



**Mercy Hospital of Buffalo
(a subsidiary of the Catholic
Health System, Inc.)**

**Consolidated Financial Statements
December 31, 2010 and 2009**

Mercy Hospital of Buffalo
(a subsidiary of the Catholic Health System, Inc.)
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December 31, 2010 and 2009

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Report of Independent Auditors

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

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations and changes in net assets (deficits) and of cash flows present fairly, in all material respects, the financial position of Mercy Hospital of Buffalo (the Hospital) as of December 31, 2010 and 2009, 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 consolidated financial statements are the responsibility of the Hospital's management. Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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 13, the Hospital had significant transactions with related parties.

PricewaterhouseCoopers LLP

May 6, 2011

Mercy Hospital of Buffalo
(a subsidiary of the Catholic Health System, Inc.)
Consolidated Balance Sheets
December 31, 2010 and 2009

	2010	2009
Assets		
Current assets		
Cash and cash equivalents	\$ 34,215,294	\$ 31,358,435
Patient/resident accounts receivable, net of estimated uncollectibles of \$5,403,000 and \$4,265,000	38,602,396	34,057,348
Other receivables	4,278,324	1,715,150
Inventories	4,648,844	986,517
Prepaid expenses and other current assets	1,320,768	932,642
Total current assets	83,065,626	69,050,092
Assets limited as to use	5,428,579	13,176,397
Investments	1,154,343	1,066,391
Due from affiliates	6,372	11,732
Property and equipment, net	76,113,227	60,939,529
Other assets	2,004,589	3,254,917
Total assets	<u>\$ 167,772,736</u>	<u>\$ 147,499,058</u>
Liabilities and Net Assets (Deficit)		
Current liabilities		
Current portion of long-term obligations	\$ 3,712,462	\$ 2,665,819
Accounts payable	15,806,319	13,352,723
Accrued expenses	11,625,243	10,949,781
Due to third-party payors	8,888,685	5,333,209
Due to affiliates	2,550,986	3,808,343
Total current liabilities	42,583,695	36,109,875
Long-term obligations, net	39,325,057	37,325,913
Long-term portion of insurance liabilities	10,200,452	9,431,979
Pension obligation	84,474,517	73,231,110
Asset retirement obligation	5,220,440	4,933,125
Interest rate swap	2,712,221	2,232,107
Deferred compensation plan	157,552	151,395
Total liabilities	184,673,934	163,415,504
Net deficit		
Unrestricted	(18,846,408)	(17,773,669)
Temporarily restricted	1,822,687	1,731,223
Permanently restricted	122,523	126,000
Total net deficit	(16,901,198)	(15,916,446)
Total liabilities and net deficit	<u>\$ 167,772,736</u>	<u>\$ 147,499,058</u>

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

Mercy Hospital of Buffalo

(a subsidiary of the Catholic Health System, Inc.)

Consolidated Statements of Operations and Changes in Net Assets (Deficits)**Years Ended December 31, 2010 and 2009**

	2010	2009
Unrestricted revenues, gains and other support		
Net patient/resident service revenue	\$ 293,306,658	\$ 278,612,427
Other revenue	4,884,150	3,641,836
Net assets released from restrictions	62,000	64,000
Total unrestricted revenues, gains and other support	<u>298,252,808</u>	<u>282,318,263</u>
Expenses		
Salaries and wages	117,018,414	111,255,426
Employee benefits	38,314,820	35,556,678
Medical and professional fees	9,027,774	7,259,058
Purchased services	25,556,653	24,103,763
Supplies	62,415,196	62,874,072
Depreciation and amortization	10,391,487	9,491,427
Interest	1,904,078	1,107,067
Insurance	2,345,886	2,582,759
Provision for bad debts	7,795,230	6,473,310
Other expenses	13,433,145	11,960,095
Total expenses	<u>288,202,683</u>	<u>272,663,655</u>
Income from operations	10,050,125	9,654,608
Nonoperating revenues and losses		
Investment income	706,068	480,207
Other	5,141	54,231
Total nonoperating revenues	<u>711,209</u>	<u>534,438</u>
Excess of revenues over expenses	<u>\$ 10,761,334</u>	<u>\$ 10,189,046</u>

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

Mercy Hospital of Buffalo

(a subsidiary of the Catholic Health System, Inc.)

Consolidated Statements of Operations and Changes in Net Assets (Deficits) Years Ended December 31, 2010 and 2009

	2010	2009
Unrestricted net assets		
Excess of revenues over expenses	\$ 10,761,334	\$ 10,189,046
Change in unrealized loss on interest rate swap	(468,610)	2,037,786
Change in minimum pension obligation	(10,608,625)	(1,133,219)
Impact of pension transfers to/ from CHS Subsidiaries	2,608,035	492,549
Net assets released from restriction	250,185	630,992
Distributions to parent	(3,615,058)	(597,850)
(Decrease) increase in unrestricted net assets	(1,072,739)	11,619,304
Temporarily restricted net assets		
Investment income	4,362	-
Grant revenue	189,677	-
Contributions	206,133	331,544
Temporarily restricted net assets released from restrictions	(308,708)	(694,992)
Increase (decrease) in temporarily restricted net assets	91,464	(363,448)
Permanently restricted net assets		
Permanently restricted net assets released from restrictions	(3,477)	-
Increase in permanently restricted net assets	(3,477)	-
(Decrease) increase in net assets	(984,752)	11,255,856
Net assets (deficit)		
Beginning of year	(15,916,446)	(27,172,302)
End of year	<u>\$ (16,901,198)</u>	<u>\$ (15,916,446)</u>

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

Mercy Hospital of Buffalo
(a subsidiary of the Catholic Health System, Inc.)
Consolidated Statements of Cash Flows
Years Ended December 31, 2010 and 2009

	2010	2009
Cash flows from operating activities		
(Decrease) increase in net assets	\$ (984,752)	\$ 11,255,856
Adjustments to reconcile (decrease) increase in net assets to net cash provided by operating activities		
Depreciation and amortization	10,391,487	9,491,427
Provision for bad debts	7,795,230	6,473,310
Loss (gain) on sale of assets	-	1,614
Gain on renewal of capital leases	(287,398)	-
Change in unrealized loss (gain) on interest rate swap	480,114	(2,079,971)
Distribution to parent and affiliates	3,615,058	597,850
Increase in pension obligation	8,000,590	640,670
Undistributed earnings in equity investees	1,683,383	51,191
Discount on issuance	15,630	6,756
Change in unrealized (gains) losses on investments	(49,209)	(117,121)
Realized (gain) loss on investment	(14,464)	15,167
Increase in cash surrender value of life insurance policies	(14,352)	(15,737)
(Increase) decrease in assets		
Patient accounts receivables	(12,340,278)	(10,199,092)
Due from affiliate	5,360	35,381
Other receivables	(2,563,174)	776,419
Inventories	(3,662,327)	22,476
Prepaid expenses and other assets	(864,149)	(341,588)
Increase (decrease) in liabilities		
Accounts payable	2,453,596	974,437
Accrued expenses	675,462	215,489
Due to affiliates	(2,302,938)	522,691
Due to third-party payors	3,555,476	(6,739,718)
Other liabilities	4,032,647	2,971,909
Net cash provided by operating activities	<u>19,620,992</u>	<u>14,559,416</u>
Cash flows from investing activities		
Purchase of property and equipment	(17,556,816)	(18,906,690)
Proceeds from sale of assets limited as to use	7,747,818	10,409,393
Change in investments, net	(9,927)	(13,600)
Net cash used in investing activities	<u>(9,818,925)</u>	<u>(8,510,897)</u>
Cash flows from financing activities		
Distribution to parent and affiliates	(3,615,058)	(597,850)
Repayment of current and long-term obligations	(3,330,150)	(2,463,929)
Net cash used in provided by financing activities	<u>(6,945,208)</u>	<u>(3,061,779)</u>
Increase in cash and cash equivalents	2,856,859	2,986,740
Cash and cash equivalents		
Beginning of year	31,358,435	28,371,695
End of year	<u>\$ 34,215,294</u>	<u>\$ 31,358,435</u>
Supplemental disclosure of cash flow information		
Cash paid during the year for interest	\$ 1,888,448	\$ 1,100,311
Noncash investing and financing activities		
Assets acquired under capital lease obligations	\$ 6,917,449	\$ 727,469

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

Mercy Hospital of Buffalo
(a subsidiary of the Catholic Health System, Inc.)
Notes to Consolidated Financial Statements
December 31, 2010 and 2009

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 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 (KMH) and Sisters of Charity Hospital (SCH).

Long-Term Care Subsidiaries

The Long-term Care Subsidiaries include St. Francis Geriatric and Healthcare Services, Inc. (closed December 2009), St. Francis Home of Williamsville, Western New York Catholic Long-Term Care, Inc. (Father Baker Manor), 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, Catholic Health Infusion Pharmacy, Continuing Care Foundation and Catholic Health System Program of All Inclusive Care for the Elderly, Inc. (LIFE) (commenced operations in December 2009).

2. Significant Accounting Policies

The significant accounting policies applied in preparing the accompanying consolidated 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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December 31, 2010 and 2009

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 when purchased, 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.

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Assets Limited as to Use

Assets limited as to use include assets set aside for debt service as required by trustee or indenture agreements, and assets set aside by the Board of Directors for specific future purposes. The Board retains control and may at its discretion subsequently use for other purposes.

Investments

Investments in marketable securities with readily determinable fair values and all investments in debt securities are reported at their fair values in the consolidated 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 \$585,000 at December 31, 2010 and 2009.

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 consolidated 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 expenses 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

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.

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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 2010 and 2009.

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,	
	2010	2009
Charity care	\$ 5,484,624	\$ 3,741,504
Cost of community benefit programs	1,185,086	927,637
Unpaid cost of Medicaid programs	7,728,661	7,914,993
Social accountability costs	<u>\$ 14,398,371</u>	<u>\$ 12,584,134</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 Hospital will also assist patients with the application process for free or low-cost insurance. Those uninsured patients who do not qualify for the Healthcare Assistance Program or low-cost insurance and live in New York State, a state contiguous to New York State, or the state of Ohio, are provided an uninsured discount based on a service specific uninsured rate. This uninsured rate is similar in calculation method and amount to third party payor methods and rates.

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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.

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. The Hospital is reimbursed at a tentative rate with final settlement determined after submission of annual cost reports by the Hospital and audits thereof by the Medicare Administrative Contractor. Cost reports have been audited and finalized by the Medicare Administrative Contractor 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 payors, except Medicaid, Workers' Compensation and No-Fault insurance programs, negotiate hospital's payment rates. If negotiated rates are not established, payors are billed at hospitals established charges. Medicaid, Workers' Compensation and No-Fault payors pay hospital rates promulgated by the New York State Department of Health (DOH) on a prospective basis. Adjustments to current and prior years' rates for these payors will continue to be made in the future. Effective December 1, 2009, NYS implemented inpatient reimbursement reform. The reform updated the data utilized to calculate the NYS DRG rates and service intensity weights (SIWS) in order to utilize refined data and more current information in DOH promulgated rates. Similar type outpatient reforms were implemented effective December 1, 2008.

Amounts recognized in 2010 and 2009 related to prior years, including adjustments to prior year estimates and audit settlements, increased the performance indicator approximately \$3,170,000 and \$2,970,000, respectively. These changes in estimates related to estimates for prior years cost report reopening, appeals, and tentative final cost reports, some of which are still subject to audit, additional reopening, and/or appeals.

Approximately 53% and 52% of net patient/resident service revenue was generated from services rendered to patients/residents under Medicare and Medicaid programs in 2010 and 2009, respectively. Approximately 29% and 30% of net patient/resident service revenue was generated from services rendered to patients under managed care programs in 2010 and 2009.

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

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Notes to Consolidated Financial Statements

December 31, 2010 and 2009

Operating and Nonoperating Revenues and Losses

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

Other Revenues

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

	2010	2009
Shared services (Note 13)	\$ 422,392	\$ 301,240
Cafeteria revenue	977,824	910,526
Parking revenue	631,740	597,827
Rental income	173,103	219,446
OLV Family Care Center - VA Contract	836,252	778,157
Contributions to Buffalo Mercy Foundation, Inc.	256,176	167,707
Gift shop income, net	345,648	298,226
Other	1,241,015	368,707
	<u>\$ 4,884,150</u>	<u>\$ 3,641,836</u>

Other Expenses

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

	2010	2009
System dues (a)	\$ 2,888,568	\$ 2,721,804
Rents and operating leases	5,582,277	5,495,366
NYS Health Facilities Cash Receipts Assessment Program	1,374,960	1,092,892
Other dues	577,343	687,853
Catholic Health System other expense	1,158,536	864,639
Equipment rentals	406,367	491,953
Other	1,445,094	605,588
	<u>\$ 13,433,145</u>	<u>\$ 11,960,095</u>

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System dues are comprised of the following expenses:

	2010	2009
Dues to Catholic Health East	\$ 1,628,450	\$ 1,653,871
Salaries, wages and employee benefits	653,173	557,107
Professional fees and purchased services	255,223	224,532
Other	351,722	286,294
	<u>\$ 2,888,568</u>	<u>\$ 2,721,804</u>

Excess of Revenues Over Expenses

The statement of operations and changes in net assets (deficits) 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 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 consolidated 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 consolidated 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 accounting guidance. 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 \$736,819 during 2010 and \$333,864 during 2009. Capitalized internal project labor costs amounted to \$249,067 during 2010 and \$7,586 during 2009.

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Reclassifications

Certain prior year amounts were reclassified to conform to the 2010 consolidated financial statement presentation.

3. New Authoritative Pronouncements

In August 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Updates (ASU) 2010-24 "Health Care Entities (Topic 954) Presentation of Insurance Claims and Related Insurance Recoveries" which clarifies that a health care entity should not net insurance recoveries against a related claim liability. The guidance provided in this ASU is effective for the fiscal years beginning after December 15, 2010. The adoption of this standard is not expected to have any impact on our financial condition, results of operations or cash flows.

In August 2010, the FASB issued ASU 2010-23, "Health Care Entities (Topic 954): Measuring Charity Care for Disclosure" which prescribes a specific measurement basis of charity care for disclosure. The guidance provided in this ASU is effective for fiscal years beginning after December 15, 2010. The adoption of this standard is not expected to have any impact on our financial condition, results of operations or cash flows.

In May 2009, the FASB issued new guidance establishing general standards of accounting and disclosure requirements for subsequent events, events that occur after the balance sheet date but before the financial statements are issued. In addition, certain events subsequent to the balance sheet date may require recognition in the financial statements as of the balance sheet date based on the requirements of this new guidance. The Hospital adopted the provisions of the guidance as of December 31, 2009, and evaluated the impact of subsequent events through May 6, 2011, representing the date at which the consolidated financial statements were issued.

In March 2008, the FASB issued new guidance intended to enhance the current disclosure framework for derivative instruments. This guidance requires that objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation. Additionally, disclosure is required of (i) the purpose of derivative use in terms of the risks that the entity is intending to manage, (ii) the fair values of derivative instruments and their gains and losses in a tabular format, and (iii) information about credit-risk-related contingent features. This new standard is effective for fiscal years and interim periods beginning after November 15, 2008. The Hospital has adopted this standard as of December 31, 2010. See Note 10 for the disclosures required by this new guidance.

4. Assets Limited as to Use

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

	2010	2009
Held by Trustee under Letter of Credit Agreement		
Cash and cash equivalents	\$ 5,271,027	\$ 13,025,002
Board designated		
Deferred compensation arrangements		
Equity securities	157,552	151,395
Assets limited as to use	<u>\$ 5,428,579</u>	<u>\$ 13,176,397</u>

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5. Investments

Investments consist of the following at December 31:

	2010	2009
Investment in debt and equity securities	\$ 739,502	\$ 665,902
Cash surrender value of life insurance policies and other	414,841	400,489
Total investments	<u>\$ 1,154,343</u>	<u>\$ 1,066,391</u>

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

	2010	2009
Investment in debt and equity securities		
Fair value	\$ 739,502	\$ 665,902
Cost	690,293	548,781
Unrealized gain	<u>\$ 49,209</u>	<u>\$ 117,121</u>

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

	2010	2009
Interest and dividend income	\$ 642,395	\$ 378,253
Net realized and unrealized gains	63,673	101,954
Total investment income	<u>\$ 706,068</u>	<u>\$ 480,207</u>

Interest and dividend income includes interest income on unrestricted cash and cash equivalents of \$640,591 and \$355,922 in 2010 and 2009, 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 \$4,208 and \$3,540 for the years ended December 31, 2010 and 2009, respectively.

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6. Property and Equipment

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

	2010	2009
Land and land improvements	\$ 1,656,406	\$ 1,557,861
Buildings	65,062,654	41,858,851
Leasehold improvements	8,443,861	7,503,242
Equipment	37,376,431	36,273,025
Equipment under capital leases	13,583,241	9,315,063
Foundation assets	95,524	86,399
	<u>126,218,117</u>	<u>96,594,441</u>
Less: Accumulated depreciation	(47,768,998)	(47,436,400)
Accumulated amortization on equipment under capital leases	<u>(5,664,336)</u>	<u>(6,471,777)</u>
	72,784,783	42,686,264
Construction in progress	<u>3,328,444</u>	<u>18,253,265</u>
Property and equipment, net	<u>\$ 76,113,227</u>	<u>\$ 60,939,529</u>

Depreciation expense amounted to \$8,204,320 and \$7,576,388 in 2010 and 2009, respectively. Amortization expense on equipment under capital leases amounted to \$1,854,907 and \$1,627,501 in 2010 and 2009, respectively. Fully depreciated assets of \$7,662,631 and \$3,792,659 were written-off for the years ended December 31, 2010 and 2009, respectively.

7. Other Assets

Other assets consist of the following at December 31:

	2010	2009
Debt issuance costs - Series 2008	\$ 939,309	\$ 967,309
Workers compensation funding surplus	476,023	-
Debt issuance costs - Series 2006	420,437	449,433
Equity investments	154,792	142,660
Other	14,028	-
Long-term portion of receivables	<u>-</u>	<u>1,695,515</u>
	<u>\$ 2,004,589</u>	<u>\$ 3,254,917</u>

Amortization expense on debt issuance costs amounted to \$60,145 and \$28,996 in 2010 and 2009, respectively.

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8. Accrued Expenses

Accrued expenses consist of the following at December 31:

	2010	2009
Workers compensation	\$ 2,208,692	\$ 2,048,493
Payroll and benefits	9,175,472	8,569,696
Other	241,079	331,592
	<u>\$ 11,625,243</u>	<u>\$ 10,949,781</u>

9. Long-Term Obligations

Long-Term Debt

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

	2010	2009
Mercy Hospital Series 2006 A (a)	\$ 11,152,044	\$ 11,712,789
Mercy Hospital Series 2008 (b)	24,097,175	24,378,300
Individual subordinated to mortgage held by Lackawanna Community Development Corporation, monthly payments of \$1,239, including interest at 10%, matures December 2012.	26,840	38,385
Capital lease obligations, at interest rates ranging from 3.38% to 8.1% , collateralized by equipment.	<u>7,761,460</u>	<u>3,862,258</u>
	43,037,519	39,991,732
Less: Current portion	<u>(3,712,462)</u>	<u>(2,665,819)</u>
	<u>\$ 39,325,057</u>	<u>\$ 37,325,913</u>

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- a. In 2006, the System formed the Acute Care Obligated Group (the Obligated Group), consisting of its three primary hospitals (MHB, SOC, and KMH) 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 Obligated Group entered into a Loan Agreement (the Loan Agreement) whereby the Obligated Group 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. In the event the letter of credit is not renewed at expiration, the outstanding Bonds, at the option of the members of the Obligated Group, will convert to a five year (initial) Term Loan. Repayment of the principal of Initial Term Loan shall be identical to the scheduled principal payments on the Bonds with the remaining amount due at the end of the five year term.

The interest borne by the Series 2006 Bonds will be determined by the Remarketing Agent to be the lowest rate that, in the judgment of the Remarketing Agent, under prevailing financial market conditions, enables such Series 2006 Bonds to be sold at a price of par. The variable interest rate was 0.33% and 0.21% at December 31, 2010 and 2009, respectively.

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, 2010 and 2009.

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- 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 expiring November 18, 2013 (with the option of an initial term loan), 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. Refer to Note 10 for details.

Aggregate maturities of long-term obligations, including capital lease obligations, subsequent to December 31, 2010 are as follows:

	Loans	Capital Leases	Total
2011	\$ 1,177,686	\$ 2,875,171	\$ 4,052,857
2012	1,229,020	1,853,423	3,082,443
2013	1,267,433	1,540,526	2,807,959
2014	1,322,433	1,383,161	2,705,594
2015	1,379,933	745,546	2,125,479
Thereafter	28,899,554	230,766	29,130,320
	<u>\$ 35,276,059</u>	<u>8,628,593</u>	<u>\$ 43,904,652</u>
Less: Interest		(867,133)	
		<u>\$ 7,761,460</u>	

Operating Leases

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

2011	\$ 4,381,832
2012	4,336,896
2013	4,387,621
2014	3,502,557
2015	3,175,424
Thereafter	4,453,814
	<u>24,238,144</u>
Minimum sublease rental obligations	(714,269)
	<u>\$ 23,523,875</u>

Total expense for rents and operating type leases was approximately \$5,582,277 and \$5,495,366 in 2010 and 2009, respectively.

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10. Derivative Financial Instruments

In connection with the issuance of the Series 2006 and Series 2008 Bonds and execution of the Loan Agreement, the Hospital entered into interest rate swap agreements (derivative agreements) 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 or Series 2008 Bonds be converted to bonds that bear a fixed rate of interest. The terms of the Series 2006 swap require the Hospital to pay a fixed rate of 3.80% on the notional amount (\$11,540,000 at December 31, 2010) and in exchange, the Hospital will receive a variable rate payment based upon the Securities Industry and Financial Markets Association Index (SIFMA), calculated weekly. The notional amount of the swap is matched to the maturity schedule of the Series 2006 Bonds. The 2006 swap agreement was executed on December 13, 2006 and expires July 1, 2025. The terms of the Series 2008 swap require the Hospital to pay 3.785% on the notional amount (\$24,700,000 at December 31, 2010) and in exchange, the Hospital will receive a variable rate payment based upon the SIFMA, calculated weekly. The 2008 swap agreement was executed on November 19, 2008 and expires on July 1, 2034. These dates correlate to the issue date and due date of the Bonds. The instrument qualifies for hedge treatment 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. The System is currently in the process of renewing the Letter of Credit which supports the 2006 Bonds.

The fair value of derivative instruments at December 31 is as follows:

	2010		2009	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Interest rate contracts	Other liabilities	<u>\$ 2,712,221</u>	Other liabilities	<u>\$ 2,232,107</u>

The effects of derivative instruments on the consolidated statements of operations and changes in net assets (deficits) for 2010 and 2009 are as follows:

	Amount of Gain (Loss) Recognized in Statement of Operations		Amount of Gain (Loss) Recognized in Net Assets (Deficits)	
	2010	2009	2010	2009
Change in fair value of interest rate swaps	<u>\$ (11,504)</u>	<u>\$ 42,185</u>	<u>\$ (468,610)</u>	<u>\$ 2,037,786</u>

The Hospital measures its interest rate swaps at fair market value on a recurring basis. The fair market value of the interest rate swaps is determined based on financials models that consider current and future market interest rates and adjustments for nonperformance risk. The inputs utilized in the valuation process of the interest rate swaps are considered to be Level 2 within the fair value hierarchy defined in Note 15.

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11. Employee Benefit Plans

Pension Arrangements

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

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

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

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Funded Status

The following tables summarize the System's 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, 2010 and 2009.

	December 31,	
	2010	2009
Benefit obligations		
Change in benefit obligation		
Benefit obligation at beginning of year	\$ 133,156,558	\$ 118,491,240
Service cost	4,844,642	4,257,410
Interest cost	7,879,435	7,226,573
Actuarial (gains) losses	14,060,238	7,374,801
Transfers (to) from CHS Subsidiaries	(4,691,367)	(895,605)
Amendments	250,120	-
Benefits paid	(3,475,284)	(3,240,648)
Expenses	(70,497)	(57,213)
Benefit obligation at end of year	<u>\$ 151,953,845</u>	<u>\$ 133,156,558</u>
Accumulated benefit obligation, end of year	<u>\$ 135,914,939</u>	<u>\$ 120,812,493</u>
Plan Assets		
Change in plan assets		
Fair value of plan assets at beginning of year	\$ 59,925,448	\$ 48,421,866
Actual return on plan assets	6,815,004	9,455,737
Transfers (to) from CHS Subsidiaries	(2,083,332)	(403,056)
Benefits paid	(3,475,284)	(3,240,648)
System contributions	6,367,989	5,748,762
Expenses	(70,497)	(57,213)
Fair value of plan assets at end of year	<u>\$ 67,479,328</u>	<u>\$ 59,925,448</u>
Funded status at end of year	<u>\$ 84,474,517</u>	<u>\$ 73,231,110</u>
Amounts recognized in the consolidated balance sheets		
Noncurrent liabilities	<u>\$ (84,474,517)</u>	<u>\$ (73,231,110)</u>
Net amounts recognized	<u>\$ (84,474,517)</u>	<u>\$ (73,231,110)</u>
Amounts recognized in unrestricted net assets consists of		
Actuarial net loss	\$ (52,510,993)	\$ (44,514,201)
Prior service cost	(1,489,989)	(1,486,191)
Total amount recognized	<u>\$ (54,000,982)</u>	<u>\$ (46,000,392)</u>
Components of net periodic pension cost		
Service cost	\$ 4,844,642	\$ 4,257,410
Interest cost	7,879,435	7,226,573
Expected return on plan assets	(5,550,563)	(4,937,773)
Amortization of prior service cost or (credit)	246,322	221,083
Recognized actuarial loss	2,190,971	1,502,535
Net periodic pension cost	<u>\$ 9,610,807</u>	<u>\$ 8,269,828</u>

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Since the Hospital is a participant in the System's plan, the following disclosures are made for the entire plan in the aggregate.

The estimated transition obligation, prior service cost, and net loss that will be amortized from unrestricted net assets into net periodic pension cost over the next fiscal year for the System are \$0, \$229,260 and \$8,197,864, respectively.

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 2011 and the actual asset allocation percentages for 2010 and 2009 are as follows at the respective measurement dates:

Asset category	Pension target allocation	Percentage of pension plan assets	
	2011	2010	2009
Equities	60%	51%	44%
Fixed income	20%	33%	40%
Other	20%	16%	16%
	<u>100%</u>	<u>100%</u>	<u>100%</u>

The portfolio is diversified among a mix of assets including large and small cap, domestic and foreign equities, fixed income, alternatives (a fund of hedge funds), and cash. Asset mix is targeted to a specific allocation, either intermediate or long-term, that is established by evaluating expected return, standard deviation, and correlation of various assets against the plan's long-term objectives. Asset performance is monitored quarterly and rebalanced if asset classes exceed explicit ranges. The investment policy governs permitted types of investments, and outlines specific benchmarks and performance percentiles. The Investment Subcommittee of the Stewardship Committee of the CHE Board oversees the pension investment program and monitors investment performance. Risk is closely monitored through the evaluation of portfolio holdings and tracking the beta and standard deviation of the portfolio performance. The use of derivative financial instruments as an investment vehicle is specifically limited.

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The following tables present the Plan's financial instruments as of December 31, 2010 and 2009, measured at fair value on a recurring basis using the fair value hierarchy defined in Note 15.

December 31, 2010	Total	Level 1	Level 2	Level 3
Investments				
Cash and cash equivalents	\$ 11,000,388	\$ 10,991,112	\$ 9,276	\$ -
Marketable equity securities	96,114,532	87,431,232	8,678,267	5,033
Marketable debt securities	57,537,008	22,182,587	35,354,421	-
Managed funds	31,275,299	-	-	31,275,299
	<u>\$ 195,927,227</u>	<u>\$ 120,604,931</u>	<u>\$ 44,041,964</u>	<u>\$ 31,280,332</u>
December 31, 2009	Total	Level 1	Level 2	Level 3
Investments				
Cash and cash equivalents	\$ 20,753,348	\$ 20,387,215	\$ 366,133	\$ -
Marketable equity securities	61,693,305	56,236,925	5,456,380	-
Marketable debt securities	62,063,234	32,544,405	29,478,552	40,277
Managed funds	26,654,949	-	-	26,654,949
	<u>\$ 171,164,836</u>	<u>\$ 109,168,545</u>	<u>\$ 35,301,065</u>	<u>\$ 26,695,226</u>

A roll forward of those marketable securities and investments whose use is limited that have been classified by the defined benefit plan as Level 3 within the fair value hierarchy (defined above) is as follows:

	2010	2009
Fair value January 1	\$ 26,695,226	\$ 24,380,736
Realized and unrealized gains (losses)	1,062,550	2,281,529
Purchases	10,152,201	-
Sales	(6,361,481)	39,908
Transfers in/out	(268,164)	(6,947)
Fair value December 31	<u>\$ 31,280,332</u>	<u>\$ 26,695,226</u>
Amount of unrealized losses related to Level 3 investments held at December 31, included in the statement of operations	<u>\$ -</u>	<u>\$ -</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 \$17,700,000 to the pension plan trust in 2010 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.

2011	\$ 11,756,000
2012	13,093,000
2013	14,646,000
2014	16,365,000
2015	18,021,000
2016 - 20	120,290,000

	2010	2009
Weighted-average assumptions used to determine end of year benefit obligations		
Discount rate	5.50%	6.00%
Rate of compensation increase	3.00%	3.75%
Weighted-average assumptions used to determine net periodic pension cost		
Discount rate	6.00%	6.20%
Expected long-term rate of return on plan assets	8.25%	8.25%
Measurement date	12/31/2010	12/31/2009

12. Insurance Arrangements

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

The coverage provided by SMICL is on a claims-made basis. The System, on the Hospital's behalf therefore retains the liability for unasserted claims resulting from incidents that occurred on services provided prior to the financial statement date. The System has independent actuaries estimate the ultimate costs of such unasserted claims, which were discounted at 4.0% in 2010 and 2009. The Hospital's portion of the System's liability for unpaid and incurred but not reported claims at December 31, 2010 and 2009 are \$2,610,000 and \$2,514,000, respectively, recorded in accrued expenses and long-term liabilities. The charges to expenses for professional and general liability for 2010 and 2009 approximated \$2,034,045 and \$2,263,089, 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 \$350,000 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.

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The Hospital's portion of the System's current portion of liabilities for unpaid and incurred but not reported claims at December 31, 2010 and 2009 is \$2,148,692 and \$1,999,190, respectively, and is included in accrued expenses. The Hospital's portion of the System's long term portion of liabilities for unpaid and incurred but not reported claims at December 31, 2010 and 2009 is \$7,720,952 and \$7,043,679, respectively, and is included in other long-term liabilities. The charges to expenses for workers compensation costs approximated \$3,203,869 and \$4,135,073 in 2010 and 2009, 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 \$300,000 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.

13. Related Party Transactions

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

During 2010 and 2009 the Hospital incurred expenses to affiliates for administration services, rent and other services. These expenses approximated \$37,644,190 for 2010 and \$34,293,939 for 2009 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 \$306,149 and \$143,880 for 2010 and 2009, respectively.

During 2010, a distribution was made to the parent of \$3,615,058. During 2010 and 2009, 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, 2010 and 2009 were \$2,550,986 and \$3,808,343, respectively. Amounts due from affiliates at December 31, 2010 and 2009 were \$6,372 and \$11,732, 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 lease guidance and did not qualify as a capital lease.

14. Legal Matters

The Hospital is involved in litigation and regulatory investigations arising in the course of business. The health care industry is subject to numerous laws and regulations of federal, state and local governments. Compliance with these laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at the time. Recently, government activity has increased with respect to investigations and allegations

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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 Hospital's future financial position, results from operations or cash flows.

15. Fair Value Measurements

The following methods and assumptions were used by the Hospital in estimating fair value disclosures for these consolidated 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.

Investments

The fair values for marketable equity, marketable debt, government, and fixed income securities are valued at the closing price reported on the active market on which the individual securities are traded.

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, the Hospital receives a variable rate based on the Securities Industry and Financial Markets Association Index 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.

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, as defined by accounting guidance, are directly related to the amount of subjectivity associated with the inputs to fair valuation of these assets and liabilities as follows:

- Level 1 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 1 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 bonds that are highly liquid and are actively traded in over-the counter markets.

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- 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.

Financial instruments measured at fair value are based on one or more of the three valuation techniques noted in fair value guidance. The three valuation techniques are as follows:

Market approach: Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

Cost approach: Amount that would be required to replace the service capacity of an asset (i.e., replacement cost).

Income approach: Techniques to convert future amounts to a single present amount based on market expectations (including present value techniques and option-pricing models).

The following tables present information about assets and liabilities that are measured at fair value on a recurring basis and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value as of December 31, 2010 and 2009.

	December 31, 2010				Valuation Technique
	Level I	Level 2	Level 3	Total	
Assets Limited As To Use					
Cash and cash equivalents	\$ 86,243	\$ 5,184,784	\$ -	\$ 5,271,027	Market
Marketable equity securities	157,552	-	-	157,552	Market
	<u>\$ 243,795</u>	<u>\$ 5,184,784</u>	<u>\$ -</u>	<u>\$ 5,428,579</u>	
Investments					
Cash and cash equivalents	\$ 22,630	\$ -	\$ -	\$ 22,630	Market
Marketable equity securities	548,964	1,512	-	550,476	Market
Marketable debt securities	28,867	39,476	9	68,352	Market
Other	-	414,841	-	414,841	Market
	<u>\$ 600,461</u>	<u>\$ 455,829</u>	<u>\$ 9</u>	<u>\$ 1,056,299</u>	
Managed funds				98,044	
				<u>\$ 1,154,343</u>	
Interest Rate Swap	\$ -	\$ 2,712,221	\$ -	\$ 2,712,221	Market

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	December 31, 2009				Valuation Technique
	Level 1	Level 2	Level 3	Total	
Assets Limited As To Use					
Cash and cash equivalents	\$ 86,160	\$ 12,938,842	\$ -	\$ 13,025,002	Market
Marketable equity securities	151,395	-	-	151,395	Market
	<u>\$ 237,555</u>	<u>\$ 12,938,842</u>	<u>\$ -</u>	<u>\$ 13,176,397</u>	
Investments					
Cash and cash equivalents	\$ 112,940	\$ 15	\$ -	\$ 112,955	Market
Marketable equity securities	400,469	390	-	400,859	Market
Marketable debt securities	22,591	40,929	325	63,845	Market
Other	-	400,489	-	400,489	Market
	<u>\$ 536,000</u>	<u>\$ 441,823</u>	<u>\$ 325</u>	<u>\$ 978,148</u>	
Managed funds				88,243	
				<u>\$ 1,066,391</u>	
Interest rate swap	\$ -	\$ 2,232,107	\$ -	\$ 2,232,107	Market

A roll forward of those marketable securities and investments whose use is limited that have been classified by the Hospital as Level 3 within the fair value hierarchy (defined above) is as follows:

	2010	2009
Fair value January 1	\$ 325	\$ 108
Purchases	-	217
Realized and unrealized gains (losses)	8	-
Transfers in/out	(324)	-
Sales	-	-
Fair value December 31	<u>\$ 9</u>	<u>\$ 325</u>
Amount of unrealized losses related to Level 3 investments held at December 31, included in the statement of operations	<u>\$ -</u>	<u>\$ -</u>

The following managed fund investments are recorded under the equity method of accounting, which is similar to using the net asset value per share of the investments as of December 31, 2010:

(in thousands of dollars)	Recorded Value	Unfunded Commitments	Commitment Terms	Redemption Terms
Fund of Hedge Funds	\$ 84,928	\$ -	n/a	Quarter-end, semiannually, or anniversary date; with 45-90 days prior written notice
Real estate	5,310	2,524	4 - 9 year; n/a for one mutual fund	Redemption not permitted
Private equity	7,806	7,542	5 - 13 years	Redemption not permitted
Total	<u>\$ 98,044</u>			

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The objective of the hedge funds investments is to achieve equity and fixed income like returns utilizing a conservative strategy with low risk and volatility. All hedge fund investing is done in a fund of funds approach and the use of diversified funds.

The objective of the private equity and real estate portfolios is to enhance return while reducing the overall risk through investments in limited partnerships in funds with expertise in these categories. These illiquid, longer term investments seek higher returns but are held at a very low percentage of the investment portfolio.

16. 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:

	2010	2009
Medicare	39 %	39 %
Medicaid	3 %	3 %
Blue Cross	8 %	9 %
Other third-party payors	37 %	36 %
Patients	13 %	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.

17. Commitments and Contingencies

In 2004, the System entered into a Strategic Alliance Agreement (SAA) with Siemens Medical Solutions to develop and implement innovative solutions to enhance the System's ability to efficiently and effectively deliver quality patient care. The SAA focused on three key areas:

1. Updating and improving diagnostic modalities.
2. Developing and implementing a common platform for both clinical and financial information systems across the enterprise.
3. Evaluating and improving building technologies to gain operational efficiencies from the physical plant.

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. All recurring fees increase annually based on the Consumer Price Index (CPI). 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

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pricing. Certain exclusions apply in situations where competition prices are below those offered by Siemens or if another vendor provides "breakthrough" technology.

18. 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:

	2010	2009
Health care services	\$ 212,747,143	\$ 206,497,040
General and administrative	<u>75,455,540</u>	<u>66,166,615</u>
	<u>\$ 288,202,683</u>	<u>\$ 272,663,655</u>