KALEIDA HEALTH

Consolidated Financial Statements

December 31, 2004 and 2003

(With Independent Auditors' Report Thereon)

KALEIDA HEALTH

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KPMG LLP
515 Broadway
Albany, NY 12207

Independent Auditors' Report

The Board of Directors
Kaleida Health:

We have audited the accompanying consolidated balance sheets of Kaleida Health (Kaleida) as of Decembers 31, 2004 and 2003, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of Kaleida's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Kaleida's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Kaleida Health as of December 31, 2004 and 2003, and the results of their operations and changes in net assets, and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

February 25, 2005

KALEIDA HEALTH

Consolidated Balance Sheets

December 31, 2004 and 2003

(Dollars in thousands)

Assets		2004	2003
Current assets:			
Cash and cash equivalents	$	11,478	28,680
Investments (note 6)		74,419	38,727
Accounts receivable:			
Patient, less estimated allowance for doubtful accounts of approximately $29,695 in 2004 and $32,301 in 2003		89,215	100,574
Other		9,986	8,715
Inventories		17,967	17,467
Prepaid expenses and other current assets		4,724	4,815
Total current assets		207,789	198,978
Assets limited as to use (notes 5 and 6):			
Designated under debt agreements		31,791	33,098
Designated under self-insurance programs		108,327	98,034
Board designated and donor restricted		71,376	65,114
Other		928	591
		212,422	196,837
Property and equipment, less accumulated depreciation and amortization (note 7)		237,256	242,360
Deferred financing costs, net		8,994	7,747
Other		2,114	2,422
Total assets	$	668,575	648,344

See accompanying notes to consolidated financial statements.

Liabilities and Net Assets		2004	2003
Current liabilities:			
Accounts payable and other accrued expenses	$	69,949	63,457
Accrued payroll and related expenses		25,356	27,822
Estimated third-party payor settlements (note 4)		2,436	18,686
Current portion of long-term debt (note 8)		14,173	15,540
Other current liabilities		9,051	3,793
Total current liabilities		120,965	129,298
Long-term debt, less current portion (note 8)		183,754	186,051
Estimated self-insurance reserves (note 5)		109,427	100,582
Deferred credit		1,172	4,183
Other long-term liabilities (note 10)		56,404	57,638
		350,757	348,454
Total liabilities		471,722	477,752
Commitments and contingencies (notes 4, 7, 9 and 13)			
Net assets:			
Unrestricted		131,221	109,341
Temporarily restricted (note 11)		45,759	43,064
Permanently restricted (note 11)		19,873	18,187
Total net assets		196,853	170,592
Total liabilities and net assets	$	668,575	648,344

KALEIDA HEALTH

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2004 and 2003

(Dollars in thousands)

		2004	2003
Unrestricted revenue, gains, and other support:			
Net patient service revenue (notes 3 and 4)	$	829,322	791,576
Investment income (note 6)		11,961	5,298
Other operating revenue (notes 8 and 11)		30,327	34,026
Total unrestricted revenue, gains, and other support		871,610	830,900
Expenses:			
Salaries and benefits		441,812	419,516
Purchased services, supplies, and other		331,964	316,923
Depreciation and amortization		48,717	44,893
Bad debt expense		29,800	34,211
Interest		11,831	13,322
Total expenses		864,124	828,865
Excess of revenue, gains, and other support over expenses	$	7,486	2,035

(Continued)

KALEIDA HEALTH

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2004 and 2003

(Dollars in thousands)

		2004	2003
Unrestricted net assets:			
Excess of revenue, gains, and other support over expenses	$	7,486	2,035
Net change in unrealized gains on investments		2,010	16,021
Change in additional minimum pension liability (note 10)		8,560	(4,502)
Contributions for capital acquisitions		67	1,015
Net assets released from restrictions for property acquisitions		3,373	2,434
Other transfers, net		384	103
Increase in unrestricted net assets		21,880	17,106
Temporarily restricted net assets:			
Contributions, bequests, and grants		15,315	15,941
Investment income		4,372	1,002
Net change in unrealized (losses) gains on investments		(147)	7,780
Net assets released from restrictions for operations		(13,827)	(14,973)
Net assets released from restrictions for property acquisitions		(3,373)	(2,434)
Other transfers, net		355	66
Increase in temporarily restricted net assets		2,695	7,382
Permanently restricted net assets:			
Contributions		28	28
Investment income		2,343	442
Net change in unrealized gains on investments		54	4,141
Other transfers, net		(739)	(169)
Increase in permanently restricted net assets		1,686	4,442
Increase in net assets		26,261	28,930
Net assets, beginning of year		170,592	141,662
Net assets, end of year	$	196,853	170,592

See accompanying notes to consolidated financial statements.

KALEIDA HEALTH

Consolidated Statements of Cash Flows

Years ended December 31, 2004 and 2003

(Dollars in thousands)

		2004	2003
Cash flows from operating activities:			
Change in net assets	$	26,261	28,930
Adjustments to reconcile change in net assets to net cash provided by operating activities:			
Depreciation and amortization		48,717	44,893
Gain on refinancing transactions		(2,891)	—
Net assets released from restrictions for property acquisitions		(3,373)	(2,434)
Net change in unrealized gains on investments		(1,917)	(27,942)
Bad debt expense		29,800	34,211
Change in additional minimum pension liability		(8,560)	4,502
Change in operating assets and liabilities:			
Patient accounts receivable		(18,441)	(39,873)
Other receivables, inventories, and prepaid expenses		(1,680)	(849)
Accounts payable, accrued expenses, and accrued payroll		4,026	(3,939)
Estimated third-party payor settlements		(16,250)	3,256
Other liabilities		21,070	36,360
Donor-restricted assets, net of unrealized losses		(6,355)	5,226
Net cash provided by operating activities		70,407	82,341
Cash flows from investing activities:			
Additions to property and equipment, net		(30,091)	(28,192)
Net purchases of investments		(43,005)	(32,465)
Change in other assets		308	(819)
Net cash used by investing activities		(72,788)	(61,476)
Cash flows from financing activities:			
Principal payments on debt and capital lease obligations		(13,987)	(15,454)
Proceeds from release of debt service funds		1,820	—
Payments for deferred financing fees		(2,654)	—
Net cash used by financing activities		(14,821)	(15,454)
Net (decrease) increase in cash and cash equivalents		(17,202)	5,411
Cash and cash equivalents, beginning of year		28,680	23,269
Cash and cash equivalents, end of year	$	11,478	28,680
Supplemental schedules on noncash investing activities:			
Capital lease obligations	$	10,149	11,342

See accompanying notes to consolidated financial statements.

(1) Organization and Basis of Consolidation

Kaleida Health (Kaleida) is an integrated healthcare delivery system that provides acute, skilled nursing, rehabilitative, outpatient, and home healthcare primarily to the residents of Western New York. The entities consolidated within Kaleida are the Hospital Corporation (Buffalo General Hospital, Women's and Children's Hospital, the Millard Fillmore Hospitals, and DeGraff Memorial Hospital), Waterfront Health Care Center, Visiting Nursing Association of WNY, Inc., VNA Home Care Services, Inc., several other wholly owned subsidiaries, and a number of charitable foundations that raise funds for Kaleida. All significant intercompany transactions have been eliminated in consolidation.

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation

The accompanying consolidated financial statements, which are presented on the accrual basis of accounting, have been prepared consistent with the American Institute of Certified Public Accountants *Audit and Accounting Guide, Health Care Organizations* (Audit Guide). In accordance with the provisions of the Audit Guide, net assets and revenue, expenses, gains and losses are classified based on the existence or absence of donor-imposed restrictions. Accordingly, unrestricted net assets are amounts not subject to donor-imposed stipulations and are available for operations. Temporarily restricted net assets are those whose use has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained in perpetuity.

(b) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates, and the differences in estimates from actual results could be significant. The most significant areas which are affected by the use of estimates include the allowance for uncollectible accounts, estimated third-party payor settlements, insurance reserves and pension obligations (see notes 4, 5, and 10).

(c) Cash and Cash Equivalents

Cash equivalents include amounts invested in short-term interest-bearing accounts and highly liquid debt instruments with original maturity dates of three months or less. For purposes of the statements of cash flows, cash equivalents exclude amounts maintained within investment portfolios and amounts classified as assets limited as to use.

Kaleida invests cash in money market securities and commercial paper with high-credit-quality issuers. At December 31, 2004 and 2003, Kaleida had cash balances in financial institutions in excess of federal deposit insurance limits.

(Continued)

(d) ***Charity Care and Provision for Uncollectible Accounts***

Kaleida provides care to patients who meet certain criteria under its charity care policies without charge or at amounts less than their established rates. Because Kaleida does not anticipate collection of amounts determined to qualify as charity care, they are not reported as revenue.

Kaleida grants credit without collateral to patients, most of whom are local residents and are insured under third-party arrangements. Additions to the estimated allowance for doubtful accounts are made by means of the provision for uncollectible accounts. Accounts written off as uncollectible are deducted from the allowance and subsequently recoveries are added. The amount of the provision for uncollectible accounts is based upon management's assessment of historical and expected net collections, business and economic conditions, trends in Federal and State governmental health care coverage and other collection indicators.

(e) ***Net Patient Service Revenue***

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered. Revenue under certain third-party payor agreements is subject to audit and retroactive adjustment. Provision for estimated third-party payor settlements and adjustments are estimated in the period the related services are rendered and adjusted in future periods as final settlements are determined (see note 4).

(f) ***Investments and Investment Income***

Investments in equity securities with readily determinable fair values and all investments in debt securities are presented in the consolidated financial statements at fair value. Donated investments are reported at fair value at the date of the donation which is then treated as cost. Investments in hedge funds are dependent on the legal form and legal entity of the fund, level of ownership of the fund, and the frequency with which the unit value is published in the fund. Kaleida's investments in hedge funds are recorded on a cost basis in the consolidated financial statements. Management believes the fair value of their investments in these hedge funds exceeds their carrying value.

Investment income includes interest, dividends, and realized gains and losses on investments and is included in excess (deficiency) of revenue, gains and other support over expenses and as an addition to restricted net assets when restricted by the donor. The cost of specific securities sold is used to compute realized gains or losses on sales. The net change in unrealized gains on investments is included in other changes in net assets consistent with the purpose of the investment and donor-imposed restriction. A decline in the market value of an investment security below its cost that is designated to be other than temporary is recognized through an impairment charge. The impairment charge is included in the excess (deficiency) over revenue, gains, and other support over expenses in the consolidated statements of operations and changes in net assets and a new cost basis is established.

Participation units in pooled investment funds held within unrestricted, temporarily restricted and permanently restricted net assets are determined monthly based on the market value of the underlying investments at the calculation date. Income earned on pooled investments is allocated to participating funds based on their respective unit shares of the pool.

(g) *Inventories*

Inventories consist principally of pharmaceutical and other medical supplies and are stated at the lower of cost or market. Cost is determined using the first-in, first-out method.

(h) *Assets Limited as to Use*

Assets limited as to use include investments maintained by a trustee under irrevocable self-insurance agreements and cash and investments held by trustees in a debt reserve account. Assets limited as to use also include investments set aside by the board of directors for specific purposes, as well as investments restricted by donors and grantors for a specific time period or purpose.

(i) *Property and Equipment*

Property and equipment are carried at cost, except for donated items, which are recorded at fair market value at the date of donation. Cost includes interest incurred on related indebtedness during periods of construction. The costs of routine maintenance and repairs are charged to expense as incurred.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets. The estimated useful lives of assets generally follow American Hospital Association guidelines: land improvements, 10 years; buildings, fixtures, and improvements, 10 to 40 years; and movable equipment, 3 to 15 years. Assets recorded as capital leases are amortized over the lease term of the asset or its useful life, if shorter. Lease amortization is included within depreciation and amortization expense.

(j) *Deferred Financing Costs*

Kaleida has capitalized various costs associated with obtaining long-term financing. These costs are being amortized over the terms of related obligations.

(k) *Deferred Credit*

As a result of prior years' mortgage debt refinancing and mortgage modifications, Kaleida received funds to be used for various approved facility renovation projects. Kaleida has no obligation to repay these funds, provided the mortgage balances are paid and operations continue at certain facilities. Kaleida has recorded the funds received as a deferred credit. The balance is being amortized over the respective mortgage terms. The annual amortization is recorded as a reduction of mortgage interest expense.

(l) *Self-Insurance Trusts and Estimated Self-Insurance Reserves*

Certain divisions of Kaleida are partially self-insured for medical malpractice, general liability, and workers' compensation costs, and excess liability policies are generally maintained for exposures in excess of self-insurance retentions. Trusts have been established for the purpose of setting aside assets based on actuarial funding recommendations. Under the trust agreements, the trust assets can be used only for payment of losses, related expenses, and the costs of administering the trust.

(Continued)

(m) Donor Contributions

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations limiting the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported as net assets released from restrictions and included as a component of other operating revenue. Contributions whose restrictions lapse, expire, or are otherwise met in the same reporting period as the contribution was received are recorded as unrestricted support and included as additions to unrestricted net assets.

At December 31, 2004 and 2003, pledges receivable, net of estimated allowances for uncollectible pledges and discounted for long-term pledges, recognized by the Foundations totaled approximately $2,631,000 and $1,807,000, respectively.

(n) Financial Instruments

The carrying values of cash and cash equivalents, accounts receivable, and accounts payable are reasonable estimates of their fair value due to the short-term nature of these financial instruments. Kaleida's long-term debt instruments are carried at cost. Fair values are estimated based on quoted market prices for the same or similar issues. The estimated fair value of Kaleida's long-term debt as of December 31, 2004 is approximately $201,800,000. The fair value of debt was estimated by discounted cash flow analysis using current borrowing rates for similar types of arrangements. Judgment is required in certain circumstances to develop the estimates of fair value, and the estimates may not be indicative of the amounts that could be realized in a current market exchange.

(o) Income Taxes

Kaleida and substantially all of its affiliates have been determined by the Internal Revenue Service to be organizations described in Internal Revenue Code (the Code) Section 501 (c) (3) and, therefore, are exempt from federal income taxes on related income pursuant to Section 501(a) of the Code.

(p) Excess of Revenue Gains, and Other Support Over Expenses

Kaleida's primary mission is meeting the healthcare needs of the people in the regions in which it operates. Kaleida is committed to providing a broad range of general and specialized healthcare services, including inpatient acute care, long-term care, home care, outpatient services, and other healthcare-related services. All activities, including unrestricted contributions and investment income, associated with the furtherance of this mission are considered to be operating activities. Changes in unrestricted net assets which are excluded from excess of revenue, gains and other support over expenses, consistent with industry practice, include unrealized gains and losses on investments, net assets released from restrictions used for purchase of property and equipment and minimum pension liability.

(q) ***Reclassifications***

Certain amounts in the 2003 consolidated financial statements have been reclassified to conform to 2004 presentation.

(3) Uncompensated Care

Kaleida accepts all patients regardless of their ability to pay. A patient's care may be classified as charity care in accordance with certain established policies of Kaleida. Essentially, these policies define charity services as those services for which no payment is anticipated. In addition, Kaleida serves a large Medicaid and indigent patient population whose healthcare service is only partially paid for by the Medicaid program. The following table summarizes charity care provided during the years ended December 31.

		2004	**2003**
		(Dollars in thousands)	
Charity care excluded from revenue, based on established rates for services provided	$	952	863
Revenue shortfall compared to expenses for services provided to Medicaid and indigent patients		14,735	13,660
	$	15,687	14,523

Kaleida also provided additional uncompensated services totaling $29,800,000 and $34,211,000 in 2004 and 2003, respectively, representing uncollectible patient accounts.

(4) Third-Party Reimbursement Agreements

Kaleida has agreements with third-party payors that provide for payments at amounts different from their established rates as follows:

Inpatient Acute Care Services: Inpatient acute care services rendered are paid at prospectively determined rates per discharge in accordance with the Federal Prospective Payment System (PPS) for Medicare and generally at negotiated or otherwise pre-determined amounts under the provisions of the New York Health Care Reform Act (HCRA) for Medicaid and other non-Medicare payors, Inpatient nonacute services are paid at various rates under different arrangements with third-party payors, commercial insurance carriers and health maintenance organizations. The basis for payment under these agreements includes prospectively determined per diem and per visit rates and fees, discounts from established charges, fee schedules, and reasonable cost subject to limitations. Medicare outpatient services are paid under a prospective payment system whereby services are reimbursed on a predetermined amount for each outpatient procedure, subject to various mandated modifications.

In addition, under HCRA, all non-Medicare payors are required to make surcharge payments for the subsidization of indigent care and other health care initiatives. The percentage amounts of the surcharge varies by payor and applies to a broader array of health care services. Also, certain payors are required to fund a pool for graduate medical education expenses through surcharges on payments to hospitals for inpatient services or through voluntary election to pay a covered lives assessment directly to the New York State Department of Health (DOH).

HCRA, first enacted in 1996 and subsequently modified through 2003, is set to expire June 30, 2005. The Governor and the New York State Legislature have agreed to extend HCRA through June 30, 2007. The HCRA extension will include, among other items, an assessment on hospital operating revenues, a provision allowing selective contracting for a limited number of Medicaid services, legislation creating a hospital and nursing home right sizing commission, and funding for recruitment and retention of health care workers. At this time, the scope of this extension or the effect on Kaleida cannot be fully determined.

Skilled Nursing and Home Health Care Services: Net patient service revenue for skilled nursing services under the Medicaid program is based on a modified pricing system using the Resource Utilization Group (RUGs) patient classification system. Under this methodology, reimbursement is at a predetermined rate depending on the intensity of the services rendered to residents regardless of the cost of delivering those services. Medicaid's predetermined rate is computed using cost report data from the facility's designated base year and elements from annual cost report filings. Medicare reimbursement for skilled nursing services are determined on a prospective payment system (PPS) basis. Under skilled nursing PPS, a single per diem rate is paid that covers all routine, ancillary, and capital related costs. The per diem payment is adjusted for each Medicare beneficiary, based on their care needs as measured by a patient assessment form.

Effective for certified home health care services on or after October 1, 2000, Medicare modified their reimbursement formula from a cost basis to a prospective payment system (PPS). The unit of payment for Medicare PPS is based on a 60 day episode, case mix adjusted into one of the eighty home health resource groups (HHRG). Adjustments exist for low and high utilization of services during a 60 day episode. Medicare will generally make an initial payment of 60% based on the submitted HHRG with the balance of the payment due at the end of the 60 day episode or at discharge, whichever occurs sooner. For all non-Medicare payors, the basis of payment under these agreements includes prospectively determined per visit rates and fees, discount on charges and fee schedules.

Kaleida is required to prepare and file various reports of actual and allowable costs annually. Provisions have been made in the consolidated financial statements for prior and current years' estimated final settlements. The difference between the amount provided and the actual final settlement is recorded as an adjustment to net patient service revenue as adjustments become known or as years are no longer subject to audits, reviews, and investigations. During 2004 and 2003, Kaleida recorded adjustments for estimated settlements with third-party payors which resulted in increases to net patient service revenue of approximately $18,000,000 and $12,700,000, respectively. Net patient service revenue from Medicare and New York State Medicaid programs accounted for approximately 28% and 11%, respectively, for the year ended December 31, 2004 and 27% and 11%, respectively, for the year ended December 31, 2003. Significant concentrations of patient accounts receivable at December 31, 2004 include Medicare 20%, Medicaid 17%, and health maintenance organizations 34%.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Kaleida receives regulatory inquiries and reviews in the normal course of business. Kaleida believes it is in compliance with all applicable laws and regulations. Compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action, including fines, penalties, and exclusion from the Medicare and Medicaid programs.

(5) Self-Insurance Trusts and Estimated Self-Insurance Reserves

Kaleida is partially self-insured for medical malpractice, general liability, and workers' compensation costs, and excess liability policies are generally maintained for exposures in excess of self-insurance retentions. Trusts are established for the purpose of setting aside assets based on actuarial funding recommendations. Under the trust agreements, the trust assets can be used only for payment of losses, related expenses, and the costs of administering the trust. The estimated liability for both asserted and unasserted self-insurance claims for medical malpractice and general liability are discounted at 6.00% and 6.25% at December 31, 2004 and 2003, respectively, and discounted at 4.5% for workers' compensation costs at December 31, 2004 and 2003. Estimated self-insurance reserves are approximately $109,000,000 and $101,000,000 at December 31, 2004 and 2003. At December 31, 2004, Kaleida has irrevocable secured letters of credit supporting the self insurance program totaling approximately $8,675,000. The annual fee for the letters of credit approximates 75 basis points and renew automatically unless the issuer notifies both parties in writing sixty days in advance.

Excess liability coverage from April 1998 through December 2000 was provided by an insurance carrier that was in receivership and liquidation as of March 7, 2002. As such, it is possible that no excess insurance coverage is available for claims reported during that period. There are known claims and incidents that may result in the assertion of additional claims, as well as claims from unknown incidents that may be asserted arising from services provided to patients during that period. The Hospital has employed independent actuaries to estimate the ultimate costs of the settlement of such claims.

At December 31, 2004 and 2003, there were various actions filed against Kaleida by former patients and others seeking compensatory and punitive damages. Management believes current estimates for known and unknown claims reflected in the self-insurance accrual are adequate. If the ultimate costs differ from the estimates, such additional amounts will be accrued when known. Excess coverage retroactive to the date of Kaleida's formation has been obtained for incidents reported after December 31, 2000.

(Continued)

(6) Investments

The fair value of investments, including amounts classified as assets limited as to use, at December 31, are as follows:

		2004	2003
		(Dollars in thousands)	
Current investments:			
Cash and cash equivalents	$	25,140	2,516
U.S. government securities		10,106	7,317
Corporate bonds		6,623	5,999
Marketable equity securities		23,734	18,744
Other		8,816	4,151
	$	74,419	38,727
Assets limited as to use:			
Designated under debt agreements:			
Cash and cash equivalents	$	12,355	5,641
U.S. government securities		19,436	27,457
		31,791	33,098
Designated under self-insurance programs:			
Cash and cash equivalents		42,916	37,467
U.S. government securities		2,674	1,638
Corporate bonds		13,794	19,164
Marketable equity securities		41,502	37,114
Other		7,441	2,651
		108,327	98,034
Board designated and donor restricted:			
Cash and cash equivalents		3,712	3,520
U.S. government securities		375	762
Corporate bonds		10,554	8,412
Marketable equity securities		46,141	46,247
Other		10,594	6,173
		71,376	65,114
Other:			
Cash and cash equivalents		928	591
	$	212,422	196,837

Unrestricted investment income includes the following for the years ended December 31:

	2004	2003
	(Dollars in thousands)	
Interest and dividend income	$ 3,738	3,103
Net realized gains on investments	8,223	2,195
	$ 11,961	5,298

(7) Property and Equipment

A summary of property and equipment at December 31, follows:

	2004	2003
	(Dollars in thousands)	
Land and land improvements	$ 17,143	18,254
Buildings, fixtures, and improvements	535,599	519,524
Movable equipment	409,033	382,579
	961,775	920,357
Less accumulated depreciation and amortization	737,697	690,850
	224,078	229,507
Construction in progress	13,178	12,853
	$ 237,256	242,360

Kaleida routinely has commitments outstanding for the purchase of goods and services for construction projects. Commitments outstanding at December 31, 2004 totaled approximately $20,602,000.

At December 31, amounts included above for property and equipment under capital leases are as follows:

	2004	2003
	(Dollars in thousands)	
Property and equipment	$ 33,907	22,444
Less accumulated amortization	12,784	6,960
	$ 21,123	15,484

(8) Debt

Debt consists of the following at December 31:

		2004	2003
		(Dollars in thousands)	
Mortgage and building loan payable (Buffalo General Hospital) in monthly installments of $625,000, including interest at 5.25% through August 1, 2023	$	89,151	—
Mortgage and building loan payable (Buffalo General Hospital) in monthly installments of $1,191,000, including interest at 7.76% through February 1, 2013. The mortgage was refinanced in May 2004.		—	93,508
Mortgage payable in monthly installments of $574,000 including interest at 6.04% through November 1, 2017. Thereafter, monthly principal and interest installments of $355,000, with the remaining principal balance due April 1, 2020		66,093	68,900
Mortgage payable (Waterfront Health Care Center, Inc.) in monthly installments of $48,000 including interest at 6.25% through July 1, 2024. As outlined below, the terms of this mortgage were modified in June 2004.		6,476	7,129
Industrial Development bond payable in monthly fixed principal installments of $25,000, plus interest at 5.57% through January 2011. Thereafter, varying monthly principal and interest installments through January 2026		4,041	4,341
Capital lease obligations, less imputed interest of $1,694,000 and $1,555,000 at December 31, 2004 and 2003, respectively		21,384	16,583
Other		10,782	11,130
		197,927	201,591
Less current maturities		14,173	15,540
	$	183,754	186,051

Long-term Debt: The mortgages represent agreements with the Dormitory Authority of the State of New York (DASNY) and Greystone Servicing Corporation, Inc. (Greystone), a private servicing corporation. The mortgages and industrial development bonds payable are secured by essentially all assets of the respective borrowing entities.

On May 20, 2004, Kaleida refinanced the existing mortgage related to Buffalo General Hospital. Although the principal amount refinanced remained the same, the mortgage term, interest rate and monthly payment were modified. The new mortgage remains insured by the U.S. Department of Housing and Urban Development (HUD).

As a result, Kaleida entered into a new Regulatory Agreement with HUD, which sets forth certain provisions and requirements. Among these requirements are certain performance indicators, financial ratios and reporting requirements. Also among these requirements is the substitution of a Mortgage Reserve Fund Agreement (Mortgage Reserve) for the Depreciation Reserve Fund Agreement, dated April 3, 1998. As required under the Mortgage Reserve, Kaleida is required to maintain a certain balance either through deposits or investment earnings. Failure to comply with these requirements may result in oversight activities by HUD or its designated agent, the Department of Health and Human Services (HHS). Such oversight activities could include HUD/HHS approvals for short-term borrowings, leases or other long-term debt obligations over threshold amounts, and for certain transactions with affiliates.

On June 1, 2004, Kaleida, as the sole corporate member of Waterfront Health Care Center, Inc. entered into a Modification of Mortgage Note and Mortgage Agreement (the Agreement). As a part of the Agreement, the original mortgage dated May 21, 1992 was assigned by DASNY to Greystone, effective February 26, 2004. The original mortgage note remains in effect with the exception of modifications to the interest rate, monthly payment, and revisions to the prepayment penalty provisions. This mortgage remains insured by HUD and continues to be covered under certain provisions and requirements as set forth under the HUD Regulatory Agreement dated May 21, 1992.

Included in other operating revenue in the consolidated statement of operations and changes in net assets for the year ended December 31, 2004 is a net gain on the refinancing of these debt instruments of $2.8 million.

Capital Leases: On March 31, 2004, Kaleida entered into a capital lease arrangement with GE Capital totaling approximately $10,000,000 to finance the acquisition of various pieces of equipment. This lease arrangement is administered by DASNY as part of their Tax-Exempt Leasing Program.

In April 2005, Kaleida intends to obtain an additional $16,000,000 of tax-exempt financing for the acquisition of certain equipment. The finalization of this credit arrangement is pending DASNY and HUD approval.

(Continued)

Future annual principal payments of long-term debt for the next five years as of December 31, 2004 (dollars in thousands):

2005	$	14,173
2006		13,505
2007		13,500
2008		11,542
2009		11,699

Interest paid approximated interest expense for the years ended December 31, 2004 and 2003.

Lines of Credit: In September 2002, Kaleida entered into a Revolving Credit Loan Agreement (the Agreement) with General Electric Capital Corporation (GE Capital). The maximum aggregate principal amount of credit that can be extended under the Agreement is $20,000,000. Interest is payable monthly at prime plus 1%. In connection with the Agreement, Kaleida agreed to pay a commitment fee equal to 1% of the maximum loan amount. The commitment fee has been deferred and is being amortized over the term of the Agreement. Advances under the Agreement are made against a borrowing base equal to 85% of qualified accounts, as defined within the Agreement. DASNY and HUD agreed to subordinate its security interest in the first $33.0 million worth of accounts receivable to GE Capital as collateral for borrowings on the line of credit. No borrowings were outstanding under this Agreement as of December 31, 2004 and 2003.

(9) Leases Commitments

Kaleida leases various equipment and facilities under operating leases expiring at various dates in the future. Rental expense for all operating leases were approximately $17,600,000 and $15,800,000 in 2004 and 2003, respectively. Future minimum payments under noncancelable operating leases as of December 31, 2004 having lease terms in excess of one year are as follows (dollars in thousands):

2005	$	11,942
2006		11,628
2007		11,128
2008		10,705
2009		8,676

(10) Employee Benefits

(a) Pension Plans

Defined Benefit Plan: Kaleida sponsors a defined benefit plan (the Plan) covering substantially all of its eligible employees. The Plan provide benefits based upon years of service and the employee's compensation. Kaleida's funding policy is to contribute amounts required by the Employee Retirement Income Security Act. The amount to be funded is subject to annual review by management and Kaleida's consulting actuary. The following table sets forth the funded status of Kaleida's defined benefit pension plan and amounts recognized in the consolidated balance sheets at December 31:

		2004	2003
		(Dollars in thousands)	
Change in benefit obligation:			
Benefit obligation at beginning of year	$	302,081	258,779
Service cost		13,565	11,782
Interest cost		17,696	17,032
Actuarial loss		1,499	26,547
Benefits paid		(10,758)	(12,090)
Plan amendments		—	31
Benefit obligation at end of year		324,083	302,081
Change in plan assets:			
Fair value of plan assets at beginning of year		209,371	183,758
Actual return on plan assets		26,591	33,703
Employer contributions		5,200	4,000
Benefits paid		(10,758)	(12,090)
Fair value of assets at end of year		230,404	209,371
Reconciliation of funded status:			
Funded status		(93,679)	(92,710)
Fourth quarter employer contribution		1,400	1,200
Unrecognized transition obligation		—	(147)
Unrecognized prior service cost		(2,799)	(3,214)
Unrecognized actuarial loss		63,943	70,932
Net amount recognized at year end	$	(31,135)	(23,939)
Amounts recognized in the consolidated balance sheets consist of:			
Accrued pension liability	$	(52,077)	(53,441)
Additional minimum pension liability		20,942	29,502
Net amount recognized at year end	$	(31,135)	(23,939)

The accumulated benefit obligation at the Plan's measurement date (September 30) for 2004 and 2003 was approximately $283,881,000 and $263,812,000, respectively.

(Continued)

A minimum pension liability adjustment is required when the actuarial present value of accumulated benefits exceeds plan assets and accrued pension liabilities. As a result, Kaleida has reflected an additional minimum pension liability of $20,942,000 and $29,502,000 at December 31, 2004 and 2003, respectively, in the consolidated balance sheets. The change in the additional minimum pension liability at December 31, 2004 of $8,560,000 is reflected as an increase in unrestricted net assets in the accompanying consolidated statement of operations and changes in net assets for the year ended December 31, 2004.

The following sets forth the components of net pension cost as of December 31:

		2004	2003
		(Dollars in thousands)	
Components of net pension cost:			
Service cost	$	13,565	11,782
Interest cost		17,696	17,032
Expected return on plan assets		(19,386)	(18,898)
Amortization of transition obligation		(147)	(149)
Amortization of prior service cost		(415)	(416)
Amortization of actuarial loss		1,471	—
Net pension cost	$	12,784	9,351

The weighted average assumptions used to determine pension cost and benefit obligations at the Plan's measurement date (September 30):

	2004	2003
Discount rate for benefit obligation	6.00%	6.00%
Discount rate for net pension cost	6.00%	6.75%
Rate of compensation increase	4.00%	4.00%
Expected long-term rate of return on plan assets	8.50%	8.50%

Asset Allocations: Kaleida's pension plan asset allocations at the Plan's measurement date (September 30) are as follows:

	2004	2003	Target allocation
Asset category:			
Equity securities	58%	62%	62%
Debt securities	26	30	30
Real estate	6	3	5
Other	10	5	3
Total	100%	100%	100%

(Continued)

Investment Policy: The Plan's investment policy provides for a diversified portfolio to minimize risk to the extent possible. The expected long-term rate of return on plan assets reflects long-term earnings expectations on existing plan assets and those contributions expected to be received during the current plan year. In estimating that rate, appropriate consideration was given to historical returns earned by plan assets in the fund and the rates of returns expected to be available for reinvestment. Rates of return were adjusted to reflect current capital market assumptions and investment allocations.

Contributions: Kaleida expects to contribute $7,700,000 to the Plan in 2005. Kaleida contributed $5,400,000 to the Plan in 2004.

Estimated Future Benefit Payments: The following benefit payments, which reflect expected future service, as appropriate, are as follows for the Plan (dollars in thousands):

2005	$	14,932
2006		15,146
2007		16,082
2008		16,925
2009		18,068
2010-2014		109,875

Other Pension Benefit Plans: In addition, Kaleida contributes to a multi-employer defined benefit pension plan as required by union contracts from which benefits are paid to certain union employees. Additionally, Kaleida provides an employer-matched Tax Sheltered Annuity program (403(b) Plan) for nonunion employees. Total expense under these plans was approximately $1,800,000 for both 2004 and 2003.

(b) Retiree Health and Life Insurance Plan

Kaleida also maintains a contributory retiree health and life insurance plan covering only certain eligible employees of DeGraff Memorial Hospital (DeGraff). The accumulated postretirement benefit obligations (APBO) related to the DeGraff postretirement benefit plan were $4,738,000 and $6,035,000 at December 31, 2004 and 2003, respectively. The accrued liabilities for postretirement benefits recognized in the consolidated balance sheets as other long-term liabilities at December 31, 2004 and 2003 were $3,951,000 and $3,786,000, respectively. Net periodic postretirement benefit cost was $468,000 in 2004 (discount rate of 6.20%) and $497,000 in 2003 (discount rate of 6.75%). As this plan is unfunded, no assumption is needed for expected return on assets.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) became law in the United States. The Act introduces a prescription drug benefit under Medicare as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to the Medicare benefit. As a result of the adoption of FASB Staff Position FAS 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, retroactive to March 8, 2004, Kaleida's APBO at March 8, 2004 decreased by $953,000 and its 2004 benefit cost decreased by $160,000.

For measurement purposes, 2004 increases in the per capita cost of covered health care benefits were assumed for medical pre 65 at 11%, medical post 65 at 8%, and drugs at 14%. The rates were assumed to decrease gradually to 5% by 2014 and remain at that level thereafter for all classifications.

Assumed health care cost trend rates have an effect on the amounts reported for the health care plan. A one-percentage-point change in assumed health care cost trend rates would have the following effect:

		Point increase	Point decrease
		(Dollars in thousands)	
Effect on total of service and interest cost components	$	32	(27)
Effect on postretirement benefit obligation		498	(429)

Estimated future post-retirement benefits for other than pensions for the year ending December 31, 2005 are $355,000 and increase gradually thereafter, through the year 2014.

(11) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets at December 31 are available for the following purposes:

		2004	2003
		(Dollars in thousands)	
Capital expansion and improvements	$	6,371	4,846
Advancement of medical education and research, and general healthcare services		39,388	38,218
	$	45,759	43,064

Permanently restricted net assets at December 31 are restricted as follows:

		2004	2003
		(Dollars in thousands)	
Funds to be held in perpetuity, the income from which is expendable to support healthcare services, including medical research	$	15,068	14,101
Funds to be held in perpetuity, the income from which is expendable to support pediatric healthcare services		4,805	4,086
	$	19,873	18,187

In 2004 and 2003, net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes of operating expenses of $13,827,000 and $14,973,000, respectively, and purchases of equipment of $3,373,000 and $2,434,000, respectively.

(12) Functional Expenses

Kaleida provides general healthcare services to residents within its geographic location. Expenses related to these services are as follows for the years ended December 31:

		2004	2003
		(Dollars in thousands)	
Healthcare services	$	691,299	663,092
General and administrative		172,825	165,773
	$	864,124	828,865

(13) Commitments and Contingencies

Concentration of Credit Risk: Financial instruments which potentially subject Kaleida to concentrations of credit risk consist primarily of accounts receivable and certain investments. The risk associated with temporary cash investments is mitigated by the fact that the investments are placed with what management believes are high credit quality financial institutions. Investments, which include government obligations, marketable equity securities, and corporate bonds, are not concentrated in any corporation or industry.

Kaleida receives a significant portion of its payments for services rendered from a limited number of government and commercial third-party payors, including Medicare, Medicaid, and various health maintenance organizations. Kaleida has not historically incurred any significant concentrated credit losses in the normal course of business.

JCAHO Review: Kaleida was surveyed in February 2005, by the Joint Commission on Accreditation of Healthcare Organizations (JCAHO). JCAHO accreditation is the minimum requirement for healthcare facilities to receive federal and state funding. Kaleida received a three year accreditation from JCAHO.

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<u>Collective Bargaining Agreements</u>: A significant portion of Kaleida employees work under collective bargaining agreements. The majority of these agreements will expire by the end of May 2005. At this time, the impact of renewing these agreements or their effect on Kaleida cannot be reasonably determined.