



CONSOLIDATED FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION

Fairview Health Services
Years Ended December 31, 2011, 2010, and 2009
With Reports of Independent Auditors

Ernst & Young LLP

 **ERNST & YOUNG**

Fairview Health Services

Consolidated Financial Statements
and Supplementary Information

Years Ended December 31, 2011, 2010, and 2009

Contents

Report of Independent Auditors.....1

Consolidated Financial Statements

Consolidated Balance Sheets2

Consolidated Statements of Operations and Changes in Net Assets4

Consolidated Statements of Cash Flows.....6

Notes to Consolidated Financial Statements.....7

Supplementary Information

Report of Independent Auditors on Supplementary Information41

Consolidating Balance Sheet at December 31, 201142

Consolidating Statement of Operations and Changes in Net Assets for the
Year Ended December 31, 201144

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, 2011, 2010, and 2009, and the related consolidated statements of operations and changes in net assets and cash flows for each of the three years in the period ended December 31, 2011. 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. We were not engaged to perform an audit of Fairview's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Fairview's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and 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 at December 31, 2011, 2010, and 2009, and the consolidated results of its operations and changes in net assets and cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

April 23, 2012

Fairview Health Services
Consolidated Balance Sheets

	December 31		
	2011	2010	2009
	<i>(Dollars in Thousands)</i>		
Assets			
Current assets:			
Cash and cash equivalents	\$ 31,278	\$ 31,511	\$ 34,920
Short-term investments	53,160	69,375	89,982
Accounts receivable for medical services, less allowance for doubtful accounts of \$44,201 in 2011, \$50,522 in 2010, and \$40,973 in 2009	388,523	329,560	317,404
Current portion of pledges receivable	10,060	8,929	7,569
Inventories	53,525	44,568	39,493
Other current assets	40,833	68,623	40,906
Total current assets	577,379	552,566	530,274
Investments	772,721	792,956	692,593
Assets limited as to use:			
Debt service reserve fund investments	33,678	34,393	37,758
Construction fund investments	665	41,153	91,765
Investments held by insurance subsidiaries	44,300	43,986	42,823
Investments pledged under workers' compensation program	31,100	30,963	30,994
Restricted fund investments	16,381	16,195	15,385
Total assets limited as to use	126,124	166,690	218,725
Other long-term assets:			
Pledges receivable, less current portion	36,879	30,483	31,508
Deferred debt acquisition costs	13,861	14,103	16,468
Investments in related parties	40,324	36,388	33,589
Goodwill and intangible assets and other assets	41,314	41,208	27,801
Total other long-term assets	132,378	122,182	109,366
Land, buildings, and equipment, net	992,028	930,567	856,080
Total assets	\$ 2,600,630	\$ 2,564,961	\$ 2,407,038

	December 31		
	2011	2010	2009
	<i>(Dollars in Thousands)</i>		
Liabilities and net assets			
Current liabilities:			
Checks outstanding	\$ 10,769	\$ 13,501	\$ 16,472
Accounts payable	149,890	139,203	119,152
Accrued salaries, benefits, and other liabilities	228,372	217,177	220,338
Payable under third-party reimbursement contracts	10,247	7,750	7,559
Current maturities of long-term debt	15,136	12,292	9,644
Current portion of insurance subsidiaries claims reserves	5,275	2,451	4,295
Current portion of workers' compensation reserves	5,945	6,098	6,672
Total current liabilities	425,634	398,472	384,132
Other liabilities:			
Insurance subsidiaries claims reserves, less current portion	15,198	16,168	19,085
Workers' compensation reserves, less current portion	30,154	26,931	26,940
Derivative financial instruments	54,452	22,952	10,518
Other long-term liabilities	38,776	31,407	36,426
Total other liabilities	138,580	97,458	92,969
Long-term debt, less current maturities	923,387	936,064	915,920
Total liabilities	1,487,601	1,431,994	1,393,021
Net assets:			
Unrestricted	1,053,870	1,075,155	963,817
Temporarily restricted	59,159	57,812	50,200
Total net assets	1,113,029	1,132,967	1,014,017
Total liabilities and net assets	\$ 2,600,630	\$ 2,564,961	\$ 2,407,038

See accompanying notes.

Fairview Health Services

Consolidated Statements of Operations
and Changes in Net Assets

	Year Ended December 31		
	2011	2010	2009
	<i>(Dollars in Thousands)</i>		
Unrestricted revenue:			
Net patient service revenue	\$ 2,657,135	\$ 2,494,307	\$ 2,454,579
Other operating revenue	350,771	329,563	287,047
Net assets released from restrictions	3,603	3,126	2,936
Total unrestricted revenue	3,011,509	2,826,996	2,744,562
Expenses:			
Salaries and benefits	1,571,070	1,433,827	1,388,171
Supplies	557,052	511,148	494,849
Purchased services	419,076	381,518	329,224
Depreciation and amortization	95,952	88,029	104,083
Interest	45,486	46,123	45,887
Provision for bad debts	58,072	40,148	44,330
Utilities and maintenance	99,998	92,641	85,530
Insurance and rent	49,431	53,693	50,937
State and local taxes	63,285	61,365	60,281
Other operating expenses	35,420	35,832	31,028
Total expenses	2,994,842	2,744,324	2,634,320
Operating income before nonrecurring item	16,667	82,672	110,242
Nonrecurring item:			
Expenses related to nursing strike	-	1,892	-
Operating income	16,667	80,780	110,242
Nonoperating (losses) gains:			
Investment (loss) income, net	(2,079)	57,812	46,316
(Loss) gain on interest and basis rate swaps, net	(36,731)	(34,457)	83,232
Loss on refinancing of debt	-	(2,283)	-
Total nonoperating (losses) gains, net	(38,810)	21,072	129,548
(Deficit) excess of revenue and gains over expenses and losses	(22,143)	101,852	239,790

	Year Ended December 31		
	2011	2010	2009
	<i>(Dollars in Thousands)</i>		
Other changes in unrestricted net assets:			
(Deficit) excess of revenue and gains over expenses and losses	\$ (22,143)	\$ 101,852	\$ 239,790
Pension and other postretirement liability adjustments	(12,661)	6,147	1,547
Contributions of long-lived assets and other changes	13,519	3,339	129
(Decrease) increase in unrestricted net assets	<u>(21,285)</u>	111,338	241,466
Temporarily restricted net assets:			
Contributions and other changes, net	17,107	10,738	42,747
Net assets released from restrictions	(15,760)	(3,126)	(2,936)
Increase in temporarily restricted net assets	<u>1,347</u>	7,612	39,811
Total (decrease) increase in net assets	(19,938)	118,950	281,277
Net assets at beginning of year	1,132,967	1,014,017	732,740
Net assets at end of year	<u>\$ 1,113,029</u>	<u>\$ 1,132,967</u>	<u>\$ 1,014,017</u>

See accompanying notes.

Fairview Health Services

Consolidated Statements of Cash Flows

	Year Ended December 31		
	2011	2010	2009
	<i>(Dollars in Thousands)</i>		
Operating activities			
(Decrease) increase in net assets	\$ (19,938)	\$ 118,950	\$ 281,277
Adjustments to reconcile (decrease) increase in net assets to net cash provided by operating activities:			
Depreciation and amortization	95,952	88,029	104,083
Provision for bad debts	58,072	40,148	44,330
Pension and other postretirement liability adjustments	12,661	(6,147)	(1,547)
Contributions of long-lived assets	(39)	187	(808)
Loss on refinancing of debt	–	2,283	–
Change in fair value of interest and basis rate swaps, net	32,943	32,544	(86,539)
Changes in assets and liabilities:			
Accounts receivable for medical services	(117,035)	(52,304)	(37,266)
Inventories and other current assets	18,833	(32,172)	19,471
Trading investments, net	77,016	(27,721)	(84,224)
Pledges receivable	(7,527)	(335)	(38,815)
Accounts payable; accrued salaries, benefits, and other liabilities; and other current liabilities	21,647	14,111	(29,601)
Other, net	3,069	1,037	8,996
Net cash provided by operating activities	175,654	178,610	179,357
Investing activities			
Purchases of land, buildings, and equipment, net	(155,259)	(160,824)	(151,103)
Acquisition of physician clinic practices	(1,713)	(1,000)	–
Other, net	(3,964)	(2,827)	(2,648)
Net cash used in investing activities	(160,936)	(164,651)	(153,751)
Financing activities			
Proceeds from issuance of long-term debt	1,381	18,374	–
Principal payments on long-term debt	(11,214)	(10,182)	(10,036)
Payment for collateral on derivative financial instruments, net	(5,118)	(25,163)	–
Deferred debt acquisition costs	–	(397)	–
Net cash used in financing activities	(14,951)	(17,368)	(10,036)
(Decrease) increase in cash and cash equivalents	(233)	(3,409)	15,570
Cash and cash equivalents at beginning of year	31,511	34,920	19,350
Cash and cash equivalents at end of year	\$ 31,278	\$ 31,511	\$ 34,920

See accompanying notes.

Fairview Health Services

Notes to Consolidated Financial Statements (Dollars in Thousands)

December 31, 2011, 2010, and 2009

1. Organization and Basis of Presentation

Fairview Health Services is a non-profit 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. Fairview operates seven general acute care hospital facilities; primary care, occupational health, and specialty care clinic facilities; senior care and senior housing facilities; and other ambulatory services, retail pharmacy, counseling centers, home health care programs, and various foundations supporting health-related services. As of December 31, 2011, Fairview operated more than 40 primary care clinics and more than 55 specialty clinics and employed approximately 820 physicians.

Effective May 1, 2010, Fairview purchased the University of Minnesota Physicians (UMP) Oncology Clinic. The Oncology Clinic is a specialty clinic providing oncology-related services, including the provision of oncology-related drugs and compounds. Between the acquisition date and December 31, 2010, and during 2011, Fairview recorded \$36,482 and \$59,366, respectively, of operating revenue related to this acquisition.

The consolidated financial statements include the accounts of Fairview, which includes both tax-exempt and taxable entities. All significant interaffiliate and intercompany balances and transactions have been eliminated in consolidation. Investments in entities of which Fairview controls 50% or less of the entity's operations and has no operational control are recorded under the equity method of accounting.

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

2. Summary of Significant Accounting Policies

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles 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 that have not otherwise been classified as long-term assets due to a designation for long-term purposes.

Fairview places its cash investments with high-quality financial institutions. Fairview has cash balances at financial institutions that may exceed federal depository insurance limits.

Short-Term Investments

Short-term investments include investments designated for use within one year.

Inventories

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

Investments

Fairview's investments include money market, fixed income, and equity securities that are carried at fair value, based on quoted market prices, and are classified as a trading portfolio. Investment securities are exposed to various risks, such as interest rate, credit, and overall market volatility.

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

In addition, Fairview invests in investment companies that hold interests in diversified funds of hedge funds and real estate funds. Investments in fund of hedge funds and real estate funds are recorded using the equity method of accounting, with the change in value of these investments recorded as investment income in the accompanying consolidated statements of operations and changes in net assets. Fairview generally has liquidity ranging from 95 to 125 days in these funds. The value of each fund of hedge fund or real estate fund is determined by the investment manager or general partner of the respective fund. Values of some of the underlying investments may be based on estimates that require varying degrees of judgment, and consequently, these estimates may differ from the values that would have been used had a ready market existed and may also differ from the values at which investments may be sold. Values for fund of hedge funds are primarily based on financial data supplied by the underlying investee funds. Values for real estate funds are based on the fair value of the underlying real estate. Generally, the value for fund of hedge funds and real estate funds reflects net contributions to the investee and an ownership share of realized and unrealized investment income and expenses.

Investment income on professional and general liability funds is recorded in other operating revenue on the consolidated statements of operations and changes in net assets. Investment return (including realized gains and losses on investments, unrealized gains and losses on trading investments, interest, and dividends) from all other investments is recorded as nonoperating gains (losses) unless the income is restricted by donor or law.

Derivative Financial Instruments

All derivatives are recognized as either assets or liabilities based on the net fair value in accordance with the netting provisions in the counterparty agreement. Fairview uses pricing models for various types of derivative instruments that take into account the present value of estimated future cash flows and credit valuation adjustments.

Gains or losses resulting from changes in the fair values of derivative financial instruments are reflected in the consolidated statements of operations and changes in net assets as nonoperating gains or losses, as none of the derivative financial instruments are considered to be an accounting hedge. Any differences between interest received and paid under swap agreements are reported with the change in fair value of the swaps as nonoperating gains or losses.

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

Deferred Debt Acquisition Costs

Costs of bond issuance are deferred and amortized on a straight-line basis, which approximates the effective interest method, over the term of the related indebtedness.

Investments in Related Parties

Investments in entities in which Fairview has the ability to exercise significant influence over operating and financial policies, but does not have operational control, are recorded under the equity method of accounting in investments in related parties in the consolidated balance sheets. Fairview records investments in related parties at cost, net of Fairview's share of earnings and losses on related parties. The change in investments in related parties is recorded in other operating revenue in the consolidated statements of operations and changes in net assets.

Land, Buildings, and Equipment

Land, buildings, and equipment are recorded at cost and depreciated over estimated useful lives using the straight-line method. The following estimated useful lives are used in computing depreciation:

Land improvements	5–10 years
Buildings	30–40 years
Building additions and improvements	17–25 years
Equipment	2–20 years

Interest cost, net of related interest income incurred on funds used during the period for construction of capital assets, is capitalized as part of the cost of acquiring those assets. During 2011, 2010, and 2009, capitalized interest relating to construction-in-progress was \$2,611, \$1,872, and \$2,376, respectively.

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

Goodwill and Intangible Assets

Goodwill and intangible assets, related to physician clinic acquisitions, are recorded on the consolidated balances sheets. During 2010, Fairview acquired an indefinite-lived intangible asset related to a trade name acquired as a result of physician clinic acquisitions.

Beginning January 1, 2010, goodwill and intangible assets are evaluated for impairment at least annually or more frequently if events or changes occur that suggest the carrying value may not be recoverable. Management considers future operating results, cash flows, changes in working capital, capital expenditures and cost of capital in the impairment evaluation. Management determined that no impairment of goodwill and intangible assets had occurred during 2011 and 2010. Prior to January 1, 2010, goodwill and intangible assets were amortized on a straight-line basis over a five-year period from the acquisition date.

Changes in the carrying amount of goodwill and indefinite-lived intangible assets are summarized as follows:

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Balance, beginning of the year	\$ 32,231	\$ 18,151	\$ 23,720
Acquisitions	–	14,080	–
Amortization	–	–	(5,569)
Balance, end of the year	<u>\$ 32,231</u>	<u>\$ 32,231</u>	<u>\$ 18,151</u>

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

Asset Impairment of Long-Lived assets

Fairview considers whether indicators of impairment are present and performs the necessary tests to determine if the carrying value of an asset is appropriate. Impairment write-downs are recognized in operating income at the time the impairment is identified.

Unrestricted and Temporarily Restricted Net Assets

Unrestricted net assets are used to account for all transactions related to medical services and other operating and nonoperating activities. 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.

Contributions and Pledges

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. Conditional promises to give are reported at fair value when the gift is received and all conditions have been satisfied. All unrestricted contributions are reported in other operating revenue, in the consolidated statements of operations and changes in net assets.

Contributions are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction is satisfied (as to time and/or purpose), temporarily restricted net assets are reclassified to unrestricted net assets and reported as net assets released from restrictions in the consolidated statements of operations and changes in net assets. Donor-restricted contributions whose restrictions are met within the same fiscal year as they are received are reported as unrestricted contributions in the accompanying consolidated financial statements.

Pledges are recorded in the period that the pledges are made and represent unconditional promises to give. Pledges that are expected to be collected in future years are recorded at the present value of their estimated future cash flows. An allowance for uncollectible pledges receivable is determined based on a review of estimated collectability.

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

Net Patient Service Revenue

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

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 could 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.

The allowance for doubtful accounts is based upon management's assessment of historical and expected net collections considering historical business and economic conditions, trends in health care coverage, and other collection indicators.

Member Premium Revenue and Health Claims

Fairview has agreements to manage care for subscribing participants or members. The agreements either provide for predefined payments (on a per-member/per-month basis) regardless of services actually performed, or result in Fairview sharing in risk arrangements related to these members. Revenue related to these agreements is recognized over the period of service and is recorded in other operating revenue. The cost to provide health care services under these agreements is accrued in the period in which the health care services are provided to a member, based in part on estimates, including an accrual for medical services provided but not yet reported.

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

Charity Care

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

The cost of providing charity care was \$18,450, \$21,728, and \$19,728 during the years ended December 31, 2011, 2010, and 2009, respectively. The cost of providing charity care is measured by applying an overall cost to charge ratio to the charges incurred. Total cost includes wages and salaries, supplies, building maintenance, equipment, and administration.

Fairview also provides a significant amount of uncompensated care to other uninsured and underinsured patients, which is included in the provision for bad debts.

Nonrecurring Expenses

Operating expenses that are not expected to recur on a regular basis are classified as nonrecurring expenses. During 2010, Fairview incurred payroll and contingency planning costs related to a nurses' strike, which were classified as nonrecurring expenses because of their infrequent nature.

(Deficit) Excess of Revenue and Gains Over Expenses and Losses

The consolidated statements of operations and changes in net assets include (deficit) excess of revenue and gains over expenses and losses. Changes in unrestricted net assets that are excluded from (deficit) excess of revenue and gains over expenses and losses include changes in pension and other postretirement liability adjustments, and contributions of long-lived assets.

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

2. Summary of Significant Accounting Policies (continued)

Adoption of New Accounting Pronouncements

On January 1, 2011, Fairview adopted new accounting guidance for health care entities requiring that estimated insurance recoveries be recognized as receivables separately from related claim liabilities. In addition, the amount of the claim liability should be determined without consideration of insurance recoveries. Adoption of this guidance did not have a material impact on the consolidated financial statements.

On January 1, 2011, Fairview adopted new accounting guidance requiring that cost be used as the measurement basis for charity care disclosure purposes. The method used to identify the direct and indirect costs of providing the charity care must be disclosed. Adoption of this guidance did not have a material impact on the consolidated financial statements.

On December 31, 2011, Fairview adopted new accounting guidance requiring additional and enhanced disclosures for multiemployer pension plans and multiemployer other postretirement benefit plans in which Fairview participates. Adoption of this guidance did not have a material impact on the consolidated financial statements.

New Accounting Guidance Not Yet Applicable

In July 2011, guidance was issued requiring health care entities to reflect the provision for debts as a reduction to net patient service revenue on the consolidated statements of operations and changes in net assets. Additional disclosures are also required related to revenue recognition policies, sources of patient service revenue, and qualitative and quantitative information about changes in the allowance for doubtful accounts. This guidance is effective for Fairview as of January 1, 2012. Adoption of this guidance will change the presentation of the consolidated statements of operations and changes in net assets and provide additional disclosures. It will not have an impact on Fairview's financial condition or the results of its operations.

Reclassifications

Certain prior year amounts in the consolidated financial statements have been reclassified to conform to the 2011 presentation. These reclassifications had no effect on the change in net assets or net assets as previously reported.

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

3. Affiliations

Effective January 1, 1997, certain assets and liabilities related to clinical care at the 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 have 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.

Fairview's bylaws authorize a Board of Directors of up to 21 members. Three of the 21 members of Fairview's Board of Directors 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 the University of Minnesota 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.

Prior to January 1, 2011, Fairview 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 could be fully reduced by lease payments made by Fairview to the University over the same period. Effective January 1, 2011, Fairview and the University revised the funding methodology of the Agreement to more accurately reflect market conditions and simplify accounting and administrative processes. The revised methodology is not expected to have a material impact on the overall funding of the Agreement.

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

3. Affiliations (continued)

Revenue and expenses recorded by Fairview under all of its agreements with the University were, respectively, \$4,639 and \$49,318 for 2011; \$21,501 and \$46,052 for 2010; and \$23,305 and \$44,042 for 2009. Amounts receivable from and payable to the University were, respectively, \$5,281 and \$8,112 at December 31, 2011; \$10,227 and \$12,967 at December 31, 2010; and \$4,679 and \$7,800 at December 31, 2009.

Fairview has entered into an affiliation agreement with University of Minnesota Physicians (UMPhysicians). UMPhysicians employs or has contracts with more than 750 University of Minnesota Medical School faculty members whose primary practice site is in clinics located at the University of Minnesota Medical Center, Fairview. The majority of the clinics are outpatient specialty clinics owned by Fairview. Fairview's affiliation agreement with UMPhysicians provides, among other things, that the primary clinical site for UMPhysicians shall be the University of Minnesota Medical Center, including the specialty clinics, and Fairview will maintain the University of Minnesota Medical Center facility in accordance with specified standards.

In addition, Fairview and UMPhysicians entered into a management services agreement pursuant to which UMPhysicians agreed to manage the Fairview-owned outpatient specialty clinics that are located at the University of Minnesota Medical Center, Fairview. The two parties have additional service agreements with each other for medical direction, professional laboratory and pathology services, perfusion services, information services, cardiology service line management services, and other purchased services.

Revenue and expenses recorded by Fairview under all of its agreements with UMPhysicians were, respectively, \$9,730 and \$159,351 for 2011; \$11,122 and \$132,837 for 2010; and \$11,772 and \$108,731 for 2009. Amounts receivable from and payable to UMPhysicians were, respectively, \$1,531 and \$33,101 at December 31, 2011; \$3,325 and \$18,925 at December 31, 2010; and \$1,671 and \$18,890 at December 31, 2009.

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

4. Net Patient Service 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 third-party payors. The Medicare and Medicaid programs pay for most services at predetermined rates. Services provided to patients covered by other third-party payors are paid for on the basis of negotiated or contractual payment rates. Changes in the Medicare and Medicaid programs or certain negotiated contracts could have a material effect on Fairview. Fairview utilizes a process to identify and appeal settlements on cost reports and claims by Medicare and other payors. Routine appeals and cost report settlements pertaining to prior periods resulted in an increase in operating income of approximately \$6,300, \$2,200, and \$5,900 in 2011, 2010, and 2009, respectively, which represented 0.2%, 0.1%, and 0.2%, respectively, of net patient service revenue.

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

	2011	2010	2009
Medicare	33%	33%	31%
Medicaid	17	16	15
Negotiated contracts	46	47	49
Commercial and other	4	4	5
	100%	100%	100%

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

4. Net Patient Service Revenue and Contractual Agreements With Third-Party Payors (continued)

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 accounts receivable at December 31 consists of the following:

	2011	2010	2009
Medicare	25%	25%	24%
Medicaid	16	14	14
Negotiated contracts	46	46	49
Commercial and other	13	15	13
	100%	100%	100%

Two negotiated contract payors accounted for 28%, 28%, and 29% of gross patient charges for 2011, 2010, and 2009, respectively, and 22%, 23%, and 24% of patient accounts receivable at December 31, 2011, 2010, and 2009, respectively.

5. Pledges

At December 31, 2011, pledges receivable, discounted at rates ranging from 4.11% to 4.34%, are \$46,939. Management believes total pledges will be received as follows:

Within one year	\$ 10,060
One to five years	21,972
After five years	24,472
	56,504
Less present value component and allowances	(9,565)
	\$ 46,939

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

5. Pledges (continued)

During the year ended December 31, 2009, Fairview received a pledge of \$50,000 for Fairview's replacement Children's Hospital through the Minnesota Medical Foundation (MMF). The pledge receivable at December 31, 2011 and 2010, is \$38,253 and \$44,324, respectively. In recognition of the gift, the replacement Children's hospital facility will be named the University of Minnesota Amplatz Children's Hospital (the Children's Hospital). The pledge will be used for the ongoing capital needs of the Children's Hospital. MMF will release funds to Fairview as time and purpose restrictions are fulfilled.

During the year ended December 31, 2011, Fairview received a pledge of \$11,180 to transform pediatric behavioral health services at the Children's Hospital. The pledge receivable was \$11,180 at December 31, 2011. This pledge will be used for renovation of two children and adolescent behavioral health inpatient units, creating a consistent care experience for pediatric patients, and is expected to be completed by 2014.

These pledges have been recorded as contributions at the time the pledges were made as temporarily restricted support. The donor has stipulated certain time limits as to the use of the donated assets. When the donor restrictions are satisfied (as to time and/or purpose) temporarily restricted net assets are reclassified to unrestricted net assets and reported as contributions of long-lived assets in the consolidated statements of operations and changes in net assets. Fairview recorded \$12,157 as contributions of long-lived assets for the year ended December 31, 2011, related to these pledges in the consolidated statements of operations and changes in net assets.

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

6. Investments

The composition of Fairview's investments, including those with limited uses, at December 31 is summarized as follows:

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Cash and cash equivalents	\$ 398,124	\$ 222,573	\$ 395,629
Certificates of deposit	2,717	4,599	4,068
Collateralized mortgage obligation securities	–	96	130
Commercial mortgage-backed securities	71	156	133
Commercial paper	6,936	13,992	15,903
Corporate debt securities	1,348	572	820
Equity mutual funds	280,407	330,481	183,151
Equity securities	35,928	34,472	21,502
Municipal debt securities	3,840	637	428
U.S. government agency debt securities	172,794	369,545	325,048
U.S. Treasury debt securities	1,222	1,383	5,764
Fund of hedge funds	47,316	49,203	47,422
Real estate investment trusts	1,302	1,312	1,302
	<u>\$ 952,005</u>	<u>\$ 1,029,021</u>	<u>\$ 1,001,300</u>

Through Fairview's investments in fund of hedge funds, Fairview is indirectly involved in investment activities, such as securities lending, trading in futures and forward contracts, and other derivative products. Derivatives are used to adjust portfolio risk exposure. While these financial instruments may contain varying degrees of risk, Fairview's risk with respect to such transactions is limited to its capital balance in each investment.

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

6. Investments (continued)

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

	2011	2010	2009
Dividends and interest	\$ 19,339	\$ 17,239	\$ 12,313
Net realized gains (losses)	9,737	4,243	(7,404)
Investment (loss) income from investments in fund of hedge funds	(1,887)	1,850	1,682
Changes in unrealized gains and losses on trading investments	(27,876)	37,009	42,422
	\$ (687)	\$ 60,341	\$ 49,013
Included in other operating revenue	\$ 1,322	\$ 1,556	\$ 1,585
Included in nonoperating (losses) gains	(2,079)	57,812	46,316
Included in changes in temporarily restricted net assets	70	973	1,112
	\$ (687)	\$ 60,341	\$ 49,013

7. Derivative Financial Instruments

Fairview uses various derivative financial instruments, including interest rate swaps and basis rate swaps, as part of its risk management strategy to manage exposure to fluctuation in interest rates and to manage the overall cost of its debt. Derivatives are used to manage identified and approved exposures and are not used for speculative purposes.

Interest rate swaps and basis rate swaps between Fairview and a third party (counterparty) provide for the periodic exchange of payments between the parties based on changes in a defined index and a fixed rate and include counterparty credit risk. Counterparty credit risk is the risk that contractual obligations of the counterparties will not be fulfilled. Concentrations of credit

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

7. Derivative Financial Instruments (continued)

risk relate to groups of counterparties that have similar economic or industry characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. Counterparty credit risk is managed by requiring high credit standards for Fairview's counterparties. The counterparties to these contracts are financial institutions that carry investment-grade credit ratings. The interest rate swap contracts contain collateral provisions applicable to both parties to mitigate credit risk. Fairview does not anticipate nonperformance by its counterparties.

In December 2011, Fairview amended the contract for the floating to fixed rate swaps to assign the swaps to another counterparty. The impact to Fairview as a result of the novation was an increase in the rate paid under the swap agreement and an increase in the collateral threshold with the new counterparty, resulting in lower collateral posting requirements.

The following is a summary of the outstanding positions under these interest rate swaps and basis rate swaps at December 31, 2011.

Instrument Type	Notional Amount	Maturity Date	Rate Paid	Rate Received
Variable basis swap	\$ 200,000,000	February 21, 2012	Variable based on weekly SIFMA	72% of 1-month LIBOR
Variable basis swap	\$ 100,000,000	March 21, 2012	Variable based on weekly SIFMA	71% of 1-month LIBOR
Variable basis swap	\$ 50,000,000	March 22, 2012	Variable based on weekly SIFMA	71% of 1-month LIBOR
Variable basis swap	\$ 50,000,000	March 25, 2012	Variable based on weekly SIFMA	71% of 1-month LIBOR
Floating to fixed rate swap	\$ 147,620,000	November 15, 2047	3.4275%	62.4% of 1-month LIBOR and 0.29%
Floating to fixed rate swap	\$ 74,880,000	November 15, 2047	3.5325%	62.4% of 1-month LIBOR and 0.29%
Fixed spread basis swap	\$ 275,000,000	September 12, 2028	Variable based on weekly SIFMA	67% of 1-month LIBOR and 0.504%
Fixed spread basis swap	\$ 250,000,000	July 3, 2028	Variable based on weekly SIFMA	67% of 1-month LIBOR and 0.452%
Variable basis swap	\$ 125,000,000	July 1, 2028	Variable based on weekly SIFMA	76.03% of 1-month LIBOR
Variable basis swap	\$ 125,000,000	October 1, 2028	Variable based on weekly SIFMA	79% of 1-month LIBOR

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

7. Derivative Financial Instruments (continued)

The fair value of derivative instruments at December 31 is as follows:

	2011	2010	2009
Derivative financial instruments			
Variable basis rate swaps	\$ (10,618)	\$ (10,352)	\$ (2,036)
Fixed spread basis swaps	(6,813)	(17,616)	(506)
Floating to fixed rate swaps	(67,302)	(24,140)	(13,033)
Forward BMA yield curve swaps	—	3,993	5,057
Collateral posted	30,281	25,163	—
	\$ (54,452)	\$ (22,952)	\$ (10,518)

The fair value of derivative instruments is recorded in derivative financial instruments in the consolidated balance sheets.

None of the derivative financial instruments are designated as hedging instruments. Therefore, the gain (loss) is recorded in (loss) gain on interest and basis rate swaps, net, in the consolidated statements of operations and changes in net assets:

	Year Ended December 31		
	2011	2010	2009
Variable basis rate swaps	\$ (539)	\$ (8,720)	\$ 21,598
Fixed spread basis swaps	13,133	(14,966)	28,956
Floating to fixed rate swaps	(49,834)	(17,425)	25,292
Forward BMA yield curve swaps	509	6,654	7,386
	\$ (36,731)	\$ (34,457)	\$ 83,232

In June 2010, Fairview terminated a 10-year forward BMA yield curve swap with a notional amount of \$100,000. The swap had an effective date of October 12, 2007, and an expiration date in 2017; the termination resulted in a gain of \$2,200 in 2010, which was recorded in (loss) gain on interest and basis rate swaps, net, in the consolidated statement of operations and changes in net assets.

In April 2011, Fairview terminated its remaining 20-year forward BMA yield curve swap with a notional amount of \$100,000. The swap had an effective date of October 12, 2007, and an expiration date in 2027; the termination resulted in a gain of \$509 in 2011, which was recorded in (loss) gain on interest and basis rate swaps, net, in the consolidated statement of operations and changes in net assets.

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

7. Derivative Financial Instruments (continued)

Fairview offsets fair value amounts recognized for the derivative instruments and fair value amounts recognized for the right to reclaim cash collateral (a receivable) based on the terms of the master netting agreement with the counterparty. All counterparties were in a liability position at December 31, 2011, 2010, and 2009. Fairview's master netting agreements contain provisions that require Fairview to post collateral with the counterparty when the net liability of the derivative instruments is greater than the predetermined threshold. Collateral was required of \$30,281 and \$25,163 at December 31, 2011 and 2010, respectively. No collateral was required at December 31, 2009.

8. Fair Value Measurements

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Fair Value Measurements and Disclosures Section of the Financial Accounting Standards Board's Accounting Standards Codification establishes a framework for measuring fair value. The framework consists of a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

Level 1 – Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 – Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

8. Fair Value Measurements (continued)

The following table presents the financial instruments carried at fair value on a recurring basis as of December 31, 2011, based on the definition of the fair value hierarchy:

	Level 1	Level 2	Level 3	Total
Assets				
Short-term investments:				
Cash and cash equivalents	\$ 53,160	\$ –	\$ –	\$ 53,160
Investments, excluding investments accounted for using the equity method:				
Cash and cash equivalents	284,330	–	–	284,330
Certificates of deposit	–	1,203	–	1,203
Corporate debt securities	–	304	–	304
Equity mutual funds	274,417	–	–	274,417
Equity securities	35,928	–	–	35,928
Municipal debt securities	–	699	–	699
U.S. government agency debt securities	–	126,562	–	126,562
U.S. Treasury debt securities	589	–	–	589
Mortgage-backed securities	–	71	–	71
Assets limited as to use:				
Cash and cash equivalents	60,634	–	–	60,634
Certificates of deposit	–	1,514	–	1,514
Corporate debt securities	–	1,044	–	1,044
Municipal debt securities	–	3,141	–	3,141
Commercial paper	–	6,936	–	6,936
Equity mutual funds	5,990	–	–	5,990
U.S. government agency debt securities	–	46,232	–	46,232
U.S. Treasury debt securities	633	–	–	633
Total	<u>\$ 715,681</u>	<u>\$ 187,706</u>	<u>\$ –</u>	<u>\$ 903,387</u>
Liabilities				
Derivative financial instruments	<u>\$ –</u>	<u>\$ (54,452)</u>	<u>\$ –</u>	<u>\$ (54,452)</u>

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

8. Fair Value Measurements (continued)

The following table presents the financial instruments carried at fair value on a recurring basis as of December 31, 2010, based on the definition of the fair value hierarchy:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets				
Short-term investments:				
Cash and cash equivalents	\$ 69,375	\$ –	\$ –	\$ 69,375
Investments, excluding investments accounted for using the equity method:				
Cash and cash equivalents	99,436	–	–	99,436
Certificates of deposit	–	2,300	–	2,300
Corporate debt securities	–	572	–	572
Equity mutual funds	323,634	–	–	323,634
Equity securities	34,472	–	–	34,472
Municipal debt securities	–	637	–	637
U.S. government agency debt securities	–	280,118	–	280,118
U.S. Treasury debt securities	1,020	–	–	1,020
Mortgage-backed securities	–	156	–	156
Collateralized mortgage obligation securities	–	96	–	96
Assets limited as to use:				
Cash and cash equivalents	53,762	–	–	53,762
Certificates of deposit	–	2,299	–	2,299
Commercial paper	–	13,992	–	13,992
Equity mutual funds	6,847	–	–	6,847
U.S. government agency debt securities	–	89,427	–	89,427
U.S. Treasury debt securities	363	–	–	363
Total	<u>\$ 588,909</u>	<u>\$ 389,597</u>	<u>\$ –</u>	<u>\$ 978,506</u>
Liabilities				
Derivative financial instruments	\$ –	\$ (22,952)	\$ –	\$ (22,952)

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

8. Fair Value Measurements (continued)

The following table presents the financial instruments carried at fair value on a recurring basis as of December 31, 2009, based on the definition of the fair value hierarchy:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets				
Short-term investments:				
Cash and cash equivalents	\$ 89,982	\$ –	\$ –	\$ 89,982
Investments, excluding investments accounted for using the equity method:				
Cash and cash equivalents	196,580	–	–	196,580
Certificates of deposit	–	2,086	–	2,086
Corporate debt securities	–	820	–	820
Equity mutual funds	177,145	–	–	177,145
Equity securities	21,502	–	–	21,502
Municipal debt securities	–	428	–	428
U.S. government agency debt securities	–	243,890	–	243,890
U.S. Treasury debt securities	1,155	–	–	1,155
Mortgage-backed securities	–	133	–	133
Collateralized mortgage obligation securities	–	130	–	130
Assets limited as to use:				
Cash and cash equivalents	109,067	–	–	109,067
Certificates of deposit	–	1,982	–	1,982
Commercial paper	–	15,903	–	15,903
Equity mutual funds	6,006	–	–	6,006
U.S. government agency debt securities	–	81,158	–	81,158
U.S. Treasury debt securities	4,609	–	–	4,609
Total	<u>\$ 606,046</u>	<u>\$ 346,530</u>	<u>\$ –</u>	<u>\$ 952,576</u>
Liabilities				
Derivative financial instruments	\$ –	\$ (10,518)	\$ –	\$ (10,518)

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

8. Fair Value Measurements (continued)

The fair values for Level 1 assets in the fair value measurements tables were based upon quoted market prices. Fair value for Level 2 is based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets. Inputs are obtained from various sources, including market participants, dealers, and brokers. Fairview utilizes a discounted cash flow methodology for valuing derivative financial instruments. The valuations reflect a credit spread adjustment to the LIBOR discount curve in order to reflect the credit value adjustment for “nonperformance” risk. The credit spread adjustment is derived from other comparably rated entities’ bonds priced in the market. Fair value for Level 3 is based on unobservable market data.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while Fairview believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

The following table is a rollforward of the consolidated balance sheet amounts for financial instruments classified by Fairview within Level 3 of the valuation hierarchy:

	Derivative Financial Instruments
Fair value at January 1, 2009	\$ (97,057)
Realized and unrealized gains included in deficit of revenue over expenses	86,539
Purchases, issuances, and settlements, net	—
Transfers out at fair value from Level 3 classification	10,518
Fair value at December 31, 2009	<u>\$ —</u>

There were no financial instruments classified as Level 3 during 2010 and 2011.

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

8. Fair Value Measurements (continued)

The carrying values of cash and cash equivalents, accounts receivable for medical services, 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 (excluding the impact of third-party credit enhancements) was approximately \$68,256, \$28,882, and \$46,047 more than its carrying value at December 31, 2011, 2010, and 2009.

9. Land, Buildings, and Equipment

Land, buildings, and equipment at December 31 consist of the following:

	2011	2010	2009
Land and improvements	\$ 68,765	\$ 68,228	\$ 67,389
Buildings and improvements	1,182,125	980,398	961,048
Capital leased assets	28,397	28,337	28,337
Equipment	600,765	525,638	581,285
	1,880,052	1,602,601	1,638,059
Less accumulated depreciation and amortization	934,787	892,575	915,795
	945,265	710,026	722,264
Construction-in-progress	46,763	220,541	133,816
	\$ 992,028	\$ 930,567	\$ 856,080

Depreciation expense was \$95,303, \$87,254, and \$97,325 for 2011, 2010, and 2009, respectively.

10. Short-Term Credit Arrangements

Fairview has a total of \$69,000 in various lines of credit available for short-term borrowing at varying interest rates, as defined in the agreements. Outstanding borrowings under these agreements at December 31, 2011, 2010, and 2009, were \$3,253, \$3,714, and \$468, respectively. The interest rate on borrowings outstanding at December 31, 2011 is three-month LIBOR plus 1.75% per annum.

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

11. Long-Term Debt

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

	2011	2010	2009
City of Minneapolis Health Care System Revenue Bonds, Series 2008A and 2008B (annual interest rates from 5.00% to 6.75%, and 6.50%, respectively), payable in installments through 2032 and 2038, respectively, and Health Care System Revenue Bonds, Series 2008C, 2008D, and 2008E, payable in installments through 2047 (including unaccreted discount of \$14,427, \$15,042, and \$15,656 at December 31, 2011, 2010, and 2009, respectively), Series 2008C, 2008D, and Series 2008E, refinanced in 2010	\$ 729,433	\$ 729,698	\$ 729,084
City of Minneapolis Health Care System Revenue Bonds, Series 2005D, at an annual interest rate of 5.0%, payable in installments through 2030 and 2034 (including unaccreted premium of \$2,189 in 2011, \$2,284 in 2010, and \$2,380 in 2009)	74,934	75,029	75,125
City of Minneapolis Health Care System Revenue Refunding Bonds, Series 2002B, payable in installments through 2032 at annual interest rates from 4.25% to 5.50% (including unaccreted premium of \$666 in 2011, \$737 in 2010, and \$808 in 2009)	16,826	20,407	23,833
Minnesota Agriculture and Economic Development Board Healthcare System Revenue Bonds, Series 2000A, payable in installments through 2029 at annual interest rates from 5.750% to 6.375% (net of unaccreted discount of \$399 in 2011, \$421 in 2010, and \$443 in 2009), portion refinanced in 2005	6,936	9,049	11,052
Minnesota Agriculture and Economic Development Board Healthcare System Revenue Bonds, Series 1997A, payable in installments through 2019 at annual interest rates from 5.40% to 5.75% (net of unaccreted discount of \$257 in 2011, \$289 in 2010, and \$322 in 2009)	7,958	8,726	9,453

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

11. Long-Term Debt (continued)

	2011	2010	2009
Hennepin County Housing and Redevelopment Authority (HRA) Senior Housing Revenue Bond, Series 2009A, payable in installments through 2019 at an annual interest rate of 5.25%, and Senior Housing Revenue Bond, Series 2009B, payable in installments through 2024 at an annual interest rate of 8.50%	\$ 15,268	\$ 15,268	\$ —
Capital lease obligations	26,744	28,233	30,154
Other revenue bonds and notes, at varying interest rates, payable in installments through 2044 (net of unaccreted premium of \$198 in 2011, \$204 in 2010, and \$210 in 2009)	60,424	61,946	46,863
	938,523	948,356	925,564
Less current maturities included in current liabilities (including unaccreted discount of \$490 in 2011, \$490 in 2010, and \$503 in 2009)	15,136	12,292	9,644
	\$ 923,387	\$ 936,064	\$ 915,920

In October 2010, Fairview tendered the Series 2008C, 2008D, and 2008E bonds and terminated the related letters of credit. On the same day, Fairview entered into direct purchase agreements with two financial institutions for the Series 2008C, 2008D, and 2008E bonds in the aggregate principal amount of \$222,500. The direct purchase agreements expire in October 2013. Principal payment on the Series 2008C and Series 2008D bonds would be due in entirety on October 2014 and principal payment on the Series 2008E bonds would be due in four equal quarterly installments beginning in January 2014 unless Fairview renews the direct purchase agreements, enters into a direct purchase agreement with other financial institutions, or changes the modes on the Series 2008C, 2008D, and 2008E bonds. It is Fairview's intent that these bonds will be resold within the terms of the direct purchase agreement. As such, Fairview has continued to disclose the aggregate maturities in accordance with their original loan agreements and respective principal payment schedules.

In January 2010, the Hennepin County HRA, on behalf of Fairview's senior care facilities, issued fixed rate Senior Housing Tax Exempt Bonds, Series 2009A and Series 2009B, in the aggregate principal amount of \$15,286. Proceeds of the Series 2009A and Series 2009B bonds will be used to construct a 76-unit assisted living facility.

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

11. Long-Term Debt (continued)

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, including days' cash on-hand, debt capitalization, and debt service coverage. Fairview paid interest, net of capitalized interest, of \$48,401, \$47,165, and \$51,282 for 2011, 2010, and 2009, respectively.

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

2012	\$	15,136
2013		17,120
2014		15,764
2015		15,981
2016		16,862

Guarantee

In October 2005, Fairview and North Memorial Medical Center (NMMC) formed Maple Grove Hospital Corporation (MGHC) to construct and operate the Maple Grove Hospital. Fairview and NMMC are the only two members of MGHC, and Fairview holds a 25% interest in MGHC, which is recorded within investments in related parties in the consolidated balance sheets. Fairview has guaranteed 25% of the principal and interest obligations associated with the Health Care Facilities Revenue Bonds, Series 2007, issued on behalf of MGHC, in the event of MGHC's default. The bonds have an outstanding principal balance of \$143,605 as of December 31, 2011, 2010, and 2009, and are payable in installments through May 2037 at annual interest rates ranging from 4.50% to 5.25%. Fairview has not recorded a liability related to the guarantee, as payments under the guarantee are considered remote as of December 31, 2011.

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

12. Commitments and Contingencies

Fairview has operating leases for computer, medical, communications, and other equipment. Rental expense associated with the operating leases was \$41,800, \$39,492, and \$37,761 for 2011, 2010, and 2009, respectively.

Future minimum lease payments on noncancelable operating leases in effect on December 31, 2011, for each of the five subsequent years and thereafter are as follows:

2012	\$ 27,429
2013	22,199
2014	16,834
2015	14,588
2016	10,839
Thereafter	47,900

Fairview is insured with an external insurance carrier for professional and general liability claims in excess of amounts self-insured through its insurance subsidiaries. Fairview self-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 and could result in a retrospective adjustment.

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 self-insured claims includes an estimate of the ultimate cost for reported claims and claims incurred but not reported (IBNR). The estimate for professional and general liability, workers' compensation, and employee health insurance claims is based on actual claims to date and actuarial studies of Fairview's estimated future liability for such claims.

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

12. Commitments and Contingencies (continued)

The estimate for professional and general liability, workers' compensation, and employee health insurance claims totaled \$69,605, \$63,494, and \$69,549 at December 31, 2011, 2010, and 2009, respectively. Fairview discounts its reserves for professional and general liability claims using a 1.7%, 1.3%, and 2.0% annual discount rate as of December 31, 2011, 2010, and 2009, respectively.

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. However, there can be no assurance that this will be the case.

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.

Approximately 27% of Fairview's employees are represented by various collective bargaining arrangements, which expire within one to three years.

13. Employee Benefit Plans

Fairview sponsors a number of defined-contribution pension plans covering most of its employees who meet certain eligibility requirements. Fairview's contribution expense for these plans was \$51,683, \$47,230, and \$50,229 for 2011, 2010, and 2009, respectively.

Fairview maintains three defined-benefit plans, participation in which is frozen, and one postretirement plan. The plans provide pension and postretirement benefits to approximately 10% of all of Fairview's employees. Net periodic benefit costs for the four plans totaled \$2,076, \$3,304, and \$3,416 for 2011, 2010, and 2009, respectively. At December 31, 2011, 2010, and 2009, the accrued benefit costs for Fairview's defined-benefit plans totaled \$30,201, \$19,496, and \$24,069, respectively. The change to Fairview's unrestricted net assets arising from changes

Fairview Health Services

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

13. Employee Benefit Plans (continued)

in plan assets and benefit obligations was \$12,661, \$(6,147), and \$(1,547) in 2011, 2010, and 2009, respectively. The weighted-average discount rate and expected long-term rate of return on plan assets used to estimate the net periodic benefit cost was, respectively, 5.48% and 7.91% for 2011; 5.85% and 7.93% for 2010; and 5.93% and 8.00% for 2009. The discount rate used to estimate the accrued benefit cost at December 31, 2011, 2010, and 2009, was 4.71%, 5.69%, and 6.03%, respectively.

The fair value of pension plan assets was determined using the fair value hierarchy, as defined in Note 8, at December 31, 2011:

	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents	\$ 28	\$ –	\$ –	\$ 28
Mutual funds	3,070	–	–	3,070
Pooled separate accounts	–	33,493	1,337	34,830
Immediate participation guarantee contracts	–	–	1,148	1,148
	<u>\$ 3,098</u>	<u>\$ 33,493</u>	<u>\$ 2,485</u>	<u>\$ 39,076</u>

The fair value of pension plan assets was determined using the fair value hierarchy, as defined in Note 8, at December 31, 2010:

	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents	\$ 27	\$ –	\$ –	\$ 27
Mutual funds	3,274	–	–	3,274
Pooled separate accounts	–	32,738	810	33,548
Immediate participation guarantee contracts	–	–	1,216	1,216
	<u>\$ 3,301</u>	<u>\$ 32,738</u>	<u>\$ 2,026</u>	<u>\$ 38,065</u>

Fairview Health Services

Notes to Consolidated Financial Statements (continued)
(Dollars in Thousands)

13. Employee Benefit Plans (continued)

The fair value of pension plan assets was determined using the fair value hierarchy, as defined in Note 8, at December 31, 2009:

	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents	\$ 26	\$ –	\$ –	\$ 26
Mutual funds	3,099	–	–	3,099
Pooled separate accounts	–	28,510	700	29,210
Immediate participation guarantee contracts	–	–	1,293	1,293
	<u>\$ 3,125</u>	<u>\$ 28,510</u>	<u>\$ 1,993</u>	<u>\$ 33,628</u>

The following table is a rollforward of the pension plan assets classified within Level 3 of the valuation hierarchy defined above:

	Pooled Separate Accounts	Immediate Participation Guarantee Contracts
Fair value at January 1, 2009	\$ 1,026	\$ 1,379
Purchases, issuances, and settlements	–	(168)
Interest earned	–	82
Investment depreciation	(326)	–
Fair value at December 31, 2009	700	1,293
Purchases, issuances, and settlements	–	(152)
Interest earned	–	75
Investment appreciation	110	–
Fair value at December 31, 2010	810	1,216
Purchases, issuances, and settlements	377	(138)
Interest earned	–	70
Investment appreciation	150	–
Fair value at December 31, 2011	<u>\$ 1,337</u>	<u>\$ 1,148</u>

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

13. Employee Benefit Plans (continued)

In addition, Fairview participates in union-sponsored multiemployer plans to which contributions are made in accordance with collective bargaining agreements. The risks of participation in these multiemployer plans are different from single-employer plans in the following aspects: a) assets contributed to the multiemployer plan by one employer may be used to provide benefits to employees of other participating employers; b) if a participating employer stops contributing to the plan, the unfunded obligations of the plan may be borne by the remaining participating employers; and c) if Fairview chooses to stop participating in some of its multiemployer plans and if the plan is underfunded, Fairview may be required to pay those plans an amount based on the underfunded status of the plan, referred to as the withdrawal liability.

Fairview's participation in these plans for the year ended December 31, 2011, is outlined in the table below. The "EIN/Pension Plan Number" column provides the Employee Identification Number (EIN) and the three-digit plan number, if applicable. Unless otherwise noted, the most recent Pension Protection Act zone status available in 2011 and 2010 is for the plan's year-end at December 31, 2010 and 2009, respectively. The zone status is based on information that Fairview received from the plan and is certified by the plan's actuary. Among other factors, plans in the red zone are generally less than 65% funded, plans in the yellow zone are less than 80% funded, and plans in the green zone are at least 80% funded. The "FIP/RP Status Pending/Implemented" column indicates plans for which a financial improvement plan (FIP) or a rehabilitation plan (RP) is either pending or has been implemented. The last column lists the expiration date of the collective-bargaining agreement to which the plans are subject.

Pension Fund	EIN/Pension Plan Number	Pension Protection Act Zone Status		FIP/RP Status Pending/Implemented	Contributions of Fairview			Surcharge Imposed	Expiration Date of Collective-Bargaining Agreement
		2010	2009		2011	2010	2009		
MNA Plan	41-6184922 - 001	Yellow	Yellow	Implemented	\$ 9,435	\$ 13,011	\$ 9,466	No	05/31/2013
LPN Plan	41-1817108 - 001	Green	Green	N/A	709	236	-	No	N/A
Total Contributions					<u>\$ 10,144</u>	<u>\$ 13,247</u>	<u>\$ 9,466</u>		

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

13. Employee Benefit Plans (continued)

Total amounts expensed under the union-sponsored multiemployer plans were \$11,003, \$13,962, and \$10,162 for 2011, 2010, and 2009, respectively.

Fairview contributes more than 5% of the total contributions to all of the plans in which it participated for the plan years 2010 and 2009. Fairview is required to make a minimum contribution of \$10,899 in 2012.

The funding improvement plan for the Twin City Hospitals Minnesota Nurses Association Pension Plan (MNA Plan) requires no contribution or benefit changes from the currently bargained amounts to achieve the funding improvement plan goals.

At the date Fairview's financial statements were issued, Forms 5500 were not available for the plan year ended in 2011.

14. Functional Expenses

Fairview provides health-related services to patients in the communities it serves. Recurring and nonrecurring expenses related to providing these services, included in the consolidated statements of operations and changes in net assets, are as follows:

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Health care services	\$ 2,158,235	\$ 2,084,733	\$ 1,998,126
General and administrative	836,607	661,483	636,194
Total	<u>\$ 2,994,842</u>	<u>\$ 2,746,216</u>	<u>\$ 2,634,320</u>

Fairview Health Services

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

15. Income Taxes

Most of Fairview's controlled affiliates are tax-exempt organizations described in Section 501(c)(3) of the Internal Revenue Code. These organizations are subject to income tax on any income from unrelated business activities. Fairview also owns or controls certain taxable affiliates.

Fairview files income tax returns in the U.S. federal jurisdiction and in various state and local jurisdictions. With few exceptions, Fairview is no longer subject to U.S. federal, state, and local, or non-U.S. income tax examinations by tax authorities for years before 2007

Fairview recognizes all tax positions, including those positions in a previously filed tax return or a position expected to be taken in a future tax filing that is reflected in measuring current or deferred income tax assets and liabilities, when it is more likely than not (likelihood of greater than 50%) that, based on technical merits, the position will be sustained upon examination.

Fairview does not expect that there will be a significant change in the total dollar amount of unrecognized tax benefits within the next 12 months.

There are no uncertain tax positions recorded in the consolidated balance sheets.

At December 31, 2011, 2010, and 2009, Fairview has net operating loss carryforwards for federal income tax purposes. A valuation allowance has been recorded for the full amount of the deferred tax asset related to the net operating loss carryforwards due to the uncertainty regarding their use.

16. Subsequent Events

Fairview evaluated events and transactions occurring subsequent to December 31, 2011 through April 23, 2012, the date of issuance of the consolidated financial statements. During this period, there were no other subsequent events requiring recognition in the consolidated financial statements.

Supplementary Information

Report of Independent Auditors on Supplementary Information

The Board of Directors
Fairview Health Services

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating balance sheet and statement of operations and changes in net assets are presented for purposes of additional analysis and are not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in our audits of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Ernst + Young LLP

April 23, 2012

Fairview Health Services

Consolidating Balance Sheet

(Dollars in Thousands)

December 31, 2011

	Obligated Group	Non-Obligated Group	Eliminations and Reclassifications	Consolidated Totals
Assets				
Current assets:				
Cash and cash equivalents	\$ 5,704	\$ 25,574	\$ –	\$ 31,278
Short-term investments	44,143	9,017	–	53,160
Accounts receivable for medical services, net of allowance for doubtful accounts	360,940	17,783	9,800	388,523
Current portion of pledges receivable	8,510	1,550	–	10,060
Inventories	52,599	926	–	53,525
Other current assets	33,458	15,661	(8,286)	40,833
Total current assets	505,354	70,511	1,514	577,379
Investments	769,519	3,202	–	772,721
Assets limited as to use:				
Debt service reserve fund investments	33,678	–	–	33,678
Construction fund investments	–	665	–	665
Investments held by insurance subsidiaries	–	44,300	–	44,300
Investments pledged under workers' compensation program	31,100	–	–	31,100
Restricted fund investments	121	16,260	–	16,381
Total assets limited as to use	64,899	61,225	–	126,124
Other long-term assets:				
Pledges receivable, less current portion	36,879	–	–	36,879
Deferred debt acquisition costs	12,752	1,109	–	13,861
Investments in related parties	40,013	311	–	40,324
Goodwill and intangible assets and other assets	65,040	3,457	(27,183)	41,314
Total other long-term assets	154,684	4,877	(27,183)	132,378
Land, buildings, and equipment, net	918,773	73,255	–	992,028
Total assets	\$ 2,413,229	\$ 213,070	\$ (25,669)	\$ 2,600,630

	Obligated Group	Non-Obligated Group	Eliminations and Reclassifications	Consolidated Totals
Liabilities and net assets				
Current liabilities:				
Checks outstanding	\$ 10,769	\$ –	\$ –	\$ 10,769
Accounts payable	147,375	2,515	–	149,890
Accrued salaries, benefits, and other liabilities	208,103	24,413	(4,144)	228,372
Payable under third-party reimbursement contracts	942	–	9,305	10,247
Current maturities of long-term debt	13,076	2,060	–	15,136
Current portion of insurance subsidiaries claims reserves	–	5,275	–	5,275
Current portion of workers' compensation reserves	5,945	–	–	5,945
Total current liabilities	386,210	34,263	5,161	425,634
Other liabilities:				
Insurance subsidiaries claims reserves, less current portion	4,893	10,305	–	15,198
Workers' compensation reserves, less current portion	30,053	101	–	30,154
Derivative financial instruments	54,452	–	–	54,452
Other long-term liabilities	38,736	30,870	(30,830)	38,776
Total other liabilities	128,134	41,276	(30,830)	138,580
Long-term debt, less current maturities	870,824	52,563	–	923,387
Total liabilities	1,385,168	128,102	(25,669)	1,487,601
Net assets:				
Unrestricted	982,527	71,343	–	1,053,870
Temporarily restricted	45,534	13,625	–	59,159
Total net assets	1,028,061	84,968	–	1,113,029
Total liabilities and net assets	\$ 2,413,229	\$ 213,070	\$ (25,669)	\$ 2,600,630

Fairview Health Services

Consolidating Statement of Operations and Changes in Net Assets (Dollars in Thousands)

Year Ended December 31, 2011

	Obligated Group	Non-Obligated Group	Eliminations	Consolidated Totals
Unrestricted revenue:				
Net patient service revenue	\$ 2,551,154	\$ 201,248	\$ (95,267)	\$ 2,657,135
Other operating revenue	196,766	192,528	(38,523)	350,771
Net assets released from restrictions	313	3,290	–	3,603
Total unrestricted revenue	2,748,233	397,066	(133,790)	3,011,509
Expenses:				
Salaries and benefits	1,386,103	185,395	(428)	1,571,070
Supplies	542,737	19,863	(5,548)	557,052
Purchased services	374,470	137,622	(93,016)	419,076
Depreciation and amortization	89,185	6,767	–	95,952
Interest	41,647	3,839	–	45,486
Provision for bad debts	53,878	4,194	–	58,072
Utilities and maintenance	94,922	5,076	–	99,998
Insurance and rent	40,886	22,579	(14,034)	49,431
State and local taxes	58,454	4,831	–	63,285
Other operating expenses	28,734	27,450	(20,764)	35,420
Total expenses	2,711,016	417,616	(133,790)	2,994,842
Operating income (loss)	37,217	(20,550)	–	16,667
Nonoperating losses:				
Investment loss, net	(1,174)	(905)	–	(2,079)
Loss on interest and basis rate swaps, net	(36,731)	–	–	(36,731)
Total nonoperating losses, net	(37,905)	(905)	–	(38,810)
Deficit of revenue and gains over expenses and losses	(688)	(21,455)	–	(22,143)

	Obligated Group	Non-Obligated Group	Eliminations	Consolidated Totals
Other changes in unrestricted net assets:				
Deficit of revenue and gains over expenses and losses	\$ (688)	\$ (21,455)	\$ –	\$ (22,143)
Capital contribution	(28,630)	28,630	–	–
Pension and other postretirement liability adjustments	(12,661)	–	–	(12,661)
Contributions of long-lived assets and other changes	10,945	2,574	–	13,519
(Decrease) increase in unrestricted net assets	(31,034)	9,749	–	(21,285)
Temporarily restricted net assets:				
Contributions and other changes, net	13,083	4,024	–	17,107
Net assets released from restrictions	(12,470)	(3,290)	–	(15,760)
Increase in temporarily restricted net assets	613	734	–	1,347
Total (decrease) increase in net assets	(30,421)	10,483	–	(19,938)
Net assets at beginning of year	1,058,482	74,485	–	1,132,967
Net assets at end of year	\$ 1,028,061	\$ 84,968	\$ –	\$ 1,113,029

Ernst & Young LLP

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 152,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit www.ey.com.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. This Report has been prepared by Ernst & Young LLP, a client serving member firm located in the United States.

