



*Fairview Annual Report 2002*

 **FAIRVIEW**



# Executive Summary

The course we set two years ago to improve our key business processes continues to drive Fairview's financial performance. Through hard work and high-impact revenue cycle initiatives, Fairview maintained its financial performance in 2002. Fairview's operating income reached a record high of \$30.6 million, an increase of 6 percent over 2001. Revenues grew to \$1.62 billion, also the highest in our history.

Investment in our employees continues to be our primary focus. Salaries and benefits totaled \$880 million in 2002, up from \$809 million in 2001. In recent years, the growing shortage of nurses has resulted in higher overtime and temporary agency cost. To address this, Fairview pursued significant recruitment and retention initiatives in 2002.

These efforts proved successful and related measures indicated gains in the fourth quarter.

In 2002, Fairview invested \$82 million in capital expenditures, furthering our commitment to the communities we serve. At the same time, we increased our cash flows and significantly decreased our patient accounts receivable. Fairview's balance sheet clearly strengthened from 2001.

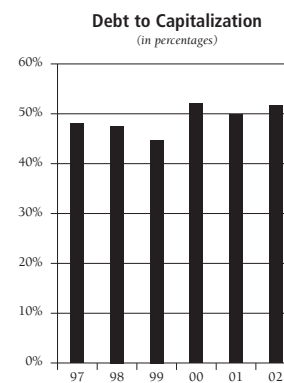
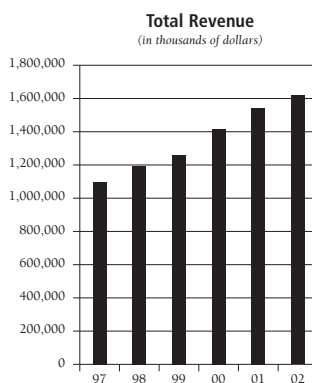
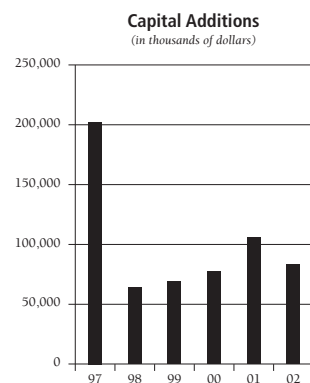
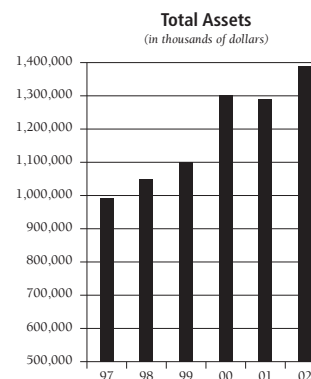
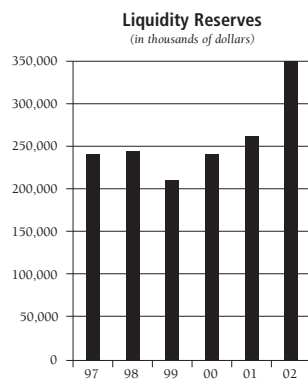
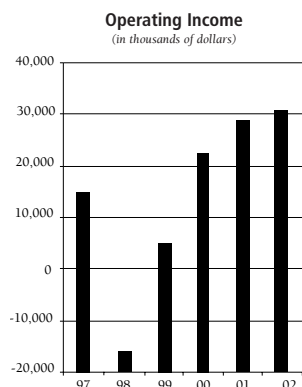
To ensure we maintain our momentum in 2003, our commitment to process improvement must be sustained. Our commitment to physicians and our employees also must intensify. We are fortunate to have committed individuals on the Fairview team who are dedicated to making this a reality.

## Statements of Financial Position for the Years Ended December 31

(Dollars in Thousands)

	2002	2001	% Change
Total revenue	\$1,623,367	\$1,537,544	6%
Operating income	\$30,638	\$28,704	7%
Net operating margin	1.9%	1.9%	
Total assets	\$1,389,352	\$1,292,918	7%
Liquidity reserves*	\$346,626	\$263,456	32%

\* Liquidity Reserves consist of cash, short-term investments and board designated fund investments.



# Customers Served

	For the Years Ended December 31,					
	2002	2001	2000	1999	1998	1997
<b>Ambulatory Care</b>						
Hospitals	1,085,747	1,048,291	943,637	889,663	787,656	745,047
Clinics	936,425	948,634	963,076	933,733	925,127	863,939
Institute for Athletic Medicine	183,480	189,442	176,204	168,801	174,993	166,505
Hospital home care	240,873	237,983	245,423	310,881	363,189	273,701
Orthopedic laboratories (procedures)	23,879	20,464	19,510	18,863	19,500	17,123
Retail pharmacy	1,318,544	1,269,410	1,210,014	1,074,621	975,295	618,118
<b>FPA Care System</b>						
Members served	44,470	71,540	62,185	62,189	61,589	46,903
<b>Inpatient Admissions</b>						
Acute care	68,237	68,558	68,891	68,774	68,003	69,367
Behavioral services	9,421	9,148	8,766	8,285	8,821	9,071
<i>Total inpatient admissions</i>	77,658	77,706	77,657	77,059	76,824	78,438
<b>Patient Days</b>						
Acute care	273,022	283,708	290,314	285,395	284,741	282,681
Behavioral services	69,410	69,273	68,376	63,350	71,385	78,182
Long-term care	199,530	208,832	229,163	240,573	294,478	227,089
<i>Total patient days</i>	541,962	561,813	587,853	589,318	650,604	587,952
<b>Average Length of Stay</b>						
Acute care	4.0	4.1	4.2	4.1	4.2	4.1
Behavioral services	7.4	7.6	7.8	7.6	8.1	8.6

# Consolidated Statements of Operations and Changes in Net Assets

(Dollars in Thousands)	Years Ended December 31,		
	2002	2001	2000
<b>Unrestricted revenue:</b>			
Net patient revenue	\$1,447,171	\$1,301,680	\$1,198,375
Other revenue	174,165	234,275	220,828
Net assets released from restrictions	2,031	1,589	2,781
<i>Total unrestricted revenue</i>	1,623,367	1,537,544	1,421,984
<b>Expenses:</b>			
Salaries and benefits	879,984	809,149	747,096
Supplies	301,434	263,771	245,220
Purchased services	141,012	168,252	154,618
Depreciation and amortization	68,473	56,232	58,218
Interest	23,703	20,423	24,787
Other operating expenses	178,123	191,013	169,465
<i>Total expenses</i>	1,592,729	1,508,840	1,399,404
<b>Operating income</b>	30,638	28,704	22,580
<b>Nonoperating gains (losses):</b>			
Investment income	4,915	12,272	13,826
Loss on interest and basis rate swaps (net)	(4,615)	(1,616)	-
Loss on early extinguishment of debt	(2,450)	-	-
Total nonoperating (losses) gains, net	(2,150)	10,656	13,826
<i>Excess of revenue over expenses</i>	28,488	39,360	36,406
<b>Other changes in unrestricted net assets:</b>			
Excess of revenue over expenses	28,488	39,360	36,406
Changes in unrealized gains and losses	(5,224)	(8,903)	(3,892)
Cumulative effect of adopting new accounting principle	-	5,375	-
Additional liability relating to defined benefit plan	(666)	-	-
Contributions of long-lived assets	1,274	1,231	-
Other transfers	-	-	(817)
<i>Increase in unrestricted net assets</i>	23,872	37,063	31,697
<b>Temporarily restricted net assets:</b>			
Contributions and other changes	2,394	2,895	3,498
Net assets released from restrictions	(3,305)	(2,820)	(2,781)
Other transfers	-	-	817
<i>(Decrease) increase in temporarily restricted net assets</i>	(911)	75	1,534
<b>Total increase in net assets</b>	22,961	37,138	33,231
<b>Net assets at beginning of year</b>	509,581	472,443	439,212
<i>Net assets at end of year</i>	<u>\$ 532,542</u>	<u>\$ 509,581</u>	<u>\$ 472,443</u>

See accompanying notes.

## Balance Sheets

(Dollars in Thousands)

	Years Ended December 31,		
	2002	2001	2000
<b>Assets</b>			
<b>Current assets:</b>			
Cash and cash equivalents	\$ 55,748	\$ 51,137	\$ 31,204
Short-term investments	49,605	5,502	9,332
Patient accounts receivable, less allowance for doubtful accounts of \$49,208 in 2002, \$55,958 in 2001, and \$46,700 in 2000	252,031	296,289	299,311
Receivable under third-party reimbursement contracts	7,994	—	—
Inventories	33,561	32,785	29,686
Other current assets	65,821	64,049	62,577
<i>Total current assets</i>	464,760	449,762	432,110
<b>Assets whose use is limited:</b>			
Board-designated fund investments	241,273	206,817	202,204
Debt service reserve fund investments	30,203	24,366	22,510
Construction fund investments	54,353	49,863	131,653
Investments held by insurance subsidiaries	38,464	39,616	37,293
<i>Total assets whose use is limited</i>	364,293	320,662	393,660
<b>Other long-term assets:</b>			
Investments	10,277	12,551	16,208
Deferred debt acquisition costs	10,425	8,743	8,753
Other assets	45,193	22,715	11,094
<i>Total other long-term assets</i>	65,895	44,009	36,055
<b>Property, plant and equipment net</b>	494,404	478,485	436,448
<i>Total assets</i>	\$1,389,352	\$1,292,918	\$1,298,273
<b>Liabilities and net assets</b>			
<b>Current liabilities:</b>			
Checks outstanding	\$ 15,789	\$ 14,826	\$ 20,712
Notes and accounts payable	74,069	80,174	101,555
Accrued liabilities	129,761	123,131	122,787
Payable under third-party reimbursement contracts	—	11,635	14,416
Current maturities of long-term debt	8,363	8,566	8,255
<i>Total current liabilities</i>	227,982	238,332	267,725
<b>Other liabilities:</b>			
Insurance subsidiaries claims reserves	45,326	39,300	38,193
Other long-term liabilities	24,117	11,979	13,759
<i>Total other liabilities</i>	69,443	51,279	51,952
<b>Long-term debt, less current maturities</b>	559,385	493,726	506,153
<b>Net assets:</b>			
Unrestricted	521,264	497,392	460,329
Temporarily restricted	11,278	12,189	12,114
<i>Total net assets</i>	532,542	509,581	472,443
<i>Total liabilities and net assets</i>	\$1,389,352	\$1,292,918	\$1,298,273

See accompanying notes.

# Consolidated Statements of

## Cash Flows

(Dollars in Thousands)

	Years Ended December 31,		
	2002	2001	2000
<b>Operating activities</b>			
Increase in net assets	\$ 22,961	\$ 37,138	\$ 33,231
Adjustments to reconcile increase in net assets to net cash provided by operating activities:			
Depreciation and amortization	68,473	56,232	58,218
Provision for bad debts	26,691	42,465	30,598
Changes in unrealized gains and losses	5,224	8,903	3,892
Cumulative effect of adoption of new accounting principle	–	(5,375)	–
Additional liability relating to defined benefit plan	666	–	–
Contributions of long-lived assets	(1,274)	(1,231)	–
Loss on early extinguishment of debt	2,450	–	–
Loss on interest and basis rate swaps (net)	4,615	1,616	–
Changes in assets and liabilities:			
Patient accounts receivable	17,567	(39,443)	(50,936)
Inventories and other current assets	(10,542)	(6,788)	(12,326)
Notes and accounts payable, accrued and other current liabilities	(10,147)	(29,160)	5,438
Other, net	(10,423)	(673)	6,303
<i>Net cash provided by operating activities</i>	116,261	63,684	74,418
<b>Investing activities</b>			
Additions to property, plant and equipment	(82,546)	(107,485)	(77,195)
Investment purchases	(239,766)	(115,313)	(259,684)
Investment sales	149,082	179,714	110,327
Other, net	698	5,487	1,590
<i>Net cash used in investing activities</i>	(172,532)	(37,597)	(224,962)
<b>Financing activities</b>			
Proceeds from long-term debt	114,410	800	182,399
Payment for defeasance of long-term debt	(42,565)	–	(15,500)
Payments on long-term debt	(8,839)	(6,954)	(8,912)
Deferred debt acquisition costs	(2,124)	–	(2,112)
<i>Net cash provided by (used in) financing activities</i>	60,882	(6,154)	155,875
Increase in cash and cash equivalents	4,611	19,933	5,331
Cash and cash equivalents at beginning of year	51,137	31,204	25,873
<i>Cash and cash equivalents at end of year</i>	\$ 55,748	\$ 51,137	\$ 31,204

See accompanying notes.

# Consolidated Financial Statements

December 31, 2002, 2001, and 2000 (Dollars in Thousands)

## Note 1. Organization and Basis of Presentation

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

The consolidated financial statements include the accounts of Fairview and its wholly controlled affiliates or wholly owned subsidiaries, 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, limit 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. Net realized gains and changes in net unrealized gains are included in the consolidated statements of operations and changes in net assets.

**Assets Whose Use Is Limited** – Assets whose use is limited include investments externally designated under bond indenture and self-insurance programs as well as assets internally designated by the Board of Directors for property, plant, and equipment replacement and expansion and other purposes. The board, at its discretion, may subsequently authorize the use of internally designated assets for other purposes. At December 31, 2002, 2001 and 2000, \$13,591, \$13,591 and \$13,284, respectively, is required and has been pledged to the State of Minnesota as collateral under its workers' compensation program.

**Interest 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

Fairview capitalizes interest related to construction-in-progress. During 2002 and 2001, capitalized interest was \$1,844 and \$300, respectively. No interest was capitalized in 2000.

**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 by Medicare and other intermediaries. Additional reimbursement is recorded in the year the appeal is successful. During 2002, Fairview was successful in appealing certain issues relating to Medicare disproportionate share reimbursement, which resulted in additional net patient revenue totaling \$23,300 for the period from 1998 to 2001 being recorded in 2002. In addition, Fairview has successful appeals, cost report settlements, and adjustments to estimated amounts due from patients for prior years' patient care on an ongoing basis, which amounted to approximately one percent of net patient revenue in each of 2002, 2001 and 2000. As in prior years, management expects appeals will be settled successfully in future years relating to 2002 and prior years' patient care activities.

**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 has reported 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 on investments, cumulative effect of a change in accounting principle, contributions of long-lived assets, additional minimum liability relating to a defined benefit plan and other transfers.

**Reclassifications** – Certain reclassifications were made to the 2000 and 2001 consolidated financial statements to conform to the 2002 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, University of Minnesota (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 (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, 2002, Fairview's bylaws authorized a board of directors of up to 38 members. Seven members of Fairview's Board of Directors, which consisted of 33 members as of December 31, 2002, were either appointed by and/or held positions at the University. In January 2003, the maximum number of board members was reduced to 21 members. Currently, there are 19 board members of which three are from the University.

Under the terms of the academic affiliation agreement (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 percent of Fairview's net operating margin, as defined in the Agreement, in excess of 3.5 percent 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 \$25,642 and \$35,007, respectively, for 2002, \$28,084 and \$33,232, respectively, for 2001, and \$25,904 and \$32,189, respectively, for 2000. Amounts receivable from and payable to the University were \$44,281 and \$11,469, respectively, at December 31, 2002, \$37,080 and \$9,346, respectively, at December 31, 2001, and \$23,649 and \$18,019, respectively, at December 31, 2000.

In December 2002, Fairview and the University reached an agreement to settle amounts due to each other. The settlement includes adjustments to certain receivables and payables, agreement on a payment schedule, and a reduction in payments to Fairview for future services. As a result, the net amount due from the University has been reduced by approximately \$3,000, which includes the effect of discounting certain long-term receivables to their net present value.

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

	2002	2001	2000
Medicare	27%	27%	28%
Medicaid	7	7	7
Managed care	59	58	56
Commercial and other	7	8	9
	100%	100%	100%

The Medicare program pays primarily all inpatient and most outpatient services at predetermined rates. Prior to August 1, 2000, certain outpatient services were reimbursed based on allowable costs, which are subject to retroactive audit and adjustment. Services provided to patients involved in 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.

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 consisted of the following:

	2002	2001	2000
Medicare	24%	21%	22%
Medicaid	14	16	14
Managed care	41	42	45
Commercial and other	21	21	19
	100%	100%	100%

#### 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:

	2002	2001	2000
Cost of providing community services	\$ 23,203	\$ 23,167	\$ 26,322
Cost of providing charity care	937	1,116	1,244
Unpaid costs of public programs:			
Medicare	71,166	54,275	54,896
Medicaid	14,486	4,051	8,253
Medicaid surcharge	11,198	9,955	8,995
Minnesota care tax	11,438	11,637	10,398
Total	\$132,428	\$104,201	\$110,108

#### Note 6. Investments and Other Financial Instruments

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

	2002	2001	2000
Cash and cash equivalents	\$141,038	\$ 93,496	\$191,183
Fixed income securities	188,433	164,527	160,149
Mutual funds	70,301	60,414	60,936
Equity securities	24,403	20,278	6,932
	\$424,175	\$338,715	\$419,200

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

	2002	2001	2000
Dividends and interest	\$ 6,245	\$ 7,532	\$12,993
Net realized (losses) gains	(1,330)	4,740	833
	4,915	12,272	13,826
Changes in unrealized gains and losses	(5,224)	(8,903)	(3,892)
	\$ (309)	\$ 3,369	\$ 9,934

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 \$63,075, \$33,455, and \$35,843 more than its carrying value at December 31, 2002, 2001, and 2000, 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 percent and pays interest at a variable rate, based on the London Interbank Offered Rate (LIBOR). At December 31, 2002, the interest rate swap had a fair value of \$996, which has been recorded as an asset and in nonoperating gains and losses. The basis rate swaps have a ten-year term and a notional amount totaling \$400,000, whereby Fairview receives interest based on LIBOR and pays interest based on the Bond Market Association Mutual Swap Index Rate (BMA). At December 31, 2002, the basis rate swaps were recorded at their fair value, resulting in a liability and a nonoperating loss of \$11,152. 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 percent. 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 in 2002.

#### Note 7. Property, Plant, and Equipment

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

	2002	2001	2000
Land and improvements	\$ 31,988	\$ 27,744	\$ 18,116
Buildings and improvements	550,646	520,319	466,665
Equipment	557,403	513,612	482,666
	1,140,037	1,061,675	967,447
Less: accumulated depreciation	682,426	622,647	582,260
	457,611	439,028	385,187
Construction in progress	36,793	39,457	51,261
Total property, plant, and equipment	\$ 494,404	\$ 478,485	\$436,448

Depreciation expense was \$67,901, \$55,201, and \$57,230, for 2002, 2001, and 2000, 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, 2002 and 2001. Outstanding borrowings under these agreements were at \$15,194 at December 31, 2000.

**Note 9. Long-Term Debt**

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

	2002	2001	2000
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 percent to 5.625 percent (net of unaccreted discount of \$1,171 in 2002).	\$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 percent to 6.375 percent (net of unaccreted discount of \$6,378 in 2002, \$6,623 in 2001 and \$6,890 in 2000).	173,937	173,692	173,425
Minnesota Agriculture and Economic Development Board Healthcare System Revenue Bonds, Series 1997A, payable in installments through 2026 at interest rates from 4.75 percent to 5.75 percent (net of unaccreted discount of \$5,438 in 2002, \$5,661 in 2001, and \$5,884 in 2000).	165,357	166,274	167,141
Other revenue bonds and notes, at varying interest rates, payable in installments through 2042 (net of unaccreted discount of \$862 in 2002, \$919 in 2001 and \$975 in 2000).	114,044	120,322	130,051
Revenue bonds, Series 1991, defeased in 2002.	-	42,004	43,791
Subtotal	567,748	502,292	514,408
Less current maturities included in current liabilities (net of unaccreted discount of \$557 in 2002, \$547 in 2001, and \$578 in 2000).	8,363	8,566	8,255
	<u>\$559,385</u>	<u>\$493,726</u>	<u>\$506,153</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 April 2000, the Minnesota Agricultural and Economic Development Board, on behalf of Fairview, issued fixed-rate Healthcare System Revenue Bonds in the aggregate principal amount of \$180,315. The proceeds of these bonds were used primarily to construct, renovate and equip certain of Fairview's hospital facilities, advance refund City of Red Wing Health Care Facilities Revenue Bonds, Series 1993, and make deposits into a debt service reserve fund.

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, 2004. 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 (\$16,600 at December 31, 2002) 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.

Interest paid was \$23,928, \$21,024, and \$24,472 for 2002, 2001, and 2000, 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:

2003	\$ 8,920
2004	9,116
2005	9,429
2006	9,938
2007	10,461

**Note 10. Commitments and Contingencies**

At December 31, 2002, Fairview had commitments of \$17,600 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 \$27,023, \$25,892, and \$23,356 for 2002, 2001, and 2000, respectively.

Future minimum lease payments on operating leases in effect on December 31, 2002, for each of the five subsequent years and thereafter are as follows:

2003	\$15,074
2004	13,000
2005	11,535
2006	9,395
2007	9,164
Thereafter	17,196

Approximately 34 percent 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 successfully resolved.

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 \$58,176, \$50,508 and \$49,153 at December 31, 2002, 2001 and 2000, respectively, is based on actual claims to date and an actuarial study 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 \$34,052, \$30,211, and \$31,587 for 2002, 2001, and 2000, respectively.

Fairview also sponsors several defined benefit pension plans covering certain groups of employees and provides other post-retirement benefits to certain contract employees. 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:

	2002	2001	2000
Health services	\$1,312,209	\$1,216,184	\$1,153,972
General and administrative	280,520	292,656	245,432
Total	<u>\$1,592,729</u>	<u>\$1,508,840</u>	<u>\$1,399,404</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 2002, 2001, and 2000, 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 2002, 2001 and 2000.

**Note 14. New Accounting Pronouncement**

In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46, *Consolidation of Variable Interest Entities*, which provides new criteria for consolidation accounting. The Interpretation may require Fairview to consolidate in its financial statements those entities in which Fairview has a primary beneficiary interest and provide additional disclosures for certain other entities. Fairview is in the process of determining the impact of the new accounting pronouncement on its financial statements.

## **The Board of Directors**

### *Fairview Health Services*

We have audited the accompanying consolidated balance sheets of Fairview Health Services (Fairview) as of December 31, 2002, 2001 and 2000, 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 as of December 31, 2002, 2001 and 2000, 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.

As described in Note 2 to the financial statements, in 2001, Fairview implemented Statement of Financial Accounting Standards Nos. 133 and 138, recording an interest rate swap at its fair value.

*Ernst & Young LLP*

May 2, 2003

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Juntunen Media Group

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Academic Health Center  
University of Minnesota

*\*Executive Committee Member*

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Fairview Health Services

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Executive Vice President and  
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Fairview Health Services

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Senior Vice President and  
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Fairview Health Services

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Senior Vice President and  
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Fairview Health Services

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Chief Administrative Officer  
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## Church Congregations – April 2003

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  
Christ the Redeemer Lutheran Church – Minneapolis  
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  
Good Shepherd Lutheran Church – Minneapolis  
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  
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 – Arden Hills  
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 Saviour'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 (*formerly Zion*)  
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. John's Lutheran Church – Rosemount  
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





**FAIRVIEW**

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