



Mercy Hospital of Buffalo
(a subsidiary of the
Catholic Health System, Inc.)
Financial Statements
December 31, 2006 and 2005

Report of Independent Auditors

To the Board of Directors of the
Catholic Health System, Inc.

In our opinion, the accompanying balance sheets and the related statements of operations and changes in net assets and of cash flows present fairly, in all material respects, the financial position of Mercy Hospital of Buffalo (the Hospital) as of December 31, 2006 and 2005, and the results of its operations and changes in net assets (deficits) and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Hospital's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 4, the Hospital adopted the provisions of FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations".

As discussed in Note 11, the Hospital adopted the provisions of FASB 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans".

As discussed in Note 13, the Hospital had significant transactions with related parties.

PricewaterhouseCoopers LLP

Buffalo, New York
April 16, 2007

Mercy Hospital of Buffalo
Balance Sheets
December 31, 2006 and 2005

	2006	2005
Assets		
Current assets		
Cash and cash equivalents	\$ 13,800,807	\$ 4,658,473
Patient/resident accounts receivable, net of estimated uncollectibles of approximately \$3,424,000 and \$3,249,000	24,104,718	22,870,446
Other receivables	608,142	505,088
Inventories	927,038	912,039
Prepaid expenses and other assets	523,396	841,159
Total current assets	39,964,101	29,787,205
Interest in net assets of Mercy Hospital Foundation, Inc.	1,406,425	1,787,286
Assets limited as to use	1,418,677	1,260,697
Property and equipment, net	44,010,820	43,393,831
Other assets	3,621,929	4,024,972
Due from affiliates	1,001,731	4,086,500
Total Assets	<u>\$ 91,423,683</u>	<u>\$ 84,340,491</u>
Liabilities and Net Assets (Deficit)		
Current liabilities		
Current portion of long-term obligations	\$ 1,767,021	\$ 1,628,175
Accounts payable	8,643,063	7,731,219
Accrued expenses	9,164,000	8,793,583
Due to third-party payors	7,523,522	8,651,297
Due to affiliates	248,932	2,653,390
Total current liabilities	27,346,538	29,457,664
Long-term obligations	17,705,016	17,374,641
Long-term pension obligation	46,868,571	41,740,507
Long-term portion of insurance liabilities	9,963,600	9,107,165
Asset retirement obligation	4,431,260	4,223,814
Deferred compensation plan	1,418,677	1,260,619
Interest rate swap	103,518	-
Total liabilities	<u>107,837,180</u>	<u>103,164,410</u>
Net assets (deficit)		
Unrestricted	(16,970,237)	(19,711,753)
Temporarily restricted	556,740	887,834
Total net assets (deficit)	<u>(16,413,497)</u>	<u>(18,823,919)</u>
Total Liabilities and Net Assets (Deficit)	<u>\$ 91,423,683</u>	<u>\$ 84,340,491</u>

The accompanying notes are an integral part of these financial statements.

Mercy Hospital of Buffalo
Statements of Operations and Changes in Net Assets
For the Years Ended December 31, 2006 and 2005

	2006	2005
Unrestricted revenues, gains and other support		
Net patient/resident service revenue	\$ 215,136,618	\$ 199,806,322
Other revenue	<u>5,253,232</u>	<u>5,024,090</u>
Total unrestricted revenues, gains and other support	<u>220,389,850</u>	<u>204,830,412</u>
Expenses		
Salaries and wages	89,117,890	83,207,535
Employee benefits	28,728,020	24,928,804
Medical and professional fees	5,659,871	5,081,614
Purchased services	18,546,027	19,652,436
Supplies	42,270,095	37,905,573
Depreciation and amortization	8,224,321	7,348,946
Interest	1,727,457	1,589,956
Insurance	2,624,606	2,973,761
Provision for bad debts	7,278,041	7,846,928
Other expenses	<u>8,536,756</u>	<u>7,973,026</u>
Total expenses	<u>212,713,084</u>	<u>198,508,579</u>
Income from operations	7,676,766	6,321,833
Nonoperating revenues and losses		
Dividend and interest income	632,429	212,684
Loss on extinguishment of debt	(46,667)	-
Other	<u>157,352</u>	<u>60,814</u>
Total nonoperating revenues and losses	<u>743,114</u>	<u>273,498</u>
Excess of revenues over expenses	8,419,880	6,595,331

(Continued)

The accompanying notes are an integral part of these financial statements.

Mercy Hospital of Buffalo
Statements of Operations and Changes in Net Assets (Continued)
For the Years Ended December 31, 2006 and 2005

	2006	2005
Unrestricted net assets		
Excess of revenues over expenses	\$ 8,419,880	\$ 6,595,331
Change in unrestricted interest in Mercy Hospital Foundation, Inc.	(121,715)	(41,405)
Net assets released from restriction	417,000	209,000
Unrealized gains on investments	-	8,214
Unrealized loss on interest rate swap	(100,438)	-
Decrease (increase) in minimum pension liability adjustment	8,280,277	(1,234,415)
Distributions to affiliates	(700,000)	-
Distributions to parent	(1,727,315)	-
Increase in unrestricted net assets before cumulative effect of changes in accounting principles	14,467,689	5,536,725
Cumulative effect of adoption of FASB Statement No. 158 (Note 11)	(11,734,173)	-
Cumulative effect of adoption of FIN 47 (Note 4)	-	(4,223,814)
Increase in unrestricted net assets	2,733,516	1,312,911
Temporarily restricted net assets		
Change in temporarily restricted interest in Mercy Hospital Foundation, Inc.	93,906	123,652
Temporarily restricted net assets released from restrictions	(417,000)	(209,000)
Decrease in temporarily restricted net assets	(323,094)	(85,348)
Increase in net assets	2,410,422	1,227,563
Net assets (deficit), beginning of year	(18,823,919)	(20,051,482)
Net Assets (Deficit), End of Year	\$ (16,413,497)	\$ (18,823,919)

The accompanying notes are an integral part of these financial statements.

Mercy Hospital of Buffalo
Statements of Cash Flows
For the Years Ended December 31, 2006 and 2005

	2006	2005
Increase in net assets	\$ 2,410,422	\$ 1,227,563
Adjustments to reconcile increase in net assets to net cash provided (used) by operating activities		
Depreciation and amortization	8,224,321	7,348,946
Provision for bad debts	7,278,041	7,846,928
Undistributed change in interest in Mercy Hospital Foundation, Inc.	380,861	(68,008)
Cumulative effect of adoption of FIN 47	-	4,223,814
Unrealized loss on interest rate swap	103,518	-
Distribution to parent and affiliates	2,427,315	-
Cumulative effect of adoption of FASB 158	11,734,173	-
(Increase) decrease in minimum pension liability	(8,280,277)	1,234,415
Undistributed earnings in equity investees	(633,549)	(260,321)
(Increase) decrease in assets		
Patient accounts receivables	(8,512,313)	(10,677,715)
Due from affiliate	388,341	(15,181,939)
Other receivables	(103,054)	(19,471)
Inventories	(14,999)	190,474
Prepaid expenses and other assets	317,763	(310,423)
Other assets	936,299	(541,260)
Increase (decrease) in liabilities		
Accounts payable	911,844	(775,844)
Accrued expenses	370,417	59,154
Accrued pension	1,698,168	1,978,876
Long-term portion of issuance liabilities	856,435	-
Due to third-party payors	(1,127,775)	218,891
Other liabilities	143,754	45,647
Net cash provided by (used in) operating activities	<u>19,509,705</u>	<u>(3,460,273)</u>
Cash flows from investing activities		
Purchase of property and equipment	(6,648,905)	(7,514,261)
Assets limited as to use, net	<u>(157,980)</u>	<u>1,552,010</u>
Net cash used in investing activities	<u>(6,806,885)</u>	<u>(5,962,251)</u>
Cash flows from financing activities		
Distribution to parent and affiliates	(2,427,315)	-
Proceeds from issuance of long-term debt	21,685,000	12,675,000
Discount on issuance	(125,541)	-
Repayment of current and long-term obligations	<u>(22,692,630)</u>	<u>(4,774,965)</u>
Net cash (used in) provided by financing activities	<u>(3,560,486)</u>	<u>7,900,035</u>
Increase (decrease) in cash and cash equivalents	9,142,334	(1,522,489)
Cash and cash equivalents, beginning of year	<u>4,658,473</u>	<u>6,180,962</u>
Cash and cash equivalents, end of year	<u>\$ 13,800,807</u>	<u>\$ 4,658,473</u>
Supplemental disclosure of cash flow information		
Cash paid during the year for interest	\$ 1,804,395	\$ 1,296,560
Noncash investing and financing activities		
Assets acquired under capital lease obligations	\$ 1,602,392	\$ 2,119,551

The accompanying notes are an integral part of these financial statements.

Mercy Hospital of Buffalo

Notes to Financial Statements

December 31, 2006 and 2005

1. Organization

Mercy Hospital of Buffalo (the Hospital), located in Buffalo, New York, is a not-for-profit acute care hospital and skilled nursing facility. The Hospital provides inpatient, outpatient, and emergency services for the residents of South Buffalo and its surrounding area. Admitting physicians are primarily practitioners in the local area. The Hospital is part of the Catholic Health System, Inc. (CHS or the System) and its organizational structure is discussed below.

The System

On February 17, 1998, final closing documents were signed to create the Catholic Health System, Inc. (CHS), a not-for-profit parent holding corporation. Catholic Health System, Inc. and Subsidiaries (the System) is an integrated healthcare delivery system in Western New York jointly sponsored by the Sisters of Mercy, the Daughters of Charity, the Franciscan Sisters of St. Joseph and the Diocese of Buffalo. Catholic Health East (CHE), Ascension Health System and the Diocese of Buffalo are the corporate members of CHS, with equal ownership interest.

Acute Care Subsidiaries

The Acute Care Subsidiaries include Mercy Hospital of Buffalo (MHB), Kenmore Mercy Hospital including The McAuley Residence (KMH), Sisters of Charity Hospital (SCH) and St. Joseph Hospital (SJH) (also collectively referred to as the Hospitals).

Long-Term Care Subsidiaries

The Long-term Care Subsidiaries include St. Clare Manor (closed December 2003), St. Francis Geriatric and Healthcare Services, Inc., St. Francis Home of Williamsville, Western New York Catholic Long-Term Care, Inc. (Father Baker Manor), St. Joseph's Manor (closed August 2006), St. Luke's Manor of Batavia (closed June 2004), St. Mary's Manor (closed 2003), Nazareth Home of the Franciscan Sisters of the Immaculate Conception, St. Elizabeth's Home, and St. Vincent's Home for the Aged.

Home Care Subsidiaries and Other

The Home Care and Other Subsidiaries include Mercy Home Care of Western New York, Inc., McAuley Seton Home Care (MSHC), OLV Renaissance Corporation and Catholic Continuing Care

2. Management's Plans and Intentions (Unaudited)

Management recognizes the need to accelerate investments in its acute care programs and continues to advance operational efficiencies within the hospital. The implementation of innovative strategic and capital initiatives, as well as prudent investment in existing programs, will serve to enhance the overall profitability and liquidity of the Hospital.

Such initiatives include:

- Minimally Invasive Technologies - Prior year investment in a 64 slice CT allowed the introduction of CT Angiography into our minimally invasive diagnostic array. Plans are underway to upgrade CT capabilities at the Mercy Ambulatory Care Center during 2007. Investments in endovascular training and equipment will increase endovascular surgeries in 2007.
- Center of Excellence – Neurosciences program development has been enhanced by addition of physician specialists performing emergency interventions for neurologic impediments. Mercy Hospital has applied for New York State Department of Health designation in late 2006 and is confident that it will receive a stroke center designation in the first quarter of 2007.

Mercy Hospital of Buffalo
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- Cardiovascular Service Line - Mercy Hospital was selected as a Blue Cross/Blue Shield Blue Distinction Center for Cardiac Care based on our performance data from 2005 through July 2006. Mercy opened its Electrophysiology Lab in 2006 and performed the first transcatheter closure of PFO in Western New York. Four additional cardiac surgeons have applied for privileges in 2006 and 2007. Mercy Hospitals third catheterization lab will be operational in late first quarter 2007. Digital Echo will be available system wide by second quarter 2007.
- Capacity Management – Mercy Hospital operational management of patient throughput has been enhanced through the implementation of Teletracking Technologies. In the last two years, "Bed-Tracker" and "Transport-Tracker" modules have been facilitating in-patient room turnover, thereby improving patient throughput and helping to minimize emergency department wait times. In 2007, we are adding the "Pre-Admit" module, which will serve to tie the 3 modules together for maximum impact. As a result, we will create physical capacity that had been lost to inherent inefficiencies in the historic room turnover process.
- Emergency Services – A Certificate of Need ("CON") application has been submitted to the New York State Department of Health for the construction of a new Emergency Department that will more than triple the size of the current Emergency Department, which serves almost 40,000 patients annually. Construction will begin in late 2007 or early 2008.

3. Significant Accounting Policies

The significant accounting policies applied in preparing the accompanying financial statements are summarized below:

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates made by the Hospital include, but are not limited to, reserve for bad debts, reserve for third-party payor contractual adjustments and allowances, the provision for estimated receivables and payables for final settlements with those payors, the reserve for employee health insurance, worker's compensation and professional and general liability and actuarial assumptions used in determining pension expense.

Risks and Uncertainties

Investment securities are exposed to various risks, such as interest rate, market and credit. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the fair value of investment securities, it is at least possible that changes in risks in the near term would materially affect the net assets of the Hospital.

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates related to third-party payment matters will change by a material amount in the near term.

Cash and Cash Equivalents

The Hospital considers all highly liquid investments, generally with original maturities of three months or less, and short term investments (certificates of deposit), excluding amounts held as assets limited as to use, to be cash equivalents. The Hospital maintains funds on deposit in excess of amounts insured by the Federal Depository Insurance limits.

Mercy Hospital of Buffalo
Notes to Financial Statements
December 31, 2006 and 2005

Inventory

Inventories are generally stated at the lower of cost (first-in, first-out) or market.

Assets Limited as to Use

Assets limited as to use represent amounts held in trust under a deferred compensation agreement. A corresponding liability is recorded by the Hospital within long-term liabilities.

Property and Equipment

Property and equipment are stated at cost if purchased, or if contributed, at the fair market value on the date contributed. Depreciation is computed using the straight-line method over useful lives ranging from three to forty years. Equipment under capital lease is amortized on the straight-line method over the shorter of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the financial statements.

Gifts of long-lived assets such as land, building, or equipment are reported as unrestricted support 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 these long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

Prepaid Expenses and Other Assets

Prepaid expense and other assets consist of prepaid general expenses, interest, deferred financing costs, investments in health care related joint ventures and partnerships, loans to affiliates and other miscellaneous deferred charges. Amortization of the financing costs is provided on the effective interest method over the maturity of the bond issues. The investments in health care related joint ventures and partnerships are accounted for on the equity or cost methods, as appropriate.

Impairment of Long-Lived Assets

Under the provisions of Statement of Financial Accounting Standards (SFAS) No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," the Hospital evaluates its long-lived assets for financial impairment as events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable.

The Hospital evaluates the recoverability of long-lived assets not held for sale by measuring the carrying amount of the assets against the estimated undiscounted future cash flows associated with them. If such evaluations indicate that the future undiscounted cash flows of certain long-lived assets are not sufficient to recover the carrying value of such assets, the assets are adjusted to their fair values. No adjustments were made in 2006 and 2005.

Mercy Hospital of Buffalo
Notes to Financial Statements
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Social Accountability Costs (Unaudited)

The Hospitals provide care to patients at no charge or at a discounted rate who meet eligibility requirements under its Health Care Assistance Policy (charity care). In addition to charity care, the Hospitals provide services to patients covered by Medicaid. The payments received for services provided to patients covered by Medicaid may be at or below costs in addition to the cost of care for patients without insurance. The Hospitals are also required to pay a gross receipts assessment to New York State which is used to fund the New York State Medicaid program and HCRA.

	December 31,	
	2006	2005
Cost of care for those who are poor (charity care)	\$ 4,376,714	\$ 4,708,315
Cost of community benefit programs	293,537	268,195
Unpaid cost of Medicaid programs	4,188,089	4,219,398
Social accountability costs	<u>\$ 8,858,340</u>	<u>\$ 9,195,908</u>

Net Patient/Resident Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered including estimated adjustments under various reimbursement agreements with third-party payors. The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Third-party payors retain the right to review and propose adjustments to amounts recorded by the Hospital. Such adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

Under the New York Health Care Reform Act (NYHCRA), hospitals are authorized to negotiate reimbursement rates with certain non-Medicare payors except for Medicaid, Workers' Compensation and No-fault, which are regulated by New York State. These negotiated rates may take the form of rates per discharge, reimbursed costs, discounted charges or as per diem payments. Reimbursement rates for non-Medicare payors regulated by New York State are determined on a prospective basis. These rates also vary according to a patient classification system defined by NYHCRA that is based on clinical, diagnostic and other factors.

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

- **Medicare.** Inpatient acute care services and outpatient services rendered to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Inpatient nonacute services and defined capital costs related to Medicare beneficiaries are paid based on a cost reimbursement methodology. The Hospital is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by the Hospital and audits thereof by the Medicare fiscal intermediary. Cost reports have been audited and finalized by the Medicare fiscal intermediary through December 31, 2004.
- **Medicaid.** Inpatient and outpatient services rendered to Medicaid program beneficiaries are reimbursed under a cost reimbursement methodology. The Hospital is reimbursed at a tentative rate with final settlement determined after submission of annual cost reports by the

Mercy Hospital of Buffalo
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Hospital and audits thereof by the Medicaid fiscal intermediary. Medicaid cost reports have been audited and finalized through December 31, 2004.

Amounts recognized in 2006 and 2005 related to prior years, including adjustments to prior year estimates increased the performance indicator approximately \$2,595,000 and (\$599,000), respectively.

Approximately 63% and 66% of net patient/resident service revenue was generated from services rendered to patients/residents under Medicare and Medicaid programs in 2006 and 2005, respectively. Approximately 30% and 28% of net patient/resident service revenue was generated from services rendered to patients under managed care programs in 2006 and 2005.

Operating and Nonoperating Revenues and Losses

The System's primary mission is dedicated to meeting the health care needs in the regions in which it operates. The System is committed to providing a broad range of general and specialized health care services including inpatient, primary care, long-term care, outpatient services, and other health care related services. Only those activities directly associated with the furtherance of this mission are considered to be operating activities. Such activities include operation of cafeterias, parking lots, rental real estate and other ancillary activities. Other activities that result in gains or losses unrelated to the System's primary mission are considered to be nonoperating.

Other Revenues

The composition of other revenue for the years ended December 31, is set forth in the following table:

	2006	2005
Shared services (Note 13)	\$ 781,458	\$ 647,078
Cafeteria revenue	1,053,605	1,032,129
Parking revenue	633,098	615,479
Rental income	241,860	211,359
OLV Family Care Center - VA Contract	644,305	613,323
CHS Miscellaneous Revenue	114,397	574,377
PCC Incentives/Quality Awards	201,745	508,887
Earnings in Equity Investees	1,282,124	297,547
Other	300,640	523,911
	<u>\$ 5,253,232</u>	<u>\$ 5,024,090</u>

Mercy Hospital of Buffalo
Notes to Financial Statements
December 31, 2006 and 2005

Other Expenses

The composition of other expenses for the years ended December 31, is set forth in the following table:

	2006	2005
System dues (a)	\$ 2,429,861	\$ 2,059,243
Rents and operating leases	3,554,475	3,637,058
NYS Health Facilities Cash Receipts Assessment Program	718,156	500,000
Other dues	712,809	737,422
Catholic Health System Other Expense	469,402	371,241
Equipment Rentals	261,273	253,799
Seminars/Conferences	83,214	97,419
Other	307,566	316,844
	<u>\$ 8,536,756</u>	<u>\$ 7,973,026</u>

(a) System dues are comprised of the following expenses:

	2006	2005
Dues to Catholic Health East	\$ 1,295,931	\$ 946,098
Salaries, wages and employee benefits	333,449	599,606
Professional fees and purchased services	376,481	336,163
Other	424,000	177,376
	<u>\$ 2,429,861</u>	<u>\$ 2,059,243</u>

Excess of Revenues Over Expenses

The statement of operations and changes in net assets includes excess of revenues over expenses, commonly referred to as the performance indicator. Changes in unrestricted net assets which are excluded from excess of revenues over expenses, consistent with industry practice, include unrealized gains and losses on investments other than trading securities, permanent transfers of assets to and from affiliates for other than goods and services, contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets), the effective portion of cash flow hedging derivatives and additional minimum pension liability adjustments.

Net Assets

Unrestricted net assets are available for the general operating purposes of the Hospital and are not subject to any donor limitations.

Temporarily restricted net assets are those whose use is limited by donors to a specific period or purpose and includes the Hospital's interest in the temporarily restricted net assets of the Mercy Hospital Foundation, Inc. (the Foundation). Temporarily restricted net assets are released to unrestricted net assets as restrictions are met, which can occur in the same period. Gifts whose restrictions are met in the same period in which they are received are recorded as an increase in unrestricted net assets. Such restrictions include purpose restrictions where donors have specified the purpose for which the net assets are to be spent, or time restrictions imposed by donors or implied by the nature of the gift, pledges to be paid in future periods, life income funds. Investment return is included in unrestricted net assets unless the return is restricted by donor or law.

Mercy Hospital of Buffalo

Notes to Financial Statements

December 31, 2006 and 2005

Income Taxes

The financial statements do not include a provision for income taxes, since each facility is a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code. The tax-exempt organizations are subject to federal taxes on unrelated business income under section 511 of the Internal Revenue Code which are reported as other expenses in these financial statements.

Reclassifications

Certain prior year amounts were reclassified to conform to the 2006 consolidated financial statement presentation.

Revision in the Classification of Certain Accrued Expenses and Other Long-term Liabilities

In connection with the preparation of the consolidated financial statements for the period ended December 31, 2006, the Hospital concluded that it was appropriate to classify a portion of insurance-related accrued expenses on the Hospital's Consolidated Balance Sheet as other long-term liabilities. Previously, these accruals had been classified as accrued expenses. These accruals are described in greater detail in Note 12.

This revision in classification has no impact on previously reported total current assets, total assets, working capital position, results of operations, or financial covenants and does not affect previously reported cash flows.

Capitalized Software Costs

The Hospital capitalizes certain costs that are incurred to purchase or to create and implement internal-use computer software, which includes software coding, installation, testing and certain data conversion from both internal and external providers in accordance with Statement of Position No. 98-1. These capitalized costs are amortized on a straight-line basis over ten years and reviewed for impairment on an annual basis. Total capitalized software is \$464,767 as of December 31, 2006. There were no costs capitalized in 2005.

4. New Accounting Pronouncement

In February 2007, the Financial Accounting Standards Board ("FASB") issued FAS 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (including an amendment of FAS 115) ("FAS 159"). FAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement. This Statement is effective as of the beginning of the Hospital's first fiscal year that begins after November 15, 2007. The Hospital does not expect the adoption of FAS 159 to have a material impact on its consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standard No. 157, "Fair Value Measurements" ("FAS 157"). FAS 157 provides a definition of fair value, establishes acceptable methods of measuring fair value and expands disclosures for fair value measurements. The principles apply under accounting pronouncements which require measurement of fair value. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Hospital does not expect the adoption of FAS 157 to have a material impact on its financial statements.

On September 29, 2006, the FASB issued Statement of Financial Accounting Standard No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" ("FAS 158"). FAS 158 requires, among other things, the recognition of the funded status of the Hospital's defined pension benefit plan on the balance sheet. The Hospital's plan is underfunded and the underfunded

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amount is recognized as a liability. The initial impact of the standard is to recognize prior service costs, net actuarial gains or losses, as well as subsequent changes to the funded status which is recognized in the ending balance of unrestricted net assets. Additional minimum pension liabilities and the related intangible pension asset are also derecognized upon adoption of the new standard. FAS 158 requires initial application for nonpublic companies for fiscal years ending after June 15, 2007, with earlier application encouraged. The Hospital early adopted FAS 158 as of December 31, 2006 (Note 11).

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). FIN 48 applies to all tax positions accounted for under SFAS No. 109, "Accounting for Income Taxes" and defines the confidence level that a tax position must meet in order to be recognized in the financial statements. The interpretation requires that the tax effects of a position be recognized only if it is "more-likely-than-not" to be sustained by the taxing authority as of the reporting date. If a tax position is not considered "more-likely-than-not" to be sustained then no benefits of the position are to be recognized. FIN 48 requires additional disclosures and is effective as of the beginning of the first fiscal year beginning after December 15, 2006. The Hospital does not expect the adoption of FIN 48 to have a material impact on its financial statements.

In March 2005, the FASB issued FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (FIN 47), which is effective for the Hospital as of and for the year ended December 31, 2005. FIN 47 was issued to provide clarity surrounding the recognition of conditional asset retirement obligations, as referred to in FASB Statement No. 143, *Accounting for Asset Retirement Obligations*. FIN 47 defines a conditional asset retirement obligation as a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. Uncertainty with respect to the timing and/or method of settlement of the asset retirement obligation, does not defer recognition of a liability. The obligation to perform the asset retirement activity is unconditional, and accordingly, a liability should be recognized. FIN 47 also provides guidance with respect to the criteria to be used to determine whether sufficient information exists to reasonably estimate the fair value of an asset retirement obligation. Based on the guidance in FIN 47, management of the Hospital determined that sufficient information was available to reasonably estimate the fair value of known asset retirement obligations.

FIN 47 requires the initial application of the interpretation to be recognized as a cumulative effect of a change in accounting principle. Specifically, FIN 47 requires the recognition, as a cumulative effect, the cumulative accretion and accumulated depreciation for the time period from the date the liability would have been recognized had the provisions of the interpretation been in effect when the liability was incurred to the date of adoption of this Interpretation. The liability incurred date is presumed to be the date upon which the legal requirement to perform the asset retirement activity was enacted.

Upon initial application of FIN 47, the Hospital recognized \$4,223,814 as the cumulative effect of a change in accounting principle in the consolidated statement of operations. As of December 31, 2006, \$4,431,260 of conditional asset retirement obligation are included within other liabilities in the consolidated balance sheet.

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The following table illustrates the effect on excess of revenue over expenses as if this Interpretation had been applied during the periods presented:

	Year ended December 31,	
	2006	2005
Excess of revenues over expenses, as reported	\$ 8,419,880	\$ 6,595,331
Less: total depreciation and interest accretion costs	221,750	210,689
Pro forma excess of revenues over expenses	<u>\$ 8,198,130</u>	<u>\$ 6,384,642</u>

5. Interest in Net Assets of Mercy Hospital Foundation, Inc.

The Hospital accounts for its interest in Mercy Hospital Foundation (Foundation) in accordance with the provisions of Statement of Financial Accounting Standards No. 136, *Transfer of Assets to a Not-for-Profit Organization or Charitable Trust that Raises or Holds Contributions for Others* ("FAS 136"). FAS 136 establishes standards for transactions in which a not-for-profit organization (the recipient organization, or the Foundation) accepts a contribution from a donor and agrees to transfer those assets, the return on investment of those assets, or both to another entity (the beneficiary, or the Hospital) that is specified by the donor. FAS 136 further provides that when these organizations are financially interrelated, as defined in FAS 136, the beneficiary is required to recognize its interest in the net assets of the recipient organization and adjust that interest for its share of the change in net assets. The Foundation is a separate not-for-profit organization with its own board of directors and finances separate from those of the Hospital and is not part of the Hospital's financial reporting entity. However, the Hospital can influence the financial decisions of the Foundation to such an extent that the Hospital can determine the timing and amount of distributions from the Foundations, and as such, the net asset classifications reported by the Hospital are consistent with the Foundation's financial statements.

A summary of MHF's assets, liabilities, net assets, and changes in net assets are as follows at December 31:

	2006	2005
Cash, investments and other assets	\$ 1,546,928	\$ 1,972,408
Liabilities	\$ 140,503	\$ 185,122
Net assets		
Unrestricted	\$ 841,685	\$ 899,452
Temporarily restricted	564,740	887,834
Total net assets	<u>\$ 1,406,425</u>	<u>\$ 1,787,286</u>
Change in unrestricted net assets	\$ (57,767)	\$ 153,356
Change in temporarily restricted net assets	(323,094)	(85,348)
	<u>\$ (380,861)</u>	<u>\$ 68,008</u>

Distributions were made to the Hospital in the amount of \$353,052 and \$14,239 during 2006 and 2005, respectively.

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6. Assets Limited as to Use

The composition of assets limited as to use is as follows at December 31:

	2006	2005
Board designated		
Deferred compensation arrangements		
Cash and cash equivalents	\$ -	\$ 1,260,697
Debt securities	850,736	-
Equity securities	567,941	-
Total assets limited as to use	<u>\$ 1,418,677</u>	<u>\$ 1,260,697</u>

7. Property and Equipment

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

	2006	2005
Land and land improvements	\$ 1,247,770	\$ 1,281,694
Buildings	51,683,152	54,994,014
Leasehold improvements	3,447,112	1,829,531
Equipment	31,220,746	30,585,424
Equipment under capital leases	7,172,556	5,570,164
	<u>94,771,336</u>	<u>94,260,827</u>
Less: Accumulated depreciation	(49,211,373)	(52,563,013)
Accumulated amortization on equipment under capital leases	(2,136,714)	(1,045,660)
	<u>43,423,249</u>	<u>40,652,154</u>
Construction in progress	587,571	2,741,677
Property and equipment, net	<u>\$ 44,010,820</u>	<u>\$ 43,393,831</u>

Depreciation expense amounted to \$6,835,224 and \$6,326,905 in 2006 and 2005, respectively. Amortization expense on equipment under capital leases amounted to \$1,091,054 and \$875,636 in 2006 and 2005, respectively.

8. Other Assets

Other assets consist of the following at December 31:

	2006	2005
Equity investments	\$ 3,027,256	\$ 2,504,102
Debt issuance costs - Series 2006	531,376	-
Debt issuance costs - Siemens	-	120,000
Long-term portion of note receivable	63,297	124,957
Intangible asset - pension	-	1,275,913
	<u>\$ 3,621,929</u>	<u>\$ 4,024,972</u>

Amortization expense on debt issuance costs amounted to \$76,293 and \$146,405 in 2006 and 2005, respectively. A loss of \$46,667 on extinguishment of debt was recorded related to unamortized debt issuance costs.

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Equity investments consist of the following at December 31:

Equity Investment	Ownership Interest	2006		2005	
		Balance of Investment Carried by MHB	Total Net Assets of Investee	Balance of Investment Carried by MHB	Total Net Assets of Investee
Orchard Park Medical Building LP (a)	100%	\$ 10,942	\$ 10,942	\$ 303,889	\$ 303,889
Southtowns Catholic MRI, Inc.	(b)	1,758,415	1,758,415	875,338	1,750,676
Southtowns Catholic MRI, LLC	50%	564,113	1,128,226	650,097	1,300,194
OLV Brierwood Health Care	33%	663,286	1,989,858	615,993	1,866,645
Other	Varies	30,500	30,500	58,785	58,785
Total		<u>\$ 3,027,256</u>	<u>\$ 4,917,941</u>	<u>\$ 2,504,102</u>	<u>\$ 5,280,189</u>

(a) Equity investee consists of a real estate holding company that owns minority interest in a real estate joint venture with a third party. Management believes the effects of not consolidating this investment to be immaterial to the financial statements.

(b) Ownership interest at December 31, 2006 and 2005 was 100% and 50%, respectively.

9. Long-Term Obligations

Long-Term Debt

Long-term debt, inclusive of capital lease obligations, were comprised of the following at December 31:

	2006	2005
Mercy Hospital Series 2006 D (a)	\$ 13,234,459	\$ -
Siemens Term Loan (b)	-	12,675,000
Clinic mortgage, collateralized by real property, monthly payment of \$2,160, including interest at 9% and matures July 2008.	128,534	142,215
Individual subordinated to mortgage held by Lackawanna Community Development Corporation, monthly payments of \$1,239, including interest at 10%, matures December 2012.	66,857	74,608
Capital lease obligations, at interest rates ranging from 5.84% to 9.5% , collateralized by equipment.	6,042,187	6,110,993
	<u>19,472,037</u>	<u>19,002,816</u>
Less: Current portion	<u>(1,767,021)</u>	<u>(1,628,175)</u>
	<u>\$ 17,705,016</u>	<u>\$ 17,374,641</u>

(a) In 2006, the System formed the Acute Care Obligated Group ("the Obligated Group"), consisting of its four primary hospitals (MHB, SOC, KMH and SJH) and the parent. No affiliates of CHS other than the Members of the Obligated Group were included in this offering. Collectively, the Obligated Group refinanced all outstanding indebtedness of the Obligated Group. On November 29, 2006, \$68,820,000 of Dormitory Authority of the State of New York (DASNY) Catholic Health System Obligated Group Revenue Bonds, Series 2006 were issued. Series 2006D for \$13,360,000 was loaned to the Hospital to repurchase the outstanding Siemens Financial Services, Inc. Term Loans outstanding and to pay certain

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transaction related costs. The discount on the bonds of \$125,541 will be accreted over the life of the bonds.

In connection with the issuance of the Series 2006 Bonds, the Hospital entered into a Loan Agreement (the Loan Agreement) whereby the Hospital is required to pay funds sufficient in timing and amount to pay the principal and redemption price of the Series 2006 Bonds and related interest and administrative expenses as they come due. The Series 2006 Bonds pay interest at a variable rate ("auction rate") and are collateralized by a Line of Credit with HSBC Bank. The interest payable by the Hospital under the terms of the Loan Agreement is variable as determined by the Bond Marketing Association Index.

The Loan Agreement specifies that the Hospital shall continuously pledge, as a security for the payment of all liabilities and the performance of all obligations of the Hospital pursuant to the loan agreement, a security interest in and assignment the gross receipts of the Hospital, together with the Hospital's right to receive or collect the gross receipts. Further, the Hospital delivered a mortgage to secure all obligations and liabilities of the Hospital under the Loan Agreement. As further security to the Loan Agreement, the Hospital granted DASNY a security interest in such fixtures, furnishings and equipment as owned by the Hospital. In addition, a letter of credit in the amount of the bonds was entered into with HSBC Bank USA to provide security on the Series 2006 Bonds.

Certain financial covenants must be maintained by the Obligated Group. Failure to comply with these covenants requires a formal consultants report and quarterly progress reports demonstrating how the facility is progressing towards compliance. The Loan Agreement requires each the Obligated Group to comply with certain financial covenants, including maintenance of (i) a minimum number of days cash on hand; (ii) long-term debt service coverage; (iii) a maximum leverage ratio. The Obligated Group was in compliance with these covenants at December 31, 2006.

In connection with the issuance of the Series 2006 Bonds and execution of the Loan Agreement, the Hospital entered into an interest rate swap agreement (a derivative agreement) with HSBC Bank USA, NA. (HSBC) and JP Morgan Chase. Pursuant to the Loan Agreement, the Hospital agreed to maintain a derivative agreement for purposes of mitigating risk posed by the Bonds accruing interest at a variable rate. Further, the Hospital agreed not to take or omit to take any action that could reasonably be expected to result in the termination of the derivative agreement unless otherwise approved by JP Morgan Chase and HSBC, provided, however, that termination of the derivative agreement shall not constitute an event of default for purposes of the Loan Agreement, but upon any such termination of the derivative agreement JP Morgan Chase or HSBC may require that the Hospital direct the Series 2006 Bonds be converted to bonds that bear a fixed rate of interest. The terms of the swap require the Hospital to pay a fixed rate of 3.80% on the notional amount (\$13,360,000 at December 31, 2006) and in exchange, the Hospital will receive a variable rate payment based upon the Bond Market Association Index, calculated weekly. The notional amount of the swap is matched to the maturity schedule of the Series 2006 Bonds. The swap agreement was executed on December 13, 2006 and expires July 1, 2025. These dates correlate to the issue date and due date of the Series 2006 Bonds. In accordance with Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activity, the swap is recorded on the accompanying financial statements at estimated fair value, determined to be approximately \$103,518 (liability) at December 31, 2006. The instrument qualifies for hedge treatment under this statement and is designated a cash flow hedge of future interest payments. The effective portion of the hedge has been excluded from excess of revenues over expenses and recorded within changes to net assets.

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- (b) In June 2005, the Hospital closed on term loans with Siemens Financial Services, Inc., of which \$12,675,000 was drawn down at December 31, 2005. The proceeds of this loan were used to repay outstanding bond debt as well as outstanding intercompany balances and to fund working capital requirements. Under the loan agreements, the Hospital was required to make interest only payments until June 2007. Through June 2006, the interest rate on this debt was 6.55%. Thereafter, the interest increased by ten basis points on the first day of each quarter.

In January 2006, the Hospital drew down the remaining balance on this loan, in the amount of \$8,325,000. In November 2006, this obligation was paid in full with the proceeds of the Obligated Group Debt.

Under the terms of the obligation, the property and profits from the Hospital are pledged as collateral for payment of the obligation. The loan agreements associated with the obligations also require the Hospital to, among other things, maintain certain levels of insurance coverage and the following financial ratios discusses as follows - minimum Earnings before interest, depreciation, and amortization ("EBITDA"), total funded debt to EBITDA, EBITDA annual debt service ratio, and minimum cash liquidity levels. At December 31, 2005, the Hospital was in compliance with all of the financial covenants.

Aggregate maturities of long-term obligations subsequent to December 31, 2006 are:

	Loans	Capital Leases	Total
2007	\$ 238,527	\$ 1,865,411	\$ 2,103,938
2008	638,030	1,418,320	2,056,350
2009	545,450	1,545,121	2,090,571
2010	566,544	1,338,651	1,905,195
2011	592,753	631,174	1,223,927
Thereafter	10,848,546	116,976	10,965,522
	<u>\$ 13,429,850</u>	<u>6,915,653</u>	<u>\$ 20,345,503</u>
Less: Interest		(873,466)	
		<u>\$ 6,042,187</u>	

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Operating Leases

Future minimum lease payments under non-cancellable operating leases (net of sublease rental) are as follows:

2007	\$ 3,863,317
2008	3,927,350
2009	3,623,309
2010	3,712,287
2011	3,148,149
Thereafter	<u>17,915,312</u>
	36,189,724
Minimum sublease rental obligations	<u>(765,795)</u>
	<u>\$ 35,423,929</u>

Total expense for rents and operating type leases was approximately \$3,554,475 and \$3,621,161 in 2006 and 2005, respectively.

10. Accrued Expenses

Accrued expenses consist of the following at December 31:

	2006	2005
Workers compensation	\$ 2,821,686	\$ 2,714,714
Payroll and benefits	6,333,936	5,961,626
Other	<u>8,378</u>	<u>117,243</u>
	<u>\$ 9,164,000</u>	<u>\$ 8,793,583</u>

11. Employee Benefit Plans

Pension Arrangements

Effective January 1, 2001, the System began maintaining a qualified defined benefit pension plan covering substantially all of its employees at its five constituent hospitals. As of that date, the Mercy Hospital of Buffalo Pension Plan was merged into the Retirement Plan of the Catholic Health System (the Plan).

Effective January 1, 2001, all nonunion employees who had met the age and service requirements under their previous plan were given the option of choosing to participate in the cash balance feature of the Plan. Those who did not choose to participate in the cash balance feature accrue benefits under the same formula as their previous plan. All nonunion employees who become participants after that date automatically participate under the cash balance formula.

The Plan bases benefits upon both years of service and earnings. Participants under the Mercy Hospital of Buffalo formula earn benefits based on a career average formula. The cash balance formula is a hypothetical account balance formula.

Funded Status

FAS 158 focuses primarily on balance sheet reporting for the funded status of benefit plans and requires recognition of benefit liabilities for under-funded plans and benefit assets for over-funded plans, with offsetting impacts to unrestricted net assets. The System has elected to early adopt the balance sheet recognition provisions of FAS 158 as of December 31, 2006.

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The following table summarizes the effects of the adoption of FAS 158 as of December 31, 2006

	<u>Prior to SFAS 158 Adjustments</u>	<u>SFAS 158 Adjustment</u>	<u>Post SFAS 158 Adjustments</u>
Other assets	\$ 1,312,970	\$ (1,312,970)	\$ -
Pension obligations	36,447,368	10,421,203	46,868,571
Unrestricted Net Assets	(5,236,064)	(11,734,173)	(16,970,237)

The following tables summarize changes in the benefit obligation, the plan assets and the funded status of our pension plan as well as the components of net periodic benefit costs, including key assumptions. The measurement dates for plan assets and obligations were December 31, 2006 and 2005.

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
Benefit Obligations		
Change in benefit obligation		
Benefit obligation at beginning of year	\$ 100,553,546	\$ 92,182,972
Service cost	4,143,614	3,555,843
Interest cost	5,694,399	5,445,906
Actuarial (gains) losses	(2,919,897)	2,432,131
Benefits paid	(2,632,296)	(2,948,434)
Expenses	(108,356)	(114,872)
Benefit obligation at end of year	<u>\$ 104,731,010</u>	<u>\$ 100,553,546</u>
Plan Assets		
Change in plan assets		
Fair value of plan assets at beginning of year	\$ 50,239,979	\$ 44,754,217
Actual return on plan assets	5,741,112	3,697,034
Benefits paid	(2,632,296)	(2,948,434)
System contributions	4,622,000	4,852,034
Expenses	(108,356)	(114,872)
Fair value of plan assets at end of year	<u>\$ 57,862,439</u>	<u>\$ 50,239,979</u>
Funded status at end of year	<u>\$ 46,868,571</u>	<u>\$ 50,313,567</u>
Amounts not yet recognized		
Unrecognized actuarial net loss	-	(30,285,595)
Unrecognized prior service credit	-	(1,286,828)
Net amount recognized	<u>\$ 46,868,571</u>	<u>\$ 18,741,144</u>
Amounts recognized in the consolidated balance sheets		
Intangible pension asset	\$ -	\$ 1,275,913
Noncurrent liabilities	(46,868,571)	(41,740,507)
Net Assets (Minimum Pension Liability)	-	21,723,450
Net amounts recognized	<u>\$ (46,868,571)</u>	<u>\$ (18,741,144)</u>

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The funded status of the plan, reconciled to the amounts reported in the consolidated balance sheet, follows:

	2006	2005
Amounts recognized in unrestricted net assets		
consists of		
Actuarial net loss	\$ (10,584,680)	
Prior service cost	(1,149,493)	
Total amount recognized	<u>\$ (11,734,173)</u>	
Amounts expected to be recognized as components		
of the net periodic pension cost in the following year		
Amortization of prior service cost	\$ (137,335)	
Amortization of loss	(1,539,185)	
Amounts expected to be recognized in the following year	<u>\$ (1,676,520)</u>	
Components of net periodic pension cost		
Service cost	\$ 4,143,614	\$ 3,555,843
Interest cost	5,694,399	5,445,906
Expected return on plan assets	(4,343,200)	(4,031,456)
Amortization of prior service cost or (credit)	137,335	70,385
Recognized actuarial loss	1,939,933	1,711,509
Net periodic pension cost	<u>\$ 7,572,081</u>	<u>\$ 6,752,187</u>

The Plan's investment policies and strategies were used to develop the expected long-term rate of return on risk-free investment (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. The expected return of each asset class was then weighted based on the target asset allocation to develop the expected long-term rate of return on assets assumption.

The Plan's target asset allocation for 2006 and the actual asset allocation percentages for 2006 and 2005 are as follows at the respective measurement dates:

Asset Category	Pension target allocation range	Percentage of pension plan assets	
	2006	2006	2005
Equities	63%	65%	62%
Fixed Income	25%	24%	26%
Other	12%	11%	12%
	<u>100%</u>	<u>100%</u>	<u>100%</u>

The System is expected to contribute an aggregate amount of approximately \$11,000,000 to the pension plan trust in 2007 to be allocated amongst participating entities.

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Estimated future benefit payments by the Plan are as follows as of December 31:

2007	\$ 7,084,000
2008	8,157,000
2009	9,163,000
2010	10,198,000
2011	11,435,000
2012 - 16	77,330,000
	<u>\$ 123,367,000</u>

	2006	2005
Weighted-average assumptions used to determine end of year benefit obligations		
Discount rate	6.00%	5.75%
Rate of compensation increase	3.75%	3.75%
Weighted-average assumptions used to determine net periodic pension cost		
Discount rate	5.75%	6.00%
Expected long-term rate of return on plan assets	8.50%	8.50%
Measurement date	12/31/2006	12/31/2005

12. Insurance Arrangements

The System, on the Hospital's behalf, participates in the CHE insurance program which provides coverage for healthcare professional (medical malpractice) and general liability exposures. The primary limits for healthcare professional and general liability are \$3 million per occurrence and are insured by Stella Maris Insurance Company, Ltd. ("SMICL"), a Cayman-domiciled insurer wholly-owned by CHE. SMICL also provides excess coverage to the System, and this excess coverage is fully reinsured with non-affiliated commercial insurance companies. SMICL retains the full risk in the primary layer and no risk in the excess layers.

The coverage provided by SMICL is on a claims-made basis. The System, on the Hospital's behalf therefore retains the liability for unasserted claims resulting from incidents that occurred on services provided prior to the financial statement date. The System has independent actuaries estimate the ultimate costs of such unasserted claims, which were discounted at 5.00% and 5.25% in 2006 and 2005, respectively. The Hospital's liability for unasserted claims at December 31, 2006 and 2005 are \$2,027,000 and \$1,882,000, respectively. The charges to expenses for professional and general liability for 2006 and 2005 approximated \$2,290,000 and \$2,583,000, respectively, which has been included in insurance expense.

The System's insurance program for workers' compensation, in which the Hospital participates, has a deductible of \$250,000 per occurrence. Claims in excess of self-insurance levels are fully insured. Losses from asserted claims and from unasserted claims identified by the System's incident reporting for the Hospital were accrued on an undiscounted basis based on actuarial estimates of the settlement of such claims. The Hospital's liability for unpaid and incurred but not reported claims at December 31, 2006 and 2005 are \$10,047,000 and \$9,149,000, respectively. The charges to expenses for workers compensation costs approximated \$4,870,000 and \$3,556,000 in 2006 and 2005, respectively, which has been included in employee benefits expense.

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The System's insurance for employee health costs, in which the Hospital participates, is self-insured up to \$250,000 per claim. Claims in excess of self-insurance levels are fully insured. Claims are accrued based upon the Hospital's estimates of the aggregate liability for claims incurred using certain actuarial assumptions used in the insurance industry and based on the System's experience.

13. Related Party Transactions

The Hospital is one of a group of health care providers who are affiliated as a result of their association with the Catholic Health System, Inc. (the System).

During 2006 and 2005 the Hospital recorded expenses to affiliates for administration services, rent and other services. These expenses approximated \$24,078,209 for 2006 and \$14,673,579 for 2005 and are recorded in the statement of operations and changes in net assets. The Hospital also provided cost sharing services to and received reimbursement from affiliates for laboratory, computer and other services. Revenues from these services approximated \$1,428,155 and \$1,374,510 for 2006 and 2005, respectively.

During 2006, a distribution was made to the parent of \$1,727,315. During 2006 and 2005, the Hospital received cash payments from affiliates and made cash payments to affiliates in the normal course of operations.

Amounts due to affiliates at December 31, 2006 and 2005 were \$248,932 and \$2,653,390, respectively. Amounts due from affiliates at December 31, 2006 and 2005 were \$1,001,731 and \$4,086,500, respectively, of which \$977,864 and \$4,074,662 are due from parent.

14. Legal Matters

The Hospital is involved in litigation and regulatory investigations arising in the course of business. The health care industry is subject to numerous laws and regulations of federal, state and local governments. Compliance with these laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at the time. Recently, government activity has increased with respect to investigations and allegations concerning possible violations by health care providers of fraud and abuse statutes and regulations, which could result in the imposition of significant fines and penalties as well as significant repayments for patient services previously billed under Medicare and Medicaid programs in the current and preceding years. Management believes it is in compliance with such laws and regulations and no unknown or unasserted claims were known at this time, which could have a material adverse affect on the System's future financial position, results from operations or cash flows.

15. Concentrations of Credit Risk

The Hospital grants credit without collateral to its patients, most of who are residents of Western New York and are insured under third-party agreements. The mix of receivables from patients and third-party payors at December 31:

	2006	2005
Medicare	41%	41%
Medicaid	3%	2%
Blue Cross	5%	6%
Other third-party payors	36%	35%
Patients	15%	16%
	<u>100%</u>	<u>100%</u>

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The Hospital maintains funds in excess of amounts insured by the Federal Depository Insurance limits. The Hospital has diversified its deposit amounts in a variety of institutions to reduce the level of concentrated risk.

16. Commitments and Contingencies

Siemens Strategic Alliance

On June 24, 2004, the System entered into a Strategic Alliance with Siemens Medical USA to provide capital, preferred pricing, and IT solutions. The 10-year Strategic Alliance Agreement with Siemens consists of three distinct initiatives with several sub-components. The distinct initiatives are outlined below:

- 1.) A preferred provider agreement between CHS and Siemens at Strategic Partner pricing for medical equipment/radiology modality needs.
- 2.) An IT solution to replace the current disparate clinical and financial platforms with Siemens' new Soarian web-based product.
- 3.) An initiative from Siemens Building Technologies to evaluate and implement an Energy Performance Program across the acute care enterprise.

Under the agreement, whereby the System is committed to pay a base licensing fee of \$232,000 per month, incremental licensing fees related to the Soarian platform, in the amount of \$179,000 per month, will be at risk (either increased or decreased) based upon the System's achievement of certain clinical, financial, and implementation metrics. Further, the System is obligated under this agreement to purchase no less than 80% of its compliant (as defined in the Strategic Alliance Agreement) medical equipment through Siemens Medical. In return the System receives Strategic Partner pricing. Certain exclusions apply in situations where competition prices are below those offered by Siemens or if another vendor provides "breakthrough" technology.

In connection with this agreement, the Hospital will be participating in the initiatives outlined above.

17. Functional Expenses

The Hospital provides general health care services to residents within its geographic region. Expenses related to providing these services for the years ended December 31 are as follows:

	2006	2005
Health care services	\$ 161,100,582	\$ 155,759,978
General and administrative	<u>51,612,502</u>	<u>42,748,601</u>
	<u>\$ 212,713,084</u>	<u>\$ 198,508,579</u>

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18. Fair Values of Financial Instruments

The following methods and assumptions were used by the Hospital in estimating fair value disclosures for financial statements:

Assets Limited as to Use

The fair values for marketable equity, government, and fixed income securities are based on quoted market prices.

Long-Term Debt Obligations

The fair value of long-term debt excluding capital lease obligations is based on quoted market prices or estimated using discounted cash flow analysis, based on the participating institution's incremental borrowing rates for similar types of borrowing arrangements in estimating fair value disclosures for long-term obligations.

Interest Rate Swap

Fair value of derivatives is calculated as the difference between fixed rate interest payments made under the swap agreement and expected variable payments under the agreement. Expected payments are projected based upon the forward yield curve for tax-exempt debt as of December 31, 2006 and 2005 and discounted utilizing the London Interbank Offering Rate ("LIBOR").

The carrying amounts and approximate fair values of financial instruments at December 31 are as follows:

	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	\$ 13,800,807	\$ 13,800,807	\$ 4,658,473	\$ 4,658,473
Assets limited as to use	1,418,677	1,418,677	1,260,697	1,260,697
Long-term debt obligations, including line of credit payable and excluding capital lease obligations	13,429,850	13,431,194	12,891,823	12,629,556
Interest rate swap	103,518	103,518	-	-