

PROVIDENCE HEALTH SYSTEM

Consolidated Financial Statements

December 31, 2004 and 2003

(With Independent Auditors' Report Thereon)



KPMG LLP
Suite 900
801 Second Avenue
Seattle, WA 98104

Independent Auditors' Report

The Board of Directors,
Providence Health System:

We have audited the accompanying consolidated balance sheets of Providence Health System (the Health System) as of December 31, 2004 and 2003, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Health System's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 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 the Health System's internal control over financial reporting. Accordingly, we express no such opinion. 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Providence Health System as of December 31, 2004 and 2003, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

February 25, 2005

PROVIDENCE HEALTH SYSTEM

Consolidated Balance Sheets

December 31, 2004 and 2003

(In thousands of dollars)

Assets	2004	2003
Current assets:		
Cash and cash equivalents	\$ 229,130	195,103
Accounts receivable, less allowance for bad debts of \$149,770 and \$125,592, respectively	508,483	517,666
Premiums receivable	2,117	3,527
Other receivables	60,860	48,745
Supplies inventory, at cost	49,507	45,341
Other current assets	24,048	21,966
Current portion of assets whose use is limited	2,240	1,434
Total current assets	<u>876,385</u>	<u>833,782</u>
Assets whose use is limited:		
Board-designated cash and investments	1,358,850	1,099,532
Funds held for long-term purposes	25,686	28,570
Gift annuities and trusts	28,424	25,294
Funds held by trustee	300,225	266,297
Assets whose use is limited, net of current portion	<u>1,713,185</u>	<u>1,419,693</u>
Property, plant, and equipment, net	1,714,501	1,604,768
Other long-term assets	130,606	144,477
Total assets	<u>\$ 4,434,677</u>	<u>4,002,720</u>

PROVIDENCE HEALTH SYSTEM

Consolidated Balance Sheets

December 31, 2004 and 2003

(In thousands of dollars)

Liabilities and Net Assets	2004	2003
Current liabilities:		
Current portion of long-term debt	\$ 33,679	35,563
Accounts payable	157,850	151,234
Accrued compensation	162,857	168,071
Payable to contractual agencies	58,519	66,604
Unearned premiums/deferred revenue	27,488	38,392
Liability for unpaid medical claims	36,799	43,783
Liability for risk-sharing	3,913	7,063
Other, including accrued interest	32,999	11,178
Total current liabilities	<u>514,104</u>	<u>521,888</u>
Long-term debt, net of current portion	912,913	860,068
Other long-term liabilities:		
Self-insurance liability	179,847	151,570
Pension benefit obligation	130,489	169,668
Gift annuity obligations and trusts and other	46,453	42,804
Total other long-term liabilities	<u>356,789</u>	<u>364,042</u>
Total liabilities	<u>1,783,806</u>	<u>1,745,998</u>
Net assets:		
Unrestricted	2,518,592	2,136,477
Temporarily restricted	102,005	94,275
Permanently restricted	30,274	25,970
Total net assets	<u>2,650,871</u>	<u>2,256,722</u>
Total liabilities and net assets	<u>\$ 4,434,677</u>	<u>4,002,720</u>

See accompanying notes to consolidated financial statements.

PROVIDENCE HEALTH SYSTEM
Consolidated Statements of Operations
Years ended December 31, 2004 and 2003
(In thousands of dollars)

	<u>2004</u>	<u>2003</u>
Operating revenues:		
Net patient service revenues	\$ 3,197,598	3,025,763
Health plan revenues	652,294	583,683
Other revenues	170,709	170,726
	<u>4,020,601</u>	<u>3,780,172</u>
Operating expenses (including charity and unsponsored community benefit expenses of \$330,686 in 2004 and \$304,862 in 2003):		
Purchased healthcare	380,750	350,448
Salaries and wages	1,530,970	1,462,858
Employee benefits	418,895	372,438
Professional fees	94,437	91,810
Supplies	515,223	510,189
Depreciation	199,024	194,209
Interest and amortization	27,301	27,515
Purchased services, bad debts, and other	668,366	644,248
	<u>3,834,966</u>	<u>3,653,715</u>
Income from operations	185,635	126,457
Net nonoperating gains, principally investment income	<u>52,942</u>	<u>50,140</u>
Net income	238,577	176,597
Net assets released from restriction	49,828	40,796
Decrease (increase) in accrued additional minimum pension liability	38,241	(17,238)
Change in net unrealized gains/losses on investments	55,469	90,429
Increase in unrestricted net assets	<u>\$ 382,115</u>	<u>290,584</u>

See accompanying notes to consolidated financial statements.

PROVIDENCE HEALTH SYSTEM

Consolidated Statements of Changes in Net Assets

Years ended December 31, 2004 and 2003

(In thousands of dollars)

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total net assets</u>
Balance, December 31, 2002	\$ 1,845,893	85,646	21,785	1,953,324
Net income	176,597	—	—	176,597
Contributions, grants, investment income, and other	—	59,081	4,185	63,266
Net assets released from restriction	40,796	(50,997)	—	(10,201)
Increase in accrued additional minimum pension liability	(17,238)	—	—	(17,238)
Change in net unrealized gains/losses on investments	90,429	545	—	90,974
Increase in net assets	<u>290,584</u>	<u>8,629</u>	<u>4,185</u>	<u>303,398</u>
Balance, December 31, 2003	2,136,477	94,275	25,970	2,256,722
Net income	238,577	—	—	238,577
Contributions, grants, investment income, and other	—	82,339	4,304	86,643
Net assets released from restriction	49,828	(74,649)	—	(24,821)
Decrease in accrued additional minimum pension liability	38,241	—	—	38,241
Change in net unrealized gains/losses on investments	55,469	40	—	55,509
Increase in net assets	<u>382,115</u>	<u>7,730</u>	<u>4,304</u>	<u>394,149</u>
Balance, December 31, 2004	\$ <u>2,518,592</u>	<u>102,005</u>	<u>30,274</u>	<u>2,650,871</u>

See accompanying notes to consolidated financial statements.

PROVIDENCE HEALTH SYSTEM
Consolidated Statements of Cash Flows
Years ended December 31, 2004 and 2003
(In thousands of dollars)

	2004	2003
Operating activities:		
Change in net assets	\$ 394,149	303,398
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	199,811	195,331
Provision for bad debt	160,601	166,969
Gain on sale of property, plant, and equipment	(2,239)	(10,067)
Changes in certain current assets and current liabilities	(172,501)	(153,707)
Change in other long-term liabilities and other	(9,418)	74,706
Restricted contributions and investment income received	(85,954)	(41,600)
Net realized and unrealized gains on investments	(102,441)	(124,960)
Net cash provided by operating activities	382,008	410,070
Investing activities:		
Property, plant, and equipment additions	(308,402)	(260,385)
Proceeds from disposal of property, plant, and equipment	9,514	60,607
Purchases of investments	(1,790,048)	(2,081,803)
Proceeds from sales of investments	1,626,309	1,790,828
Change in other long-term assets and other	(2,967)	4,343
Net cash used in investing activities	(465,594)	(486,410)
Financing activities:		
Proceeds from restricted contributions and restricted net income	85,954	41,600
Long-term debt borrowings	100,500	324,760
Long-term debt payments	(49,539)	(220,834)
Change in deferred financing costs and other	8,815	1,080
Increase in funds held by trustee, net	(28,117)	(39,833)
Net cash provided by financing activities	117,613	106,773
Increase in cash and cash equivalents	34,027	30,433
Cash and cash equivalents, beginning of year	195,103	164,670
Cash and cash equivalents, end of year	\$ 229,130	195,103
Supplemental disclosure of cash flow information:		
Cash paid for interest (net of amounts capitalized)	\$ 31,315	28,138

See accompanying notes to consolidated financial statements.

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

(1) Organization

(a) *Sisters of Providence*

Sisters of Providence (the Congregation), a religious congregation of Roman Catholic women, was founded in 1843. The religious congregation's central headquarters is in Montreal, Quebec, Canada. Sisters of Providence – Mother Joseph Province (the Province) was formed in 2000 through the combination of the Sacred Heart Province (founded in 1856) and the St. Ignatius Province (founded in 1891). The activities of the Province include apostolic works in healthcare, social services, and education. Members of the Province serve in these works through related and unrelated organizations. The Province is compensated for the services of its members. The Mother Joseph Province has 184 professed members and maintains Provincial Administration facilities in both Seattle and Spokane, Washington. The members of the Mother Joseph Province represent the Congregation in the following:

- Archdiocese of Anchorage
- Archdiocese of Los Angeles
- Archdiocese of Portland in Oregon
- Archdiocese of Seattle
- Archdiocesis de San Salvador
- Diocese of Boise
- Diocese of Great Falls – Billings
- Diocese of Helena
- Diocese of Oakland
- Diocese of Orange in California
- Diocese of Spokane
- Diocese of Yakima
- Diocese of Stockton
- Diocesis Santiago de Maria, El Salvador

The Provincial Superior and the members of the Provincial Council of the Sisters of Providence – Mother Joseph Province control various corporations comprising Providence Health System (the Health System): Providence Health System – Washington; Providence Health System – Oregon; Providence Health System – Southern California (co-sponsored by the Congregation and the American Province of the Little Company of Mary Sisters); Providence Everett Medical Center, Everett, Washington; Providence Plan Partners; Providence Health Plan; Providence Health Assurance; Hospice of Snohomish; Providence Health System Housing; Providence Home Services; The St. Luke Association; The Lundberg Association; Providence St. Francis Association; Providence Blanchet Association; Providence Rossi Association; Providence Peter Claver

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

Association; The Gamelin Association; The Gamelin Oregon Association; The Gamelin California Association; Sisters of Providence Oregon Management Corporation; The John Gabriel Ryan Association; Lifecare Ventures; Providence Assurance Cayman Limited; and 20 fund-raising foundations. The corporations own or operate 17 general acute care hospitals, a children's nursing center and Montessori school, a high school, five assisted living projects, ten low-income housing projects, seven long-term care facilities, a preferred provider organization, a health services contractor, and two programs of all inclusive care for the elderly.

The Health System provides inpatient, outpatient, primary care, and home care services in Alaska, Washington, Oregon, and Southern California. The Health System operates these businesses primarily in the greater metropolitan areas of Anchorage, Alaska; Everett, Seattle and Olympia, Washington; Portland and Medford, Oregon; and Los Angeles, California.

During 2003, the Health System, through its affiliate, Providence Health System – Washington (PHS-W) entered into an agreement to sell certain assets of Providence Yakima Medical Center (PYMC) and Providence Toppenish Hospital (PTH) to Yakima HMA, Inc., a for-profit corporation for approximately \$80,000,000. The transaction closed on August 15, 2003 and included the sale of substantially all of the assets of PYMC and PTH, including property, plant, and equipment, and supplies inventories. As a result of the transaction the Health System recorded a gain of \$13,800,000, which is included in net nonoperating gains in the consolidated statement of operations for the year ended December 31, 2003. Also included in nonoperating gains is a charge of approximately \$7,000,000 to expense termination benefits and other defined benefit plan costs related to the former employees of PYMC and PTH. The resulting impact of this transaction was a net gain of \$6,800,000. The patient accounts receivable, ownership interests in partnerships and joint ventures, and certain other liabilities related to PYMC and PTH as of the date of the transaction remained with the Health System.

The following represents the summary of the statement of operations for PYMC and PTH included in the consolidated statement of operations of the Health System for 227 days in the year ended December 31, 2003:

Total operating revenues	\$	82,459
Total operating expenses		90,156
Net loss from operations		(7,697)
Net loss		(1,368)

In connection with the transfer of certain entities to Swedish Health Services (SHS) in 2000, certain obligations remain on the Health System's consolidated balance sheets as a component of long-term debt and a corresponding long-term receivable from SHS of \$42,165,000 and \$46,481,000 as of December 31, 2004 and 2003, respectively, have been recorded as a component of other assets. The interest income and interest expense related to this debt and corresponding receivable was \$1,942,000 and \$2,245,000 in 2004 and 2003, respectively.

The Strategic Alliance Agreement between PHS-W and SHS also provided for the establishment of a new company to be jointly owned by PHS-W and SHS. This joint venture was established to provide opportunities for joint development and delivery of certain new healthcare services and various

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

administrative and billing functions. As part of this transaction, SHS has pledged to make an annual donation to PHS-W, if certain financial thresholds have been met, to support the charitable tax-exempt purposes of PHS-W. During fiscal years 2004 and 2003 a contribution of approximately \$2,614,000 and \$986,000, respectively, was made under the terms of the pledge.

All significant transactions and accounts between consolidated divisions and affiliates of the Health System have been eliminated.

(b) *Affiliated Transactions*

Interaffiliate Borrowings

The Health System has a policy to loan funds among its affiliates at various interest rates. Those transactions with unconsolidated affiliates are not eliminated.

Liability Self-Insurance

The Health System has established self-insurance funds for the deductible portion of professional and general liability and workers' compensation insurance coverage. These funds provide insurance coverage for healthcare institutions associated with the Health System and certain other related institutions. The Health System also operates an off-shore insurance captive, Providence Assurance Cayman Limited, to self-insure certain layers of professional and general liability risk. In addition, the Health System maintains excess coverage with independent insurance carriers. The Health System discounts the ultimate cost of claims at a discount rate of 5.50% and 5.25% as of December 31, 2004 and 2003, respectively.

(2) Summary of Significant Accounting Policies

(a) *Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(b) *Cash and Cash Equivalents*

Cash and cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less.

(c) *Property, Plant, and Equipment*

Property, plant, and equipment are stated at cost. Improvements and replacements of plant and equipment are capitalized. Maintenance and repairs are expensed. The cost of the property, plant, and equipment sold or retired and the related accumulated depreciation are removed from the accounts, and the resulting gain or loss is recognized at the time of disposal.

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

(d) Depreciation

The provision for depreciation is determined by the straight-line method, which allocates the cost of tangible property equally over its estimated useful life.

(e) Interest During Construction

Interest capitalized on internally generated and borrowed funds expended for construction is a component of the cost of plant additions to be allocated to future periods through the provision for depreciation. Capitalization of interest ceases when the plant addition is placed into service. The Health System capitalized \$1,740,000 and \$2,136,000 of interest costs during the years ended December 31, 2004 and 2003, respectively.

(f) Financing Costs

Financing costs are recorded in other assets and are amortized using the effective interest method over the term of the related debt.

(g) Goodwill

Goodwill is recorded in other assets as the excess of cost over fair value of the acquired entity. The provision for amortization is determined using the straight-line method over a period not to exceed twenty years. Additionally, goodwill is tested at least annually for impairment.

(h) Assets Whose Use is Limited

Assets whose use is limited primarily include assets held by trustees under indenture agreements, self-insurance funds, funds held for the payment of health plan medical claims, assets held by related foundations, and designated assets set aside by the Board of Directors of Providence Health System for future capital improvements and other purposes over which the board retains control. Amounts required to meet current liabilities of the Health System have been reclassified as current in the consolidated balance sheets at December 31, 2004 and 2003.

A decline in fair value below cost that is deemed to be other-than-temporary is recorded as an impairment loss and is classified as nonoperating in the accompanying consolidated statements of operations. A new cost basis is then established for the security.

(i) Liability for Unpaid Medical Claims

The liability for unpaid medical claims represents a provision for services provided for which payment had not been made, and includes claims received but not yet paid, estimated claims incurred but not yet billed by providers, outstanding amounts due to contracted providers for primary care services, as well as estimated risk pool settlement liabilities.

(j) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the Health System has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the Health System in perpetuity.

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

(k) Donor-Restricted Gifts

Unconditional promises to give cash and other assets to the Health System are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted contributions if they are received with donor stipulations that limit the use of the donated assets. When the terms of a donor restriction are met, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restriction.

(l) Net Patient Service Revenues

The divisions of the Health System have agreements with governmental and other third-party payers that provide for payments to the divisions at amounts different from their established charges. Payment arrangements for major third-party payers may be based on prospectively determined rates, reimbursed cost, discounted charges, per diem payments, predetermined rates per HMO enrollee per month, or other methods.

Net patient service revenues are reported at the estimated net realizable amounts due from patients, third-party payers, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payers. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. Included in net patient service revenues are \$9,968,000 and \$1,606,000 in 2004 and 2003, respectively, related to other changes in estimates and settlements on third-party payer contracts.

(m) Health Plan Revenues, Premiums Receivable, and Unearned Premiums

Health plan revenues consist of premiums paid by employers, individuals, and agencies of the Federal and state governments for healthcare services. Health plan revenues are received on a prepaid basis and are recognized as revenue during the month for which the premium is associated. Premium billings for future months are recorded as unearned premiums.

(n) Charity and Un-sponsored Community Benefit Costs

The divisions of the Health System have policies that provide for serving those without the ability to pay. The policies also provide for discounted sliding scale payments based on the income and assets of the person responsible for the bill. In addition to direct charity, the Health System's divisions also provide services that benefit the poor and others in the communities they serve. The cost of providing these community benefits can exceed the revenue sources available.

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

Information for the Health System for the years ended December 31, 2004 and 2003, is summarized below:

	2004	2003
	(In thousands of dollars)	
Cost of charity care provided	\$ 74,594	54,220
Unpaid cost of Medicare services	103,559	106,247
Unpaid cost of Medicaid services	93,002	93,592
Education and research programs, net cost	19,027	14,936
Nonbilled services, net cost	15,288	15,095
Negative margin services and other, net cost	25,216	20,772
Un-sponsored community benefit costs	\$ 330,686	304,862
Percentage of total operating expenses, excluding purchased healthcare	9.6%	9.2%

The cost of charity care provided is based on each division's aggregate relationship of costs to charges. The unpaid cost of Medicaid and Medicare services is the cost of treating Medicaid and Medicare patients in excess of government payments. Education includes the unpaid cost of training health professionals, such as medical residents. Research programs include the unpaid cost of controlled studies of therapeutic protocols and development of new treatment protocols. Nonbilled services include the cost of services for which a patient is not billed or for which a nominal fee has been assessed. Negative margin services include programs for which net patient service revenue is less than cost provided to meet a need in the community. Nonbilled and negative margin services benefit the poor and the broader community but are not expected to be financially self-supporting.

Charity care has also been measured in terms of charges forgone for services furnished under the charity care policy. The forgone charges for services to persons unable to pay were \$200,071,000 and \$127,951,000 for the years ended December 31, 2004 and 2003, respectively.

(o) Income Taxes

The Health System and the various corporations within the Health System, except for Providence Assurance Cayman Limited and Lifecare Ventures, are not-for-profit organizations and have been recognized as exempt from federal income taxes, except on unrelated business income, under Section 501(c)(3) of the Internal Revenue Code.

Providence Plan Partners (PPP) is a not-for-profit entity. Management believes that PPP qualifies for exemption from federal income taxes, except on unrelated business income, as a social welfare organization under Section 501(c)(4) of the Internal Revenue Code.

For the taxable corporations, income taxes are accounted for based on the liability method and, accordingly, deferred income taxes are provided to reflect temporary differences between financial and tax reporting. Deferred tax assets and liabilities are measured based on enacted tax laws and

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

rates without anticipation of future changes. The use of the liability method to account for income taxes did not have a material impact on the financial position or results of operations of the Health System as of and for the years ended December 31, 2004 and 2003.

(p) Recently Adopted Accounting Standards

During 2004, the Health System adopted EITF 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (EITF 03-1). EITF 03-1 provides guidance for organizations to determine whether or not an investment has an impairment that is other than temporary and suggested information for disclosure purposes. The Health System's existing policy for analyzing its investment portfolio and determining if other-than-temporary impairment has occurred complies with EITF 03-1, so adoption of this new pronouncement did not have a material impact on the Health System's financial position or results of operations. The Health System did add new disclosures to comply with the requirements of EITF 03-1 as presented in note 3.

In 2003, the Health System adopted SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. The provisions of SFAS No. 146 are effective for exit or disposal activities that are initiated after December 31, 2002. The adoption of SFAS No. 146 did not have a material impact on the Health System's consolidated financial statements.

In 2003, the Health System adopted FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, an interpretation of FASB Statements No. 5, 57, and 107 and a rescission of FASB Interpretation No. 34. The Interpretation clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation. The provisions of the Interpretation are applicable to guarantees issued or modified after December 31, 2002 and did not have a material impact on the Health System's consolidated financial statements.

In December 2003, FASB Statement No. 132 (revised), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, was issued. SFAS No. 132 (revised) prescribes employers' disclosures about pension plans and other postretirement benefit plans; it does not change the measurement or recognition of those plans. The Statement retains and revises the disclosure requirements contained in the original SFAS No. 132. It also requires additional disclosures about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other postretirement benefit plans. The Health System's disclosures in note 6 incorporate these requirements.

(q) Reclassifications

Certain reclassifications have been made to prior year amounts to conform to the current year presentation to more consistently present financial information between years.

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

(3) Investments

Board-Designated Cash and Investments and Funds Held by Trustee

The composition of board-designated cash and investments and funds held by trustee at December 31, 2004 and 2003 is set forth in the following table. Investments are stated at fair value.

	2004	2003
	(In thousands of dollars)	
Board-designated cash and investments:		
Cash and cash equivalents	\$ 86,031	67,026
Government securities	440,465	388,303
Equity securities	531,001	350,345
Fixed income obligations	295,737	290,348
Accrued investment income	5,616	3,510
Total board-designated cash and investments	\$ 1,358,850	1,099,532
Funds held by trustee:		
Cash and cash equivalents	\$ 160,343	141,110
Government securities	42,043	16,445
Equity securities	46,378	51,520
Fixed income obligations	53,701	58,656
Total funds held by trustee	\$ 302,465	267,731

The Health System's funds held by trustee are segregated from other cash and investments for various purposes. Included in funds held by trustee are \$131,529,000 and \$132,755,000 obtained from borrowings under the Health System's master trust indenture for construction and other projects as of December 31, 2004 and 2003, respectively. The Health System holds \$141,221,000 and \$104,555,000 at December 31, 2004 and 2003, respectively, related to the self-insured trusts. The remainder of funds held by trustee are for requirements on the Health System's defined benefit pension plans, borrowing arrangements, and other items.

Investment income from board-designated cash and investments and funds held by trustee are comprised of the following for the years ended December 31, 2004 and 2003:

	2004	2003
	(In thousands of dollars)	
Nonoperating income:		
Interest income	\$ 23,001	15,065
Net realized gains	23,415	19,196
Changes in net assets:		
Change in net unrealized gains/losses on investments	55,509	90,974

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

The following table summarizes the Health System's investments with unrealized losses as of December 31, 2004.

Description of securities	Less than 12 months		12 months or longer		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Bonds and commercial paper	\$ 223,333	(2,603)	106,252	(2,475)	329,585	(5,078)
Equity securities	8,272	(310)	11,708	(1,295)	19,980	(1,605)
Total temporarily impaired securities	\$ 231,605	(2,913)	117,960	(3,770)	349,565	(6,683)

Securities Lending Agreement

The Health System has a securities lending agreement with a financial institution that serves as the lending agent. The agreement authorizes the lending agent to lend securities owned by the Health System to an approved list of borrowers. Under the agreement, the lending agent is responsible for negotiating each loan for an unspecified term while retaining the power to terminate the loan at any time. At the time each loan is made, the lending agent requires collateral equal to 102% of the market value of the loaned securities and accrued interest. The Health System cannot sell or pledge a borrower's collateral; accordingly, the right to receive the collateral and obligation to return it are not recorded in the accompanying consolidated balance sheets. While any securities are loaned, the Health System retains all rights of ownership, except it waives its right to vote such securities. Securities loaned subject to this securities lending agreement totaled \$78,725,000 and \$79,509,000 at December 31, 2004 and 2003, respectively, and are included in assets whose use is limited in the accompanying consolidated balance sheets. The Health System has recorded income related to the securities lending agreement of \$207,000 and \$232,000, which is included in net nonoperating gains in the accompanying consolidated statements of operations for the years ended December 31, 2004 and 2003, respectively.

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

(4) Property, Plant, and Equipment

Property, plant, and equipment and the total accumulated depreciation at December 31, 2004 and 2003 are shown below:

	<u>Approximate useful life (years)</u>	<u>2004</u>	<u>2003</u>
		(In thousands of dollars)	
Land and improvements	5-25	\$ 167,372	146,731
Buildings and improvements	5-40	1,346,676	1,288,767
Equipment:			
Fixed	5-25	449,195	435,970
Major movable and minor	3-20	1,262,912	1,209,073
Rental property	15-40	289,638	278,810
Construction in progress	—	267,380	175,706
		<u>3,783,173</u>	<u>3,535,057</u>
Less accumulated depreciation		<u>2,068,672</u>	<u>1,930,289</u>
Property, plant, and equipment, net		<u>\$ 1,714,501</u>	<u>1,604,768</u>

Construction in progress primarily represents renewal and replacement of various facilities in the Health System's operating divisions.

(5) Long-Term Debt

Long-term debt at December 31, 2004 and 2003 consists of the following:

	<u>2004</u>	<u>2003</u>
	(In thousands of dollars)	
Master trust debt:		
Washington Health Care Facilities Authority, Revenue Bonds, 4.0% to 6.4%, due serially through 2021	\$ 162,070	170,660
Hospital Facility Authority of Clackamas County, Oregon, Hospital Revenue Bonds, interest rate of 1.3% at December 31, 2004, due serially through 2033	213,475	213,475
Hospital Facility Authority of Multnomah County, Oregon, Hospital Revenue Bonds, 3.0% to 5.25%, due serially through 2024	100,000	—
California Health Facilities Financing Authority, Hospital Revenue Bonds, 3.4% to 6.4%, due serially through 2028	103,475	45,175
Alaska Industrial Development and Export Authority, Hospital Revenue Bonds, 3.0% to 5.25%, due serially through 2015	56,495	58,995

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

	2004	2003
	(In thousands of dollars)	
Direct Obligation Bonds, 7.4% to 7.5%, due serially through 2013	\$ 11,075	12,260
Direct Obligation Bonds, 7.5% to 7.7%, due serially through 2017	25,890	27,025
Direct Obligation, Variable Rate Bonds, Series 1999, interest rate of 1.4% at December 31, 2004, due serially through 2013	19,600	29,500
Alaska Industrial Development Authority, Variable Rate Demand Revenue Bonds, Series 1985, interest rate of 1.3% at December 31, 2004, due serially through 2010	4,660	5,210
Washington Health Care Facilities Authority, Variable Rate Demand Revenue Bonds, Series 2001B, interest rate of 1.2% at December 31, 2004, due serially through 2010	46,150	48,650
California Health Facilities Financing Authority, Variable Rate Demand Revenue Bonds, interest rate of 0.9% at December 31, 2004, due serially through 2021	157,400	157,400
US Bank Credit Facility, 3.0% interest rate as of December 31, 2004, due in 2007	9,180	13,260
Total master trust indenture	909,470	781,610
Other debt:		
Hospital Revenue Bonds, Series 1998, 3.5% to 5.0%, due serially through 2028	—	67,840
Mortgages, capital leases, lines of credit, and other	34,698	43,757
Total other debt	34,698	111,597
Loans from affiliate	2,424	2,424
Total long-term debt	946,592	895,631
Less current portion	33,679	35,563
Long-term debt, net of current portion	\$ 912,913	860,068

Providence Health System – Washington; Providence Health System – Oregon (exclusive of Providence Plan Partners); Providence Health System – Southern California (exclusive of Medical Institute of Little Company of Mary; Lifecare Ventures, Inc; and TrinityCare Hospice); and Providence Everett Medical Center, Everett, Washington, exclusive of related housing and foundations, are the members of an Obligated Group formed for issuing debt under a master trust indenture. Members of the Obligated Group are jointly and severally responsible for the debt of the other members of the Obligated Group. The master trust indenture and bond trust indentures for each debt issue require the Obligated Group to meet certain financial covenants.

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

In 2004, the Little Company of Mary Health Services; Bay Harbor Hospital, Inc; Little Company of Mary Hospital; and San Pedro Peninsula Hospital, all divisions of Little Company of Mary Service Area, formerly Little Company of Mary Health Services, were admitted to the Obligated Group. At that time, the California Health Facilities Financing Authority, Hospital Revenue Bonds, Series 1998, became subject to the Master Trust Indenture. These bonds are classified as master trust debt in 2004 and were classified as other debt in 2003.

Long-term debt maturities for the next five years and thereafter are as follows:

	Master Trust	Other	Total
	(In thousands of dollars)		
2005	\$ 31,525	2,154	33,679
2006	36,150	1,825	37,975
2007	34,590	1,823	36,413
2008	33,550	1,906	35,456
2009	35,065	1,946	37,011
Thereafter	738,590	25,044	763,634
	\$ 909,470	34,698	944,168

(a) Leases

The Health System leases various medical and office equipment and buildings under operating leases. Future minimum lease commitments under noncancelable operating leases for the next five years and thereafter are as follows (in thousands of dollars):

2005	\$	26,547
2006		23,681
2007		21,678
2008		15,321
2009		10,879
Thereafter		21,100
	\$	119,206

Rental expense was \$40,101,000 and \$39,624,000 for the years ended December 31, 2004 and 2003, respectively.

(b) Letters of Credit

The Health System has letters of credit with various banks, with the ability to draw up to \$1,142,000 as of December 31, 2004. No amounts had been drawn upon or were outstanding on these letters of credit during 2004 or 2003.

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

(6) Retirement Plans

The Health System has a noncontributory cash balance plan covering substantially all employees. The plan benefits are based on defined average compensation and years of service. The vesting period is five years. The Health System's funding policy is based on the actuarially determined cost method and includes normal service cost and prior service costs amortized over a 20-year period. The cash balance plan meets the definition of a defined benefit plan under SFAS No. 87 *Employers' Accounting for Pensions* (SFAS 87). Under the cash balance plan, each employee carries an individual account balance. The Health System makes a defined, annual contribution and provides a defined interest credit to each employee's account.

The Health System also sponsors the Providence Health System Matching Plan. The plan is a money purchase pension plan which provides for the Health System to make matching contributions to the plan based on employee contributions to the Providence Health System Tax Deferred Annuity Plan. The Matching Plan contribution vesting period is five years.

Expense related to the Health System's contributions for these pension plans for the years ending December 31, 2004 and 2003 were \$76,896,000 and \$61,955,000, respectively.

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

The measurement dates for the defined contribution plan are September 30, 2004 and 2003, respectively. A rollforward of the change in benefit obligation and change in the fair value of plan assets for the defined benefit plans is as follows:

	2004	2003
	(In thousands of dollars)	
Change in benefit obligation:		
Benefit obligation at beginning of year	\$ 1,050,536	898,348
Service cost	66,402	59,186
Interest cost	60,629	58,549
Termination benefits	—	5,980
Curtailment	—	(6,501)
Actuarial (gain) loss	(13,809)	86,478
Benefits paid	(75,568)	(51,504)
Benefit obligation at end of year	\$ 1,088,190	1,050,536
Change in fair value of plan assets:		
Fair value of plan assets at beginning of year	\$ 763,417	660,672
Actual return on plan assets	87,735	116,846
Employer contributions	63,880	37,403
Benefits paid	(75,568)	(51,504)
Fair value of plan assets at end of year	\$ 839,464	763,417
Funded status	\$ (248,726)	(287,119)
Unrecognized net actuarial loss	102,662	106,445
Accrued additional minimum pension liability	48,048	86,289
Fourth quarter contributions	16,870	13,452
Unrecognized prior service cost	22,057	26,545
Net amount recognized	\$ (59,089)	(54,388)
Weighted average assumptions:		
Discount rate	6.00%	6.00%
Rate of increase in compensation levels	4.00	4.00
Long-term rate of return on assets	8.00	8.00

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

Prepaid pension costs are included in other assets and pension liabilities are included in other liabilities on the Health System's consolidated balance sheets. Net periodic pension cost for the defined benefit plans for 2004 and 2003 is included in employee benefits in the accompanying consolidated statements of operations and includes the following components:

	2004	2003
	(In thousands of dollars)	
Components of net periodic pension cost:		
Service cost	\$ 67,687	59,186
Interest cost	60,629	58,549
Expected return on plan assets	(65,771)	(66,246)
Amortization of prior service cost	4,488	4,547
Recognized net actuarial loss	1,923	1,227
Net periodic pension cost	68,956	57,263
Termination benefits	—	5,980
Net loss due to curtailment	—	1,020
Net loss due to settlement	3,043	—
Total benefit cost	\$ 71,999	64,263

At December 31, 2004 and 2003, the Health System's accumulated benefit obligation exceeded the fair value of the plan assets held in the various pension plans by \$144,375,000 and \$180,432,000, respectively. In accordance with SFAS No. 87, the Health System has accrued an additional minimum pension liability and certain other intangible assets to recognize this change in the funded status of the pension plans. The change in the accrual of these amounts on the Health System's consolidated balance sheets resulted in an increase of \$38,241,000 and a decrease of \$17,238,000 to unrestricted net assets in 2004 and 2003, respectively.

The Health System's pension plans' weighted average asset allocations at December 31, 2004 and 2003 by asset category are as follows:

	2004	2003
Asset category:		
Debt securities	21%	20%
Equity securities	74	67
Other	5	13
Total	100%	100%

The expected long-term rate of return on plan assets is the expected average rate of return on the funds invested currently and on funds to be invested in the future in order to provide for the benefits included in the projected benefit obligation. The Health System used 8.00% in calculating the 2004 and 2003 expense amounts. This assumption is based on capital market assumptions and the plan's target asset allocation.

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

The Health System continues to monitor the expected long-term rate of return. If changes in those parameters cause 8.00% to be outside of a reasonable range of expected returns or if actual plan returns over an extended period of time suggest that general market assumptions are not representative of expected plan results, the Health System will change this estimate.

The following pension benefit payments reflect expected future service. Payments expected to be paid over the next ten years are as follows (in thousands of dollars):

2005	\$	76,700
2006		81,070
2007		90,900
2008		97,620
2009		104,820
2010 – 2014		<u>639,930</u>
	\$	<u><u>1,091,040</u></u>

The Health System expects to contribute approximately \$61,892,000 to the defined benefit pension plans in 2005.

Total expense for all of the Health System's retirement programs for the years ending December 31, 2004 and 2003 was \$83,414,000 and \$68,363,000, respectively, and are included in employee benefits in the accompanying consolidated statements of operations. The termination benefits and other costs related to the sale of the PYMC and PTH facilities of \$7,000,000 are included in net nonoperating gains in the consolidated statements of operations for the year ended December 31, 2003, as described in note 1(a).

(7) Fair Value of Financial Instruments

The fair value of board-designated cash and investments, funds held for long-term purposes, and funds held by trustee, which are the amounts reported in the consolidated balance sheets, are estimated based on quoted market prices, when available. For long-term debt, the fair value is estimated based on quoted market prices, when available, or on the discounted value of the future cash flows using current rates for debt with the same remaining maturities, considering the existing call premium and protection. The carrying value and fair value of long-term debt, including accrued interest was \$953,463,000 and \$987,143,000, respectively, for 2004 and \$900,370,000 and \$928,435,000, respectively, for 2003.

Other financial instruments of the Health System include cash and cash equivalents and other receivables. The carrying amount of these instruments approximates fair value because these items mature in less than one year. The carrying amount of other long-term investments, including affiliate, approximates fair value.

(8) Commitments

The Health System has committed to several significant construction projects and other purchase commitments, with an estimated cost of \$231,875,000 remaining to be spent as of December 31, 2004.

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

(9) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes at December 31, 2004 and 2003:

	<u>2004</u>	<u>2003</u>
	(In thousands of dollars)	
Charity care	\$ 10,599	16,306
Program support	40,252	30,549
Low income housing	15,067	15,147
Capital acquisition and other	<u>36,087</u>	<u>32,273</u>
Total temporarily restricted net assets	<u>\$ 102,005</u>	<u>94,275</u>

The Health System's fund-raising foundations have obtained contributions to support the various programs offered by the Health System. Many of these contributions remain temporarily restricted as of December 31, 2004 and 2003 because the time or purpose restrictions stipulated by the donor have not been met. Total fundraising expenses were \$7,194,000 and \$6,142,000 for the years ended December 31, 2004 and 2003, respectively. Generally, program support consists of items that will defray the cost of operating certain patient care activities of the Health System.

Other operating revenues included \$26,416,000 and \$13,388,000 of assets released from restriction for the years ended December 31, 2004 and 2003, respectively.

Income from permanently restricted net assets is restricted primarily for program support.

(10) Litigation and Contingencies

The healthcare industry is subject to numerous laws and regulations from federal, state, and local governments. Compliance with these laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time. Government activity has increased with respect to investigations and allegations concerning possible violations by healthcare providers of regulations which could result in the imposition of significant fines and penalties, as well as significant repayments of patient services previously billed. Institutions within the Health System are subject to similar regulatory reviews.

Management is aware of certain asserted and unasserted legal claims and regulatory matters arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on the Health System's future financial position or results of operations.

The Health System is a defendant in a lawsuit filed in Oregon State Court in Multnomah County, Oregon, alleging that the Health System has charged inflated rates to uninsured patients. The complaint is similar to a number of other lawsuits filed throughout the country in both federal and state courts. The Health System intends to defend itself against these allegations and believes its current and prior practices have been consistent with applicable law. It is uncertain at this time what the implications of this litigation are for the Health System.

PROVIDENCE HEALTH SYSTEM

Notes to Consolidated Financial Statements

December 31, 2004 and 2003

(11) Functional Expenses

The Health System provides healthcare services to residents within its geographic service areas. Expenses related to providing these services for the years ended December 31, 2004 and 2003, are as follows:

	<u>2004</u>	<u>2003</u>
	(In thousands of dollars)	
Healthcare direct expenses	\$ 2,478,097	2,359,110
Healthcare indirect expenses	345,294	349,529
Purchased healthcare expenses	380,750	350,448
General and administrative expenses	<u>630,825</u>	<u>594,628</u>
Total operating expenses	<u>\$ 3,834,966</u>	<u>3,653,715</u>