



KALEIDA HEALTH
Consolidated Financial Statements
December 31, 2005 and 2004
(With Independent Auditors' Report Thereon)

KALEIDA HEALTH
Consolidated Financial Statements
December 31, 2005 and 2004

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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, 2005 and 2004, 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, 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, 2005 and 2004, and the results of their operations and changes in net assets, and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

As discussed in Note 3 to the consolidated financial statements, Kaleida adopted the provisions of the Financial Accounting Standards Board (FASB) Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, an interpretation of FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, in 2005.

KPMG LLP

February 24, 2006

KALEIDA HEALTH
Consolidated Balance Sheets
December 31, 2005 and 2004
(Dollars in thousands)

Assets	2005	2004
Current assets:		
Cash and cash equivalents	\$ 21,512	11,478
Investments (note 7)	103,454	74,419
Accounts receivable:		
Patient, less estimated allowance for doubtful accounts of approximately \$30,680 in 2005 and \$29,695 in 2004	96,340	89,215
Other	15,272	9,986
Inventories	20,755	17,967
Prepaid expenses and other current assets	4,569	4,724
Total current assets	261,902	207,789
Assets limited as to use (notes 6 and 7):		
Designated under debt and lease agreements	38,148	31,791
Designated under self-insurance programs	122,199	108,327
Board designated and donor restricted	75,621	71,376
Other	1,743	928
	237,711	212,422
Property and equipment, less accumulated depreciation and amortization (note 8)	231,321	237,256
Deferred financing costs, net	8,261	8,994
Other	904	2,114
Total assets	\$ 740,099	668,575

See accompanying notes to consolidated financial statements.

Liabilities and Net Assets		2005	2004
Current liabilities:			
Accounts payable and other accrued expenses	\$	57,293	69,949
Accrued payroll and related expenses		34,468	25,356
Estimated third-party payor settlements (note 5)		22,706	2,436
Current portion of long-term debt (note 9)		17,270	14,173
Other current liabilities		8,423	9,051
Total current liabilities		140,160	120,965
Long-term debt, less current portion (note 9)		184,400	183,754
Estimated self-insurance reserves (note 6)		121,684	109,427
Asset retirement obligations (note 3)		9,900	—
Other long-term liabilities (note 11)		64,382	57,576
		380,366	350,757
Total liabilities		520,526	471,722
Commitments and contingencies (notes 5, 8, 10 and 14)			
Net assets:			
Unrestricted		147,805	131,221
Temporarily restricted (note 12)		50,803	45,759
Permanently restricted (note 12)		20,965	19,873
Total net assets		219,573	196,853
Total liabilities and net assets	\$	740,099	668,575

KALEIDA HEALTH**Consolidated Statements of Operations and Changes in Net Assets**

Years ended December 31, 2005 and 2004

(Dollars in thousands)

	2005	2004
Unrestricted revenue, gains, and other support:		
Net patient service revenue (notes 4 and 5)	\$ 893,369	829,322
Investment income (note 7)	15,399	11,961
Other operating revenue (notes 9 and 12)	26,402	30,327
Total unrestricted revenue, gains, and other support	935,170	871,610
Expenses:		
Salaries and benefits	470,029	441,812
Purchased services, supplies, and other	351,542	331,964
Depreciation and amortization	50,226	48,717
Bad debt expense	25,925	29,800
Interest	11,371	11,831
Total expenses	909,093	864,124
Excess of revenue, gains, and other support over expenses	\$ 26,077	7,486

KALEIDA HEALTH

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2005 and 2004

(Dollars in thousands)

	<u>2005</u>	<u>2004</u>
Unrestricted net assets:		
Excess of revenue, gains, and other support over expenses	\$ 26,077	7,486
Net change in unrealized (losses) gains on investments	(180)	2,010
Change in minimum pension liability (note 11)	(2,987)	8,560
Cumulative effect of a change in accounting principle (note 3)	(9,900)	—
Contributions for capital acquisitions	757	67
Net assets released from restrictions for property acquisitions	2,497	3,373
Other transfers, net	320	384
Increase in unrestricted net assets	<u>16,584</u>	<u>21,880</u>
Temporarily restricted net assets:		
Contributions, bequests, and grants	15,194	15,315
Investment income	2,380	4,372
Net change in unrealized gains (losses) on investments	747	(147)
Net assets released from restrictions for operations	(10,847)	(13,827)
Net assets released from restrictions for property acquisitions	(2,497)	(3,373)
Other transfers, net	67	355
Increase in temporarily restricted net assets	<u>5,044</u>	<u>2,695</u>
Permanently restricted net assets:		
Contributions	7	28
Investment income	919	2,343
Net change in unrealized gains on investments	553	54
Other transfers, net	(387)	(739)
Increase in permanently restricted net assets	<u>1,092</u>	<u>1,686</u>
Increase in net assets	<u>22,720</u>	<u>26,261</u>
Net assets, beginning of year	<u>196,853</u>	<u>170,592</u>
Net assets, end of year	<u>\$ 219,573</u>	<u>196,853</u>

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Cash Flows
Years ended December 31, 2005 and 2004
(Dollars in thousands)

	<u>2005</u>	<u>2004</u>
Operating activities:		
Change in net assets	\$ 22,720	26,261
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	50,226	48,717
Loss on disposal of property and equipment	2,635	—
Gain on refinancing transactions	—	(2,891)
Net assets released from restrictions for property acquisitions	(2,497)	(3,373)
Net change in unrealized gains on investments	(1,120)	(1,917)
Bad debt expense	25,925	29,800
Change in additional minimum pension liability	2,987	(8,560)
Change in accounting principle	9,900	—
Change in operating assets and liabilities:		
Patient accounts receivable	(33,050)	(18,441)
Other receivables, inventories, and prepaid expenses	(7,919)	(1,680)
Accounts payable, accrued expenses, and accrued payroll	(3,544)	4,026
Estimated third-party payor settlements	20,270	(16,250)
Other assets	1,210	308
Other liabilities	16,460	21,070
Net cash provided by operating activities	<u>104,203</u>	<u>77,070</u>
Investing activities:		
Additions to property and equipment, net	(40,963)	(30,091)
Net purchases of investments	(53,204)	(49,360)
Net cash used by investing activities	<u>(94,167)</u>	<u>(79,451)</u>
Financing activities:		
Principal payments on debt and capital lease obligations	(16,358)	(13,987)
Proceeds from equipment financing	16,356	—
Proceeds from release of debt service funds	—	1,820
Payments for deferred financing fees	—	(2,654)
Net cash used by financing activities	<u>(2)</u>	<u>(14,821)</u>
Net increase (decrease) in cash and cash equivalents	10,034	(17,202)
Cash and cash equivalents, beginning of year	11,478	28,680
Cash and cash equivalents, end of year	<u>\$ 21,512</u>	<u>11,478</u>
Supplemental schedules on noncash investing activities:		
Capital lease obligations	\$ 3,745	10,149

See accompanying notes to consolidated financial statements.

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Notes to Consolidated Financial Statements

December 31, 2005 and 2004

(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 U.S. generally accepted accounting principles 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 doubtful accounts, estimated third-party payor settlements, self-insurance reserves and pension obligations (see notes 5, 6, and 11).

(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 consolidated 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, 2005 and 2004, Kaleida had cash balances in financial institutions in excess of federal deposit insurance limits.

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Notes to Consolidated Financial Statements

December 31, 2005 and 2004

(d) *Charity Care and Bad Debt Expense*

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 bad debts. Accounts written off as uncollectible are deducted from the allowance and subsequently recoveries are added. The amount of the provision for bad debts 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 5).

(f) *Investments and Investment Income*

Investments in marketable 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, collective and private equity funds and similar investments are accounted for at fair value, with changes in fair value recorded as realized gains and losses in each net asset class using the equity method. These alternative investments are valued using current estimates of fair value obtained from the investment manager in the absence of readily determinable public market values. Such valuations generally reflect discounts for liquidity and consider variables such as financial performance of the issuer, including comparison of comparable companies' earnings multiples, cash flow analysis, recent sales prices of investments and other pertinent information. Because of the inherent uncertainty of the valuation for these investments, the estimated fair values may differ from the values that would have been used had a ready market existed.

Investment income includes interest, dividends, and realized gains and losses on investments and is included in excess 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, other than those accounted for using the equity method, are 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 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.

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Notes to Consolidated Financial Statements

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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) *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.

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December 31, 2005 and 2004

(l) 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, 2005 and 2004, pledges receivable, net of estimated allowances for uncollectible pledges and discounted for long-term pledges, recognized by the Foundations totaled approximately \$2,255,000 and \$2,631,000, respectively.

(m) 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, 2005 is approximately \$198,340,000. 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.

(n) 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.

(o) 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 that are other than trading securities, net assets released from restrictions used for purchase of property and equipment and minimum pension liability.

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Notes to Consolidated Financial Statements

December 31, 2005 and 2004

(p) *Reclassifications*

Certain amounts in the 2004 consolidated financial statements have been reclassified to conform to 2005 presentation.

(3) **Adoption of New Accounting Pronouncement**

In March 2005, the Financial Accounting Standards Board (FASB) issued Interpretation No. 47 (FIN 47), *Accounting for Conditional Asset Retirement Obligations*, an interpretation of FASB Statement No. 143, FIN 47 clarifies that the term “conditional asset retirement obligation” as used in FASB Statement (SFAS) No. 143, *Accounting for Asset Retirement Obligations*, refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. This interpretation is effective for entities whose fiscal year ends after December 15, 2005.

As a result, Kaleida has adopted the provisions of FIN 47 in 2005 and recorded a noncash charge for the cumulative effect of a change in accounting principle of approximately \$9,900,000, for Kaleida’s current obligation to remediate certain conditions in the event Kaleida were to renovate or demolish buildings in the future. The cumulative effect of the change in accounting principle is reflected as a reduction to unrestricted net assets in the consolidated statement of operations and changes in net assets for the year ended December 31, 2005.

(4) **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.

	<u>2005</u>	<u>2004</u>
	(Dollars in thousands)	
Charity care excluded from revenue, based on established rates for services provided	\$ 3,024	952
Revenue shortfall compared to expenses for services provided to Medicaid and indigent patients	14,135	14,735
	<u>\$ 17,159</u>	<u>15,687</u>

Kaleida also provided additional uncompensated services totaling \$25,925,000 and \$29,800,000 in 2005 and 2004, respectively, representing uncollectible patient accounts.

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December 31, 2005 and 2004

(5) 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).

Effective April 1, 2005, the Governor and the New York State Legislature agreed to extend HCRA through June 30, 2007. The HCRA extension included, 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.

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.

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December 31, 2005 and 2004

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 2005 and 2004, Kaleida recorded adjustments for estimated settlements with third-party payors which resulted in increases to net patient service revenue of approximately \$16,000,000 and \$18,000,000, respectively. Net patient service revenue from Medicare and New York State Medicaid programs accounted for approximately 27% and 11%, respectively, for the year ended December 31, 2005 and 28% and 11%, respectively, for the year ended December 31, 2004. Significant concentrations of patient accounts receivable at December 31, 2005 include Medicare 22%, Medicaid 17%, and health maintenance organizations 36%.

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. 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.

Kaleida believes it is in substantive compliance with all applicable laws and regulations. In the event Kaleida identifies an issue of noncompliance, it has established a practice of self reporting to the appropriate regulatory agencies, principally the U.S. Attorney's Office in the Western Region of New York. Management believes ultimate resolution of these disclosures will not result in a material adverse effect on Kaleida's future financial position or results of operations.

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Notes to Consolidated Financial Statements

December 31, 2005 and 2004

(6) 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 5.25% and 6.00% at December 31, 2005 and 2004, respectively, and discounted at 4.5% for workers' compensation costs at December 31, 2005 and 2004. Estimated self-insurance reserves are approximately \$122,000,000 and \$109,000,000 at December 31, 2005 and 2004, respectively. At December 31, 2005, Kaleida has irrevocable secured letters of credit supporting the self insurance program totaling approximately \$26,313,000. 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. Kaleida's independent actuaries have provided estimates for the ultimate costs of the settlement of such claims.

At December 31, 2005 and 2004, 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.

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(7) Investments

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

	<u>2005</u>	<u>2004</u>
	(Dollars in thousands)	
Current investments:		
Cash and cash equivalents	\$ 22,688	26,310
U.S. government securities	16,760	10,856
Corporate bonds	10,984	7,435
Marketable equity securities	25,360	14,515
Collective investment funds	26,739	15,177
Other	923	126
	<u>\$ 103,454</u>	<u>74,419</u>
Assets limited as to use:		
Designated under debt and lease agreements:		
Cash and cash equivalents	\$ 38,148	12,355
U.S. government securities	—	19,436
	<u>38,148</u>	<u>31,791</u>
Designated under self-insurance programs:		
Cash and cash equivalents	27,439	42,919
U.S. government securities	3,391	4,780
Corporate bonds	17,497	11,690
Marketable equity securities	26,221	18,100
Collective investment funds	44,940	30,069
Other	2,711	769
	<u>122,199</u>	<u>108,327</u>
Board designated and donor restricted:		
Cash and cash equivalents	4,826	3,718
U.S. government securities	264	375
Corporate bonds	10,134	10,558
Marketable equity securities	23,369	20,921
Collective investment funds	33,350	32,629
Other	3,678	3,175
	<u>75,621</u>	<u>71,376</u>
Other:		
Cash and cash equivalents	1,743	928
	<u>\$ 237,711</u>	<u>212,422</u>

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December 31, 2005 and 2004

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

	<u>2005</u>	<u>2004</u>
	(Dollars in thousands)	
Interest and dividend income	\$ 6,430	3,738
Net realized gains	8,969	8,223
	<u>\$ 15,399</u>	<u>11,961</u>

Information regarding investments with unrealized losses at December 31, 2005 and 2004 is presented below, segregated between those that have been in a continuous unrealized loss position for less than twelve months and those that have been in a continuous unrealized loss position for twelve or more months:

<u>December 31, 2005</u>	<u>Less than 12 months</u>		<u>12 months or longer</u>	
	<u>Fair</u>	<u>Unrealized</u>	<u>Fair</u>	<u>Unrealized</u>
	value	loss	value	loss
	(Dollars in thousands)		(Dollars in thousands)	
Internally board-designated, designated under debt agreements and self-insurance programs, and donor restricted funds:				
Cash equivalents	\$ 74	1	73	2
Corporate bonds	1,056	22	1,307	36
U.S. government securities	2,084	27	793	18
Collective investment funds	5,342	559	206	11
Marketable equity securities	7,650	578	2,321	761
Total temporarily impaired securities	<u>\$ 16,206</u>	<u>1,187</u>	<u>4,700</u>	<u>828</u>
 <u>December 31, 2004</u>				
Internally board-designated, designated under debt agreements and self-insurance programs, and donor restricted funds:				
Cash equivalents	\$ 25	—	—	—
Corporate bonds	1,144	13	505	6
U.S. government securities	1,247	9	352	4
Collective investment funds	—	—	397	51
Marketable equity securities	1,657	255	1,126	402
Total temporarily impaired securities	<u>\$ 4,073</u>	<u>277</u>	<u>2,380</u>	<u>463</u>

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Notes to Consolidated Financial Statements

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Unrealized losses on temporarily impaired securities have not been included as impairment charges on the above aggregate impairments based upon a determination made after consideration of both the level of the decline in value as well as the longevity of such decline.

(8) Property and Equipment

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

	<u>2005</u>	<u>2004</u>
	(Dollars in thousands)	
Land and land improvements	\$ 17,676	17,143
Buildings, fixtures, and improvements	550,067	535,599
Movable equipment	434,692	409,033
	<u>1,002,435</u>	<u>961,775</u>
Less accumulated depreciation and amortization	784,267	737,697
	218,168	224,078
Construction in progress	13,153	13,178
	<u>\$ 231,321</u>	<u>237,256</u>

Kaleida routinely has commitments outstanding for the purchase of goods and services for construction projects. Commitments outstanding at December 31, 2005 totaled approximately \$11,237,000.

In addition, Kaleida intends to expand its campus at the Millard Fillmore Suburban site beginning in 2006. The cost of this expansion project has been estimated at approximately \$60 million, and is expected to be financed through the Department of Housing and Urban Development's Insured Mortgage Program. Also, Kaleida intends to purchase and install new cardiac equipment at its various sites with a portion of the proceeds from this financing. The total cost of the capital equipment project has been estimated at approximately \$19 million. Certificate of need requests have been submitted and are currently in the review process at the New York State Department of Health for approval.

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

	<u>2005</u>	<u>2004</u>
	(Dollars in thousands)	
Property and equipment	\$ 46,621	33,907
Less accumulated amortization	21,425	12,784
	<u>\$ 25,196</u>	<u>21,123</u>

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(9) Debt

Debt consists of the following at December 31:

	<u>2005</u>	<u>2004</u>
	(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	\$ 86,260	89,151
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	63,112	66,093
Mortgage payable (Waterfront Health Care Center, Inc.) in monthly installments of \$48,000 including interest at 6.25% through July 1, 2024.	6,301	6,476
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	3,741	4,041
Capital lease obligations, less imputed interest of \$2,607,000 and \$1,694,000 at December 31, 2005 and 2004, respectively	32,895	21,384
Other	9,361	10,782
	<u>201,670</u>	<u>197,927</u>
Less current maturities	17,270	14,173
	<u>\$ 184,400</u>	<u>183,754</u>

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.

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

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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.

Kaleida, as the sole corporate member of Waterfront Health Care Center, Inc. (the Center) entered into a modification of the Center's Mortgage Note and Agreement (the Agreement). As a part of the Agreement, the original mortgage dated May 21, 1992 was assigned by DASNY to Greystone. 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: In March 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 (TELP).

In April 2005, Kaleida entered into an additional capital lease arrangement with GE Capital totaling approximately \$16,000,000 to finance the acquisition of certain equipment. This lease arrangement is administered by DASNY as part of TELP.

Future annual principal payments of long-term debt for the next five years as of December 31, 2005 (dollars in thousands):

2006	\$	17,270
2007		17,427
2008		15,624
2009		15,947
2010		10,525

Interest paid approximated interest expense for the years ended December 31, 2005 and 2004.

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Line of Credit: In September 2002, Kaleida entered into a Revolving Credit Loan Agreement (the Agreement) with General Electric Capital Corporation (GE Capital). This agreement was amended in September 2005 to extend the term for 3 years, expiring 2008. The maximum aggregate principal amount of credit that can be extended under the Agreement is \$20,000,000. Interest is payable monthly and is calculated at Kaleida's option of using the 1 to 3 month reserve – adjusted LIBOR plus a margin of 1.65% or a floating rate at the higher of prime or 50 basis points over the Federal Funds rate. Kaleida also pays monthly an unused facility fee equal to 15 basis points per year on the average unused daily balance. 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, 2005 and 2004.

(10) Leases Commitments

Kaleida leases various equipment and facilities under noncancelable operating leases expiring at various dates in the future. Rental expense for all operating leases were approximately \$21,037,000 and \$17,600,000 in 2005 and 2004, respectively. Future minimum payments under noncancelable operating leases as of December 31, 2005 having lease terms in excess of one year are as follows (dollars in thousands):

2006	\$	16,155
2007		15,471
2008		14,263
2009		12,704
2010		11,399

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(11) 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:

	<u>2005</u>	<u>2004</u>
	(Dollars in thousands)	
Change in benefit obligation:		
Benefit obligation at beginning of year	\$ 324,083	302,081
Service cost	13,290	13,565
Interest cost	19,016	17,696
Actuarial loss and plan amendments	27,812	1,499
Benefits paid	<u>(11,847)</u>	<u>(10,758)</u>
Benefit obligation at end of year	<u>372,354</u>	<u>324,083</u>
Change in plan assets:		
Fair value of plan assets at beginning of year	230,404	209,371
Actual return on plan assets	34,374	26,591
Employer contributions	5,200	5,200
Benefits paid	<u>(11,847)</u>	<u>(10,758)</u>
Fair value of assets at end of year	<u>258,131</u>	<u>230,404</u>
Reconciliation of funded status:		
Funded status	(114,223)	(93,679)
Fourth quarter employer contribution	6,200	1,400
Unrecognized net prior service credit	(617)	(2,799)
Unrecognized actuarial loss	<u>73,490</u>	<u>63,943</u>
Accrued pension cost	<u>\$ (35,150)</u>	<u>(31,135)</u>
Amounts recognized in the consolidated balance sheets consist of:		
Accrued pension cost	\$ (35,150)	(31,135)
Minimum pension liability	<u>(23,929)</u>	<u>(20,942)</u>
Net amount recognized at year end as a component of other long-term liabilities	<u>\$ (59,079)</u>	<u>(52,077)</u>

The accumulated benefit obligation at the Plan's measurement date (September 30) for 2005 and 2004 was approximately \$323,410,000 and \$283,881,000, respectively.

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A minimum pension liability adjustment is required when the actuarial present value of accumulated benefit obligation exceeds plan assets and accrued pension liabilities. As a result, Kaleida has reflected an additional minimum pension liability of \$23,929,000 and \$20,942,000 at December 31, 2005 and 2004, respectively, in the consolidated balance sheets. The change in the additional minimum pension liability at December 31, 2005 of \$2,987,000 is reflected as a decrease to unrestricted net assets in the accompanying consolidated statement of operations and changes in net assets for the year ended December 31, 2005. The change in the additional minimum pension liability at December 31, 2004 of \$8,560,000 was reflected as an increase to 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:

	<u>2005</u>	<u>2004</u>
	(Dollars in thousands)	
Components of net pension cost:		
Service cost	\$ 13,290	13,565
Interest cost	19,016	17,696
Expected return on plan assets	(19,918)	(19,386)
Amortization of transition obligation	—	(147)
Amortization of net prior service credit	(415)	(415)
Amortization of actuarial loss	2,042	1,471
Net pension cost	<u>\$ 14,015</u>	<u>12,784</u>

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

	<u>2005</u>	<u>2004</u>
Discount rate for benefit obligation	5.50%	6.00%
Discount rate for net pension cost	6.00	6.00
Rate of compensation increase	4.00	4.00
Expected long-term rate of return on plan assets	8.50	8.50

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

	2005	2004	Target allocation
Asset category:			
Equity securities	59%	58%	62%
Debt securities	24	26	30
Real estate	6	6	5
Other	11	10	3
Total	100%	100%	100%

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 \$10,000,000 to the Plan in 2006. Kaleida contributed \$10,000,000 to the Plan in 2005

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

2006	\$ 15,451
2007	15,834
2008	16,707
2009	17,573
2010	18,684
2011-2015	114,343

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 \$1,600,000 and \$1,800,000 for 2005 and 2004, respectively.

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(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 following table sets forth the funded status and amounts recognized in the consolidated balance sheets at December 31:

	<u>2005</u>	<u>2004</u>
	(Dollars in thousands)	(Dollars in thousands)
Change in benefit obligation:		
Accumulated postretirement obligation at beginning of year	\$ 4,738	6,036
Service cost	5	8
Interest cost	274	293
Benefits paid	(1,562)	(387)
Participant contributions	1,247	84
Actuarial loss (gain) and plan amendments	1,213	(1,296)
Accumulated postretirement obligation at end of year	<u>5,915</u>	<u>4,738</u>
Change in plan assets:		
Fair value of plan assets at beginning of year	—	—
Employer contributions	315	303
Benefits paid	(1,562)	(387)
Participant contributions	1,247	84
Fair value of plan assets at end of year	<u>—</u>	<u>—</u>
Reconciliation of funded status:		
Funded status	(5,915)	(4,738)
Unrecognized prior service cost	799	125
Unrecognized actuarial loss	1,019	663
Net amount recognized at year end as a component of other long-term liabilities	<u>\$ (4,097)</u>	<u>(3,950)</u>

The following sets forth the components of net postretirement benefit costs as of December 31:

	<u>2005</u>	<u>2004</u>
	(Dollars in thousands)	(Dollars in thousands)
Components of net postretirement benefit cost		
Service cost	\$ 5	8
Interest cost	274	293
Amortization of prior service cost	146	122
Amortization of actuarial loss	35	44
Net postretirement benefit cost	<u>\$ 460</u>	<u>467</u>

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

	<u>2005</u>	<u>2004</u>
Discount rate for benefit obligations	5.50%	6.00%
Discount rate for net postretirement cost	6.00	6.20

For measurement purposes, 2005 increases in the per capita cost of covered health care benefits were assumed for medical pre 65 at 10%, medical post 65 at 8%, and drugs at 14%. The rates were assumed to decrease gradually to 5% by 2013 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:

	<u>Point increase</u>	<u>Point decrease</u>
	(Dollars in thousands)	
Effect on total of service and interest cost components	\$ 30	(26)
Effect on postretirement benefit obligation	505	(437)

Estimated future postretirement benefits for other than pensions for the year ending December 31, 2006 are \$324,000 and increase gradually thereafter, through the year 2015.

(12) Temporarily and Permanently Restricted Net Assets

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

	<u>2005</u>	<u>2004</u>
	(Dollars in thousands)	
Capital expansion and improvements	\$ 7,526	6,371
Advancement of medical education and research, and general healthcare services	43,277	39,388
	<u>\$ 50,803</u>	<u>45,759</u>

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Notes to Consolidated Financial Statements

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

	<u>2005</u>	<u>2004</u>
	(Dollars in thousands)	(Dollars in thousands)
Funds to be held in perpetuity, the income from which is expendable to support healthcare services, including medical research	\$ 15,692	15,068
Funds to be held in perpetuity, the income from which is expendable to support pediatric healthcare services	<u>5,273</u>	<u>4,805</u>
	<u>\$ 20,965</u>	<u>19,873</u>

In 2005 and 2004, net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes of operating expenses of \$10,847,000 and \$13,827,000, respectively, and purchases of equipment of \$2,497,000 and \$3,373,000, respectively.

(13) 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:

	<u>2005</u>	<u>2004</u>
	(Dollars in thousands)	(Dollars in thousands)
Healthcare services	\$ 727,274	691,299
General and administrative	<u>181,819</u>	<u>172,825</u>
	<u>\$ 909,093</u>	<u>864,124</u>

(14) 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.

Collective Bargaining Agreements: A significant portion of Kaleida employees work under collective bargaining agreements. The majority of these agreements will expire by the end of May 2008.