, was approximately \$79,770, \$63,075, and \$33,455 more than its carrying value at December 31, 2003, 2002, and 2001, respectively.

During 2002, in order to reduce the effective interest rate on its fixed-rate debt, Fairview entered into an interest rate swap and various basis rate swaps. The interest rate swap has a five-year term and a notional amount of \$100,000, whereby Fairview receives interest at a fixed rate of 3.34% and pays interest at a variable rate, based on the London Interbank Offered Rate (LIBOR). At December 31, 2003 and 2002, the interest rate swap is included in other assets at a fair value of \$738 and \$996, respectively. A nonoperating loss of \$259 and a nonoperating gain of \$996 were recorded during 2003 and 2002, respectively, reflecting the change in fair value of the swap during each year. The basis rate swaps have ten-year terms and notional amounts totaling \$400,000, whereby Fairview receives interest based on LIBOR and pays interest based on the Bond Market Association Mutual Swap Index Rate (the BMA). At December 31, 2003 and 2002, the basis rate swaps are included in other long-term liabilities at their fair value of \$8,415 and \$11,152, respectively. A nonoperating gain of \$2,737 and a nonoperating loss of \$11,152 were recorded for 2003 and 2002, respectively, reflecting the change in fair value of the swaps during each year. None of the swaps has been designated as a hedging instrument.

In conjunction with a bond issue in May 2000, Fairview entered into an interest rate swap, which was sold in November 2002. The interest rate swap had the effect of converting \$100,000 of debt from fixed to variable interest rates. Under the agreement, Fairview paid interest at a variable rate, based on the BMA, and received interest at a fixed rate of 5.67%. Effective January 1, 2001, upon adoption of SFAS No. 133, the interest rate swap was included in other assets at its fair value of \$5,375. A nonoperating loss of \$1,616 was recorded in 2001 and a nonoperating gain of \$5,541 was recorded in 2002, reflecting the change in fair value of the swap during each year.

Derivative transactions contain credit risk in the event the parties are unable to meet the terms of the contract, which is generally limited to the fair value due from counterparties on outstanding contracts. At December 31, 2003, the exposure for all derivative contracts was \$738 from a counterparty with a Standard & Poor's credit quality rating of AA-.

Note 7. Property, Plant, and Equipment

Property, plant, and equipment at December 31 consists of the following:

	2003	2002	2001
Land and improvements	\$ 36,965	\$ 31,988	\$ 27,744
Buildings and improvements	584,756	550,646	520,319
Equipment	579,520	557,403	513,612
	1,201,241	1,140,037	1,061,675
Less accumulated depreciation	728,172	682,426	622,647
	473,069	457,611	439,028
Construction in progress	24,043	36,793	39,457
	<u>\$ 497,112</u>	<u>\$ 494,404</u>	<u>\$ 478,485</u>

Depreciation expense was \$69,469, \$67,901, and \$55,201 for 2003, 2002, and 2001, respectively.

Note 8. Short-Term Credit Arrangements

Fairview has various lines of credit totaling \$40,000, which are available for short-term borrowing at variable interest rates, as defined in the agreements. There were no outstanding borrowings under these agreements at December 31, 2003, 2002, and 2001.

Note 9. Long-Term Debt

Fairview's long-term debt at December 31 is summarized as follows:

	2003	2002	2001
City of Minneapolis Health Care System Revenue Bonds, Series 2002A, and Revenue Refunding Bonds, Series 2002B, payable in installments through 2032 at interest rates from 4.00% to 5.625% (net of unaccrued discount of \$1,131 in 2003 and \$1,171 in 2002)	\$112,014	\$114,410	\$ -
Minnesota Agriculture and Economic Development Board Healthcare System Revenue Bonds, Series 2000A, payable in installments through 2029 at interest rates from 5.625% to 6.375% (net of unaccrued discount of \$6,140 in 2003, \$6,378 in 2002, and \$6,623 in 2001)	172,390	173,937	173,692
Minnesota Agriculture and Economic Development Board Healthcare System Revenue Bonds, Series 1997A, payable in installments through 2026 at interest rates from 5.00% to 5.75% (net of unaccrued discount of \$5,214 in 2003, \$5,438 in 2002, and \$5,661 in 2001)	164,386	165,357	166,274
Other revenue bonds and notes, at varying interest rates, payable in installments through 2044 (net of unaccrued discount of \$717 in 2003, \$862 in 2002, and \$919 in 2001)	113,352	114,044	120,322
Revenue bonds, Series 1991, defeased in 2002	-	-	42,004
	562,142	567,748	502,292
Less current maturities included in current liabilities (net of unaccrued discount of \$557 in 2003, \$557 in 2002, and \$547 in 2001)	8,496	8,363	8,566
	<u>\$553,646</u>	<u>\$559,385</u>	<u>\$493,726</u>

In May 2002, the City of Minneapolis, on behalf of Fairview, issued fixed-rate Health Care System Revenue Bonds, Series 2002A, and Health Care System Revenue Refunding Bonds, Series 2002B, in the aggregate principal amount of \$115,580. The Series 2002A bonds, which are secured by Fairview's patient accounts receivable, are being used to acquire, construct, and renovate certain of Fairview's hospital facilities and make deposits into a debt service reserve fund. The Series 2002B bonds have been used to refinance the outstanding debt relating to City of Minneapolis Hospital System Revenue Refunding and Revenue Bonds, Series 1991A and B, and City of Princeton Hospital System Revenue Bonds, Series 1991C. In connection with this transaction, a loss of \$2,450 was recognized as a nonoperating expense in the 2002 statement of operations and changes in net assets.

In conjunction with the issuance of Fairview Hospital and Healthcare Services Taxable Variable Notes, Series 1994A, Fairview has entered into a standby bond purchase agreement with a bank that expires on January 1, 2005. Under the terms of the agreement, the bank will make a loan to Fairview, payable over a five-year period, in the amount necessary to purchase the outstanding amount of the variable notes (\$15,700 at December 31, 2003) if not remarketed.

Fairview's revenue bonds were issued pursuant to a Master Trust Indenture. The indenture contains various restrictive covenants including limitations on incurring additional debt and the maintenance of certain debt coverage ratios.

Fairview paid interest of \$28,069, \$23,928, and \$21,024 for 2003, 2002, and 2001, respectively.

Aggregate maturities and sinking fund requirements of long-term debt, including capital leases, for each of the next five years are as follows, assuming no early redemption:

2004	\$ 9,053
2005	9,479
2006	9,987
2007	10,514
2008	11,018

Note 10. Commitments and Contingencies

At December 31, 2003, Fairview had commitments of \$17,469 to complete projects relating to capital construction and software development.

Fairview has operating leases for computer, medical, communications, and other equipment. Rental expense associated with the operating leases was \$25,660, \$27,023, and \$25,892 for 2003, 2002, and 2001, respectively.

Future minimum lease payments on operating leases in effect on December 31, 2003 for each of the five subsequent years and thereafter are as follows:

2004	\$14,185
2005	12,699
2006	10,316
2007	9,963
2008	8,912
Thereafter	15,742

Approximately 33% of Fairview's employees are represented by various collective bargaining arrangements. Labor agreements are generally negotiated with terms of two or three years. During 2001, Fairview incurred an additional cost of \$9,052 during a nurses' work stoppage at two of its hospitals, which was resolved successfully.

Fairview insures a portion of its professional and general liability risk through its wholly owned captive insurance subsidiary. Premiums paid to its captive insurance subsidiary are based on the cost of comparable coverage with commercial insurance companies and are eliminated in consolidation. Fairview also maintains coverage for losses in excess of certain limits with an unrelated insurance carrier under a risk-sharing program with certain other health care providers. Premiums are based on the experience of Fairview and the other health care providers.

Fairview has made provisions for estimated professional and general liability, workers' compensation, and employee health insurance claims that have been retained by Fairview because of self-insured retention and coinsurance provisions of various policies or because of unasserted claims and other uninsured exposures. The provision for estimated self-insured claims includes estimates of the ultimate costs for reported claims and claims incurred but not reported. The estimated liability for professional and general liability, workers' compensation, and employee health insurance claims totaling \$63,254, \$60,470, and \$52,777 at December 31, 2003, 2002, and 2001, respectively, is based on actual claims to date and actuarial studies of Fairview's estimated future liability for such claims.

Fairview is a defendant in various lawsuits arising in the ordinary course of business. Although the outcome of these lawsuits cannot be predicted with certainty, management believes the ultimate disposition of such matters will not have a material adverse effect on Fairview's financial condition or operations.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. Fairview believes that it is in compliance, in all material respects, with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing that would have a material effect on its consolidated financial statements. 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 Medicaid programs.

Note 11. Employee Benefit Plans

Fairview sponsors a number of defined contribution pension plans. Pension expense was \$39,421, \$34,052, and \$30,211 for 2003, 2002, and 2001, respectively.

Fairview also sponsors several defined benefit pension plans covering certain groups of employees and provides other postretirement benefits to certain contract employees. In addition, Fairview participates in other benefit plans, which include union-sponsored multiemployer plans. Contributions to the union-sponsored multiemployer plans are made in accordance with negotiated contracts. The impact of these plans on Fairview's consolidated financial statements is not significant.

Note 12. Functional Expenses

Fairview provides health-related services to people in the communities it serves. Expenses related to providing these services are as follows:

	2003	2002	2001
Health services	\$1,315,267	\$1,312,209	\$1,216,184
General and administrative	320,661	280,520	292,656
Total	<u>\$1,635,928</u>	<u>\$1,592,729</u>	<u>\$1,508,840</u>

Note 13. Income Taxes

Fairview has been determined to be exempt from federal income tax under Section 501(a) of the Internal Revenue Code (the Code) as an organization described in Section 501(c)(3) of the Code, except for income relating to certain unrelated business activities. During 2003, 2002, and 2001, taxes payable on the operations of such unrelated activities were not significant. Fairview also has been determined to be exempt from state income tax under Minnesota Statute Section 290.05, Subdivision 2. Taxes currently due on operations of wholly owned subsidiaries that are subject to tax were not significant for 2003, 2002, and 2001.

Report of Independent Auditors

The Board of Directors
Fairview Health Services

We have audited the accompanying consolidated balance sheets of Fairview Health Services (Fairview) as of December 31, 2003, 2002, and 2001, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of Fairview's 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 consolidated financial position of Fairview Health Services as of December 31, 2003, 2002, and 2001, and the consolidated results of its operations and changes in net assets and cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

Minneapolis, Minnesota
March 19, 2004

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Care System

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Care System

Fairview Association Congregations

Abiding Savior
Lutheran Church
Moundsview

Ascension Lutheran Church
St. Louis Park

Atonement Lutheran Church
Bloomington

Bethany Lutheran Church
Minneapolis

Bethel Evangelical
Lutheran Church
Minneapolis

Bethlehem Lutheran Church
Minneapolis

Calvary Lutheran Church of
Golden Valley

Calvary Lutheran Church
Edina

Central Lutheran Church
Minneapolis

Christ Lutheran Church of Blaine

Christ the King Lutheran Church
Bloomington

Community of the Cross
Lutheran Church
Bloomington

Cross of Glory Lutheran Church
Brooklyn Center

Crown of Glory Lutheran Church
Chaska

Easter Lutheran Church
Eagan

Edina Community
Lutheran Church

El Milagro/The Miracle
Lutheran Church
Minneapolis

First Lutheran Church of
Columbia Heights

First Lutheran of St. Louis Park

Grace Lutheran Church
Apple Valley

Grace Lutheran Church
Bloomington

Holy Triune Lutheran Church
Minneapolis

Hope English Evangelical
Lutheran Church
Minneapolis

Hosanna! Lutheran Church
Lakeville

House of Hope Lutheran Church
Minneapolis

Immanuel Lutheran Church
Eden Prairie

Lake Nokomis Lutheran Church
Minneapolis

Lutheran Church of
Christ the Redeemer
Minneapolis

Lutheran Church of
Good Shepherd
Minneapolis

Messiah Lutheran Church
Minneapolis

Minnehaha Communion
Lutheran Church
Minneapolis

Minnetonka Lutheran Church

Mount Olive Lutheran Church
Minneapolis

Mount Olivet Lutheran Church
Minneapolis

Nokomis Heights
Lutheran Church
Minneapolis

Normandale Evangelical
Lutheran Church
Edina

North Heights Lutheran Church
Roseville

Norwegian Memorial
Lutheran Church
Minneapolis

Oak Grove Lutheran Church
Richfield

Oak Knoll Lutheran Church
Hopkins

Our Redeemer Lutheran Church
Minneapolis

Our Saviour's Lutheran Church
Circle Pines

Our Savior's Lutheran Church
South Minneapolis

Peace Lutheran Church
Coon Rapids

Peace Lutheran Church
Plymouth

Prairie Lutheran Church
Eden Prairie

Prince of Peace Lutheran Church
Burnsville

Richfield Lutheran Church
Minneapolis

River of Life Lutheran Church
Minneapolis

Roseville Lutheran Church

Shepherd of Hills
Lutheran Church
Hopkins

Shepherd of the Valley
Lutheran Church
Apple Valley

St. John's Evangelical
Lutheran Church
Mound

St. Olaf Lutheran Church
Minneapolis

St. Paul's Lutheran Church
Minneapolis

Trinity Lutheran Church of
Minnehaha Falls
Minneapolis

Trinity Lutheran Church
Minneapolis

University Lutheran Church
of Hope
Minneapolis

Valley of Peace Lutheran Church
Golden Valley

Westwood Lutheran Church
St. Louis Park

Woodlake Lutheran Church
Richfield

