

Mercy Hospital of Buffalo
(a subsidiary of the
Catholic Health System, Inc.)
Financial Statements
December 31, 2007 and 2006

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, 2007 and 2006, 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 10, the Hospital adopted the provisions of FASB 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans".

As discussed in Note 12, the Hospital had significant transactions with related parties.

As discussed in Note 3, Mercy Hospital of Buffalo became the sole corporate member of the Mercy Hospital Foundation.

PricewaterhouseCoopers LLP

Buffalo, New York
April 15, 2008

Mercy Hospital of Buffalo
Balance Sheets
December 31, 2007 and 2006

	2007	2006
Assets		
Current assets		
Cash and cash equivalents	\$ 20,352,212	\$ 14,198,795
Patient/resident accounts receivable, net of estimated uncollectibles of \$2,865,000 and \$3,424,000	31,537,649	24,104,718
Other receivables	2,759,337	529,009
Inventories	944,497	966,856
Prepaid expenses and other current assets	474,457	523,396
Total current assets	56,068,152	40,322,774
Assets limited as to use	335,738	1,418,677
Investments	1,112,058	1,034,685
Due from affiliates	22,234	1,001,731
Property and equipment, net	45,742,665	44,026,576
Other assets	2,920,972	3,621,929
Total Assets	\$ 106,201,819	\$ 91,426,372
Liabilities and Net Assets (Deficit)		
Current liabilities		
Current portion of long-term obligations	\$ 2,062,804	\$ 1,767,021
Accounts payable	11,025,844	8,645,752
Accrued expenses	9,679,241	9,164,000
Due to third-party payors	9,431,788	7,523,522
Due to affiliates	456,514	248,932
Total current liabilities	32,656,191	27,349,227
Long-term obligations, net	16,659,077	17,705,016
Long-term portion of insurance liabilities	10,080,212	9,963,600
Pension obligation	38,249,030	46,868,571
Asset retirement obligation	4,495,529	4,431,260
Interest rate swap	322,247	103,518
Deferred compensation plan	335,738	1,418,677
Total liabilities	102,798,024	107,839,869
Net assets (deficit)		
Unrestricted	1,048,915	(16,970,237)
Temporarily restricted	2,270,880	556,740
Permanently restricted	84,000	-
Total net assets (deficit)	3,403,795	(16,413,497)
Total Liabilities and Net Assets (Deficit)	\$ 106,201,819	\$ 91,426,372

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, 2007 and 2006

	2007	2006
Unrestricted revenues, gains and other support		
Net patient/resident service revenue	\$ 236,731,325	\$ 215,136,618
Other revenue	<u>4,353,016</u>	<u>5,598,735</u>
Total unrestricted revenues, gains and other support	<u>241,084,341</u>	<u>220,735,353</u>
Expenses		
Salaries and wages	96,730,545	89,838,737
Employee benefits	30,025,478	28,772,521
Medical and professional fees	7,043,648	5,708,380
Purchased services	22,399,586	18,224,283
Supplies	51,040,185	42,512,175
Depreciation and amortization	9,158,587	8,224,321
Interest	1,264,781	1,732,121
Insurance	1,154,179	2,625,733
Provision for bad debts	4,865,295	7,278,441
Other expenses	<u>8,834,492</u>	<u>8,558,820</u>
Total expenses	<u>232,516,776</u>	<u>213,475,532</u>
Income from operations	8,567,565	7,259,821
Nonoperating revenues and losses		
Contributions to Foundation	321,659	130,646
Investment Income	95,220	72,916
Dividend and interest income	876,004	632,429
Equity in earnings of investee	439	7,790
Loss on extinguishment of debt	-	(46,667)
Other	<u>188,765</u>	<u>241,230</u>
Total nonoperating revenues and losses	<u>1,482,087</u>	<u>1,038,344</u>
Excess of revenues over expenses	10,049,652	8,298,165

(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, 2007 and 2006

	2007	2006
Unrestricted net assets		
Excess of revenues over expenses	\$ 10,049,652	\$ 8,298,165
Change in unrealized loss on interest rate swap	(217,033)	(100,438)
Change in minimum pension liability adjustment	10,765,303	8,126,726
Impact of Pension transfers to/ from CHS Subsidiaries	226,170	153,551
Net assets released from restriction	120,655	417,000
Change in unrealized gains on investments	1,858	-
Distributions to affiliates	(750,587)	(700,000)
Distributions to parent	(2,176,866)	(1,727,315)
Increase in unrestricted net assets before cumulative effect of changes in accounting principles	18,019,152	14,467,689
Cumulative effect of adoption of FASB Statement No. 158 (Note 11)	-	(11,734,173)
Increase in unrestricted net assets	18,019,152	2,733,516
Temporarily restricted net assets		
Contributions	1,826,216	78,867
Investment income	8,579	15,039
Temporarily restricted net assets released from restrictions	(120,655)	(417,000)
Increase (decrease) in temporarily restricted net assets	1,714,140	(323,094)
Permanently restricted net assets		
Contributions	84,000	-
Increase in permanently restricted net assets	84,000	-
Increase in net assets	19,817,292	2,410,422
Net assets (deficit), beginning of year	(16,413,497)	(18,823,919)
Net Assets (Deficit), End of Year	\$ 3,403,795	\$ (16,413,497)

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, 2007 and 2006

	2007	2006
Cash flows from operating activities		
Increase in net assets	\$ 19,817,292	\$ 2,410,422
Adjustments to reconcile increase in net assets to net cash provided (used) by operating activities		
Depreciation and amortization	9,158,587	8,224,321
Provision for bad debts	4,865,295	7,278,441
Loss on sale of assets	32,803	-
Change in unrealized loss on interest rate swap	218,729	103,518
Distribution to parent and affiliates	2,927,453	2,427,315
Cumulative effect of adoption of FASB 158	-	11,734,173
(Increase) decrease in minimum pension liability adjustment	(10,991,473)	(8,280,277)
Undistributed earnings in equity investees	613,707	(633,549)
Discount on issuance	7,315	-
Change in unrealized gains on investments	(1,858)	-
Increase in cash surrender value of life insurance policies	-	1,212
(Increase) decrease in assets		
Patient accounts receivables	(12,297,901)	(8,512,313)
Due from affiliate	979,497	3,157,461
Other receivables	(2,230,653)	(73,382)
Inventories	22,359	(14,999)
Prepaid expenses and other assets	48,939	317,763
Other assets	58,797	937,987
Increase (decrease) in liabilities		
Accounts payable	2,380,092	869,603
Accrued expenses	515,241	370,417
Due to affiliates	(308,494)	(2,769,120)
Due to third-party payors	1,908,266	(1,127,775)
Other liabilities	1,236,482	2,698,357
Net cash provided by operating activities	18,960,475	19,119,575
Cash flows from investing activities		
Purchase of property and equipment	(8,796,921)	(6,648,905)
Proceeds from sale of property and equipment	56,235	-
Proceeds from sale of investments and assets limited as to use	1,082,939	-
Purchase of investments and assets limited as to use	(75,515)	(216,106)
Other	-	7,790
Net cash used in investing activities	(7,733,262)	(6,857,221)
Cash flows from financing activities		
Distribution to parent and affiliates	(2,927,453)	(2,427,315)
Proceeds from issuance of long-term debt	-	21,685,000
Repayment of current and long-term obligations	(2,146,343)	(22,752,308)
Discount on issuance	-	(125,541)
Net cash used in financing activities	(5,073,796)	(3,620,164)
Increase in cash and cash equivalents	6,153,417	8,642,190
Cash and cash equivalents, beginning of year	14,198,795	5,556,605
Cash and cash equivalents, end of year	\$ 20,352,212	\$ 14,198,795
Supplemental disclosure of cash flow information		
Cash paid during the year for interest	\$ 1,268,536	\$ 1,809,059
Noncash investing and financing activities		
Assets acquired under capital lease obligations	\$ 1,388,872	\$ 1,602,392

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

Mercy Hospital of Buffalo

Notes to Financial Statements

December 31, 2007 and 2006

1. Organization

Mercy Hospital of Buffalo (the Hospital) is a not-for-profit acute care hospital and skilled nursing facility. The Hospital provides inpatient, outpatient, and emergency services for the residents primarily in and around its surrounding area. Admitting physicians are primarily practitioners in the local area. All operations are located in Erie County, New York and serve the community of Western New York. Mercy Hospital Foundation, Inc. (the "Foundation") is a not-for-profit organization incorporated under the New York State Corporation Laws. The Foundation's sole purpose is to receive and administer gifts and bequests made on behalf of Mercy Hospital of Buffalo (the "Hospital"), which are generally used to support the capital needs of Mercy Hospital of Buffalo. Mercy Hospital of Buffalo and the Foundation (collectively the "Hospital") are a part of the Catholic Health System, Inc. (CHS or the System) and its organizational structure is discussed below.

System

On February 17, 1998, final closing documents were signed to create the CHS, a not-for-profit parent holding corporation. Catholic Health System, Inc. and Subsidiaries is an integrated healthcare delivery system in Western New York jointly sponsored by the Sisters of Mercy, 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. CHS is the sole corporate member of the following subsidiaries:

Acute Care Subsidiaries

The Acute Care Subsidiaries include Mercy Hospital of Buffalo (MHB), Kenmore Mercy Hospital including The McAuley Residence (the Hospital or KMH), Sisters of Charity Hospital (SCH) and St. Joseph Hospital (SJH).

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 (closed 2007), 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 Continuing Care Foundation.

2. Management's Plans and Intentions (Unaudited)

With the strategic intent to improve both clinical quality and financial performance, management has accelerated 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 improve the clinical outcomes of services provided while enhancing the overall profitability and liquidity of the Hospital.

Mercy Hospital of Buffalo

Notes to Financial Statements

December 31, 2007 and 2006

Such initiatives include:

- **Quality.** The Hospital continues to actively work to improve the quality of care provided. The Hospital is implementing the Culture of Safety program with the purpose of reducing significant harm events. The Hospital is focused on achieving a high level of compliance with the Perfect Care measures and reducing hospital acquired complications. The Hospital is focusing on improving outcomes for CHF, AMI, Pneumonia, and Stroke. Furthermore this is expected to align with the public reports cards and reimbursement model changes that are being proposed by the CMS and the other payers.
- **Emergency Services** – A CON application has been submitted to the NYS DOH for the construction of a new Emergency Department that will more than triple the size of the current ED, which serves almost 40,000 patients annually. Pending final NYSDOH approval, this \$32,000,000 construction project will begin in mid to late 2008.
- **Minimally Invasive and Imaging Technologies** – Completion of our third catheterization lab in 2007 has enhanced our ability to provide state-of-the-art cardiac, neuroscience, and endovascular services at Mercy Hospital. Our jointly sponsored CT Angiography services will continue to expand during 2008. Plans are underway to upgrade CT technology at the Mercy Ambulatory Care Center (MACC) into recently acquired clinical space at that campus. We have also expanded ultrasound services at that site and are realizing additional imaging volumes in partnership with a new orthopedic practice at the facility.
- **Neuroscience Center of Excellence** – In April 2007, Mercy Hospital achieved NYS Department of Health Stroke Center Designation. In 2008 telemedicine units will be deployed in the emergency departments of Mercy Hospital and Mercy Ambulatory Care Center to provide immediate neurology consultations on patients presenting with suspected diagnosis of acute stroke. Neurosciences program development has been enhanced by addition of physician specialists performing interventions for patients with cerebrovascular disease.
- **Cardiovascular Service Line** - Cardiac Surgery and Electrophysiology volumes continue to grow as our program matures, increasing by 45% and 23% respectively in 2007. Clinical outcomes are also trending favorably, to include a length of stay decrease of .1 days and decrease in mortality rate by 0.6% compared to 2006. Mercy Hospital valve and valve CABG mortality during 2007 is at the lowest rate since the program started. We continue to expand Door to Balloon (D2B) initiative, underway since December 2007 resulting in a decrease in turn around time by twenty minutes compared to 2006.

3. Significant Accounting Policies

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

Principles of Consolidation

The consolidated financial statements of the Hospital include the accounts of Mercy Hospital of Buffalo and Mercy Hospital Foundation. Effective January 1, 2007, the Hospital became the sole corporate member in the Foundation. In accordance with the pooling of interest method within Accounting Principles Board Opinions (APB) No. 16, *Business Combinations*, prior year balances have been recast to include the balance sheet and statement of operations of the Foundation as if pooling was effective on January 1, 2006. Total net assets of the Hospital for 2006 are not impacted as prior year balances were accounted for 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"). All significant intercompany balances and transactions have been eliminated in the consolidated amounts.

Mercy Hospital of Buffalo
Notes to Financial Statements
December 31, 2007 and 2006

Use of Estimates

The preparation of consolidated 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 consolidated 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, the reserves for conditional asset retirement obligations, 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 insurance reserves for worker's compensation, 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 could 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.

Contributions

Contributions received are recorded as unrestricted, temporary restricted or permanently restricted net assets depending on the existence and nature of any donor restrictions.

Contributions and pledges that are restricted by the donor are reported as an increase in unrestricted net assets if the restrictions expire, that is, when a stipulated time restriction ends or purpose restriction is accomplished in the reporting period in which the contribution is recognized. All other donor-restricted support is reported as increases in temporarily or permanently restricted net assets, depending on the nature of the restrictions. When a restriction expires, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statements of activities and changes in net assets released from restrictions.

Unconditional promises to give that are expected to be collected in future years are recorded at the present value of estimated future cash flows. The discounts on those amounts are computed using a risk-free interest rate applicable to the year in which the promise is received. Amortization of the discount is included in contributions revenue.

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.

Mercy Hospital of Buffalo

Notes to Financial Statements

December 31, 2007 and 2006

Investments

Under SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, investments in marketable securities with readily determinable fair values and all investments in debt securities are reported at their fair values in the statements of financial position. Unrealized gains and losses are included in changes in net assets. Investment income and gains restricted by a donor are reported as increases in unrestricted net assets if the restrictions are met (either by passage of time or by use) in the reporting period in which the income and gains are recognized.

Cash Surrender Value of Life Insurance Policies

Cash Surrender Value of Life Insurance Policies represents the cash value of life insurance policies for which the Foundation is the named beneficiary. The premiums for these policies are paid by the insured individual. These policies had a face value of approximately \$622,000 and \$637,000 at December 31, 2007 and 2006, respectively.

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 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. Based on these evaluations, there were no adjustments to the carrying value of long-lived assets in 2007 and 2006.

Mercy Hospital of Buffalo
Notes to Financial Statements
December 31, 2007 and 2006

Social Accountability Costs (Unaudited)

Effective January 1, 2007 the New York State Public Health Law required all hospitals to Implement financial aid policies and procedures. The law also requires hospitals to develop a summary of its financial aid policies and procedures that must be made publicly available. All standards set forth in the law are minimum standards.

The Hospital provides 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 Hospital provides 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 Hospital is 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,	
	2007	2006
Charity care	\$ 1,219,640	\$ 379,938
Other cost of care for those who are poor	2,599,204	3,996,776
Cost of community benefit programs	163,232	293,537
Unpaid cost of Medicaid programs	4,199,051	4,188,089
Social accountability costs	<u>\$ 8,181,127</u>	<u>\$ 8,858,340</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. CHS's Healthcare Assistance Program provides discounts to patients based on need. In addition, the System will also assist patients with the application process for free or low-cost insurance. For those uninsured patients who do not qualify for the Healthcare Assistance Program or low-cost insurance, the System offers a significant uninsured discount based on a sliding scale against charges.

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

Mercy Hospital of Buffalo

Notes to Financial Statements

December 31, 2007 and 2006

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. Effective October 1, 2007, the Centers for Medicare and Medicaid Services (CMS) revised the Medicare patient classification system. The new Medicare severity adjusted diagnosis related groups (MS-DRGs) reflect changes in technology and current methods of care delivery. CMS has expanded the number of DRG's from 538 to 745 and requires identification of conditions that are present upon admission.

- **Non-Medicare.** The New York Health Care Reform Act of 1996, as updated, governs payments to hospitals in New York State. Under this system, hospitals and all non-Medicare payers, except Medicaid, workers' compensation and no-fault insurance programs, negotiate hospital's payment rates. If negotiated rates are not established, payers are billed at hospitals established charges. Medicaid, workers' compensation and no-fault payers pay hospital rates promulgated by the New York State Department of Health on a prospective basis. Adjustments to current and prior years' rates for these payers will continue to be made in the future. Effective January 1, 2008 the New York State Department of Health (DOH) updated the data utilized to calculate the NYS DRG service intensity weights (SIWs) in order to utilize more current data in DOH promulgated rates. Medicaid cost reports have been submitted through December 31, 2004.

There are also various other proposals at the Federal and State level that could, among other things, reduce payment rates; including the expiration of the New York State Healthcare Reform Act on March 31, 2008. The ultimate outcome of these proposals, regulatory changes, and other market conditions cannot presently be determined.

Amounts recognized in 2007 and 2006 related to prior years, including adjustments to prior year estimates increased the performance indicator approximately \$3,355,000 and \$2,595,000, respectively.

Approximately 57% and 57% of net patient/resident service revenue was generated from services rendered to patients/residents under Medicare and Medicaid programs in 2007 and 2006, respectively. Approximately 31% and 30% of net patient/resident service revenue was generated from services rendered to patients under managed care programs in 2007 and 2006.

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.

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Other Revenues

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

	2007	2006
Shared services (Note 12)	\$ 567,009	\$ 781,458
Cafeteria revenue	910,623	1,053,605
Parking revenue	632,807	633,098
Rental income	245,418	241,860
OLV Family Care Center - VA Contract	720,880	644,305
CHS Miscellaneous Revenue	52,997	114,397
PCC Incentives/Quality Awards	-	201,745
Earnings in Equity Investees	593,687	1,282,124
Other	629,595	646,143
	<u>\$ 4,353,016</u>	<u>\$ 5,598,735</u>

Other Expenses

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

	2007	2006
System dues (a)	\$ 2,588,730	\$ 2,429,861
Rents and operating leases	3,481,684	3,554,475
NYS Health Facilities Cash Receipts Assessment Program	182,550	718,156
Other dues	709,062	712,809
Catholic Health System Other Expense	672,138	469,402
Equipment Rentals	535,345	261,273
Seminars/Conferences	99,377	83,214
Other	565,606	329,630
	<u>\$ 8,834,492</u>	<u>\$ 8,558,820</u>

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

	2007	2006
Dues to Catholic Health East	\$ 1,328,451	\$ 1,295,931
Salaries, wages and employee benefits	487,137	333,449
Professional fees and purchased services	542,247	376,481
Other	230,895	424,000
	<u>\$ 2,588,730</u>	<u>\$ 2,429,861</u>

Mercy Hospital of Buffalo
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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), and the effective portion of cash flow hedging derivatives.

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.

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.

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. The Hospital capitalized software, computer equipment, and other external costs of \$1,024,428 during 2007 and \$369,711 during 2006. Capitalized internal project labor costs amounted to \$305,026 during 2007 and \$95,056 during 2006.

Reclassifications

Certain prior year amounts were reclassified to conform to the 2007 consolidated financial statement presentation.

4. New Authoritative Pronouncements

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 is currently assessing the impact on its consolidated financial statements.

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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 is currently assessing the 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 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 adoption of FIN 48 did not have a material impact on the Hospital's financial statements.

5. Assets Limited as to Use and Investments

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

	2007	2006
Board designated		
Deferred compensation arrangements		
Debt securities	\$ 37,502	\$ 850,736
Equity securities	298,236	567,941
Total assets limited as to use	<u>\$ 335,738</u>	<u>\$ 1,418,677</u>

Investments consist of the following as of December 31:

	2007	2006
Investment in debt and equity securities	\$ 716,544	\$ 657,417
Cash surrender value of life insurance policies and other	395,514	377,268
Total investments	<u>\$ 1,112,058</u>	<u>\$ 1,034,685</u>

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Unrealized gains are summarized as follows for the years ended December 31:

	2007	2006
Investment in debt and equity securities		
Fair value	\$ 716,544	\$ 657,417
Cost	682,162	620,661
Unrealized gain	<u>\$ 34,382</u>	<u>\$ 36,756</u>

Investment income is summarized as follows for the years ended December 31:

	2007	2006
Interest and dividend income	\$ 35,840	\$ 56,156
Net unrealized and realized gains on investments	52,583	42,484
Total investment income	<u>\$ 88,423</u>	<u>\$ 98,640</u>

Investments are held in several brokerage accounts that are managed by an investment advisor who has limited power to make investments. Investment expenses totaled \$3,869 and \$2,861 for the years ended December 31, 2007 and 2006, respectively.

6. Property and Equipment

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

	2007	2006
Land and land improvements	\$ 1,271,710	\$ 1,247,770
Buildings	50,953,128	51,683,152
Leasehold improvements	4,703,720	3,447,112
Equipment	31,436,130	31,220,746
Equipment under capital leases	8,561,428	7,172,556
Foundation assets	63,986	63,986
	<u>96,990,102</u>	<u>94,835,322</u>
Less: Accumulated depreciation	(48,807,713)	(49,259,603)
Accumulated amortization on equipment under capital leases	(3,648,262)	(2,136,714)
	<u>44,534,127</u>	<u>43,439,005</u>
Construction in progress	1,208,538	587,571
Property and equipment, net	<u>\$ 45,742,665</u>	<u>\$ 44,026,576</u>

Depreciation expense amounted to \$7,385,194 and \$6,835,224 in 2007 and 2006, respectively. Amortization expense on equipment under capital leases amounted to \$1,511,548 and \$1,091,054 in 2007 and 2006, respectively. Fully depreciated assets of \$7,262,929 and \$9,822,203 were written-off for the years ended December 31, 2007 and 2006, respectively.

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7. Other Assets

Other assets consist of the following at December 31:

	2007	2006
Equity investments	\$ 690,033	\$ 1,268,841
Debt issuance costs - Series 2006	507,424	531,376
Long-term portion of receivables	1,723,515	1,821,712
	<u>\$ 2,920,972</u>	<u>\$ 3,621,929</u>

Amortization expense on debt issuance costs amounted to \$28,453 and \$76,293 in 2007 and 2006, respectively.

Equity investments consist of the following at December 31:

Equity Investment	Ownership Interest	2007		2006	
		Balance of Investment Carried by MHB	Total Net Assets of Investee	Balance of Investment Carried by MHB	Total Net Assets of Investee
Southtowns Catholic MRI, LLC	50%	\$ 20,691	\$ 41,382	\$ 564,113	\$ 1,128,226
OLV Brierwood Health Care	33%	669,342	2,008,026	663,286	1,989,858
Other	Varies	-	-	41,442	41,442
Total		<u>\$ 690,033</u>	<u>\$ 2,049,408</u>	<u>\$ 1,268,841</u>	<u>\$ 3,159,526</u>

8. Long-Term Obligations

Long-Term Debt

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

	2007	2006
Mercy Hospital Series 2006 A (a)	\$ 12,769,278	\$ 13,234,459
Clinic mortgage, collateralized by real property, monthly payment of \$2,160, including interest at 9% and matures July 2008.	113,570	128,534
Individual subordinated to mortgage held by Lackawanna Community Development Corporation, monthly payments of \$1,239, including interest at 10%, matures December 2012.	58,294	66,857
Capital lease obligations, at interest rates ranging from 5.84% to 9.76% , collateralized by equipment.	5,780,739	6,042,187
	<u>18,721,881</u>	<u>19,472,037</u>
Less: Current portion	<u>(2,062,804)</u>	<u>(1,767,021)</u>
	<u>\$ 16,659,077</u>	<u>\$ 17,705,016</u>

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- (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 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 remarketed 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 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, 2007 and 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

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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 \$322,247 (liability) and \$103,518 (liability) at December 31, 2007 and 2006, respectively. 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.

Aggregate maturities of long-term obligations, including capital lease obligations, subsequent to December 31, 2007 are as follows:

	Loans	Capital Leases	Total
2008	\$ 641,274	\$ 1,738,631	\$ 2,379,905
2009	548,694	1,882,565	2,431,259
2010	572,288	1,677,866	2,250,154
2011	595,997	961,124	1,557,121
2012	619,831	245,606	865,437
Thereafter	9,963,058	-	9,963,058
	<u>\$ 12,941,142</u>	<u>6,505,792</u>	<u>\$ 19,446,934</u>
Less: Interest		<u>(725,053)</u>	
		<u>\$ 5,780,739</u>	

Operating Leases

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

2008	\$ 4,174,326
2009	3,871,586
2010	3,961,203
2011	3,385,586
2012	3,431,233
Thereafter	<u>12,464,722</u>
	31,288,656
Minimum sublease rental obligations	<u>(767,759)</u>
	<u>\$ 30,520,897</u>

Total expense for rents and operating type leases was approximately \$3,481,684 and \$3,554,475 in 2007 and 2006, respectively.

9. Accrued Expenses

Accrued expenses consist of the following at December 31:

	2007	2006
Workers compensation	\$ 2,766,153	\$ 2,821,686
Payroll and benefits	7,089,921	6,333,936
Other	<u>(176,833)</u>	<u>8,378</u>
	<u>\$ 9,679,241</u>	<u>\$ 9,164,000</u>

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10. 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. A participant's benefit obligation is assigned to the location at which the person works. As participants transfer around the System to other CHS subsidiaries, the obligations and a proportional amount of the plan's assets transfer.

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.

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

	Prior to SFAS 158 Adjustments	SFAS 158 Adjustment	Post SFAS 158 Adjustments
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)

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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, 2007 and 2006.

	December 31,	
	2007	2006
Benefit Obligations		
Change in benefit obligation		
Benefit obligation at beginning of year	\$ 104,731,010	\$ 100,553,546
Service cost	4,089,878	4,143,614
Interest cost	6,193,140	5,694,399
Actuarial (gains) losses	(8,022,821)	(2,542,589)
Transfers (to) from CHS Subsidiaries	(694,106)	(377,308)
Benefits paid	(3,065,808)	(2,632,296)
Expenses	(165,370)	(108,356)
Benefit obligation at end of year	<u>\$ 103,065,923</u>	<u>\$ 104,731,010</u>
Plan Assets		
Change in plan assets		
Fair value of plan assets at beginning of year	\$ 57,862,439	\$ 50,239,979
Actual return on plan assets	5,717,679	5,964,869
Transfers (to) from CHS Subsidiaries	(467,936)	(223,757)
Benefits paid	(3,065,808)	(2,632,296)
System contributions	4,935,889	4,622,000
Expenses	(165,370)	(108,356)
Fair value of plan assets at end of year	<u>\$ 64,816,893</u>	<u>\$ 57,862,439</u>
Funded status at end of year	\$ 38,249,030	\$ 46,868,571
Amounts recognized in the consolidated balance sheets		
Noncurrent liabilities	<u>\$ (38,249,030)</u>	<u>\$ (46,868,571)</u>
Net amounts recognized	<u>\$ (38,249,030)</u>	<u>\$ (46,868,571)</u>

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

**Amounts expected to be recognized as components
of the net periodic pension cost in the following year**

Amortization of prior service cost	\$ (137,335)	\$ (137,335)
Amortization of loss	(391,038)	(1,539,185)
Amounts expected to be recognized in the following year	<u>\$ (528,373)</u>	<u>\$ (1,676,520)</u>

Components of net periodic pension cost

Service cost	\$ 4,089,878	\$ 4,143,614
Interest cost	6,193,140	5,694,399
Expected return on plan assets	(4,651,717)	(4,343,200)
Amortization of prior service cost or (credit)	137,335	137,335
Recognized actuarial loss	1,539,185	1,939,933
Net periodic pension cost	<u>\$ 7,307,821</u>	<u>\$ 7,572,081</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 2007 and the actual asset allocation percentages for 2007 and 2006 are as follows at the respective measurement dates:

Asset Category	Pension target allocation range	Percentage of pension plan assets	
	2007	2007	2006
Equities	63%	65%	65%
Fixed Income	25%	24%	24%
Other	12%	11%	11%
	<u>100%</u>	<u>100%</u>	<u>100%</u>

Contributions

Contributions to the Plan are made to make benefit payments to plan participants. The funding policy is to contribute amounts to the trusts sufficient to meet minimum funding requirements plus such additional amounts as may be determined to be appropriate. Contributions are made to benefit plans for the sole benefit of plan participants. The System is expected to contribute an aggregate amount of approximately \$12,874,000 to the pension plan trust in 2008 to be allocated amongst participating entities.

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Benefit Payments

The following table summarizes the System's estimated future benefit payments. Actual benefit payments may differ from expected benefit payments.

2008	\$ 8,230,000
2009	9,517,000
2010	10,092,000
2011	11,440,000
2012	12,938,000
2013 - 17	87,182,964

	2007	2006
Weighted-average assumptions used to determine end of year benefit obligations		
Discount rate	6.60%	6.00%
Rate of compensation increase	3.75%	3.75%
Weighted-average assumptions used to determine net periodic pension cost		
Discount rate	6.00%	5.75%
Expected long-term rate of return on plan assets	8.25%	8.50%
Measurement date	12/31/2007	12/31/2006

11. 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% in 2007 and 2006. The Hospital's portion of the System's liability for unpaid and incurred but not reported claims at December 31, 2007 and 2006 are \$2,132,000 and \$2,027,000, respectively recorded in accrued expenses and long-term liabilities. The charges to expenses for professional and general liability for 2007 and 2006 approximated \$863,687 and \$2,290,000, 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 portion of the System's current portion of liabilities for unpaid and incurred but not reported claims at December 31, 2007 and 2006 is \$1,915,216 and \$2,009,464, respectively, and is included in accrued expenses. The Hospital's

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portion of the System's long term portion of liabilities for unpaid and incurred but not reported claims at December 31, 2007 and 2006 is \$8,054,812 and \$8,037,854, respectively, and is included in other long-term liabilities. The charges to expenses for workers compensation costs approximated \$4,632,000 and \$4,870,000 in 2007 and 2006, respectively, which has been included in employee benefits expense.

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. Charges were billed monthly by the System and are included in employee benefit costs.

12. 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 2007 and 2006 the Hospital incurred expenses to affiliates for administration services, rent and other services. These expenses approximated \$22,411,748 for 2007 and \$24,078,209 for 2006 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 \$746,412 and \$1,428,155 for 2007 and 2006, respectively.

During 2007, a distribution was made to the parent of \$2,176,866. During 2007 and 2006, 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, 2007 and 2006 were \$456,514 and \$248,932, respectively. Amounts due from affiliates at December 31, 2007 and 2006 were \$22,234 and \$1,001,731, respectively.

13. 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.

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14. 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:

	2007	2006
Medicare	42%	41%
Medicaid	4%	3%
Blue Cross	5%	5%
Other third-party payors	36%	36%
Patients	13%	15%
	<u>100%</u>	<u>100%</u>

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.

15. 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.

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16. 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:

	2007	2006
Health care services	\$ 175,713,776	\$ 161,100,582
General and administrative	56,803,000	52,374,950
	<u>\$ 232,516,776</u>	<u>\$ 213,475,532</u>

17. Fair Values of Financial Instruments

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

Cash and Cash Equivalents

The carrying amount reported in the balance sheet for cash and cash equivalents approximates its fair value.

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, 2007 and 2006 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:

	2007		2006	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	\$ 20,352,212	\$ 20,353,212	\$ 14,198,795	\$ 14,198,175
Assets limited as to use	335,738	335,738	1,418,677	1,418,677
Long-term debt obligations, including line of credit payable and excluding capital lease obligations	12,941,142	12,969,312	13,429,850	13,431,194
Interest rate swap	322,247	322,247	103,518	103,518