KPMG

KALEIDA HEALTH

Consolidated Financial Statements

December 31, 2006 and 2005

(With Independent Auditors' Report Thereon)

KALEIDA HEALTH

Consolidated Financial Statements

December 31, 2006 and 2005

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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, 2006 and 2005, 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.

As more fully described in note 14 (b), on November 28, 2006, the *Commission on Health Care Facilities in the 21st Century* created by the Governor and New York State Legislature issued recommendations on health care capacity and resources in New York State. The recommendations include consolidation, closure, conversions and restructuring of hospital and nursing home systems throughout New York State, including specific restructuring recommendations impacting Kaleida.

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, 2006 and 2005, 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. Also discussed in note 3, is Kaleida's early adoption of the provisions of FASB No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of Financial Standards Board Statements No. 87, 88, 106 and 132(R) in 2006.

KPMG LLP

March 21, 2007

KALEIDA HEALTH

Consolidated Balance Sheets

December 31, 2006 and 2005

(Dollars in thousands)

Assets		**2006**	**2005**
Current assets:			
Cash and cash equivalents	$	25,791	21,512
Investments (note 7)		141,606	103,454
Accounts receivable:			
Patient, less estimated allowance for doubtful accounts of approximately $34,049 in 2006 and $30,680 in 2005		104,764	96,340
Other		9,654	15,272
Inventories		22,092	20,755
Prepaid expenses and other current assets		6,884	4,569
Total current assets		310,791	261,902
Assets limited as to use (notes 6 and 7):			
Designated under debt and lease agreements		41,618	38,148
Designated under self-insurance programs		128,520	122,199
Board designated and donor restricted		82,075	75,621
Other		1,166	1,743
		253,379	237,711
Property and equipment, less accumulated depreciation and amortization (notes 8 and 9)		248,743	231,321
Deferred financing costs, net		12,991	8,261
Other		1,833	904
Total assets	$	827,737	740,099

See accompanying notes to consolidated financial statements.

Liabilities and Net Assets		2006	2005
Current liabilities:			
Accounts payable and other accrued expenses	$	59,465	57,293
Accrued payroll and related expenses		37,462	34,468
Estimated third-party payor settlements (note 5)		21,101	22,706
Current portion of long-term debt (note 9)		20,677	17,270
Other current liabilities		7,912	8,423
Total current liabilities		146,617	140,160
Long-term debt, less current portion (note 9)		191,048	184,400
Construction costs payable (note 9)		7,240	—
Estimated self-insurance reserves (note 6)		128,358	121,684
Asset retirement obligations (note 3)		9,891	9,900
Other long-term liabilities (note 11)		90,149	64,382
		426,686	380,366
Total liabilities		573,303	520,526
Commitments and contingencies (notes 5, 8, 9, 10 and 14)			
Net assets:			
Unrestricted		173,900	147,805
Temporarily restricted (note 12)		60,149	50,803
Permanently restricted (note 12)		20,385	20,965
Total net assets		254,434	219,573
Total liabilities and net assets	$	827,737	740,099

KALEIDA HEALTH

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2006 and 2005

(Dollars in thousands)

		2006	2005
Unrestricted revenue, gains, and other support:			
Net patient service revenue (notes 4 and 5)	$	934,324	890,369
Investment income (note 7)		35,018	15,399
Other operating revenue (note 12)		28,442	29,402
Total unrestricted revenue, gains, and other support		997,784	935,170
Expenses:			
Salaries and benefits		506,439	470,029
Purchased services, supplies, and other		351,184	351,542
Depreciation and amortization		52,274	50,226
Bad debt expense		26,925	25,925
Interest		11,165	11,371
Total expenses		947,987	909,093
Excess of revenue, gains, and other support over expenses	$	49,797	26,077

(Continued)

KALEIDA HEALTH

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2006 and 2005

(Dollars in thousands)

		2006	2005
Unrestricted net assets:			
Excess of revenue, gains, and other support over expenses	$	49,797	26,077
Net change in unrealized losses on investments		(2,533)	(180)
Change in minimum pension liability (note 11)		19,142	(2,987)
Effect of adoption of provisions of FASB Statement No. 158 (note 11)		(46,216)	—
Cumulative effect of a change in accounting principle (note 3)		—	(9,900)
Contributions for capital acquisitions		2,957	757
Net assets released from restrictions for property acquisitions		2,387	2,497
Other transfers, net		561	320
Increase in unrestricted net assets		26,095	16,584
Temporarily restricted net assets:			
Contributions, bequests, and grants		16,178	15,194
Investment income		9,881	2,380
Net change in unrealized (losses) gains on investments		(1,239)	747
Net assets released from restrictions for operations		(12,526)	(10,847)
Net assets released from restrictions for property acquisitions		(2,387)	(2,497)
Other transfers, net		(561)	67
Increase in temporarily restricted net assets		9,346	5,044
Permanently restricted net assets:			
Contributions		35	7
Investment income and change in net unrealized (losses) gains on investments		(615)	1,472
Other transfers, net		—	(387)
(Decrease) increase in permanently restricted net assets		(580)	1,092
Increase in net assets		34,861	22,720
Net assets, beginning of year		219,573	196,853
Net assets, end of year	$	254,434	219,573

See accompanying notes to consolidated financial statements.

KALEIDA HEALTH

Consolidated Statements of Cash Flows

Years ended December 31, 2006 and 2005

(Dollars in thousands)

		2006	2005
Operating activities:			
Change in net assets	$	34,861	22,720
Adjustments to reconcile change in net assets to net cash provided by operating activities:			
Depreciation and amortization		52,274	50,226
Loss on disposal of property and equipment		—	2,635
Restricted contributions, bequests, and grants		(29,051)	(18,338)
Change in earnings in equity method investees		(10,781)	(5,767)
Net change in unrealized losses (gains) on investments		4,387	(1,120)
Bad debt expense		26,925	25,925
Change in additional minimum pension liability		(19,142)	2,987
Effect of adoption of provisions of FASB Statement No. 158 (note 11)		46,216	—
Cumulative effect of a change in accounting principle		—	9,900
Change in operating assets and liabilities:			
Patient accounts receivable		(35,349)	(33,050)
Other receivables, inventories, and prepaid expenses		1,966	(7,919)
Accounts payable, accrued expenses, and accrued payroll		5,166	(3,544)
Estimated third-party payor settlements		(1,605)	20,270
Other assets		(929)	1,210
Other liabilities		4,846	16,460
Net cash provided by operating activities		79,784	82,595
Investing activities:			
Additions to property and equipment, net of construction costs payable of $7,240 in 2006		(58,470)	(43,460)
Net purchases of investments		(47,426)	(47,437)
Net cash used by investing activities		(105,896)	(90,897)
Financing activities:			
Principal payments on debt and capital lease obligations		(18,543)	(16,358)
Proceeds from restricted contributions, bequests, and grants		29,051	18,338
Proceeds from equipment financing		16,485	16,356
Proceeds from long-term debt		8,861	—
Increase in deferred financing fees		(5,463)	—
Net cash provided by financing activities		30,391	18,336
Net increase in cash and cash equivalents		4,279	10,034
Cash and cash equivalents, beginning of year		21,512	11,478
Cash and cash equivalents, end of year	$	25,791	21,512
Supplemental schedules on noncash investing activities:			
Capital lease obligations	$	3,252	3,745

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 two 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 and post-retirement 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, 2006 and 2005, Kaleida had cash balances in financial institutions in excess of federal deposit insurance limits.

(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 subsequent 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 (common and preferred stocks) 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 collective and other alternative investment funds (i.e., hedge funds, private equity funds, REITs, and similar items) are measured based on the fair value of the underlying investments. These alternative investments are valued by management 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.

(Continued)

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.

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 pursuant to debt agreements. 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.

(Continued)

(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.

(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 if for operations or as an addition to unrestricted net assets if for capital purposes. 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, 2006 and 2005, pledges receivable, net of estimated allowances for uncollectible pledges and discounted for long-term pledges, recognized by the Foundations totaled approximately $1,274,000 and $2,255,000, 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, 2006 is approximately $218,341,000. 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, minimum pension liability, cumulative effect of change in accounting principle, and the effect of the early adoption of provisions of FASB Statement No. 158.

(p) Reclassifications

Certain amounts in the 2005 consolidated financial statements have been reclassified to conform to 2006 presentation.

(3) Adoption of New Accounting Pronouncements

(a) 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 an unconditional legal obligation to perform an asset retirement activity for 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. FIN 47 requires the costs associated with a conditional asset retirement obligation to be recognized when the obligation is incurred, regardless of whether the timing and/or method of settlement of the obligation are conditional on the occurrence of future events.

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 liability recorded for the expected future costs of removal and disposal activities is presented at its present value, assuming a discount rate of 6%. 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.

(b) In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans,* an amendment of FASB Statements No. 87, 88, 106, and 132(R). SFAS 158 requires an employer to recognize the funded status of their defined benefit pension plan and post-retirement obligations as an asset or liability in the employers' balance sheet as of the end of the fiscal year ending after December 15, 2006 for public entities and June 15, 2007 for nonpublic entities. In addition, SFAS 158 requires employers to measure plan assets and benefit obligations as of the date of the employer's year-end balance sheet for fiscal years ending after December 15, 2008. As more fully discussed in note 11, Kaleida has early adopted the provisions of SFAS 158 as of December 31, 2006. The adoption of SFAS 158 did not impact Kaleida's compliance with debt covenants.

(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 the largest Medicaid and indigent patient population in Western New York 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.

		2006	2005
		(Dollars in thousands)	
Charity care excluded from revenue, based on established rates for services provided	$	5,476	3,024
Revenue shortfall compared to expenses for services provided to Medicaid and indigent patients		14,688	14,135
	$	20,164	17,159

Kaleida also provided additional uncompensated services totaling $26,925,000 and $25,925,000 in 2006 and 2005, respectively, representing uncollectible patient accounts.

(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.

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 2006 and 2005, Kaleida recorded adjustments for estimated settlements with third-party payors which resulted in (decreases) increases to net patient service revenue of approximately $(3,100,000) and $12,000,000, respectively. Net patient service revenue from Medicare and New York State Medicaid programs accounted for approximately 29% and 13%, respectively, for the year ended December 31, 2006, and 27% and 11%, respectively, for the year ended December 31, 2005. Significant concentrations of patient accounts receivable at December 31, 2006 and 2005 include Medicare 19% and 22%, Medicaid 15% and 17%, and health maintenance organizations 40% and 36%, respectively.

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.

(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% at December 31, 2006 and 2005, and discounted at 4.5% for workers' compensation costs at December 31, 2006 and 2005. Estimated self-insurance reserves are approximately $128,000,000 and $122,000,000 at December 31, 2006 and 2005, respectively. At December 31, 2006, Kaleida has irrevocable secured letters of credit supporting the self insurance program totaling approximately $31,853,000. The annual fee for the letters of credit approximates 75 basis points and they 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, 2006 and 2005, 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)

(7) Investments

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

		2006	2005
		(Dollars in thousands)	
Current investments:			
Cash and cash equivalents	$	52,758	22,688
U.S. government securities		—	16,760
Corporate bonds		19,631	10,984
Marketable equity securities		29,276	25,360
Collective and other alternative investment funds		39,941	27,662
	$	141,606	103,454
Assets limited as to use:			
Designated under debt and lease agreements:			
Cash and cash equivalents	$	33,476	38,148
Corporate bonds		8,142	—
		41,618	38,148
Designated under self-insurance programs:			
Cash and cash equivalents		29,760	27,439
U.S. government securities		3,404	3,391
Corporate bonds		19,884	17,497
Marketable equity securities		29,569	26,221
Collective and other alternative investment funds		45,903	47,651
		128,520	122,199
Board designated and donor restricted:			
Cash and cash equivalents		8,787	4,826
U.S. government securities		259	264
Corporate bonds		16,096	10,134
Marketable equity securities		23,741	23,369
Collective and other alternative investment funds		33,192	37,028
		82,075	75,621
Other:			
Cash and cash equivalents		1,166	1,743
	$	253,379	237,711

(Continued)

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

		2006	2005
		(Dollars in thousands)	
Interest and dividend income	$	10,740	6,064
Earnings in equity method investees		10,781	5,767
Net realized gains		13,497	3,568
	$	35,018	15,399

Information regarding investments with unrealized losses at December 31, 2006 and 2005 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:

		Less than 12 months		12 months or longer	
December 31, 2006		Fair value	Unrealized loss	Fair value	Unrealized loss
		(Dollars in thousands)			
Internally board-designated, designated under debt agreements and self-insurance programs, and donor restricted funds:					
Collective investment funds	$	19,376	84	—	—
Marketable equity securities		9,450	66	955	112
Total temporarily impaired securities	$	28,826	150	955	112

		Less than 12 months		12 months or longer	
December 31, 2005		Fair value	Unrealized loss	Fair value	Unrealized loss
		(Dollars in thousands)			
Internally board-designated, designated under debt agreements and self-insurance programs, and donor restricted funds:					
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	$	16,132	1,186	4,627	826

Management reviewed the securities with unrealized losses, summarized in the preceding tables, and determined that the securities were not other than temporarily impaired. Management reached this conclusion in consultation with its investment advisors and portfolio managers, who relied on industry analyst reports, credit ratings, current market conditions, and/or other information they deemed relevant to their assessment.

(8) Property and Equipment

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

		2006	2005
		(Dollars in thousands)	
Land and land improvements	$	19,086	17,676
Buildings, fixtures, and improvements		585,392	550,067
Movable equipment		456,051	434,692
		1,060,529	1,002,435
Less accumulated depreciation and amortization		829,256	784,267
		231,273	218,168
Construction in progress		17,470	13,153
	$	248,743	231,321

Kaleida routinely has commitments outstanding for the purchase of goods and services for construction projects. Commitments outstanding at December 31, 2006 totaled approximately $11,061,000 for routine projects. In addition, in 2006 Kaleida began a construction project to expand its campus at the Millard Fillmore Suburban site and acquisition of certain equipment for Millard Fillmore Gates and the Buffalo General Hospital sites. The cost of these projects have been estimated at approximately $80 million, and are being financed through the Department of Housing and Urban Development’s Insured Mortgage Program (see note 9) and Kaleida equity. For the year ended December 31, 2006, Kaleida capitalized, as a component of construction in progress, interest costs of approximately $74,000 related to these projects.

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

		2006	2005
		(Dollars in thousands)	
Property and equipment	$	65,101	46,621
Less accumulated amortization		29,610	21,425
	$	35,491	25,196

(9) Debt

Debt consists of the following at December 31:

		2006	2005
		(Dollars in thousands)	
Mortgage and building loan payable in monthly installments of $625,000, including interest at 5.25% through August 1, 2023. (a)	$	83,214	86,260
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. (a)		59,946	63,112
Mortgage notes payable with interest only payments at 5.05% through October 2008. Thereafter, monthly principal and interest installments of $338,000 beginning through October 1, 2033. (a)		2,444	—
Mortgage notes payable with interest only payments at 5.05% through February 2007. Thereafter, monthly principal and interest installments of $107,000 through February 1, 2032. (a)		6,417	—
Mortgage payable in monthly installments of $48,000 including interest at 6.25% through July 1, 2024. (a)		6,115	6,301
Capital lease obligations, less imputed interest of $3,982,000 and $2,607,000 at December 31, 2006 and 2005, respectively. (b)		41,733	32,895
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. The bonds are secured by the related assets being financed.		3,441	3,741
Other		8,415	9,361
		211,725	201,670
Less current maturities		20,677	17,270
	$	191,048	184,400

(a) *Mortgages payable:* The mortgages payable, which are insured by the U.S. Department of Housing and Urban Development (HUD), are secured by essentially all assets of the respective borrowing entities.

On September 2, 2006, Kaleida secured a loan commitment for $75,830,000 by entering into two new mortgage notes (Mortgage Notes) and a building loan agreement. The proceeds from the loan commitment will be used to finance the cost of certain capital improvements. The Mortgage Notes, when fully drawn, will have 25 year terms, fixed monthly principal payments and annual interest rates of 5.05%. The Mortgage Notes are insured by HUD. At December 31, 2006, Kaleida has drawn $8,861,000 for costs related to the capital improvements.

Kaleida has entered into Regulatory Agreements with HUD, which set forth certain provisions and requirements. Among these requirements are certain performance indicators, financial ratios and reporting requirements. Also among these requirements is the funding of a Mortgage Reserve Fund (Mortgage Reserve) as established by the Mortgage Reserve Fund Agreement, dated May 20, 2004, as amended September 21, 2006. As required under the Mortgage Reserve, Kaledia 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.

(b) *Capital Leases*: The majority of the capital lease obligations represent arrangements entered into with GE Capital to finance acquisitions of various pieces of equipment. These arrangements are administered by DASNY as part of their Tax-Exempt Leasing Program (TELP). During 2006 and 2005, Kaleida financed approximately $16,500,000 and $16,000,000 of equipment acquisitions, respectively, through TELP.

Under the terms of the borrowing agreements, Kaleida established certain bank trusteed accounts with proceeds related to the HUD and TELP borrowings. Included in the accompanying consolidated financial statements, classified as assets limited as to use, are Kaleida's balances in these funds at December 31 as follows:

		2006	2005
		(Dollars in thousands)	
Mortgage reserve fund	$	33,476	31,998
TELP escrow		8,142	6,150
	$	41,618	38,148

Future annual principal payments of long-term debt for the next five years as of December 31, 2006 follows (dollars in thousands):

2007	$	20,677
2008		19,179
2009		17,738
2010		17,279
2011		15,575

Construction costs payable at December 31, 2006 will be paid with proceeds advanced from the HUD insured loan commitment secured in September 2006.

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 in 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, 2006 and 2005.

(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 $21,888,000 and $21,037,000 in 2006 and 2005, respectively. Future minimum payments under noncancelable operating leases as of December 31, 2006 having lease terms in excess of one year are as follows (dollars in thousands):

2007	$	17,243
2008		16,331
2009		15,523
2010		14,462
2011		12,575

(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.

As disclosed in note 3, Kaleida elected to early adopt the provisions of SFAS 158 as of December 31, 2006. SFAS 158 requires an employer to recognize the funded status (i.e. difference between the fair value of plan assets and projected benefit obligations) of its defined benefit pension plan as an asset or liability in its consolidated balance sheet and to recognize changes in that funded status in the year in which the changes occur through changes in unrestricted net assets. The adjustment to net assets by Kaleida at the adoption of SFAS 158 represents the net unrecognized actuarial losses and prior service credits, both of which were previously netted against Kaleida's funded status on the consolidated balance sheet, pursuant to the provisions of SFAS 87 in prior periods. These amounts will be recognized in future periods as net periodic pension cost, as required by SFAS 87.

The estimated amounts that will be amortized from unrestricted net assets into net periodic pension cost in 2007 are as follows (dollars in thousands):

Net actuarial loss	$	3,148
Prior service credits		(231)
	$	2,917

Additional actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic pension cost in the same period, will be recognized as a component of unrestricted net assets. These future actuarial gains and losses will be recognized as a component of net periodic pension cost on the same basis as the amounts recognized in unrestricted net assets at adoption of SFAS 158.

The effects of adopting the provisions of SFAS 158 on Kaleida's consolidated balance sheet at December 31, 2006 are presented in the following table. The adoption of SFAS 158 had no effect on Kaleida's operating results for the year ended December 31, 2006, or for any prior period presented, and it will not affect operating results in future periods. If Kaleida had not early adopted SFAS 158 at December 31, 2006, it would have only recognized a reduction in their additional minimum pension liability pursuant to the provisions of SFAS 87 of $19,142,000.

The effect of recognizing the reduction in Kaleida's additional minimum pension liability under SFAS 87 is included in the table below in the column labeled "Prior to adopting SFAS 158":

		December 31, 2006		
		Prior to adopting SFAS 158	**Effect of adopting SFAS 158**	**As reported at December 31, 2006**
			(Dollars in thousands)	
Long-term pension liability	$	(33,748)	(50,787)	(84,535)
Additional minimum pension liability		(4,787)	4,787	—
Unrestricted net assets		38,535	46,000	84,535

The following table sets forth the defined benefit pension plan's obligations and fair value of plan assets at December 31:

		2006	2005
		(Dollars in thousands)	
Change in benefit obligation:			
Benefit obligation at beginning of year	$	372,354	324,083
Service cost		15,088	13,290
Interest cost		20,166	19,016
Plan amendments		287	1,767
Adjustments due to change in measurement date		8,813	—
Actuarial (gains) loss		(5,467)	26,045
Benefits paid		(15,220)	(11,847)
Benefit obligation at end of year	$	396,021	372,354
Change in plan assets:			
Fair value of plan assets at beginning of year	$	258,131	230,404
Actual return on plan assets		42,375	34,374
Employer contributions		26,200	5,200
Benefits paid		(15,220)	(11,847)
Fair value of assets at end of year	$	311,486	258,131

The funded status of the plan and amounts recognized in the consolidated balance sheet at December 31, 2006, pursuant to SFAS 158, are as follows (dollars in thousands):

Funded status, end of year:		
Fair value of plan assets	$	311,486
Projected benefit obligation		396,021
	$	(84,535)
Amounts recognized in the consolidated balance sheet, end of year:		
Long-term pension liability, included as a component of other long-term liabilities	$	(84,535)
Unrestricted net assets:		
Net actuarial loss	$	46,179
Prior service credits		(41)
	$	46,138

(Continued)

As required by SFAS 87, the following information is presented for December 31, 2005 (this disclosure is no longer applicable under SFAS 158, therefore, 2006 information is not presented) (dollars in thousands):

Reconciliation of funded status:		
Funded status	$	(114,223)
Fourth quarter employer contribution		6,200
Unrecognized net prior service credit		(617)
Unrecognized actuarial loss		73,490
Accrued pension cost	$	(35,150)
Amounts recognized in the consolidated balance sheet consist of:		
Accrued pension cost	$	(35,150)
Minimum pension liability		(23,929)
Net amount recognized at December 31, 2005 as a component of other long-term liabilities	$	(59,079)

Kaleida recorded changes in the minimum pension liability at December 31, 2006 and 2005 as required by SFAS 87. The adjustment is prescribed when the accumulated benefit obligations of a pension plan exceed the fair value of the underlying pension plan assets. The accumulated benefit obligations at the Plan's measurement date for 2006 and 2005 was approximately $342,403,000 and $323,410,000, respectively.

The components of net periodic pension cost for the years ended December 31 is as follows:

		2006	2005
		(Dollars in thousands)	
Service cost	$	15,088	13,290
Interest cost		20,166	19,016
Expected return on plan assets		(20,998)	(19,918)
Amortization of net prior service credit		(231)	(415)
Amortization of actuarial loss		4,573	2,042
Net periodic pension cost	$	18,598	14,015

The weighted average assumptions used to determine pension cost and benefit obligations at the Plan's measurement date (December 31):

	2006	2005
Discount rate for benefit obligations	5.75%	5.50%
Discount rate for net pension cost	5.50	6.00
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 are as follows:

	Target allocation	2006	2005
Asset category:			
Equity securities	62%	51%	59%
Debt securities	30	31	24
Real estate	5	6	6
Other	3	12	11
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: In January 2007, Kaleida made its expected 2007 contribution of $15,000,000. As a result, for the plan year ending December 31, 2006 Kaleida has contributed $35,000,000.

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

2007	$ 16,330
2008	17,312
2009	18,099
2010	19,093
2011	19,833
2012-2016	127,870

The expected benefits are based on the same assumptions used to measure Kaleida's benefit obligations at December 31, 2006 and include future employee service.

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 $1,607,000 and $1,600,000 for 2006 and 2005, respectively.

(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).

As disclosed in note 3, Kaleida elected to early adopt the provisions of SFAS 158 as of December 31, 2006. SFAS 158 requires an employer to recognize the funded status (i.e. difference between the fair value of plan assets and accumulated postretirement obligations) of its other postretirement plan as an asset or liability in its consolidated balance sheet and to recognize changes in that funded status in the year in which the changes occur through changes in unrestricted net assets. The adjustment to net assets by Kaleida at the adoption of SFAS 158 represents the net unrecognized actuarial gains and prior service costs, both of which were previously netted against Kaleida's funded status on the consolidated balance sheet, pursuant to the provisions of SFAS 106 in prior periods. These amounts will be recognized in future periods as postretirement benefit cost, as required by SFAS 106.

The estimated amounts that will be amortized from unrestricted net assets into net postretirement benefit cost in 2007 are as follows (dollars in thousands):

Net actuarial gains	$	(11)
Prior service costs		99
	$	88

Additional actuarial gains and losses that arise in subsequent periods and are not recognized as net postretirement benefit cost in the same period, will be recognized as a component of unrestricted net assets. These future actuarial gains and losses will be recognized as a component of net postretirement benefit cost on the same basis as the amounts recognized in unrestricted net assets at adoption of SFAS 158.

The effects of adopting the provisions of SFAS 158 on Kaleida's consolidated balance sheet at December 31, 2006 are presented in the following table. The adoption of SFAS 158 had no effect on Kaleida's operating results for the year ended December 31, 2006, or for any prior period presented, and it will not affect operating results in future periods.

		December 31, 2006		
		Prior to adopting SFAS 158	**Effect of adopting SFAS 158**	**As reported at December 31, 2006**
			(Dollars in thousands)	
Long-term post-retirement liability	$	(4,319)	(216)	(4,535)
Unrestricted net assets		4,319	216	4,535

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

		2006	2005
		(Dollars in thousands)	
Components of net postretirement benefit cost			
Service cost	$	34	5
Interest cost		316	274
Amortization of prior service cost		100	146
Amortization of actuarial loss		37	35
Net postretirement benefit cost	$	487	460

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

		2006	2005
		(Dollars in thousands)	
Change in benefit obligation:			
Accumulated postretirement obligation at beginning of year	$	5,915	4,738
Service cost		34	5
Interest cost		316	274
Participant contributions		1,114	1,247
Plan amendments		—	821
Adjustments due to change in measurement date		88	—
Benefits and premiums paid		(1,379)	(1,561)
Actuarial (gain) loss and plan amendments		(1,553)	391
Accumulated postretirement obligation at end of year		4,535	5,915
Change in plan assets:			
Fair value of plan assets at beginning of year		—	—
Employer contributions		265	314
Benefits and premiums paid		(1,379)	(1,561)
Participant contributions		1,114	1,247
Fair value of plan assets at end of year		—	—
Reconciliation of funded staus:			
Funded status		(4,535)	(5,915)
Unrecognized prior service cost		—	799
Unrecognized actuarial loss		—	1,019
Net amount recognized at year end as a component of other long-term liabilities	$	(4,535)	(4,097)

The weighted average assumptions used to determine postretirement benefit cost and obligations at the Plan's measurement date (December 31):

	2006	2005
Discount rate for benefit obligations	5.75%	5.50%
Discount rate for net postretirement cost	5.50	6.00

For measurement purposes, 2006 increases in the per capita cost of covered health care benefits were assumed for medical pre 65 at 9%, medical post 65 at 7%, and drugs at 11%. 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:

		Point increase	Point decrease
		(Dollars in thousands)	
Effect on total of service and interest cost components	$	29	(25)
Effect on postretirement benefit obligation		335	(292)

Estimated future postretirement benefits for other than pensions for the year ending December 31, 2007 are $282,000 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:

		2006	2005
		(Dollars in thousands)	
Capital expansion and improvements	$	8,630	7,526
Advancement of medical education and research, and general healthcare services		51,519	43,277
	$	60,149	50,803

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

		2006	2005
		(Dollars in thousands)	
Funds to be held in perpetuity, the income from which is expendable to support healthcare services, including medical research	$	15,289	15,692
Funds to be held in perpetuity, the income from which is expendable to support pediatric healthcare services		5,096	5,273
	$	20,385	20,965

In 2006 and 2005, net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes of operating expenses of $12,526,000 and $10,847,000, respectively, and purchases of equipment of $2,387,000 and $2,497,000, 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:

		2006	2005
		(Dollars in thousands)	
Healthcare services	$	758,390	727,274
General and administrative		189,597	181,819
	$	947,987	909,093

(14) Commitments and Contingencies

(a) *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 other alternative investments funds, 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.

(b) *Commission Report on Health Care in the 21st Century:* On November 28, 2006, the Commission on Health Care Facilities in the 21st Century (Commission) created by the Governor and New York State Legislature issued recommendations on health care capacity and resources in New York State. The Commission's recommendations include consolidation, closures, conversions and restructuring of hospital and nursing home systems throughout New York State. The Commission recommended three significant items (as outlined below) impacting acute and long-term care (RHCF) services at Kaleida.

In Recommendation 1 for the Western Region of New York the Commission states, “It is recommended that Millard Fillmore Hospital – Gates Circle close in an orderly fashion. It is further recommended that Millard Fillmore Hospital – Gates Circle’s 75 RHCF beds be preserved and transferred to DeGraff Memorial Hospital.”

In Recommendation 3 for the Western Region of New York the Commission states, “It is recommended DeGraff Memorial Hospital downsize all 70 medical/surgical beds and cease operation as an acute care hospital. It is further recommended that DeGraff Memorial Hospital convert completely to a Residential Health Care Facility encompassing its existing 80 RHCF beds and the 75 RHCF beds to be transferred from Millard Fillmore Hospital – Gates Circle.”

In Recommendation 5 for the Western Region of New York the Commission states “It is recommended that the facilities controlled by the Erie County Medical Center Corporation and Kaleida Health be joined under a single unified governance structure under the control of an entity other than the Erie County Medical Center Corporation, Kaleida Health, or any other public benefit corporation. It is further recommended that this entity consist of a reconstituted single board including representation of Kaleida Health, Erie County Medical Center Corporation, the University at Buffalo School of Medicine and Biomedical Sciences, and community leaders… It is further recommended that the joined entity develop new infrastructure in which to locate comprehensive heart and vascular services… If Kaleida Health and the Erie County Medical Center Corporation fail to execute such an agreement by December 31, 2007, close either Buffalo General Hospital or the Erie County Medical Center Corporation and expand the other to accommodate the patient volume of the closed facility.”

It is important the Commission recommendations be read in the context of the full Commission report, which is available at *www.nyhealthcarecommission.org*. The full report discusses, among other things, the context and process under which the recommendations were made, the authority granted to the NYS Commissioner of Health to implement the recommendations and how the implementation of these recommendations may be timed and funded.

Kaleida is in active discussions with the Commissioner of Health’s office and its Medical Staff and believes it can work through the internal issues or implications related to Recommendations 1 and 3 above as these recommendations affect only facilities internal to Kaleida.

However, as it relates to Recommendation 5, although Kaleida has been in active discussions with the Commissioner of Health, the Erie County Medical Center Corporation ("Public Benefit Corporation") and the State University of New York at Buffalo, this recommendation poses a significant risk and management believes could significantly impact the financial viability of Kaleida and any new entity formed if implemented without regard to the financial implications of the differences in current and future commitments provided for in the collective bargaining agreements of Kaleida and the Public Benefit Corporation, including commitments for post-retirement health care and pension obligations for past and current employees of the Public Benefit Corporation. At this time there is insufficient information for management of Kaleida to determine the ultimate outcome of this specific Commission recommendation.

(c) *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.