

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Health Management Associates, Inc. (the “Company”), through its subsidiary companies, substantially all of which are wholly-owned, provides health care services to patients in owned and leased facilities primarily in the southeast and southwest United States. The Company consistently applies the following significant accounting policies:

### a. Principles of consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries in which the Company exercises control. All significant intercompany accounts and transactions have been eliminated.

### b. Cash equivalents

The Company considers all highly liquid investments purchased with a maturity of less than three months to be cash equivalents. The Company’s cash equivalents consist principally of investment grade instruments.

### c. Property, plant and equipment

Property, plant and equipment are carried at cost and include major expenditures which increase their values or extend their useful lives. Depreciation and amortization are computed using the straight line method based on estimated useful lives. Estimated useful lives for buildings and improvements range from twenty to forty years and for equipment range from three to ten years. Leaseholds are amortized on a straight-line basis over the terms of the respective leases. Depreciation expense was \$91.9 million, \$77.3 million and \$63.7 million for the years ended September 30, 2002, 2001 and 2000, respectively.

### d. Excess of cost over acquired net assets, net and deferred charges and other assets

Prior to October 1, 2001, excess of cost over acquired net assets (goodwill) had been amortized on a straight-line basis over lives ranging from three to twenty-five years. As of October 1, 2001, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually in accordance with the provisions of SFAS No. 142. The transition provisions of SFAS No. 142 require the completion of a transitional impairment test within six months of adoption of SFAS No. 142. The Company completed the required transitional impairment test in March 2002, which resulted in no goodwill impairment.

Deferred charges and other assets consist principally of deferred financing costs and certain non-productive assets held for sale. The financing costs are being amortized over the life of the related debt. The accumulated amortization of deferred financing costs was \$4.5 million and \$3.7 million at September 30, 2002 and 2001, respectively.

Certain long-lived assets may become impaired, requiring a writedown of the assets to their estimated fair values. The Company periodically reviews future cash flows related to these assets, and if necessary, will reduce such assets to their estimated fair values.

### e. Use of estimates

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

### f. Net patient service revenue and accounts receivable

Approximately 59%, 59% and 60% of gross patient service charges for the years ended September 30, 2002, 2001 and 2000, respectively, relates to services rendered to patients covered by the Medicare and Medicaid programs. Payments for services rendered to patients covered by these programs are generally less than billed charges. Provisions for contractual adjustments are made to reduce the charges to these

patients to estimated receipts based upon the programs' principles of payment/reimbursement (either prospectively determined or retrospectively determined costs). Final settlements under these programs are subject to administrative review and audit, and provision is currently made for adjustments which may result. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is a possibility that recorded estimates may change in the future. Revenues and receivables from government programs are significant to the Company's operations, but the Company does not believe that there are significant credit risks associated with these government programs.

Estimates for contractual allowances under managed care health plans are based primarily on the payment terms of contractual arrangements such as predetermined rates per diagnosis, per diem rates or discounted fee for service rates.

Net patient service revenue is presented net of provisions for contractual adjustments and other allowances of \$4.121 billion, \$2.981 billion and \$2.195 billion in 2002, 2001 and 2000, respectively, in the accompanying consolidated statements of income. In the ordinary course of business, the Company renders services in its facilities to patients who are financially unable to pay for their hospital care. The value of these services to patients who are unable to pay is not material to the Company's consolidated results of operations.

#### **g. Provision for doubtful accounts**

The collection of receivables from third party payers and patients is the Company's primary source of cash and is critical to its operating performance. The primary collection risks relate to uninsured patient accounts and patient accounts for which the primary insurance payer has paid, but patient responsibility amounts (generally deductibles and co-payments) remain outstanding. Provisions for doubtful accounts are estimated based primarily upon the age of the patients' account, the patients' economic ability to pay and the effectiveness of collection efforts. Accounts receivable balances are routinely reviewed in conjunction with historical collection rates and other economic conditions which might ultimately affect the collectibility of patient accounts when considering the adequacy of the amounts recorded as allowances for doubtful accounts. Significant changes in payer mix, business office operations, economic conditions or trends in Federal and state governmental health care coverage could affect the Company's collection of accounts receivable, cash flows and results of operations.

#### **h. Professional liability insurance claims**

The Company insures for its professional liability risks under a "claims-made" basis policy. Each claim is covered up to \$1 million per occurrence, subject to a \$100,000 deductible the Company must pay (with an annual deductible cap of \$6.1 million). Liabilities in excess of these amounts are covered through a combination of limits provided by commercial insurance companies and a self-insurance program. (see Note 9)

Estimates for self-insured professional liability risks are determined by management using the Company's incident reporting system and actuarially determined amounts. The estimates are continually reviewed and adjustments recorded as experience develops and/or new information becomes available. Actual results could vary from those estimates recorded. (see Note 9)

#### **i. Minority interests in consolidated entities**

The consolidated financial statements include all assets, liabilities, revenues and expenses of less than 100% owned entities controlled by the Company. Accordingly, the Company has recorded minority interests in the earnings and equity of such entities.

#### **j. Income taxes**

The Company accounts for income taxes under SFAS No. 109, *Accounting for Income Taxes*. Deferred income tax assets and liabilities are determined based upon difference between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse (see Note 5). Management must make estimates

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 1. BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

in recording the Company's provision for income taxes, including determination of deferred tax assets and deferred tax liabilities and any valuation allowance that might be required against the deferred tax asset. Management believes that future income will enable the Company to realize these benefits in the future; therefore, the Company has not recorded a valuation allowance against the deferred tax asset.

The Company operates in multiple states with varying tax laws. The Company is subject to both Federal and state audits of tax returns. Management must make estimates to determine that tax reserves are adequate to cover any potential audit adjustments. Actual results of those audits, if any, could vary from the estimates recorded by management.

#### k. Earnings per share

Earnings per share is based on the weighted average number of common and common equivalent shares (stock options and convertible debt) outstanding during the periods presented (see Note 7).

#### l. Segment reporting

The Company's business of providing health care services to patients in owned and leased facilities comprises a single reportable operating segment under SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*.

#### m. Reclassifications

Certain amounts have been reclassified in prior years to conform with the current year presentation.

#### n. Recent accounting pronouncements

In accordance with SFAS No. 142, the Company discontinued the amortization of goodwill effective October 1, 2001. During the years ended September 30, 2001 and 2000, the Company recorded \$9.2 million and \$7.8 million of goodwill amortization expense which reduced earnings by approximately \$5.5 million and \$4.7 million (net of tax expense of approximately \$3.7 million and \$3.1 million), or approximately \$0.02 per share on a diluted basis for 2001 and 2000, respectively.

In August 2001, the Financial Accounting Standards Board issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, and the accounting and reporting provisions of APB Opinion No. 30, *Reporting the Results of Operations*, for a disposal of a segment of a business. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001. The Company will adopt SFAS No. 144 as of October 1, 2002 and does not expect the adoption will have a significant impact on the Company's financial position or results of operations.

### 2. ACQUISITIONS AND DISPOSITIONS

During 2002, the Company acquired certain assets of two hospitals and the stock of three hospitals through purchase agreements for \$226.2 million in cash and the assumption of \$1.0 million in liabilities. During 2001, the Company acquired certain assets of two hospitals through purchase agreements for \$59.4 million in cash and the assumption of \$3.6 million in liabilities. During 2000, the Company acquired certain assets of three hospitals (one at September 30, 2000) through purchase agreements for \$130.4 million in cash and the assumption of \$6.2 million in liabilities. The foregoing acquisitions were accounted for using the purchase method of accounting. The allocation of the purchase price has been determined by the Company based upon available information and is subject to further refinement.

As part of a group purchase of four hospitals during 2002, the Company acquired one acute-care hospital and sold it on the same day for \$40.0 million in cash.

The operating results of the foregoing hospitals have been included in the accompanying consolidated statements of income from the respective dates of acquisition. The following unaudited pro forma combined summary of operations of the Company for each of the years in the three year period ended

September 30, 2002 give effect to the operation of the hospitals purchased in 2002, 2001 and 2000 as if the acquisitions had occurred as of October 1, 2000, 1999 and 1998, respectively:

| (in millions, except per share data) | 2002       | 2001       | 2000       |
|--------------------------------------|------------|------------|------------|
| Net patient service revenue          | \$ 2,403.0 | \$ 2,139.9 | \$ 1,963.7 |
| Net income                           | \$ 253.0   | \$ 192.8   | \$ 164.6   |
| Net income per share – Basic         | \$ 1.05    | \$ .79     | \$ .67     |
| Net income per share – Diluted       | \$ .99     | \$ .75     | \$ .64     |

The changes in the carrying amount of goodwill for the year ended September 30, 2002 are as follows:

|   | 2002              |
|---|-------------------|
| Balance at September 30, 2001             | \$ 251,315        |
| Goodwill acquired during the year         | 92,061            |
| Impairment losses                         | —                 |
| Goodwill written off related to disposals | —                 |
| Other                                     | (8,063)           |
| Balance at September 30, 2002             | <u>\$ 335,313</u> |

### 3. LONG-TERM DEBT

The Company's long-term debt consists of the following (in thousands):

| September 30,   | 2002              | 2001              |
|---|-------------------|-------------------|
| Revolving Credit Agreements (a)   | \$ —              | \$ 45,000         |
| Zero-Coupon Subordinated Convertible Debentures due 2020 at 3%, net of discount of \$184.9 and \$192.6 million at September 30, 2002 and 2001, respectively (b) | 303,274           | 295,864           |
| Zero-Coupon Convertible Senior Subordinated Notes due 2022 at at 0.875%, net of discount of \$51.2 million at September 30, 2002 (b)                            | 278,757           | —                 |
| Mortgage notes, secured by real and personal property (c)   | 10,417            | 50,486            |
| Various mortgage and installment notes and debentures, some secured by equipment, at interest rates ranging from 6% to prime plus 1%, payable through 2009      | 28,368            | 9,939             |
| Industrial Revenue Bond Issue   | 5,190             | 5,580             |
| Capitalized lease obligations (see Note 4)  | 31,762            | 28,873            |
|   | <u>657,768</u>    | <u>435,742</u>    |
| Less current maturities   | 7,609             | 6,752             |
|   | <u>\$ 650,159</u> | <u>\$ 428,990</u> |

#### a. Revolving Credit Agreements

The Company currently has a 5-year \$450 million Credit Agreement (the "Credit Agreement") due November 30, 2004. The Credit Agreement is a term loan agreement which permits the Company to borrow under an unsecured revolving credit loan at any time through November 30, 2004, at which time the agreement terminates and all outstanding amounts become due and payable. The Company may choose a Base Rate Loan (prime interest rate) or a Eurodollar Rate Loan (LIBOR interest rate). The interest rate for a Eurodollar Rate Loan is currently LIBOR plus 1.00 percent, and will increase or decrease in relation to a change in the Company's credit rating. Monthly or quarterly interest payments are required depending on the type of loan chosen by the Company. The interest rate at September 30, 2002 and 2001 was 2.8% and 3.7%, respectively. As of September 30, 2002, there were no amounts outstanding under the Credit Agreement.

The Company also has a \$15 million unsecured revolving credit commitment with a bank. The \$15 million credit commitment is a working capital commitment which is tied to the Company's cash management system, and renews annually on November 1. Currently, interest on any outstanding balance is payable monthly at a fluctuating rate not to exceed the bank's prime rate less .25%. The interest rate at September 30, 2002 and 2001 was 4.5% and 6.0%, respectively. As of September 30, 2002 and 2001, there were no amounts outstanding under this credit commitment.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 3. LONG-TERM DEBT, CONTINUED

In addition, the Company is obligated to pay certain commitment fees based upon amounts available for borrowing during the terms of the credit agreements described above.

The credit agreements contain covenants which, without prior consent of the banks, limit certain activities, including those relating to mergers, consolidations and the Company's ability to secure additional indebtedness, make guarantees, grant security interests and declare dividends. The Company must also maintain minimum levels of consolidated tangible net worth, debt service coverage and interest coverage. At September 30, 2002, the Company was in compliance with these covenants.

#### **b. Subordinated Convertible Debentures and Notes**

On August 16, 2000, the Company sold \$488.8 million face value of Zero-Coupon Subordinated Convertible Debentures due 2020 (the "Debentures") for gross proceeds of \$287.7 million. The Debentures mature on August 16, 2020 unless converted or redeemed earlier. The Debentures are convertible into the Company's common stock at a conversion rate of 29.5623 shares of common stock for each \$1,000 principal amount of the Debentures (equivalent to a conversion price of \$19.9125 per share). Interest on the Debentures is payable semiannually in arrears on August 16 and February 16 of each year at a rate of .25% per year on the principal amount at maturity. The rate of cash interest and accrual of original issue discount represent a yield to maturity of 3% per year calculated from August 16, 2000.

Holder may require the Company to purchase all or a portion of their Debentures on August 16, 2003, August 16, 2008 and August 16, 2013 for a purchase price per Debenture of \$635.88, \$724.58 and \$827.53, respectively, plus accrued and unpaid interest to each purchase date. The Company may choose to pay the purchase price in cash or common stock or a combination of cash and common stock. In addition, upon a change in control of the Company occurring on or before August 16, 2003, each holder may require the Company to repurchase all or a portion of such holder's Debentures. The Company may redeem all or a portion of the Debentures at any time on or after August 16, 2003.

On January 28, 2002, the Company sold \$330.00 million in face value of Zero-Coupon Convertible Senior Subordinated Notes due 2022 (the "Notes") for gross proceeds of approximately \$277.0 million. The Notes are the Company's general unsecured obligations and are subordinated in right of payment to the Company's existing and future indebtedness that is not, by its terms, expressly subordinated or *pari passu* in right of payment to the Notes. The Debentures rank *pari passu* with the Notes. The Notes mature on January 28, 2022, unless converted or redeemed earlier. Upon the occurrence of certain events, the Notes are convertible into the Company's common stock at a conversion rate of 32.1644 shares of common stock for each \$1,000 principal amount of the Notes (equivalent to a conversion price of \$26.11 per share). The equivalent number of shares associated with the conversion of the Notes become dilutive (and thus would be included in the Company's earnings per share calculation) when the Company's common stock attains a level of \$31.33 for at least 20 trading days of the 30 trading days prior to the conversion or the Notes otherwise become convertible. The accrual of the original issue discount represents a yield to maturity of 0.875% per year calculated from January 28, 2002, excluding any contingent interest which could be payable under the terms of the Notes.

Holder may require the Company to purchase all or a portion of their Notes on January 28, 2005, January 28, 2007, January 28, 2012 and January 28, 2017 for a purchase price per note of \$862.07, \$877.25, \$916.40 and \$957.29, respectively, plus accrued and unpaid interest to each purchase date. The Company will pay cash for all Notes so purchased on January 28, 2005. The Company may choose to pay the purchase price in cash or common stock or a combination of cash and common stock for purchases on or after January 28, 2007. In addition, upon a change in control of the Company occurring on or before January 28, 2007, each holder may require the Company to purchase all or a portion of such holder's Notes. The Company may redeem all or a portion of the Notes at any time on or after January 28, 2007.

### c. Mortgage Notes

The Company has four mortgage notes at September 30, 2002 and six mortgage notes at September 30, 2001 which are secured by all the real and personal property related to facilities with a net book value of \$64.5 million and \$96.3 million at September 30, 2002 and 2001, respectively. The notes are payable in various installments with maturity dates ranging from 2002 through 2007 and carry interest rates ranging from prime (4.75% and 6.0% at September 30, 2002 and 2001, respectively) to 11.5%.

As of September 30, 2002 and 2001, the quoted market price for the Debentures was approximately \$335.4 million and \$340.3 million, respectively. As of September 30, 2002, the quoted market price for the Notes was approximately \$287.9 million. The fair value of the other debt included above, based on available market information, approximates its carrying value.

Maturities of long-term debt and capital leases for the next five fiscal years and thereafter, are as follows (in thousands):

|            |            |
|------------|------------|
| 2003       | \$ 7,609   |
| 2004       | 8,100      |
| 2005       | 7,708      |
| 2006       | 6,742      |
| 2007       | 14,936     |
| Thereafter | \$ 612,673 |

The Company paid interest of \$7.4 million, \$14.9 million and \$31.1 million for the years ended September 30, 2002, 2001 and 2000, respectively. There was no capitalized interest for the years ended September 30, 2002 and 2001. Capitalized interest totaled \$3.1 million for the year ended September 30, 2000.

## 4. LEASES

The Company leases real estate properties, equipment and vehicles under cancelable and non-cancelable leases. Future minimum operating and capital lease payments, including amounts relating to leased hospitals, are as follows at September 30, 2002 (in thousands):

| September 30,                           | Operating        |                  | Capital                     | Total             |
|---|------------------|------------------|-----------------------------|-------------------|
|   | Real Property    | Equipment        | Real Property and Equipment |                   |
| 2003                                    | \$ 6,469         | \$ 21,310        | \$ 5,839                    | \$ 33,618         |
| 2004                                    | 5,800            | 16,674           | 5,714                       | 28,188            |
| 2005                                    | 5,432            | 12,674           | 5,134                       | 23,240            |
| 2006                                    | 4,589            | 8,439            | 4,247                       | 17,275            |
| 2007                                    | 3,869            | 3,550            | 3,048                       | 10,467            |
| Thereafter                              | 19,479           | 1,259            | 35,649                      | 56,387            |
| Total minimum payments                  | <u>\$ 45,638</u> | <u>\$ 63,906</u> | 59,631                      | <u>\$ 169,175</u> |
| Less amounts representing interest      |                  |                  | <u>27,869</u>               |                   |
| Present value of minimum lease payments |                  |                  | <u>\$ 31,762</u>            |                   |

The following summarizes amounts related to assets leased by the Company under capital leases (in thousands):

| September 30,                 | 2002             | 2001             |
|-------------------------------|------------------|------------------|
| Cost                          | \$ 76,819        | \$ 71,870        |
| Less accumulated amortization | (16,729)         | (17,191)         |
| Net book value                | <u>\$ 60,090</u> | <u>\$ 54,679</u> |

The Company entered into capitalized leases for equipment of \$8.7 million, \$4.0 million and \$.2 million for the years ended September 30, 2002, 2001 and 2000, respectively.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 5. INCOME TAXES

The significant components of the provision for income taxes are as follows (in thousands):

| Year ended September 30, | 2002       | 2001       | 2000       |
|--------------------------|------------|------------|------------|
| Federal:                 |            |            |            |
| Current                  | \$ 144,017 | \$ 114,109 | \$ 96,713  |
| Deferred                 | (11,322)   | (6,731)    | (3,439)    |
| Total Federal            | 132,695    | 107,378    | 93,274     |
| State:                   |            |            |            |
| Current                  | 28,794     | 19,823     | 16,594     |
| Deferred                 | (2,263)    | (1,228)    | (1,540)    |
| Total State              | 26,531     | 18,595     | 15,054     |
| Total                    | \$ 159,226 | \$ 125,973 | \$ 108,328 |

An analysis of the Company's effective income tax rates is as follows:

| Year ended September 30,                           | 2002       |       | 2001       |       | 2000       |       |
|--|------------|-------|------------|-------|------------|-------|
| Statutory income tax rate                          | \$ 141,982 | 35.0% | \$ 112,333 | 35.0% | \$ 96,598  | 35.0% |
| State income taxes,<br>net of Federal benefit      | 15,824     | 3.9   | 12,628     | 3.9   | 10,797     | 3.9   |
| Other items (each less than<br>5% of computed tax) | 1,420      | .4    | 1,012      | .4    | 933        | .4    |
| Total  | \$ 159,226 | 39.3% | \$ 125,973 | 39.3% | \$ 108,328 | 39.3% |

The tax effects of temporary differences that give rise to significant portions of the Federal and state deferred income tax assets and liabilities are comprised of the following (in thousands):

| September 30,                    | 2002      | 2001      |
|----------------------------------|-----------|-----------|
| Deferred income tax assets:      |           |           |
| Allowance for doubtful accounts  | \$ 27,417 | \$ 24,082 |
| Accrued liabilities              | 14,645    | 10,524    |
| Self insurance liability risks   | 17,505    | 6,519     |
| Other                            | 3,606     | 2,676     |
|                                  | 63,173    | 43,801    |
| Less: Valuation allowance        | —         | —         |
| Net deferred income tax assets   | 63,173    | 43,801    |
| Deferred income tax liabilities: |           |           |
| Depreciable assets               | (38,441)  | (32,124)  |
| Accrued liabilities and other    | (6,632)   | (2,162)   |
| Net deferred income tax asset    | \$ 18,100 | \$ 9,515  |

SFAS No. 109 requires a valuation allowance to reduce the deferred tax assets reported if, based on the weight of the evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. After consideration of all the evidence, both positive and negative, management has determined that a valuation allowance is not necessary as of September 30, 2002 and 2001, respectively.

Income taxes paid (net of refunds) amounted to \$139.7 million, \$126.1 million, and \$123.6 million for the years ended September 30, 2002, 2001 and 2000, respectively.

## 6. RETIREMENT PLAN

The Company has a defined contribution retirement plan which covers substantially all eligible employees at its hospitals and the corporate office. This plan includes a provision for the Company to match a portion of employee contributions. Total retirement program expense under this plan was \$6.0 million, \$4.5 million and \$4.0 million for the years ended September 30, 2002, 2001 and 2000, respectively.

In addition, the Company maintains a supplemental retirement plan for certain Company executives which provides for predetermined annual payments to these executives after the attainment of age 62, if still employed by the Company at that time. These payments generally continue for the remainder of the executive's life (see Note 10).

## 7. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share data):

| Year ended September 30,   | 2002              | 2001              | 2000              |
|--|-------------------|-------------------|-------------------|
| Numerator:   |                   |                   |                   |
| Numerator for basic earnings per share—<br>net income                | \$ 246,436        | \$ 194,978        | \$ 167,667        |
| Effect of convertible debt   | 5,419             | 5,346             | 655               |
| Numerator for diluted earnings per share                             | <u>\$ 251,855</u> | <u>\$ 200,324</u> | <u>\$ 168,322</u> |
| Denominator:   |                   |                   |                   |
| Denominator for basic earnings per share—<br>weighted average shares | 241,298           | 244,425           | 241,946           |
| Effect of dilutive securities:                                       |                   |                   |                   |
| Employee stock options   | 4,894             | 5,477             | 3,550             |
| Convertible debt   | 14,449            | 14,449            | 1,781             |
| Denominator for diluted earnings per share                           | <u>260,641</u>    | <u>264,351</u>    | <u>247,277</u>    |
| Basic earnings per share   | <u>\$ 1.02</u>    | <u>\$ .80</u>     | <u>\$ .69</u>     |
| Diluted earnings per share   | <u>\$ .97</u>     | <u>\$ .76</u>     | <u>\$ .68</u>     |

Outstanding options to purchase 2.8 million, 1.2 million, and 1.4 million shares of the Company's common stock were not included in the computation of earnings per share for the years ended September 30, 2002, 2001, and 2000, respectively, because the options' exercise prices were greater than the average market price of the Company's common stock.

## 8. STOCKHOLDERS' EQUITY

The Company has elected to follow Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB 25"). Under APB 25, since the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized. Pro forma disclosure of alternative fair value accounting is then required under SFAS No. 123, *Accounting for Stock-Based Compensation*, utilizing an option valuation model.

The Company has a 1991 Stock Option Plan, a 1993 Stock Option Plan and a 1996 Executive Incentive Compensation Plan for the granting of options to key employees of the Company. All options granted have 10 year terms and vest and become fully exercisable at the end of either 3 or 4 years of continued employment.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 8. STOCKHOLDERS' EQUITY, CONTINUED

Pertinent information covering the plans is summarized below:

|                                   | Shares<br>(in thousands) | Price<br>Range | Weighted<br>Average<br>Price |
|-----------------------------------|--------------------------|----------------|------------------------------|
| Balance at September 30, 1999     | 20,238                   | \$ 1.24-21.63  | \$10.30                      |
| Granted                           | 3,807                    | 12.13-14.69    | 12.14                        |
| Exercised                         | (1,809)                  | 1.24-13.00     | 5.97                         |
| Terminated                        | (403)                    | 10.33-21.63    | 16.14                        |
| Balance at September 30, 2000     | 21,833                   | 1.24-21.63     | 10.87                        |
| Granted                           | 2,804                    | 16.60-21.25    | 16.62                        |
| Exercised                         | (2,553)                  | 1.24-13.00     | 9.99                         |
| Terminated                        | (1,506)                  | 12.13-21.63    | 13.38                        |
| Balance at September 30, 2001     | 20,578                   | 2.07-21.63     | 11.59                        |
| Granted                           | 1,808                    | 19.10-19.95    | 19.93                        |
| Exercised                         | (2,847)                  | 2.07-19.63     | 4.41                         |
| Terminated                        | (320)                    | 8.25-21.63     | 18.17                        |
| Balance at September 30, 2002     | <u>19,219</u>            | \$ 2.07-21.63  | \$13.33                      |
| Exercisable at September 30, 2002 | <u>14,073</u>            |                |                              |

The following table summarizes information concerning currently outstanding and exercisable options:

| Range of<br>Exercise<br>Prices | Options Outstanding   |   |  | Options Exercisable   |  |
|--------------------------------|-----------------------|---|--|-----------------------|--|
|                                | Number<br>Outstanding | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Weighted<br>Average<br>Exercise<br>Price | Number<br>Exercisable | Weighted<br>Average<br>Exercise<br>Price |
| \$ 2.07 - \$ 8.33              | 2,419,000             | 2.8   | \$ 5.24                                  | 2,366,000             | \$ 5.18                                  |
| \$10.33 - \$13.00              | 11,298,000            | 5.7   | \$12.47                                  | 10,010,000            | \$12.49                                  |
| \$14.50 - \$21.63              | 5,502,000             | 8.4   | \$18.66                                  | 1,697,000             | \$19.76                                  |

Pro forma information regarding net income and earnings per share is required by SFAS No. 123, which also requires that the information be determined as if the Company has accounted for its employee stock options granted subsequent to December 31, 1995 under the fair value method of SFAS No. 123. The fair value for these options was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions for 2002, 2001 and 2000: risk-free interest rate of 4.60%, 5.51%, and 6.56%; no dividend yields; volatility factor of the expected market price of the Company's common stock of .536, .489 and .486; and weighted average expected lives of the options of 5, 7 and 7 years.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. The Company's pro forma information follows (in thousands, except per share data):

|                               | 2002       | 2001       | 2000       |
|-------------------------------|------------|------------|------------|
| Pro forma net income          | \$ 235,261 | \$ 184,537 | \$ 156,702 |
| Pro forma earnings per share: |            |            |            |
| Basic                         | \$ .97     | \$ .75     | \$ .65     |
| Diluted                       | \$ .93     | \$ .72     | \$ .64     |

At September 30, 2002, there were approximately 13.1 million shares of common stock reserved for future issuance under the plans. In addition, the Company has granted options for shares of Class A Common Stock to seven non-employee directors. At September 30, 2002, there were approximately 196,000 options outstanding at \$4.49 to \$21.63 per share, expiring in 2004 through 2012.

The Company also has a Stock Incentive Plan for corporate officers and management staff. This plan provides for the awarding of additional compensation to key personnel in the form of Company stock. The stock will be issued to the grantee four years after the date of grant, provided the individual is still an employee of the Company. At September 30, 2002, there were approximately 450,000 shares reserved under the plan, for which the Company has recorded \$2.9 million, \$2.0 million and \$1.5 million of compensation expense for the years ended September 30, 2002, 2001 and 2000, respectively.

In September 1999, the Board of Directors approved a stock repurchase program of up to 25 million shares of common stock. On October 14, 1999 the Company executed a share repurchase agreement with an independent third party, whereby the third party agreed to "sell short" 5 million shares of the Company's common stock to the Company. As of October 19, 1999 the 5 million shares were delivered to the Company and became treasury stock. From October 15, 1999 to December 15, 1999, a period of 60 days, the third party covered the "short sale" by buying shares on the open market. On December 15, 1999 the Company reimbursed the third party \$42,399,000, which represented the cost of the common stock purchased plus a commission plus interest (at LIBOR) on the outstanding balance of funds used to purchase the common stock.

In September 2001, the Board of Directors approved a stock repurchase program to repurchase up to 5,000,000 shares of the Company's common stock. On January 29, 2002, the Company announced that it had completed the stock repurchase program by purchasing a total of 5,000,000 shares of its common stock at an average purchase price of \$19.29 per share.

In February 2002, the Board of Directors approved a stock repurchase program to repurchase up to 5,000,000 shares of the Company's common stock. On August 8, 2002, the Company announced that it had completed the stock repurchase program by purchasing a total of 5,000,000 shares at an average purchase price of \$18.54 per share.

At September 30, 2002 and 2001, there were approximately 14.5 million shares of common stock reserved for future issuance upon the conversion of the Company's Debentures. At September 30, 2002, there were approximately 10.6 million shares of common stock reserved for future issuance upon the conversion of the Company's Notes.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 9. PROFESSIONAL LIABILITY RISKS

Through September 30, 2002, the Company insured for its professional liability risks under a “claims-made” basis policy, whereby each claim is covered up to \$1 million per occurrence, subject to a \$100,000 deductible (with an annual deductible cap of \$6.1 million). Liabilities in excess of these amounts are covered through a combination of limits provided by commercial insurance companies and a self-insurance program.

Accruals for self-insured professional liability risks are determined using asserted and unasserted claims identified by the Company’s incident reporting system and actuarially determined estimates based on Company and industry historical loss payment patterns and have been discounted to their present value using a discount rate of 6.0%. Although the ultimate settlement of these accruals may vary from these estimates, management believes that the amounts provided in the Company’s consolidated financial statements are adequate. If actual payments of claims exceed projected estimates of claims, the Company’s insurance accruals could be materially adversely affected.

Effective October 1, 2002, in response to difficulty in obtaining primary insurance from commercial companies at reasonable rates, the Company formed a wholly owned insurance subsidiary in order to self-insure a greater portion of its primary professional and general liability risk. The captive subsidiary reinsures risk up to \$1 million per claim and \$3 million in the aggregate per hospital, and further acts as an excess insurer for all hospitals in combination with three commercial insurance companies.

### 10. NON-CASH CHARGE

The non-cash charge for retirement benefits and write down of assets held for sale in 2001 represents (1) the present value of the future costs of retirement benefits granted to the Company’s chairman pursuant to an employment agreement which became effective January 2, 2001, and (2) the write down of two hospital assets held for sale in conjunction with their respective replacement.

### 11. COMMITMENTS

The Company has a number of hospital renovation/expansion projects underway at September 30, 2002. None of these projects are individually significant nor do they represent a significant commitment in total at September 30, 2002. In addition, the Company plans to replace three of its existing hospitals and build one new hospital over the next four years. Regulatory approval to begin construction on one replacement facility has been granted while the remaining planned projects are awaiting regulatory approval by the appropriate agencies. Included in these planned projects is the Company’s obligation to construct a new facility at its Carlisle, Pennsylvania location.

### 12. SUBSEQUENT EVENTS

On October 29, 2002, the Company initiated a quarterly cash dividend policy and declared its first cash dividend of \$0.02 per share of the Company’s common stock payable on December 2, 2002 to stockholders of record at the close of business on November 8, 2002.

### 13. QUARTERLY DATA (UNAUDITED)

Years ended September 30, 2002 and 2001 (in thousands, except per share data):

| Quarter                            | 1st        | 2nd        | 3rd        | 4th        | Total        |
|------------------------------------|------------|------------|------------|------------|--------------|
| <b>2002</b>                        |            |            |            |            |              |
| Net patient service revenue        | \$ 495,821 | \$ 579,948 | \$ 592,476 | \$ 594,356 | \$ 2,262,601 |
| Income before income taxes         | 83,072     | 113,965    | 109,665    | 98,960     | 405,662      |
| Net income                         | 50,466     | 69,236     | 66,616     | 60,118     | 246,436      |
| Net income per share:              |            |            |            |            |              |
| Basic                              | \$ .21     | \$ .29     | \$ .28     | \$ .25     | \$ 1.02      |
| Diluted                            | \$ .20     | \$ .27     | \$ .26     | \$ .24     | \$ .97       |
| Weighted average number of shares: |            |            |            |            |              |
| Basic                              | 243,649    | 241,259    | 241,227    | 239,052    | 241,298      |
| Diluted                            | 263,365    | 260,661    | 260,821    | 257,740    | 260,641      |
| <b>2001</b>                        |            |            |            |            |              |
| Net patient service revenue        | \$ 434,237 | \$ 481,144 | \$ 473,203 | \$ 491,217 | \$ 1,879,801 |
| Income before income taxes         | 66,122     | 80,265     | 89,156     | 85,408     | 320,951      |
| Net income                         | 40,178     | 48,740     | 54,138     | 51,922     | 194,978      |
| Net income per share:              |            |            |            |            |              |
| Basic                              | \$ .17     | \$ .20     | \$ .22     | \$ .21     | \$ .80       |
| Diluted                            | \$ .16     | \$ .19     | \$ .21     | \$ .20     | \$ .76       |
| Weighted average number of shares: |            |            |            |            |              |
| Basic                              | 243,234    | 244,117    | 245,048    | 245,297    | 244,425      |
| Diluted                            | 264,297    | 263,100    | 264,305    | 265,568    | 264,351      |