Sutter Health and Affiliates

Combined Financial Statements

Years Ended December 31, 1998 and 1997

Contents

Audited Combined Financial Statements

Report of Independent Auditors

The Board of Directors
Sutter Health and Affiliates

We have audited the accompanying combined balance sheets of Sutter Health and Affiliates as of December 31, 1998 and 1997, and the related combined statements of operations and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of Sutter Health and Affiliates' management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the combined financial position of Sutter Health and Affiliates at December 31, 1998 and 1997, and the combined results of their operations and changes in their net assets, and their cash flows for the years then ended in conformity with generally accepted accounting principles.

Ernst + Young LLP

March 5, 1999

Sutter Health and Affiliates

Combined Balance Sheets

(In Thousands)

	December 31, 1998	December 31, 1997
Assets		
Current assets:		
Cash and equivalents	**$ 105,904**	$ 93,832
Short-term investments	**263,863**	355,714
Patient accounts receivable (less allowance for doubtful accounts of $69,122 in 1998 and $75,864 in 1997)	**467,081**	394,731
Other receivables	**90,595**	99,044
Inventories	**35,610**	32,454
Other current assets	**18,099**	23,264
Total current assets	**981,152**	999,039
Non-current investments	**638,446**	522,186
Property, plant and equipment, net	**1,374,770**	1,197,129
Other assets:		
Goodwill, net	**40,530**	44,854
Prepaid rent	**21,581**	23,368
Unamortized financing costs	**21,800**	19,136
Investments in health care-related businesses	**10,753**	9,861
Other	**68,094**	51,113
	162,758	148,332
	$ 3,157,126	$ 2,866,686
Liabilities and net assets		
Current liabilities:		
Short-term borrowings	**$ 43,757**	$ 70,000
Current maturities of long-term obligations	**25,918**	27,719
Accounts payable and accrued expenses	**423,084**	403,945
Estimated third-party settlements	**99,168**	82,176
Total current liabilities	**591,927**	583,840
Non-current liabilities:		
Long-term obligations, less current maturities	**1,112,175**	938,775
Other	**129,648**	111,769
Net assets:		
Unrestricted	**1,096,233**	1,032,139
Temporarily restricted	**197,255**	172,734
Permanently restricted	**29,888**	27,429
	1,323,376	1,232,302
	$ 3,157,126	$ 2,866,686

See accompanying notes.

Sutter Health and Affiliates

Combined Statements of Operations and Changes in Net Assets

(In Thousands)

	Years Ended December 31, 1998	1997
Unrestricted net assets:		
Unrestricted revenues, gains and other support:		
Patient service revenues	**$ 2,010,108**	$ 1,810,242
Capitation revenues	**487,013**	463,906
Premium revenues	**177,225**	168,847
Other revenues	**207,034**	220,269
Total revenues	**2,881,380**	2,663,264
Operating expenses:		
Salaries and employee benefits	**1,287,370**	1,174,891
Purchased services	**557,761**	528,661
Supplies	**344,159**	319,315
Depreciation and amortization	**145,962**	129,437
Capitated purchased services	**124,900**	109,658
Provision for bad debts	**93,928**	80,278
Rentals and leases	**54,808**	52,008
Interest	**54,634**	50,052
Insurance	**15,668**	13,238
Other	**152,958**	138,580
Total operating expenses	**2,832,148**	2,596,118
Income from operations	**49,232**	67,146
Unusual charges and other	**(10,653)**	(7,122)
Income	**38,579**	60,024

Sutter Health and Affiliates

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

(In Thousands)

	Years Ended December 31, 1998	1997
Unrestricted net assets (Continued):		
Income (page 3)	**$ 38,579**	$ 60,024
Change in net unrealized gains and losses on	**14,769**	1,881
investments		
Net assets released from restrictions for equipment	**12,312**	13,486
acquisition	**2,724**	432
Donated equipment	**(4,290)**	(3,177)
Other		
Increase in unrestricted net assets before extraordinary		
item	**64,094**	72,646
Extraordinary loss from extinguishment of debt	**–**	(8,714)
Increase in unrestricted net assets	**64,094**	63,932
Temporarily restricted net assets:		
Contributions	**59,521**	41,789
Investment income	**10,118**	20,629
Change in net unrealized gains and losses on	**7,323**	3,079
investments	**(50,876)**	(47,692)
Net assets released from restrictions	**(1,565)**	(1,790)
Other		
Increase in temporarily restricted net assets	**24,521**	16,015
Permanently restricted net assets:		
Contributions	**2,207**	658
Change in net unrealized gains and losses on	**(35)**	491
investments	**302**	469
Investment gains contributed to capital	**(15)**	86
Other		
Increase in permanently restricted net assets	**2,459**	1,704
Increase in net assets	**91,074**	81,651
Net assets, beginning of year	**1,232,302**	1,150,651
Net assets, end of year	**$ 1,323,376**	$ 1,232,302

See accompanying notes.

Sutter Health and Affiliates

Combined Statements of Cash Flows

(In Thousands)

	Years Ended December 31, 1998	1997
Operating activities		
Change in net assets	**$ 91,074**	$ 81,651
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Extraordinary loss from extinguishment of debt	**–**	8,714
Depreciation and amortization	**145,962**	129,437
Change in net unrealized gains and losses on investments	**(22,057)**	(5,451)
Provision for bad debts	**93,928**	80,278
Increase in professional liability reserves	**3,701**	5,513
Equity in earnings on investments in health care-related businesses	**(4,772)**	(4,931)
Loss from impairment of long-lived assets	**10,350**	5,243
Increase (decrease) in other non-current liabilities	**14,524**	(1,774)
Restricted contributions and investment income	**(2,509)**	(1,127)
Other	**1,182**	(3,281)
Net changes in operating assets and liabilities:		
Patient accounts receivable and other receivables	**(139,413)**	(160,454)
Inventories and other assets	**4,863**	(10,123)
Accounts payable, accrued expenses and estimated third-party settlements	**15,381**	44,096
Net cash provided by operating activities	**212,214**	167,791
Investing activities		
Payments for business acquisitions, net of cash and equivalents acquired	**(93,686)**	–
Purchases of property, plant and equipment	**(230,966)**	(200,741)
Purchases and sales or maturities of investments, net	**(2,352)**	(60,789)
Purchases of investments in health care-related businesses	**(134)**	(219)
Proceeds from sale of investments in health care-related businesses	**4,457**	6,242
Other	**(20,815)**	29,221
Net cash used in investing activities	**(343,496)**	(226,286)

Sutter Health and Affiliates

Combined Statements of Cash Flows (Continued)

(In Thousands)

	Years Ended December 31, 1998	1997
Financing activities		
Net increase (decrease) in short-term borrowings	**$ (26,243)**	$ 58,000
Payments of long-term obligations	**(96,667)**	(99,030)
Payments for legal defeasance of bonds	**–**	(112,528)
Proceeds from long-term obligations	**267,670**	171,529
Bond issuance costs and discount	**(3,915)**	(4,676)
Proceeds from restricted contributions and investment income	**2,509**	1,127
Net cash provided by financing activities	**143,354**	14,422
Net increase (decrease) in cash and equivalents	**12,072**	(44,073)
Cash and equivalents at beginning of year	**93,832**	137,905
Cash and equivalents at end of year	**$ 105,904**	$ 93,832
Supplementary disclosures of cash flow information and schedule of noncash investing and financing activities:		
Cash paid during the year for interest (net of capitalized interest costs of $10,381 in 1998 and $5,325 in 1997)	**$ 38,717**	$ 44,557
Noncash investing and financing activities:		
Assets acquired ($114,403 in 1998 and $17,848 in 1997) in excess of liabilities assumed ($20,717 in 1998 and $4,327 in 1997) in connection with business acquisitions accounted for as purchases, excluding cash and equivalents	**$ 93,686**	$ 13,521

See accompanying notes.

1. ORGANIZATION

Organization: Sutter Health is a California nonprofit multi-provider integrated health care delivery system headquartered in Sacramento, California which includes a centralized support group and various health care-related businesses operating in two divisions and seven service areas, principally in Northern California.

Sutter Health and its support affiliates and subsidiaries provide the following services: health care, research, education, administration and consulting. Sutter Health’s non-exempt subsidiaries operate a health maintenance organization, health insurance plans, third-party claims administrators and other health care-related services.

Affiliates in the Eastern and Western divisions include acute care and psychiatric hospitals, skilled nursing facilities, medical foundations, fundraising foundations, and a variety of other specialized health care service providers. The acute care hospitals provide a full range of medical services (e.g., surgical, intensive care, emergency room and obstetrics). All emergency rooms provide emergency care, regardless of a patient’s ability to pay. Sutter Health and its affiliates also serve their communities with programs including health education, health libraries, school-based clinics, home health care, hospice care, adult day care, prenatal clinics, community clinics and immunization services.

2. ACCOUNTING POLICIES

Basis of Combination: The combined financial statements include the accounts of Sutter Health and affiliated corporations and subsidiaries (“Sutter”). All significant intercompany accounts and transactions have been eliminated in combination.

Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Cash Equivalents: Cash equivalents represent all highly liquid investments, including money market accounts. Financial instruments that potentially subject Sutter to concentrations of credit risk include cash equivalents and investments. Sutter places certain of its cash in banks that are federally insured in limited amounts and in investment-grade debt instruments, many of which are backed by the U.S. Government or other government agencies. Cash equivalents are stated at fair market value.

2. ACCOUNTING POLICIES (Continued)

Investments: Investments consist principally of corporate notes and stocks, and U.S. Government and agency securities, all of which are other than trading and carried at fair market value. Certain investments are designated as assets held in trust. These include assets held by trustees in accordance with the indentures relating to long-term obligations and assets set aside in accordance with self-insurance requirements. In addition, certain investments are set aside by the appropriate governing boards for future capital improvements.

Patient Accounts Receivable: Sutter's primary concentration of credit risk is patient accounts receivable, which consist of amounts owed by various governmental agencies, insurance companies and private patients. Sutter manages the receivables by regularly reviewing its accounts and contracts and by providing appropriate allowances for uncollectible amounts. Significant concentrations of gross fee-for-service patient accounts receivable were as follows:

	December 31,	
	1998	**1997**
Medicare	20%	20%
Medi-Cal	17%	16%

Inventories: Inventories, which consist principally of medical supplies, are stated on the basis of cost determined by the first-in, first-out method, which is not in excess of market.

Property, Plant and Equipment: Property, plant and equipment are stated on the basis of cost, or in the case of donated items, on the basis of fair market value at the date of donation, less any impairment write-downs. Routine maintenance and repairs are charged to expense as incurred. Expenditures that increase values, change capacities or extend useful lives are capitalized, as is interest on amounts borrowed to finance such expenditures.

Depreciation is computed by the straight-line method over the estimated useful lives of the assets, which range from 3 to 40 years for buildings and improvements and leasehold improvements, and from 3 to 20 years for equipment. Amortization of equipment under capital leases is included in depreciation expense.

2. ACCOUNTING POLICIES (Continued)

The application of Statement of Financial Standards ("SFAS") No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" resulted in unusual charges to Sutter's 1998 and 1997 operations of $10,350 and $5,243, respectively, related to long-lived assets held and used in operations and long-lived assets designated for sale. As of December 31, 1998, assets to be disposed of and sold in 1999 included certain parcels of land and a medical office building whose aggregate carrying value was $6,830. As of December 31, 1997, assets to be disposed of included certain parcels of land, hospital and medical office buildings, long-term care facilities and a laundry operation whose aggregate carrying value was $23,907. Certain medical office buildings held and used in operations were determined to be impaired as of December 31, 1998 and 1997 due to high vacancy factors. The fair market values of these assets, and resultant impairment losses, were calculated based on discounted cash flow analyses or independent appraisals.

Other Assets: Goodwill represents the excess of purchase price over the fair market value of net assets acquired and is being amortized over periods ranging from 5 to 20 years using the straight-line method. Realization of Sutter's net goodwill balance of $40,530 as of December 31, 1998 is dependent on generating sufficient operating cash flows at certain affiliates to which such balance relates. Based on current estimates, management believes that it is more likely than not that Sutter's goodwill will be realized. The amount of goodwill considered realizable, however, could be revised in the near term if estimates of future operating cash flows are reduced. Unamortized financing costs associated with the issuance of long-term obligations are amortized ratably over the term of the respective obligations. Sutter has minority interests in various health care-related businesses. The majority of these investments are accounted for on the equity method and the assets, liabilities and results of operations of these unconsolidated investees are not material to Sutter's combined financial statements.

Risk Management: Sutter maintains several self-insured medical and other benefit plans for certain employees and is self-insured for workers' compensation for certain affiliates. Also, certain affiliates of Sutter participate in wholly owned self-insured captives for professional liability claims and comprehensive general liability. In addition, certain affiliates of Sutter purchase (i) workers' compensation insurance coverage with nominal or no deductibles and (ii) professional liability insurance coverage using both claims-made and modified occurrence-basis policies. The modified occurrence-basis policies include prepaid tail coverage for seven years. The provisions for estimated workers' compensation, professional liability and comprehensive general liability claims include estimates of the ultimate costs for both reported claims and claims incurred but not reported, in accordance with actuarial projections based on past experience. Such claim reserves are based on the best data available to Sutter; however, in some cases, because of

2. ACCOUNTING POLICIES (Continued)

the lack of historical experience, these estimates are subject to a significant degree of inherent variability. Such estimates are continually monitored and reviewed, and as reserves are adjusted, the differences are reflected in current operations. While the ultimate amount of workers' compensation, professional liability and general liability claims is dependent on future developments, management is of the opinion that the associated liabilities recognized in the accompanying combined financial statements are adequate to cover such claims. Sutter has entered into reinsurance agreements with independent insurance companies to limit its losses on workers' compensation, professional liability and comprehensive general liability claims. Reserves for reported and incurred but not reported professional liability claims, which are discounted using rates of 4% and 6% as of December 31, 1998 and 1997, respectively, amount to $41,230 and $36,767 as of December 31, 1998 and 1997, respectively. Management is aware of no potential professional liability claims whose settlement, if any, would have a material adverse effect on Sutter's combined financial position.

Other Liabilities: Other non-current liabilities consist primarily of insurance liabilities, including an estimated liability for professional liability losses, estimated liability for prepaid health care services and referral claims, minority interests in net assets of subsidiaries, and obligations to return assets to local hospital districts. Reserves related to claims involving prepaid health care services provided by Sutter's majority-owned Health Maintenance Organization ("HMO"), Omni Healthcare, Inc. ("Omni"), are continually monitored and reviewed, and as reserves are adjusted, the differences are reflected in current operations. While the ultimate amount of health care expenses is dependent on future developments, management is of the opinion that the liability for health care claims payable (which is included in accounts payable and accrued expenses) recognized in the accompanying combined financial statements is adequate to cover such expenses.

Net Assets: All resources that are not restricted by donors are included in unrestricted net assets. Resources temporarily restricted by donors for specific purposes are reported as temporarily restricted net assets. When the specific purposes are achieved, either through passage of a stipulated time or the purpose for restriction is accomplished, they are reclassified to unrestricted net assets and reported as such in the combined statement of operations and changes in net assets. Resources temporarily restricted by donors for additions to land, buildings and equipment are initially reported as temporarily restricted net assets and are transferred to unrestricted net assets when expended. Donor-imposed restrictions which stipulate that the resources be maintained permanently are reported as permanently restricted net assets. Investment income for these permanently restricted net assets is classified as either temporarily restricted or unrestricted based on the intent of the donor, or is added to the balance if required by the donor.

(Dollars in Thousands)

2. ACCOUNTING POLICIES (Continued)

Temporarily restricted and permanently restricted net assets were maintained for the following purposes as determined by management:

	December 31, 1998	December 31, 1997
Temporarily restricted:		
Capital projects, medical equipment and services	**$ 50,628**	$ 65,302
Time restricted under annuity trust agreements	**8,987**	22,417
Rehabilitation medicine	**11,151**	13,865
Community benefit	**97,308**	32,537
Research and education	**29,181**	38,613
	$ 197,255	$ 172,734
Permanently restricted - Endowment	**$ 29,888**	$ 27,429

Donor Gifts: Unconditional promises to give cash and other assets are reported at fair market value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair market value at the date the gift is received (however, such amounts were not material at December 31, 1998 and 1997 and, accordingly, are not disclosed).

As of December 31, 1998, aggregate pledges receivable consisted of the following unconditional promises to give:

Pledges due in 1999	$ 14,161
Pledges due 2000-2003	13,981
Pledges due after 2003	18,194
Less allowance for uncollectible pledges	(2,914)
	$ 43,422

Gifts of long-lived operating assets such as land, buildings, or equipment are reported as unrestricted support and excluded from income, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated long-lived assets are acquired and placed in service.

2. ACCOUNTING POLICIES (Continued)

Patient Service Revenues: Patient service revenues are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement programs with third-party payors. Estimated settlements under third-party reimbursement programs are accrued in the period the related services are rendered and adjusted in future periods, primarily as a result of final settlements.

Capitation Revenues: Sutter has agreements with various HMOs to provide medical services to subscribing participants. Under these agreements, Sutter receives monthly capitation payments based on the number of each HMO's participants, regardless of services actually performed by Sutter. Certain of these agreements also contain risk sharing provisions whereby additional amounts may be due or paid.

Premium Revenues: Premiums generated by Omni are recorded as revenue in the month for which enrollees are entitled to health care services. Premium revenue billed and/or collected in advance is deferred as unearned premium revenue, which is included in accrued expenses in the accompanying combined balance sheets. A portion of premiums is subject to possible retroactive adjustment. Provisions have been made for estimated retroactive adjustments to the extent the probable outcome of such adjustments can be determined.

Charity Care: Sutter provides medically necessary care to all patients who meet certain criteria under its charity care policy regardless of the patient's ability to pay.

Performance Indicator: "Income" as reflected in the accompanying combined statements of operations and changes in net assets is a performance indicator. Income includes all changes in unrestricted net assets other than contributions of long-lived assets, unrealized gains and losses on investments, investment returns restricted by donors, extraordinary items and minimum pension liabilities. Unusual charges consist principally of losses from impairment of long-lived assets.

Income Taxes: Sutter Health and most of its affiliates have been determined to be exempt organizations by the Internal Revenue Service, pursuant to Internal Revenue Code Section 501(c)(3), and the California Franchise Tax Board and, generally, are not subject to taxes on income. Certain support activities of Sutter are subject to income taxes; however, such activities are not significant to the combined financial statements. With respect to its for-profit subsidiaries and taxable activities, Sutter records income taxes using the liability method under which deferred tax assets and liabilities are

2. ACCOUNTING POLICIES (Continued)

determined based on the differences between the financial accounting and tax bases of assets and liabilities. Deferred tax assets or liabilities at the end of each period are determined using the currently enacted tax rate expected to apply to taxable income in the periods in which the deferred tax asset or liability is expected to be realized or settled.

Fair Values of Financial Instruments: The methods and assumptions used by Sutter in estimating its financial instrument fair value disclosures, as well as the resultant amounts, are as indicated in Notes 4 and 6.

Adoption of New Accounting Pronouncements: In 1998, Sutter adopted the American Institute of Certified Public Accountants' ("AICPA") Statement of Position ("SOP") 98-1, "Accounting For the Costs of Computer Software Developed For or Obtained For Internal Use." SOP 98-1 requires the capitalization of certain costs incurred after the date of adoption in connection with developing or obtaining software for internal use. The adoption of SOP 98-1 did not have a material impact on Sutter's combined financial position.

In 1998, Sutter also retroactively adopted Statement of Financial Accounting Standards ("SFAS") No. 132, "Employers' Disclosures About Pensions and Other Postretirement Benefits." The adoption of SFAS No. 132 had no impact on Sutter's combined financial statements; however, refer to Note 10 for the revised disclosures that resulted from the retroactive adoption of this pronouncement.

Adoption of New Accounting Pronouncements in the Future: In 1998, the AICPA issued SOP 98-2, "Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Government Entities That Include Fund Raising" and SOP 98-5, "Reporting on the Costs of Start-Up Activities", and the Financial Accounting Standards Board issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." Sutter will adopt SOP 98-2 and SOP 98-5 in 1999 and SFAS No. 133 in 2000. Management does not believe that the adoption of these pronouncements will have a material impact on Sutter's combined financial position.

3. BUSINESS COMBINATIONS

On July 30, 1998, Sutter acquired specified assets and assumed certain liabilities and other obligations from Davies Medical Center ("DMC") in a transaction accounted for as a purchase. The aggregate purchase price consisted of $28,935 in cash and the assumption of certain liabilities aggregating $2,867, plus transaction costs incurred by Sutter. The acquired assets and liabilities of DMC have been adjusted to their estimated fair values as of the date of acquisition. Concurrent with this purchase transaction, DMC's sole corporate member (Franklin Holding Corporation) agreed to provide Sutter with specified annual cash gifts during a prescribed period. Such annual cash gifts constitute time conditioned, temporarily restricted pledges, the net present value of which ($17,472) Sutter recognized as pledges receivable and temporarily restricted net assets in 1998.

On January 15, 1998, Sutter acquired specified assets and assumed certain liabilities of Eden Township Hospital District (the "District") in a transaction accounted for as a purchase. Consideration for this purchase included fixed cash payments to either the District or its bond trustee aggregating $64,751, certain variable cash payments to the District aggregating $10,000 (which are payable in annual installments based on the operating income of the hospitals acquired from the District by Sutter) and the assumption of certain liabilities of the District aggregating $17,850, plus transaction costs incurred by Sutter. The net present value of the aforementioned variable cash payments is indeterminate. Therefore, if such payments are made in future periods, they will be capitalized as additions to buildings (to the extent of their respective fair values at the date of acquisition) or goodwill and amortized on a straight-line basis over the remainder of the original estimated useful lives. Under the terms of the acquisition agreement, Sutter was also required to legally defease (using a portion of the aforementioned fixed cash payments) certain long-term obligations of the District aggregating $34,751. The acquired assets and liabilities of the District have been adjusted to their estimated fair values as of the date of acquisition.

On January 1, 1997, Sutter acquired the adjusted net working capital and certain equipment of Merced Community Medical Center ("MCMC") (Sutter is leasing the related hospital facility pursuant to an operating lease agreement - Note 7) in a transaction accounted for as a purchase. The aggregate purchase price consisted of $23,016 in cash and the assumption of a long-term obligation of $3,399, plus transaction costs incurred by Sutter. The acquired assets and liabilities of MCMC have been adjusted to their estimated fair values as of the date of acquisition.

(Dollars in Thousands)

4. INVESTMENTS

Investments are held for the following uses:

	December 31, 1998	1997
Assets held in trust:		
Principal, interest and other reserves held in trust under bond indentures	**$ 177,859**	$ 114,457
Other	**8,314**	7,146
Board designated funded depreciation and other internal designations	**433,279**	372,707
Investments	**282,857**	383,590
	902,309	877,900
Less current portion	**(263,863)**	(355,714)
	$ 638,446	$ 522,186

Investments consist of the following:

	December 31, 1998		1997	
	Cost	Fair Market Value	Cost	Fair Market Value
Money market funds and other cash equivalents	**$ 127,420**	**$ 127,420**	$ 152,982	$ 152,982
U.S. Government and agency securities	**301,953**	**298,102**	380,677	378,231
Corporate debt securities	**259,025**	**262,979**	175,647	176,736
Marketable equity securities	**154,785**	**213,808**	131,525	169,951
	$ 843,183	**$ 902,309**	$ 840,831	$ 877,900

The fair market values for investments listed above are based on quoted market prices.

(Dollars in Thousands)

4. INVESTMENTS (Continued)

Investment income is comprised of the following elements:

	Years Ended December 31, 1998	1997
Interest and dividends	**$ 48,687**	$ 50,003
Realized gains on sales of securities	**12,281**	30,912
	60,968	80,915
Less amounts included in changes in restricted net assets	**(10,420)**	(21,098)
Amounts included in income	**50,548**	59,817
Less interest earned on unspent bond project funds	**(4,101)**	(999)
	$ 46,447	$ 58,818

Sutter uses the specific identification method to compute realized gains and losses on U.S. Government and agency securities and corporate debt securities. Sutter uses the average cost method to compute realized gains and losses on marketable equity securities. Marketable equity securities are primarily held for endowments and future capital improvements.

5. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of the following:

	December 31, 1998	1997
Land improvements	**$ 45,164**	$ 42,629
Leasehold improvements	**192,837**	171,155
Buildings and improvements	**907,742**	749,580
Equipment	**1,029,363**	1,044,491
	2,175,106	2,007,855
Less accumulated depreciation and amortization	**(1,166,135)**	(1,042,736)
	1,008,971	965,119
Land	**106,002**	86,181
Land held for expansion	**91**	4,767
Construction-in-progress (Note 13)	**259,706**	141,062
	$1,374,770	$1,197,129

(Dollars in Thousands)

6. LONG-TERM OBLIGATIONS

Long-term obligations consist of the following:

	December 31, 1998	December 31, 1997
Hospital revenue bonds and Certificates of Participation under the Sutter Health Master Indenture of Trust:		
1989 Series A, interest at 6.8% to 7.0%, due 2013 (net of discount of $2,104 and $2,254 at December 31, 1998 and 1997, respectively)	**$ 87,331**	$ 90,566
1989 Series A Roseville Financing Authority, variable interest at 2.9% to 4.5%, due 2014	**24,600**	25,500
1990 Series A and B, variable interest at 2.9% to 4.1%, due 2020	**38,000**	38,800
1991 Series A and B, variable interest at 3.1% to 4.4%, due 2021	**31,383**	31,383
1992 Certificates of Participation, interest at 5.1% to 6.1%, due 2022 (net of discount of $1,042 and $1,090 at December 31, 1998 and 1997, respectively)	**62,638**	63,815
1993 Certificates of Participation, interest at 4.5% to 5.5%, due 2023 (net of discount of $2,472 and $2,623 at December 31, 1998 and 1997, respectively)	**102,683**	104,587
1995 Certificates of Participation, interest at 4.8% to 6.0%, due 2025 (net of discount of $3,348 and $3,432 at December 31, 1998 and 1997, respectively)	**134,072**	136,239
1996 Series A, interest at 4.5% to 5.9%, due 2016 (net of discount of $543 and $605 at December 31, 1998 and 1997, respectively)	**47,797**	49,350
1996 Series B, variable interest at 4.9% to 5.7%, due 2012	**42,500**	42,500
1996 Series C, variable interest at 2.4% to 4.6%, due 2022	**43,100**	43,100
1997 Series A, interest at 4.0% to 5.3%, due 2027 (net of discount of $851 and $880 at December 31, 1998 and 1997, respectively)	**36,374**	36,925
1997 Series C, interest at 4.0% to 5.5%, due 2022 (net of discount of $619 and $640 at December 31, 1998 and 1997, respectively)	**85,606**	88,020

(Dollars in Thousands)

6. LONG-TERM OBLIGATIONS (Continued)

	December 31, 1998	1997
1998 Series A, interest at 5.0% to 5.4%, due 2037 (net of discount of $604 at December 31, 1998)	**174,396**	–
Hospital revenue bonds under the California Pacific Medical Center ("CPMC") Master Indenture of Trust:		
1990 Series A, interest at 6.6% to 7.0%, due 2015	**9,485**	9,775
1993 Series A, interest at 5.1% to 5.9%, due 2014 (net of discount of $966 and $1,065 at December 31, 1998 and 1997, respectively)	**34,464**	35,725
1995 Series A and B, interest at 4.7% to 6.0%, due 2015 (net of discount of $794 and $844 at December 31, 1998 and 1997, respectively)	**64,246**	65,186
Hospital revenue bonds through the City of Modesto:		
1982, variable interest based on daily rate (3.7% at December 31, 1998), due 2012	**4,350**	4,350
1993, interest at 4.8% to 6.0%, due 2018 (net of discount of $368 and $387 at December 31, 1998 and 1997, respectively)	**15,617**	16,413
1997 Series B, interest at 4.0% to 5.3%, due 2021 (net of discount of $323 and $469 at 1998 and 1997, respectively)	**18,432**	18,286
Hospital Revenue Bonds through the County of Merced:		
1985 Series B, variable interest based on daily rate (2.7% at December 31, 1998), due 2008	**2,796**	3,097
Borrowings under revolving credit, competitive advance and short-term loan placement facilities, as described below	**56,243**	30,000
Various collateralized and unsecured obligations	**18,460**	25,045
Obligations under capital leases	**3,520**	7,832
	1,138,093	966,494
Less current maturities	**(25,918)**	(27,719)
	$1,112,175	$ 938,775

6. LONG-TERM OBLIGATIONS (Continued)

The aggregate fair market values of Sutter's short-term borrowings and long-term obligations at December 31, 1998 and 1997 of $1,226,000 and $1,081,747, respectively, were established using discounted cash flow analyses based on (i) the current market yield to maturity for similar types of publicly traded debt issues and (ii) Sutter's current incremental borrowing rates for all other debt instruments.

Certain affiliates of Sutter are members of the Obligated Groups of Sutter Health and CPMC. In addition, the assets of certain affiliates of Sutter are subject to the indebtedness of the Obligated Groups of Sutter Health and CPMC.

The Obligated Groups of Sutter Health and CPMC are not legal entities. However, under the terms of the California Health Facilities Financing Authority ("CHFFA") and California Statewide Communities Development Authority bonds, members of the two Obligated Groups are jointly and severally liable for the bonds. The related financing documents and various other debt agreements contain certain restrictive covenants requiring compliance by all members, including pledges of gross revenues.

During 1998, Eden Medical Center joined the Obligated Groups of Sutter Health and CPMC.

During 1997, the following entities joined the Obligated Groups of Sutter Health and CPMC: Alta Bates Medical Center ("ABMC"); Visiting Nurses Association & Hospice of Northern California; Berkeley Long-Term Care Company; Memorial Hospitals Association, Memorial Hospital Los Banos; Novato Community Hospital; Sutter Medical Center of Santa Rosa; and Sutter Amador Hospital. Also in 1997, California Pacific Funds Corporation withdrew from the Obligated Groups of Sutter Health and CPMC.

(Dollars in Thousands)

6. LONG-TERM OBLIGATIONS (Continued)

In August and September 1997, Sutter issued $145,220 in Insured Revenue Bonds, Series 1997 A, B and C, all of which are fixed rate bonds. The proceeds of these borrowings were used to legally defease the City of Modesto Health Facility Revenue Bonds (Memorial Hospitals Association) Series 1991 A, the City of Modesto Capital Appreciation Health Facility Revenue Bonds (Memorial Hospitals Association) Series 1991 B and the City of Berkeley Health Facility Refunding Revenue Bonds (Alta Bates Medical Center) Series 1992 A. As a result of these defeasance transactions, Sutter was legally relieved of its obligations under the respective bond indentures and, accordingly, it recognized an extraordinary loss of $8,714 in 1997.

Sutter has entered into interest rate swap agreements with aggregate notional principal amounts of $436,400 and $136,400 at December 31, 1998 and 1997, respectively. Such swap agreements were used to convert fixed or variable interest rates on long-term obligations to variable rates ranging from 4.00% to 5.20% and fixed rates ranging from 5.04% to 5.10% at December 31, 1998. Under the terms of the swap agreements, Sutter pays the agreed-upon variable or fixed interest rates and receives fixed or variable payments equal to the interest rates on the respective long-term obligations. At December 31, 1998 and 1997, the aggregate fair market values of the swaps were net receivables (payables) of $2,277 and $(4,295), respectively. The interest rate differential to be received or paid is recognized over the terms of the swap agreements (which expire between 2000 and 2015) as an adjustment of interest expense.

Aggregate maturities of long-term obligations, excluding capital leases and bond discounts, are as follows as of December 31, 1998:

1999	$ 24,810
2000	26,853
2001	80,102
2002	29,098
2003	93,302
Thereafter	894,442
	$1,148,607

(Dollars in Thousands)

6. LONG-TERM OBLIGATIONS (Continued)

Sutter has a $100,000 revolving line of credit and competitive advance facility, as well as a $50,000 short-term loan placement facility with a bank and other entities under which $100,000 has been borrowed in total as of both December 31, 1998 and 1997. $43,757 and $70,000 of such borrowings outstanding as of December 31, 1998 and 1997, respectively, were repaid using existing working capital in January 1999 and 1998, respectively, and, accordingly, such borrowings are classified as current liabilities in the accompanying combined balance sheets as of December 31, 1998 and 1997. All other borrowings under these credit facilities have been excluded from current liabilities because Sutter intends that such amounts will remain outstanding under such credit facility (which expires December 27, 2001) for an uninterrupted period extending beyond one year from the respective balance sheet dates, except for amounts repaid using (i) the proceeds of new long-term obligations, (ii) the proceeds from the liquidation of non-current investments or (iii) working capital provided by operations subsequent to the respective balance sheet dates.

7. LEASES

Sutter leases various land, buildings, office space, and equipment. The leases expire at various times and contain certain contingent rental provisions, guarantees and various renewal options. These leases are classified as either capital leases (which are not material as of December 31, 1998) or operating leases based on the terms of the respective agreements.

Certain of the aforementioned operating leases relate to acute care facilities leased from various municipalities. Such operating lease agreements require Sutter to make specified capital improvements to the municipalities' facilities at various times.

Future minimum payments (net of income from subleases), by year and in the aggregate, under noncancellable operating leases with terms of one year or more consist of the following as of December 31, 1998:

1999	$ 32,841
2000	27,425
2001	24,486
2002	20,172
2003	14,384
Thereafter	72,530
	$ 191,838

(Dollars in Thousands)

8. PATIENT SERVICE AND MANAGED CARE REVENUES

Sutter has agreements with third-party payors that provide for payments to Sutter at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

- *Medicare* - Inpatient acute care services rendered to Medicare program beneficiaries are paid at prospectively determined rates per diagnosis. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Inpatient nonacute services, certain outpatient services and medical education costs related to Medicare beneficiaries are paid based on a cost reimbursement methodology. Sutter is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by Sutter and audits thereof by the Medicare fiscal intermediary. Sutter's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review. Sutter's Medicare cost reports have been audited by the Medicare fiscal intermediary through December 31, 1996.

- *Medi-Cal* - Inpatient and outpatient services rendered to Medi-Cal program beneficiaries are reimbursed either under contracted rates or reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by Sutter and audits thereof by Medi-Cal. Sutter's Medi-Cal cost reports have been audited by the Medi-Cal fiscal intermediary through December 31, 1996.

- Adjustments from finalization of prior-year cost reports from both Medicare and Medi-Cal resulted in increases in patient service revenues of approximately $11,000 and $17,000 for the years ended December 31, 1998 and 1997, respectively.

Gross patient charges, including charges related to capitated patients, from the Medicare and Medi-Cal programs accounted for the following percentages of Sutter's gross patient service revenues:

	Years Ended December 31,	
	1998	**1997**
Medicare	35%	35%
Medi-Cal	13%	14%

8. PATIENT SERVICE AND MANAGED CARE REVENUES (Continued)

Laws and regulations governing the Medicare and Medi-Cal programs are complex and subject to interpretation. Sutter believes that it is in compliance with all applicable laws and regulations and is not aware of any significant pending or threatened investigations involving allegations of potential wrongdoing. While no such significant regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medi-Cal programs.

Sutter also has entered into payment agreements with certain commercial insurance carriers, HMOs and preferred provider organizations. The basis for payment to Sutter under these agreements includes capitated arrangements, prospectively determined rates per diagnosis, discounts from established charges, and prospectively determined daily rates.

9. UNSPONSORED COMMUNITY BENEFIT EXPENSE (UNAUDITED)

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

	Years Ended December 31,	
	1998	**1997**
Services for the poor and underserved	**$ 128,697**	$ 127,420
Benefits for the broader community	**79,367**	74,487
	$ 208,064	$ 201,907

Services for the poor and underserved include services provided to persons who cannot afford health care because of inadequate resources and/or are uninsured or underinsured. Inadequate income is based on local criteria.

Benefits for the broader community include the unpaid cost of treating the elderly, providing health screenings and other health-related services, training health professionals, educating the community with various seminars and classes and the cost of performing medical research.

(Dollars in Thousands)

10. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS

Sutter sponsors or participates in various employee benefit plans, including noncontributory defined benefit plans and several contributory defined contribution plans. Sutter's total retirement benefit expense was $17,379 and $18,718 for the years ended December 31, 1998 and 1997, respectively.

The changes in benefit obligations and plan assets for Sutter's noncontributory defined benefit retirement plans are as follows:

	Years Ended December 31,	
	1998	**1997**
Projected benefit obligation at beginning of year	**$ 350,762**	$ 297,534
Service cost	**20,981**	18,034
Interest cost	**26,304**	23,002
Amendments	**–**	571
Actuarial losses	**29,598**	24,608
Benefits paid	**(12,575)**	(12,987)
Projected benefit obligation at end of year	**415,070**	350,762
Fair value of plan assets at beginning of year	**368,108**	321,276
Actual return on plan assets	**23,098**	57,829
Employer contributions	**–**	1,554
Plan participants' contributions	**–**	436
Benefits paid	**(12,575)**	(12,987)
Fair value of Plan assets at end of year	**378,631**	368,108
Funded status of the plans	**(36,439)**	17,346
Unrecognized net actuarial loss (gain)	**12,745**	(26,955)
Unrecognized net transition asset	**(4,732)**	(6,766)
Unrecognized prior service cost	**(517)**	(1,761)
Minimum pension liability	**(7,676)**	(3,124)
Net accrued retirement benefit cost at end of year	**$ (36,619)**	$ (21,260)

(Dollars in Thousands)

10. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)

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

	December 31, 1998	December 31, 1997
Accrued retirement benefit cost	**$ (38,917)**	$ (23,750)
Prepaid retirement benefit cost	**2,298**	2,490
	$ (36,619)	$ (21,260)

Several of Sutter's noncontributory defined benefit retirement plans have benefit obligations in excess of plan assets, as follows:

	December 31, 1998	December 31, 1997
Projected benefit obligation	**$ 390,320**	$ 46,741
Fair value of plan assets	**$ 352,511**	$ 38,603

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

	December 31, 1998	December 31, 1997
Discount rates	**6.75-7.25%**	7.25-7.75%
Rates of compensation increase	**4.0%**	3.0-4.0%
Expected long-term rates of return on plan assets	**9.0%**	9.0%

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

	Years Ended December 31, 1998	Years Ended December 31, 1997
Service cost	**$ 20,981**	$ 18,034
Interest cost	**26,304**	23,002
Expected return on plan assets	**(32,603)**	(27,087)
Amortization of prior service cost	**(2,622)**	(663)
Transition asset recognition	**(651)**	(2,786)
Recognized net actuarial gains	**(341)**	(286)
Benefit cost	**$ 11,068**	$ 10,214

10. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)

CPMC is a member of a multiemployer defined benefit retirement plan. For the multiemployer plan as a whole, the net assets available for benefits exceeded the actuarially computed value of vested benefits as of the most recent actuarial valuation (January 1, 1997). CPMC's funding policy is to contribute the minimum funding required by the Employee Retirement Income Security Act of 1974 and to eliminate the underfunded position of a former plan over a five-year period. The total pension expense (benefit) associated with CPMC's multiemployer plan was $(1,189) and $747 for the years ended December 31, 1998 and 1997, respectively.

Sutter maintains various defined contribution plans for eligible employees. Sutter's contributions to such plans were $7,500 and $7,757 for the years ended December 31, 1998 and 1997, respectively.

In addition to providing pension benefits, Sutter provides certain health care and health insurance benefits for eligible retired employees and certain of their relatives. The postretirement benefit obligations and costs relating to these benefits are not significant to Sutter's combined financial statements.

11. INCOME TAXES

Deferred income taxes, which as of December 31, 1998 and 1997 have a net carrying value of zero, reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting and the amounts used for income tax purposes. As of December 31, 1998 and 1997, Sutter had deferred tax assets of $36,568 and $33,546, respectively, relating principally to net operating loss carryovers. As of December 31, 1998 and 1997, such deferred tax assets are offset by a valuation allowance of $34,333 and $29,829, respectively, and deferred tax liabilities of $2,235 and $3,717, respectively, relating principally to differences between the financial reporting and tax bases of acquired assets. The aforementioned valuation allowance increased by $4,504 and $3,357 during the years ended December 31, 1998 and 1997, respectively.

Federal net operating loss carryovers totaled $95,734 at December 31, 1998 and will expire between 2004 and 2014. State net operating loss carryovers totaled $23,817 at December 31, 1998 and will expire between 1999 and 2003.

(Dollars in Thousands)

12. FUNCTIONAL CLASSIFICATION OF OPERATING EXPENSES

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

	Years Ended December 31, 1998	1997
Health services	**$2,577,254**	$2,405,303
General and administrative	**254,894**	190,815
	$2,832,148	$2,596,118

13. CONTINGENCIES AND COMMITMENTS

Contingencies: Marin General Hospital ("MGH") leases a hospital in Greenbrae, California from Marin Health Care District (the "Marin District") pursuant to a lease between MGH and the Marin District (the "Marin Lease"). MGH, Marin Community Health and Sutter Health are defendants in a lawsuit filed by the Marin District in 1997 which seeks, among other things, a judgment declaring that the Marin Lease and an Agreement for Transfer of Assets between the Marin District and MGH are void and that the Marin District is entitled to ownership and possession of the hospital and assets transferred and all proceeds and products of the hospital lease and assets transferred. On October 9, 1998, the Sacramento County Superior Court granted motions of MGH and Sutter Health for partial summary adjudication. By its order, the Sacramento County Superior Court ruled that the Marin District's claims that the Marin Lease and asset transfer were void because of alleged violations of Government Code California Section 1090 were barred by applicable statutes of limitations. The Marin District petitioned the California Court of Appeal for the Third Appellate District (the "Court of Appeal") for writ of mandate directing the Sacramento County Superior Court to reverse its partial adjudication decision, but the Court of Appeal denied the writ. The Marin District has filed a Petition for Review in the California Supreme Court. The petition requested that the California Supreme Court review and reverse the decision of the Court of Appeal. The California Supreme Court denied the petition; however, the claims regarding the breach of the Marin Lease remain pending before the Sacramento County Superior Court.

Mills-Peninsula Health Services ("MPHS") leases Mills-Peninsula Medical Center in Burlingame, California from Peninsula Health Care District (the "Peninsula District") pursuant to a lease between MPHS and the Peninsula District (the "Peninsula Lease"). MPHS is a defendant in a lawsuit filed by the Peninsula District in 1997 which seeks, among other things, a declaration that certain contracts relating to the consolidation of the hospital and medical facilities and operations of the Peninsula District and MPHS are

13. CONTINGENCIES AND COMMITMENTS (Continued)

void and canceled, including the 1985 Agreement for Consolidation of Assets and Liability, the 1985 Lease of Peninsula Hospital, the 1997 Amended Lease of Peninsula Hospital, a 1985 cash donation from the Peninsula District to Mills-Peninsula Foundation, and certain 1985 donations of property from the Peninsula District to MPHS, and a declaration that the Peninsula District is entitled to ownership and possession of the assets transferred by the foregoing contracts and documents, including all the real property, improvements and personal property, both tangible and intangible, cash and liquid assets, all proceeds and products thereof, and all substitutions and replacements for the same. Subsequent to the filing of this lawsuit, the San Mateo County Superior Court allowed both Sutter Health and the Mills-Peninsula Physicians Group, Inc. ("MPPG") to intervene as defendants. On September 5, 1997, the San Mateo County Superior Court heard arguments on a demurrer to the complaint filed by MPHS and joined in by Sutter Health and MPPG. On November 13, 1997, the San Mateo County Superior Court sustained the demurrer without leave to amend the complaint. The Peninsula District has filed a motion requesting that the San Mateo County Superior Court reconsider its decision. The motion asserts that the stipulated judgment that the San Mateo County Superior Court relied on in sustaining the demurrer is invalid under California Government Code Section 1090 because certain parties who approved the stipulation had an interest in it. The Peninsula District and the District Attorney of San Mateo County, who was a party to the stipulated judgment, moved to vacate the stipulated judgment on the same grounds. On November 19, 1998, the San Mateo County Superior Court issued an order granting the motion to vacate. No date has yet been set for the hearing on the motion for reconsideration.

The MGH and MPHS lawsuits are at an early stage and it is difficult to predict either the outcome of the litigation or the effect the litigation might have on Sutter's combined financial position and results of operations, but a negative outcome could be material.

Sutter is involved in other litigation, as both plaintiff and defendant, and other routine labor matters, tax examinations and regulatory examinations arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, these matters should be resolved without a material adverse effect on Sutter's combined financial position and results of operations.

13. CONTINGENCIES AND COMMITMENTS (Continued)

Sutter in the ordinary course of business enters into various incentive-based risk sharing agreements with managed care payors and other providers. These agreements require retroactive settlement based on data which may not be available or finalized until all claims are processed. Settlement amounts have been estimated for such risk-based incentives based on available information. However, it is reasonably possible that these estimates may change in the near term.

As of December 31, 1998, approximately 25% of Sutter's employees are represented by collective bargaining units. Employee strikes or other adverse labor actions may have an adverse impact on the System's operations in the future.

Commitments: Sutter's combined budgeted capital expenditures, as approved by the Board of Directors, for the period from January 1, 1999 to December 31, 2000 amount to approximately $112,313. Such capital expenditures will be financed by funds from various bond issues and certain investments, as designated by Sutter's Board of Directors, for capital improvements.

Sutter is in the process of reviewing the seismic safety of its facilities. Because of the declining utilization resulting from the implementation of managed care and planned replacement of older facilities, management does not anticipate that compliance with certain legislation adopted in California during 1994 (that generally requires each acute care hospital in the State to either comply with new hospital seismic safety standards or cease acute care operations by January 1, 2008) will have a materially adverse effect on Sutter's combined financial position. Management expects that Sutter, will spend approximately $350,000 through 2008 in replacement and upgrading of facilities to comply with the new seismic safety standards.

As of December 31, 1998, Sutter had irrevocable standby letters of credit to collateralize certain long-term obligations of $232,601 and to satisfy legal requirements for self-insured workers' compensation plans and for other purposes aggregating $58,642.

Sutter Health, ABMC, Alta Bates Health System and Sutter Health East Bay ("SHEB") have entered into an Affiliation Agreement dated November 18, 1998 with Summit Medical Center ("Summit"), pursuant to which Summit and ABMC will consolidate their operations (the "Affiliation"). Sutter Health is the sole corporate member of SHEB. Pursuant to the terms of the Affiliation Agreement, SHEB will be the sole corporate member of both Summit and ABMC upon closing, and SHEB, ABMC and Summit will have overlapping boards. Pursuant to the terms of the Affiliation Agreement, Sutter Health made a minimum capital commitment to SHEB for a total of $450,000 over the

13. CONTINGENCIES AND COMMITMENTS (Continued)

ten year period following closing. In addition, the Affiliation Agreement provides for Sutter Health to assume Summit's approximately $75,000 tax-exempt bond debt and for SHEB and Summit to become members of the Obligated Groups (Note 6). The parties to the affiliation are in the process of conducting due diligence and filing for appropriate governmental consents. The parties anticipate closing the Affiliation during 1999, although there can be no assurance that the Affiliation will be consummated. If consummated, the Affiliation will be accounted for in a manner analogous to a pooling of interests.

14. SUBSEQUENT EVENTS

On January 1, 1999, Sutter issued $138,000 in CHFFA Insured Revenue Bonds, Series 1999A. Such bonds bear interest at fixed rates ranging from 5.0% to 5.35% and, subject to the redemption provisions of the bond indenture, mature between August 15, 2018 and August 15, 2038.

Sutter continues to negotiate affiliations with certain acute care facilities, physician groups and other health care-related organizations.

15. YEAR 2000 ISSUE (UNAUDITED)

Sutter makes this Year 2000 ("Y2K") Readiness Disclosure Statement pursuant to public law 105-271. The Y2K issue, generally, involves potential failure or malfunctions of information systems and equipment in transitioning from the year 1999 to the year 2000. Historically, computer software programs with date/time fields, including microchips embedded in equipment, were written with two digit fields to reflect the date rather than four. Thus with the transition from the year 1999 to the year 2000, the "00" in 2000 may be incorrectly recognized as the year 1900 or not recognized. As a result, system or equipment failures or malfunctions could occur.

Sutter has instituted a comprehensive ongoing program addressing Y2K issues. The primary objective is to minimize the disruption of normal business operations in the provision of services and care to patients and to those with whom Sutter does business. Designated senior managers are responsible for plan development and implementation.

Internal and external resources are being utilized to assess, analyze and remediate Y2K noncompliance. All biomedical equipment with embedded clocks will be tested, with a target completion date of December 31, 1999. Any biomedical equipment that remains suspect/untested will be removed from service prior to January 1, 2000. Information

15. YEAR 2000 ISSUE (UNAUDITED) (Continued)

technology ("IT") systems are being assessed, analyzed and remediated utilizing a consistent and uniform protocol. It is anticipated that all non-Y2K compliant IT software systems will have been identified and either mitigated, replaced or retired from service prior to December 31, 1999. These systems include databases, interfaces, and electronic data interface systems. Testing and remediation activities are also being performed in other vital areas such as Finance, Purchasing, Real Estate, and Plant Operations. Sutter presently anticipates completing all remediation activities prior to December 31, 1999. Sutter has communicated with significant suppliers, payors and affiliated physicians to determine the extent to which interfaced systems may be impacted by a third party's failure to correct its own Y2K problems. However, there can be no guarantee that some third party systems will not be compliant, and that non-compliance will not adversely affect Sutter.

Sutter is developing Y2K contingency plans, which are expected to be complete by September 30, 1999. These plans, on a combined basis, will identify mission critical items requiring replacement, address strategies for maintaining operations, and include emergency situations and recovery programs on a system-wide basis.

Both operating and capital costs related to ensuring Y2K compliance are a part of the overall increase in IT spending. Sutter's IT capital expenditures for 1998 and 1997 were $81,800 and $54,100, respectively. The 1999 IT capital budget is $84,200. These capital costs, and the related operating costs, are funded by operations and the proceeds from debt instruments. Management does not believe that additional costs will have a materially adverse effect on the combined financial position and results of operations of Sutter. However, there can be no assurance that there will not be an increase in the costs associated with Y2K issues.

Due to Sutter's strong mandate for extensive testing and remediation activities relating to biomedical equipment, management does not believe that significant patient care or safety issues related to biomedical equipment failure or malfunction are likely. Sutter believes that its most reasonably likely Y2K worst case scenario could involve short-term malfunctions in computer hardware and software, temporary disruptions in service and a disruption to its cash flow, precipitated by third-party failures to be Y2K compliant. Sutter derives a substantial portion of its revenues through reimbursement from third-party payors, including governmental organizations. Although Sutter is attempting to obtain adequate indications from third parties regarding their respective Y2K readiness, there is always the risk that a third-party payor's systems will fail or malfunction and, consequently, despite any contingency plans, payment to Sutter might be stopped, delayed or be incomplete. As a result, Sutter may experience cash flow problems. If

15. YEAR 2000 ISSUE (UNAUDITED) (Continued)

Sutter experiences cash flow problems, it could have difficulties meeting its obligations to vendors, suppliers, employees and debt holders. Sutter would likely incur additional costs in attempting to resolve these cash flow problems. Although Sutter intends to address this scenario in its contingency planning, there can be no assurance that the contingency plans will completely resolve all of Sutter's problems in this regard, partially due to the unknown magnitude of the potential cash flow problems. Consequently, actual results could vary materially from current projections.