



Mercy Hospital of Buffalo
(a subsidiary of the
Catholic Health System, Inc.)
Financial Statements
December 31, 2008 and 2007

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, 2008 and 2007, 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 11, the Hospital had significant transactions with related parties.

PricewaterhouseCoopers LLP

April 15, 2009

Mercy Hospital of Buffalo
Balance Sheets
December 31, 2008 and 2007

	2008	2007
Assets		
Current assets		
Cash and cash equivalents	\$ 28,371,695	\$ 20,352,212
Patient/resident accounts receivable, net of estimated uncollectibles of \$3,568,000 and \$2,865,000	30,331,566	31,537,649
Other receivables	2,491,569	2,759,337
Inventories	1,008,993	944,497
Prepaid expenses and other current assets	591,054	474,457
Total current assets	62,794,877	56,068,152
Assets limited as to use	23,585,790	335,738
Investments	935,100	1,112,058
Due from affiliates	44,388	22,234
Property and equipment, net	47,019,200	45,742,665
Other assets	3,335,104	2,920,972
Total Assets	\$ 137,714,459	\$ 106,201,819
Liabilities and Net Assets (Deficit)		
Current liabilities		
Current portion of long-term obligations	\$ 2,513,285	\$ 2,062,804
Accounts payable	9,759,800	11,025,844
Accrued expenses	11,084,742	9,679,241
Due to third-party payors	12,072,927	9,431,788
Due to affiliates	2,409,740	456,514
Total current liabilities	37,840,494	32,656,191
Long-term obligations, net	39,208,151	16,659,077
Long-term portion of insurance liabilities	10,053,053	10,080,212
Pension obligation	70,069,374	38,249,030
Asset retirement obligation	4,718,363	4,495,529
Interest rate swap	4,312,078	322,247
Deferred compensation plan	145,455	335,738
Total liabilities	166,346,968	102,798,024
Net assets (deficit)		
Unrestricted	(30,853,180)	1,048,915
Temporarily restricted	2,094,671	2,270,880
Permanently restricted	126,000	84,000
Total net assets (deficit)	(28,632,509)	3,403,795
Total Liabilities and Net Assets (Deficit)	\$ 137,714,459	\$ 106,201,819

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, 2008 and 2007

	2008	2007
Unrestricted revenues, gains and other support		
Net patient/resident service revenue	\$ 255,143,914	\$ 236,731,325
Other revenue	4,334,697	4,825,219
Net assets released from restrictions	52,000	-
Total unrestricted revenues, gains and other support	<u>259,530,611</u>	<u>241,556,544</u>
Expenses		
Salaries and wages	105,960,415	96,730,545
Employee benefits	31,383,103	30,025,478
Medical and professional fees	7,050,902	7,043,648
Purchased services	23,621,501	22,399,586
Supplies	56,522,637	51,040,185
Depreciation and amortization	8,856,876	9,158,587
Interest	1,198,445	1,264,781
Insurance	2,857,762	1,154,179
Provision for bad debts	5,197,821	4,865,295
Other expenses	11,142,919	8,834,492
Total expenses	<u>253,792,381</u>	<u>232,516,776</u>
Income from operations	5,738,230	9,039,768
Nonoperating revenues and losses		
Investment income	698,511	875,489
Other	(5,671)	136,253
Total nonoperating revenues	<u>692,840</u>	<u>1,011,742</u>
Excess of revenues over expenses	6,431,070	10,051,510

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, 2008 and 2007

	2008	2007
Unrestricted net assets		
Excess of revenues over expenses	\$ 6,431,070	\$ 10,051,510
Change in unrealized loss on interest rate swap	(3,921,675)	(217,033)
Change in minimum pension liability adjustment	(31,758,179)	10,765,303
Impact of Pension transfers to/ from CHS Subsidiaries	584,330	226,170
Net assets released from restriction	197,843	120,655
Distributions to affiliates	(1,599,413)	(750,587)
Distributions to parent	(1,692,652)	(2,176,866)
Other	(143,419)	-
	<u>(31,902,095)</u>	<u>18,019,152</u>
(Decrease) increase in unrestricted net assets		
Temporarily restricted net assets		
Contributions	69,745	1,826,216
Investment income	3,889	8,579
Temporarily restricted net assets released from restrictions	(249,843)	(120,655)
	<u>(176,209)</u>	<u>1,714,140</u>
(Decrease) increase in temporarily restricted net assets		
Permanently restricted net assets		
Contributions	42,000	84,000
	<u>42,000</u>	<u>84,000</u>
Increase in permanently restricted net assets		
	<u>42,000</u>	<u>84,000</u>
(Decrease) increase in net assets	(32,036,304)	19,817,292
Net assets (deficit), beginning of year	<u>3,403,795</u>	<u>(16,413,497)</u>
Net Assets (Deficit), End of Year	<u>\$ (28,632,509)</u>	<u>\$ 3,403,795</u>

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, 2008 and 2007

	2008	2007
Cash flows from operating activities		
(Decrease) increase in net assets	\$ (32,036,304)	\$ 19,817,292
Adjustments to reconcile (decrease) increase in net assets to net cash provided by operating activities		
Depreciation and amortization	8,856,876	9,158,587
Provision for bad debts	5,197,821	4,865,295
Loss on sale of assets	(1,765)	32,803
Change in unrealized loss on interest rate swap	3,989,831	218,729
Distribution to parent and affiliates	3,292,065	2,927,453
(Increase) decrease in minimum pension liability adjustment	31,173,849	(10,991,473)
Undistributed earnings in equity investees	524,182	613,707
Discount on issuance	6,756	7,315
Change in unrealized losses (gains) on investments	160,617	(34,382)
Increase in cash surrender value of life insurance policies	20,342	-
(Increase) decrease in assets		
Patient accounts receivables	(3,991,738)	(12,297,901)
Due from affiliate	13,413	979,497
Other receivables	267,768	(2,230,653)
Inventories	(64,496)	22,359
Prepaid expenses and other assets	(116,597)	48,939
Other assets	-	58,797
Increase (decrease) in liabilities		
Accounts payable	(1,266,044)	2,380,092
Accrued expenses	1,405,501	515,241
Due to affiliates	1,242,763	(308,494)
Due to third-party payors	2,641,139	1,908,266
Other liabilities	406,241	1,236,482
Net cash provided by operating activities	<u>21,722,220</u>	<u>18,927,951</u>
Cash flows from investing activities		
Purchase of property and equipment	(8,388,551)	(8,796,921)
Proceeds from sale of property and equipment	20,000	56,235
Proceeds from sale of investments and assets limited as to use	156,938	1,115,463
Purchase of investments and assets limited as to use	(24,378,300)	(75,515)
Net cash used in investing activities	<u>(32,589,913)</u>	<u>(7,700,738)</u>
Cash flows from financing activities		
Distribution to parent and affiliates	(3,292,065)	(2,927,453)
Proceeds from issuance of long-term debt	24,700,000	-
Repayment of current and long-term obligations	(2,199,059)	(2,146,343)
Discount on issuance	(321,700)	-
Net cash provided by (used in) financing activities	<u>18,887,176</u>	<u>(5,073,796)</u>
Increase in cash and cash equivalents	8,019,483	6,153,417
Cash and cash equivalents, beginning of year	<u>20,352,212</u>	<u>14,198,795</u>
Cash and cash equivalents, end of year	<u>\$ 28,371,695</u>	<u>\$ 20,352,212</u>
Supplemental disclosure of cash flow information		
Cash paid during the year for interest	\$ 1,191,689	\$ 1,268,536
Noncash investing and financing activities		
Assets acquired under capital lease obligations	\$ 813,558	\$ 1,388,872

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

Mercy Hospital of Buffalo

Notes to Financial Statements

December 31, 2008 and 2007

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. 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. All significant intercompany balances and transactions have been eliminated in the consolidated amounts.

Mercy Hospital of Buffalo

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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, 2008 and 2007

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 \$584,826 and \$622,000 at December 31, 2008 and 2007, 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 2008 and 2007.

Mercy Hospital of Buffalo
Notes to Financial Statements
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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.

	December 31,	
	2008	2007
Charity care	\$ 4,981,823	\$ 3,818,844
Cost of community benefit programs	402,995	163,232
Unpaid cost of Medicaid programs	4,838,540	4,199,051
Social accountability costs	<u>\$ 10,223,358</u>	<u>\$ 8,181,127</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 paid based on a cost reimbursement methodology. The Hospital is reimbursed for cost

Mercy Hospital of Buffalo

Notes to Financial Statements

December 31, 2008 and 2007

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, 2006. 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, 2007.

Amounts recognized in 2008 and 2007 related to prior years, including adjustments to prior year estimates and audit settlements, increased the performance indicator approximately \$1,996,000 and \$3,355,000, respectively.

Approximately 56% and 57% of net patient/resident service revenue was generated from services rendered to patients/residents under Medicare and Medicaid programs in 2008 and 2007, respectively. Approximately 29% and 31% of net patient/resident service revenue was generated from services rendered to patients under managed care programs in 2008 and 2007.

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.

Mercy Hospital of Buffalo
Notes to Financial Statements
December 31, 2008 and 2007

Other Revenues

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

	2008	2007
Shared services (Note 12)	\$ 661,645	\$ 567,009
Cafeteria revenue	941,027	910,623
Parking revenue	585,535	632,807
Rental income	234,005	245,418
OLV Family Care Center - VA Contract	819,358	720,880
CHS Miscellaneous Revenue	47,702	52,997
Earnings in Equity Investees	204,230	594,126
Other	841,195	1,101,359
	<u>\$ 4,334,697</u>	<u>\$ 4,825,219</u>

Other Expenses

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

	2008	2007
System dues (a)	\$ 3,202,815	\$ 2,588,730
Rents and operating leases	5,075,023	3,481,684
NYS Health Facilities Cash Receipts Assessment Program	-	182,550
Other dues	733,084	709,062
Catholic Health System Other Expense	828,541	672,138
Equipment Rentals	514,074	535,345
Seminars/Conferences	138,019	99,377
Other	651,363	565,606
	<u>\$ 11,142,919</u>	<u>\$ 8,834,492</u>

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

	2008	2007
Dues to Catholic Health East	\$ 1,474,949	\$ 1,328,451
Salaries, wages and employee benefits	549,798	487,137
Professional fees and purchased services	879,612	542,247
Other	298,456	230,895
	<u>\$ 3,202,815</u>	<u>\$ 2,588,730</u>

Mercy Hospital of Buffalo

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December 31, 2008 and 2007

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 \$1,311,867 during 2008 and \$1,024,428 during 2007. Capitalized internal project labor costs amounted to \$377,270 during 2008 and \$305,026 during 2007.

Reclassifications

Certain prior year amounts were reclassified to conform to the 2008 consolidated financial statement presentation.

3. New Authoritative Pronouncements

In March 2009, the Financial Accounting Standards Board ("FASB") issued SFAS 161, "Disclosures about Derivative Instruments and Hedging Activities, an Amendment of SFAS 133". SFAS 161 required entities to provide enhanced disclosures related to an entity's derivative instruments and hedging activities in order to enable investors to better understand how derivative instruments and hedging activities impact an entity's financial reporting. The additional disclosures include how and why an entity uses derivative instruments, how derivative instruments and related hedges items are accounted for under SFAS 133 and its related interpretations, and how derivative instruments and related hedge items affect an entity's financial position, financial performance, and cash flows.

Mercy Hospital of Buffalo

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The statement is effective as of January 1, 2009. The Hospital is currently assessing the impact on its financial statements.

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 159, "The Fair Value Option of Financial Assets and Financial Liabilities", which allows entities to elect to measure specific assets and liabilities at fair value. The election to measure a financial asset or liability at fair value can be made on an instrument-by-instrument basis and is irrevocable. The Hospital has elected not to adopt SFAS 159 for any valuations at this time.

Effective January 1, 2008, the Hospital adopted SFAS No. 157, "Fair Value Measurement" for its financial and non-financial assets and liabilities which are measured on a recurring basis. A single definition of fair value, together with a framework for measuring fair value, will result in increased consistency and comparability in fair value measurements. SFAS No. 157 will apply whenever another standard requires or permits assets or liabilities to be measured at fair value, and does not expand the use of fair value to any new circumstances. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. On February 12, 2008 the FASB approved the Financial Staff Position ("FSP") No. SFAS 157-2, Effective Date of FASB Statement No. 157 ("FSP FAS 157-2"), which delays the effective date of SFAS 157 to fiscal years beginning after November 15, 2008 for non-financial assets and non-financial liabilities which are measured on a non-recurring basis.

Assets and liabilities recorded at fair value in the balance sheet are categorized based upon the level of judgment associated with the inputs used to measure their fair value. An asset or a liability's categorization within the fair value hierarchy is based on the lowest level of judgment input to its valuation. Hierarchical levels, defined by SFAS No. 157, are directly related to the amount of subjectivity associated with the inputs to fair valuation of these assets and liabilities as follows:

Level I: Valuations based on quoted prices in active markets for identical assets or liabilities that the Hospital has the ability to access. Since valuations are based on quoted prices that are readily and regularly available in active market, valuation of these products does not entail a significant degree of judgment. Level I assets include cash and cash equivalents, debt and equity securities that are traded in an active exchange markets, as well as certain U.S. Treasury and other U.S. Governments and agencies that are highly liquid and are actively traded in over-the counter markets.

Level II – Valuations based on quoted prices in active markets for similar assets or liabilities quoted prices in markets that are not active or for which all significant inputs are observable, directly or indirectly. Level II assets include equity and fixed income managed funds with quoted prices that are traded less frequently than exchange-traded instruments whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data.

Level III– Valuations based on inputs that are unobservable and significant to the overall fair value measurement. These are generally company generated inputs and are not market based inputs. Level III assets would include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques as well as instruments for which the determination of fair value requires significant investment management judgment or estimation.

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The following tables present information about our assets and liabilities that are measures at fair value on a recurring basis as of December 31, 2008, and indicates the fair value hierarchy of the valuation techniques we utilized to determine such fair value.

	December 31, 2008	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets Limited As To Use				
Cash and cash equivalents	\$ 7,061,625	\$ -	\$ 7,061,625	\$ -
Marketable equity securities	145,455	145,455	-	-
U.S. Government and Agency	16,378,710	-	16,378,710	-
	<u>\$ 23,585,790</u>	<u>\$ 145,455</u>	<u>\$ 23,440,335</u>	<u>\$ -</u>
Investments				
Cash and cash equivalents	\$ 2,602	\$ 552	\$ 2,045	\$ 5
Marketable equity securities	358,821	358,370	451	-
Marketable debt securities	100,615	40,534	59,978	103
Other	88,310	2,211	-	86,099
	<u>\$ 550,348</u>	<u>\$ 401,667</u>	<u>\$ 62,474</u>	<u>\$ 86,207</u>
Other	\$ 384,752	\$ -	\$ 384,752	\$ -
Interest Rate Swap	\$ 4,312,078	\$ -	\$ 4,312,078	\$ -

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 to Use

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

Interest Rate Swap

The Hospital has entered into standard International Swaps and Derivatives Association ("ISDA") interest rate swap agreements (the "Swap Agreements") to manage the interest rate risk associated with its debt. The Swap Agreements effectively convert a portion of our variable rate debt to a long-term fixed rate. Under these agreements, we receive a variable rate of LIBOR plus a markup and pay a fixed rate. The fair value of these interest rate derivatives are based on quoted prices for similar instruments from a commercial bank, and therefore, the interest rate derivatives are considered a Level 2 item.

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4. Assets Limited as to Use and Investments

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

	2008	2007
Held by Trustee under Letter of Credit Agreement		
Cash and cash equivalents	<u>\$ 23,440,335</u>	<u>\$ -</u>
Board designated		
Deferred compensation arrangements		
Debt securities	-	37,502
Equity securities	<u>145,455</u>	<u>298,236</u>
	145,455	335,738
Assets limited as to use	23,585,790	335,738
Less: current portion	-	-
	<u>\$ 23,585,790</u>	<u>\$ 335,738</u>

Investments consist of the following as of December 31:

	2008	2007
Investment in debt and equity securities	\$ 550,348	\$ 716,544
Cash surrender value of life insurance policies and other	<u>384,752</u>	<u>395,514</u>
Total investments	<u>\$ 935,100</u>	<u>\$ 1,112,058</u>

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

	2008	2007
Investment in debt and equity securities		
Fair value	\$ 550,348	\$ 716,544
Cost	<u>710,965</u>	<u>682,162</u>
Unrealized (loss) gain	<u>\$ (160,617)</u>	<u>\$ 34,382</u>

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

	2008	2007
Interest and dividend income	\$ 961,205	\$ 822,906
Net realized and unrealized (losses) gains	(262,694)	52,583
Total investment income	<u>\$ 698,511</u>	<u>\$ 875,489</u>

Interest and dividend income includes interest income on unrestricted cash and cash equivalents of \$855,239 and \$787,066 in 2008 and 2007, respectively. Investments are held in several brokerage accounts that are managed by an investment advisor who has limited power to make investments. Investment expenses totaled \$4,512 and \$3,869 for the years ended December 31, 2008 and 2007, respectively.

5. Property and Equipment

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

	2008	2007
Land and land improvements	\$ 1,366,251	\$ 1,271,710
Buildings	43,141,520	50,953,128
Leasehold improvements	5,261,843	4,703,720
Equipment	34,991,723	31,436,130
Equipment under capital leases	9,043,937	8,561,428
Foundation assets	86,399	63,986
	<u>93,891,673</u>	<u>96,990,102</u>
Less: Accumulated depreciation	(44,073,181)	(48,807,713)
Accumulated amortization on equipment under capital leases	(5,300,619)	(3,648,262)
	<u>44,517,873</u>	<u>44,534,127</u>
Construction in progress	2,501,327	1,208,538
Property and equipment, net	<u>\$ 47,019,200</u>	<u>\$ 45,742,665</u>

Depreciation expense amounted to \$6,929,878 and \$7,385,194 in 2008 and 2007, respectively. Amortization expense on equipment under capital leases amounted to \$1,652,357 and \$1,511,548 in 2008 and 2007, respectively. Fully depreciated assets of \$10,948,443 and \$7,262,929 were written-off for the years ended December 31, 2008 and 2007, respectively.

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6. Other Assets

Other assets consist of the following at December 31:

	2008	2007
Equity investments	\$ 209,851	\$ 690,033
Debt issuance costs - Series 2006	478,428	507,424
Debt issuance costs - Series 2008	967,309	-
Long-term portion of receivables	1,679,516	1,723,515
	<u>\$ 3,335,104</u>	<u>\$ 2,920,972</u>

Amortization expense on debt issuance costs amounted to \$28,996 and \$28,453 in 2008 and 2007, respectively.

Equity investments consist of the following at December 31:

Equity Investment	Ownership Interest	2008		2007	
		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	\$ 20,691	\$ 41,382
OLV Brierwood Health Care	33%	189,160	567,480	669,342	2,008,026
Total		<u>\$ 209,851</u>	<u>\$ 608,862</u>	<u>\$ 690,033</u>	<u>\$ 2,049,408</u>

7. Long-Term Obligations

Long-Term Debt

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

	2008	2007
Mercy Hospital Series 2006 A (a)	\$ 12,251,033	\$ 12,769,278
Mercy Hospital Series 2008 (b)	24,378,300	
Clinic mortgage, collateralized by real property, monthly payment of \$2,160, including interest at 9% and matures July 2008.	-	113,570
Individual subordinated to mortgage held by Lackawanna Community Development Corporation, monthly payments of \$1,239, including interest at 10%, matures December 2012.	48,835	58,294
Capital lease obligations, at interest rates ranging from 5.84% to 9.76% , collateralized by equipment.	5,043,269	5,780,739
	<u>41,721,437</u>	<u>18,721,881</u>
	<u>(2,513,285)</u>	<u>(2,062,804)</u>
Less: Current portion	<u>\$ 39,208,151</u>	<u>\$ 16,659,077</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 2006A 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 Letter of Credit with HSBC Bank which expires on November 28, 2011. The interest payable by the Hospital under the terms of the Loan Agreement is variable as determined by the Securities Industry and Financial Markets 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 of 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, 2008 and 2007.

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) 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 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, 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 (\$12,630,000 at December 31, 2008) and in exchange, the Hospital will receive a variable rate payment based upon the Securities Industry and Financial Markets 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

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recorded on the accompanying financial statements at estimated fair value, determined to be approximately \$1,264,527 (liability) and \$322,247 (liability) at December 31, 2008 and 2007, 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.

- (b) On November 19, 2008, \$24,700,000 of DASNY - Catholic Health System Obligated Group Revenue Bonds, Series 2008 was issued. Series 2008 was loaned to the Hospital to fund the construction of a new Emergency Department and to pay certain transaction related costs. The discount on the bonds of \$321,700 will be accreted over the life of the bonds.

The Series 2008 Bonds were issued under the Master Trust Indenture that was created in 2006 during the formation of the Obligated Group. All material components of the Series 2008 mirror the Series 2006A. Among these items are the following: 1) a variable remarketed rate (determined by SIFMA) collateralized by a letter of credit with HSBC Bank, 2) a security interest in and assignment of gross receipts of the Hospital, together with the Hospital's right to receive or collect the gross receipts, 3) consistent financial covenants, and 4) execution of an interest rate swap agreement (with HSBC Bank) consistent with the terms utilized in the 2006 swap agreement. The swap is recorded on the accompanying financial statements at estimated fair value, determined to be approximately \$3,047,551 at December 31, 2008.

Aggregate maturities of long-term obligations, including capital lease obligations, subsequent to December 31, 2008 are as follows:

	Loans	Capital Leases	Total
2009	\$ 548,695	\$ 2,217,282	\$ 2,765,977
2010	862,289	1,844,462	\$ 2,706,751
2011	11,746,929	1,198,521	\$ 12,945,450
2012	623,719	244,369	\$ 868,088
2013	637,132	-	\$ 637,132
Thereafter	22,259,404	-	\$ 22,259,404
	<u>\$ 36,678,168</u>	<u>5,504,634</u>	<u>\$ 42,182,802</u>
Less: Interest		(461,366)	
		<u>\$ 5,043,268</u>	

Operating Leases

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

2009	\$ 4,398,447
2010	4,069,727
2011	3,302,143
2012	3,272,076
2013	3,154,329
Thereafter	7,925,095
	<u>26,121,817</u>
Minimum sublease rental obligations	(707,813)
	<u>\$ 25,414,004</u>

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Total expense for rents and operating type leases was approximately \$5,075,023 and \$3,481,684 in 2008 and 2007, respectively.

8. Accrued Expenses

Accrued expenses consist of the following at December 31:

	2008	2007
Workers compensation	\$ 2,910,251	\$ 2,766,153
Payroll and benefits	8,003,837	7,089,921
Other	170,654	(176,833)
	<u>\$ 11,084,742</u>	<u>\$ 9,679,241</u>

9. 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.

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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, 2008 and 2007.

	December 31,	
	2008	2007
Benefit Obligations		
Change in benefit obligation		
Benefit obligation at beginning of year	\$ 103,065,923	\$ 104,731,010
Service cost	3,878,787	4,089,878
Interest cost	6,684,987	6,193,140
Actuarial (gains) losses	8,286,265	(8,022,821)
Transfers (to) from CHS Subsidiaries	(988,135)	(694,106)
Amendments	832,451	-
Benefits paid	(3,196,386)	(3,065,808)
Expenses	(72,652)	(165,370)
Benefit obligation at end of year	<u>\$ 118,491,240</u>	<u>\$ 103,065,923</u>
Plan Assets		
Change in plan assets		
Fair value of plan assets at beginning of year	\$ 64,816,893	\$ 57,862,439
Actual return on plan assets	(17,948,331)	5,717,679
Transfers (to) from CHS Subsidiaries	(403,805)	(467,936)
Benefits paid	(3,196,386)	(3,065,808)
System contributions	5,226,147	4,935,889
Expenses	(72,652)	(165,370)
Fair value of plan assets at end of year	<u>\$ 48,421,866</u>	<u>\$ 64,816,893</u>
Funded status at end of year	\$ 70,069,374	\$ 38,249,030
Amounts recognized in the consolidated balance sheets		
Noncurrent liabilities	\$ (70,069,374)	\$ (38,249,030)
Net amounts recognized	<u>\$ (70,069,374)</u>	<u>\$ (38,249,030)</u>

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

	2008	2007
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	-	(391,038)
Amounts expected to be recognized in the following year	<u>\$ -</u>	<u>\$ (528,373)</u>
 Components of net periodic pension cost		
Service cost	\$ 3,878,787	\$ 4,089,878
Interest cost	6,684,987	6,193,140
Expected return on plan assets	(5,219,507)	(4,651,717)
Amortization of prior service cost or (credit)	137,335	137,335
Recognized actuarial loss	391,040	1,539,185
Net periodic pension cost	<u>\$ 5,872,642</u>	<u>\$ 7,307,821</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 2008 and the actual asset allocation percentages for 2008 and 2007 are as follows at the respective measurement dates:

Asset Category	Pension target allocation	Percentage of pension plan assets	
	2008	2008	2007
Equities	63%	37%	65%
Fixed Income	25%	45%	24%
Other	12%	18%	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 \$13,800,000 to the pension plan trust in 2009 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.

2009	\$ 9,137,000
2010	10,076,000
2011	11,314,000
2012	12,955,000
2013	14,354,000
2014 - 18	95,984,000

	2008	2007
Weighted-average assumptions used to determine end of year benefit obligations		
Discount rate	6.20%	6.60%
Rate of compensation increase	3.75%	3.75%
Weighted-average assumptions used to determine net periodic pension cost		
Discount rate	6.60%	6.00%
Expected long-term rate of return on plan assets	8.25%	8.25%
Measurement date	12/31/2008	12/31/2007

10. 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 4.50% and 5.00% in 2008 and 2007. The Hospital's portion of the System's liability for unpaid and incurred but not reported claims at December 31, 2008 and 2007 are \$2,519,000 and \$2,132,000, respectively recorded in accrued expenses and long-term liabilities. The charges to expenses for professional and general liability for 2008 and 2007 approximated \$2,562,571 and \$863,687, 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, 2008 and 2007 is \$2,418,948 and \$1,915,216, 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, 2008 and 2007 is \$7,660,003 and \$8,054,812, respectively, and is included in other long-term liabilities. The charges to expenses for workers compensation costs approximated \$4,241,000 and \$4,632,000 in 2008 and 2007, 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.

11. 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 2008 and 2007 the Hospital incurred expenses to affiliates for administration services, rent and other services. These expenses approximated \$29,006,627 for 2008 and \$22,411,748 for 2007 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 \$792,096 and \$746,412 for 2008 and 2007, respectively.

During 2008, a distribution was made to the parent of \$1,692,652. During 2008 and 2007, 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, 2008 and 2007 were \$2,409,740 and \$456,514, respectively. Amounts due from affiliates at December 31, 2008 and 2007 were \$44,388 and \$22,234, respectively.

As of April 1, 2007, a lease agreement between Our Lady of Victory Corporation (landlord) and Mercy Hospital of Buffalo (tenant) was signed for the Mercy Hospital Skilled Nursing Facility (84 beds). Per the lease agreement, Mercy Hospital will pay rental expense "sufficient to reimburse Landlord for all annual payments of principal and of interest on the \$10,220,000 Erie County Industrial Development Agency Variable Rate Demand Civic Facility Revenue Bonds, Series 2007A." The agreement was tested in accordance with Statement of Financial Accounting Standards No. 13, Accounting for Leases, and did not qualify as a capital lease.

12. 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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13. 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:

	2008	2007
Medicare	38%	42%
Medicaid	3%	4%
Blue Cross	7%	5%
Other third-party payors	40%	36%
Patients	12%	13%
	<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.

14. 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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15. 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:

	2008	2007
Health care services	\$ 189,911,309	\$ 175,713,776
General and administrative	<u>63,881,072</u>	<u>56,803,000</u>
	<u>\$ 253,792,381</u>	<u>\$ 232,516,776</u>