KALEIDA HEALTH

Consolidated Financial Statements

December 31, 2008 and 2007

(With Independent Auditors' Report Thereon)

KALEIDA HEALTH

Consolidated Financial Statements

December 31, 2008 and 2007

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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, 2008 and 2007, 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, 2008 and 2007, 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 more fully described in note 15 (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.

KPMG LLP

April 20, 2009

KALEIDA HEALTH

Consolidated Balance Sheets

December 31, 2008 and 2007

(Dollars in thousands)

Assets		**2008**	**2007**
Current assets:			
Cash and cash equivalents	$	41,997	44,987
Investments (notes 6 and 7)		124,990	152,560
Accounts receivable:			
Patient, less estimated allowance for doubtful accounts of $37,577 in 2008 and $34,749 in 2007		111,419	105,448
Other		9,783	9,261
Inventories		25,258	24,102
Prepaid expenses and other current assets		9,510	6,693
Total current assets		322,957	343,051
Assets limited as to use (notes 6, 7, and 9):			
Designated under debt and lease agreements		38,546	36,027
Designated under self-insurance programs		107,037	139,725
Board designated and donor restricted		64,984	84,635
Other		1,610	1,020
		212,177	261,407
Property and equipment, less accumulated depreciation and amortization (notes 8 and 9)		283,789	276,435
Receivable for insurance recoveries (note 5)		5,809	9,460
Deferred financing costs, net		11,483	12,233
Other		5,954	5,929
Total assets	$	842,169	908,515

See accompanying notes to consolidated financial statements.

Liabilities and Net Assets		2008	2007
Current liabilities:			
Accounts payable and other accrued expenses	$	66,871	66,071
Accrued payroll and related expenses		49,777	42,796
Estimated third-party payor settlements (note 4)		1,354	14,329
Current portion of long-term debt (note 9)		22,927	19,470
Other current liabilities		5,497	7,914
Total current liabilities		146,426	150,580
Long-term debt, less current portion (note 9)		219,856	214,356
Construction costs payable (note 9)		1,022	5,539
Estimated self-insurance reserves (note 5)		139,858	135,094
Asset retirement obligations (note 12)		10,049	9,830
Other long-term liabilities (note 11)		184,482	43,675
		555,267	408,494
Total liabilities		701,693	559,074
Net assets:			
Unrestricted		74,690	263,802
Temporarily restricted (note 13)		50,732	64,199
Permanently restricted (note 13)		15,054	21,440
Total net assets		140,476	349,441
Total liabilities and net assets	$	842,169	908,515

KALEIDA HEALTH

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2008 and 2007

(Dollars in thousands)

		2008	2007
Operating revenue:			
Net patient service revenue (notes 3 and 4)	$	1,067,103	1,002,625
Other operating revenue (note 6)		24,026	26,860
Net assets released from restrictions for operations (note 13)		11,119	11,610
Total operating revenue		1,102,248	1,041,095
Operating expenses:			
Salaries and benefits		576,541	535,630
Purchased services, supplies, and other		410,711	381,850
Depreciation and amortization		60,062	57,015
Provision for bad debts		26,335	29,018
Interest		11,369	11,667
Total operating expenses		1,085,018	1,015,180
Income from operations		17,230	25,915
Nonoperating income (losses) (note 6):			
Investment (loss) income		(8,816)	14,987
Net realized (losses) gains on sales of investments		(3,231)	3,308
Net change in unrealized gains and losses on investments		(44,754)	—
Total nonoperating (losses) income, net		(56,801)	18,295
(Deficiency) excess of revenue over expenses	$	(39,571)	44,210

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KALEIDA HEALTH

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2008 and 2007

(Dollars in thousands)

	2008	2007
Unrestricted net assets:		
(Deficiency) excess of revenue over expenses	$ (39,571)	44,210
Net change in unrealized gains and losses on available-for-sale investments (note 2)	—	(5,433)
Pension and postretirement related changes other than net periodic cost (note 11)	(145,742)	34,062
Contributions for capital acquisitions	438	483
Net assets released from restrictions for property acquisitions	1,653	3,141
Net cumulative unrealized gains transferred to trading securities (note 6)	(5,886)	—
Other transfers, net	(4)	139
(Decrease) increase in unrestricted net assets	(189,112)	76,602
Temporarily restricted net assets:		
Contributions, bequests, and grants	12,671	15,060
Restricted investment (losses) income	(211)	3,276
Net change in unrealized gains and losses on investments	(12,731)	(787)
Net assets released from restrictions for operations	(11,119)	(11,610)
Net assets released from restrictions for property acquisitions	(1,653)	(3,141)
Other transfers, net	(424)	1,252
(Decrease) increase in temporarily restricted net assets	(13,467)	4,050
Permanently restricted net assets:		
Contributions	2	1,508
Restricted investment (losses) income	(425)	1,352
Net change in unrealized gains and losses on investments	(6,391)	(414)
Other transfers, net	428	(1,391)
(Decrease) increase in permanently restricted net assets	(6,386)	1,055
Change in net assets	(208,965)	81,707
Net assets, beginning of year	349,441	267,734
Net assets, end of year	$ 140,476	349,441

See accompanying notes to consolidated financial statements.

KALEIDA HEALTH

Consolidated Statements of Cash Flows

Years ended December 31, 2008 and 2007

(Dollars in thousands)

		2008	2007
Operating activities:			
Change in net assets	$	(208,965)	81,707
Adjustments to reconcile change in net assets to net cash provided by operating activities:			
Depreciation and amortization		60,062	57,015
Accretion expense		540	540
Restricted contributions, bequests, and grants		(2,143)	(6,055)
Change in receivable for insurance recoveries		3,651	3,840
Change in equity interest in limited partnerships		13,429	(7,332)
Net change in unrealized gains and losses on investments		69,762	6,634
Provision for bad debts		26,335	29,018
Pension and postretirement related changes other than net periodic cost		145,742	(34,062)
Change in operating assets and liabilities:			
Patient accounts receivable		(32,306)	(31,919)
Other receivables, inventories, and prepaid expenses		(4,495)	(1,426)
Accounts payable, accrued expenses, and accrued payroll		5,364	5,190
Estimated third-party payor settlements		(12,975)	(4,555)
Other assets		(25)	(4,096)
Other liabilities		(492)	(6,275)
Net cash provided by operating activities		63,484	88,224
Investing activities:			
Additions to property and equipment, net of change in construction costs payable		(67,862)	(71,282)
Net purchases of investments		(6,391)	(24,733)
Net cash used by investing activities		(74,253)	(96,015)
Financing activities:			
Principal payments on debt and capital lease obligations		(20,200)	(20,678)
Proceeds from restricted contributions, bequests, and grants		2,143	6,055
Proceeds from long-term debt		25,836	41,610
Net cash provided by financing activities		7,779	26,987
Net (decrease) increase in cash and cash equivalents		(2,990)	19,196
Cash and cash equivalents, beginning of year		44,987	25,791
Cash and cash equivalents, end of year	$	41,997	44,987
Supplemental schedules on noncash investing activities:			
Capital lease obligations	$	3,321	1,169
Interest paid		13,334	12,421

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 services 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, DeGraff Memorial Hospital, and three hospital based nursing homes), 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 (also see note 15(b)). All significant intercompany transactions have been eliminated in consolidation.

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation

The accompanying consolidated financial statements are presented on the accrual basis of accounting and 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 for 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 consolidated 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. 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, valuation of certain alternative investments, and pension and postretirement obligations. Actual results could differ from those estimates, and the differences in estimates from actual results could be significant.

(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 at December 31, 2008 and maintains 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.

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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 healthcare 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 (note 4).

(f) Investments and Investment Income

Investments in marketable equity securities (common and preferred stocks) with readily determinable fair values and all investments in fixed income securities are presented in the consolidated financial statements at fair value. Investments in common collective funds are measured based on the fair value of the underlying investments (note 7).

Limited partnerships (i.e., hedge funds, private equity funds, REITs, and similar items) are generally accounted for on the equity method with changes in values recorded as a change in equity interest in limited partnerships.

Participation units in pooled investment funds held within unrestricted, temporarily restricted, and permanently restricted net assets are determined monthly based on the fair 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.

In 2008, Kaleida determined the investment portfolio is more appropriately classified as trading as opposed to available-for-sale based on investment philosophy, strategy and the nature and frequency of investment activity in accordance with Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. This change has been reflected on a prospective basis in the 2008 consolidated financial statements. Accordingly, all unrealized gains and losses on unrestricted investments are reported as a component of (deficiency) excess of revenue over expenses in the accompanying 2008 consolidated statement of operations and changes in net assets. In 2007, Kaleida classified its unrestricted investments as available-for-sale, and all unrealized gains and losses on unrestricted investments were reported as a component of the changes in unrestricted net assets.

Investment income or loss (including interest, dividends, realized gains and losses on investments, change in equity interest in limited partnerships, and change in unrealized gains and losses) is included in (deficiency) excess of revenue over expenses, unless the income is restricted by the

(Continued)

donor or law. Further, investment income from funds designated for self-insurance programs and debt and lease agreements are recorded as a component of operating revenue.

(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.

Kaleida monitors its long-lived assets for impairment indicators on an ongoing basis in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. If impairment indicators exist, Kaleida performs the required analysis and records impairment charges in accordance with SFAS No. 144. In conducting its analysis, Kaleida compares the undiscounted cash flows expected to be generated from the long-lived assets to the related net book values. If the undiscounted cash flows exceed the net book value, the long-lived assets are considered not to be impaired. If the net book value exceeds the undiscounted cash flows, an impairment loss is measured and recognized. No impairments have been recorded as of December 31, 2008.

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. 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 total 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.

(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, 2008 and 2007 is approximately $248,094,000 and $239,862,000, respectively. The 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) (Deficiency) Excess of Revenue 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.

(Continued)

The consolidated statements of operations and changes in net assets include the (deficiency) excess of revenue over expenses. Changes in unrestricted net assets which are excluded from the (deficiency) excess of revenue over expenses consistent with industry practice include unrealized gains and losses on available-for-sale securities, contributions of long-lived assets, and pension and postretirement related changes other than net periodic cost.

For purposes of display, transactions deemed by management to be ongoing, major or central to the provision of healthcare services, including unrestricted contributions and interest and dividends from funds designated for self-insurance programs and debt and lease agreements, are reported as operating revenue and expenses in the determination of Kaleida's operating results. Investment trading activities are reported as nonoperating income or losses.

(p) Adoption of New Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurement* (SFAS 157). SFAS 157 establishes an authoritative definition of fair value, sets out a framework for measuring fair value, and requires additional disclosures about fair value measurements. Kaleida adopted SFAS 157 effective January 1, 2008. In February 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No 157-2, *Effective Date of FASB Statement No. 157*, which defers the effective date of SFAS 157 for one year for nonfinancial assets and liabilities that are not disclosed at fair value in the financial statements on a recurring basis. In October 2008, the FASB issued FSP No. 157-3, *Determining the Fair Value of a Financial Asset in a Market That is Not Active*, which was effective upon issuance. FSP No. 157-3's guidance clarifies various application issues with respect to the objective of a fair value measurement, distressed transactions, relevance of observable data, and the use of management's assumptions. There was no impact on the consolidated financial statements as a result of adopting SFAS 157 and FSP No. 157-3. See note 7 for disclosures of the fair value of qualifying investments required by SFAS 157.

In February 2007, the FASB released Financial Accounting Standard No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159). FAS 159 permits entities to choose to measure financial instruments and certain other items at fair value. Kaleida also adopted FAS 159 effective January 1, 2008. The adoption of FAS 159 had no impact on the consolidated financial statements since management did not elect to measure any additional eligible financial assets or financial liabilities at fair value as a result of adopting FAS 159.

(q) Reclassifications

Certain amounts in the 2007 consolidated financial statements have been reclassified to conform to 2008 presentation.

(3) Uncompensated Care

Kaleida accepts all patients regardless of their ability to pay. A patient's care may be classified as charity care in accordance with certain established policies of Kaleida. Essentially, these policies define charity services as those services for which no payment is anticipated. In addition, Kaleida serves 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 uncompensated care provided during the years ended December 31.

		2008	2007
		(Dollars in thousands)	
Charity care excluded from revenue, based on established rates for services provided	$	6,784	6,146
Revenue shortfall compared to expenses for services provided to Medicaid and indigent patients		15,895	15,163
	$	22,679	21,309

Kaleida also provided additional uncompensated services of approximately $26,335,000 and $29,018,000 in 2008 and 2007, respectively, representing uncollectible patient accounts.

(4) Third-Party Reimbursement Agreements

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

(a) 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).

(b) 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 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.

Home health care services for Medicare are reimbursed under a prospective payment system (PPS) which is based on a 60 day episode, case mix adjusted into one of the 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 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 2008 and 2007, Kaleida recorded adjustments for estimated settlements with third-party payors, which resulted in increases to net patient service revenue of approximately $8,837,000 and $6,882,000, respectively. Net patient service revenue from Medicare and New York State Medicaid programs accounted for approximately 24% and 12%, respectively, of total net patient service revenue for the year ended December 31, 2008, and 26% and 13%, respectively, of total net patient service revenue for the year ended December 31, 2007. Significant concentrations of patient accounts receivable at December 31, 2008 and 2007 include Medicare 25% and 24%, Medicaid 12% and 15%, and health maintenance organizations 40% and 40%, 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.

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

Kaleida is partially self-insured for medical malpractice, general liability, and workers' compensation costs, and excess liability policies are generally maintained for exposures in excess of self-insurance retentions. Trusts are established for the purpose of setting aside assets based on actuarial funding recommendations. Under the trust agreements, the trust assets can be used only for payment of losses, related expenses, and the costs of administering the trust. The estimated liability for both asserted and unasserted self-insurance claims for medical malpractice and general liability are discounted at 3.5% at December 31, 2008 and 5.25% at December 31, 2007, and discounted at 3.5% for workers' compensation costs at December 31, 2008 and 4.5% at December 31, 2007. Estimated self-insurance reserves are approximately \$140,000,000 and \$135,000,000 at December 31, 2008 and 2007, respectively. At December 31, 2008, Kaleida has irrevocable secured letters of credit supporting the self-insurance program totaling approximately \$34,019,000. 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.

At December 31, 2008 and 2007, 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.

(6) Investments

The components of investments at December 31 are as follows:

	2008	2007
	(Dollars in thousands)	
Current investments:		
Cash and cash equivalents	$ 18,699	30,214
Fixed income securities	27,701	30,037
Marketable equity securities	12,834	22,029
Common collective funds	42,702	53,959
Limited partnerships	23,054	16,321
	$ 124,990	152,560
Assets limited as to use:		
Designated under debt and lease agreements:		
Cash and cash equivalents	$ 7,047	36,027
U.S. government securities	31,499	—
	38,546	36,027
Designated under self-insurance programs:		
Cash and cash equivalents	35,830	39,036
U.S. government securities	2,860	3,610
Fixed income securities	18,684	21,483
Marketable equity securities	8,381	16,559
Common collective funds	25,037	43,627
Limited partnerships	16,245	15,410
	107,037	139,725
Board designated and donor restricted:		
Cash and cash equivalents	6,117	11,299
U.S. government securities	259	259
Fixed income securities	15,459	18,157
Marketable equity securities	7,162	13,169
Common collective funds	23,297	31,980
Limited partnerships	12,690	9,771
	64,984	84,635
Other:		
Cash and cash equivalents	1,610	1,020
	$ 212,177	261,407

(Continued)

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

		2008	2007
		(Dollars in thousands)	
Other operating revenue:			
Interest and dividends	$	2,788	7,454
Nonoperating income (losses):			
Investment (loss) income:			
Interest and dividends	$	4,613	7,655
Change in equity interest in limited partnerships		(13,429)	7,332
	$	(8,816)	14,987
Net realized (losses) gains on sale of investments	$	(3,231)	3,308
Net change in unrealized gains and losses on investments:			
Net cumulative unrealized gains transferred to trading securities	$	5,886	—
Net change in unrealized gains and losses on trading securities		(50,640)	—
	$	(44,754)	—

(7) Fair Value Measurements

Effective January 1, 2008, Kaleida adopted FAS 157 which clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. FAS 157 also establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of fair value hierarchy under FAS 157 are described below:

(a) ***Level 1***: Quoted prices in active markets that are accessible at the measurement date for identical assets and liabilities. Level 1 includes fixed income and equity securities that are traded in an active exchange market, as well as U.S. Treasury securities.

(b) ***Level 2***: Inputs, other than quoted prices in active markets, that are observable either directly or indirectly and fair value is determined through the use of models or other valuation methodologies. This category generally includes certain U.S. government and agency obligations, fixed income securities and alternative investments.

(c) ***Level 3***: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the asset or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant

management judgment or estimation. This category generally includes certain private debt and equity instruments and alternative investments.

Fair values for securities are based on quoted market prices or dealer quotes, where available. When quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. When necessary, Kaleida utilizes matrix pricing from a third party pricing vendor to determine fair value pricing. Matrix prices are based on quoted prices for securities with similar coupons, ratings, and maturities, rather than on specific bids and offers for the designated security.

The following presents Kaleida's investments in fixed income securities, marketable equity securities, common collective funds, and U.S. government securities at December 31, 2008 that are measured at fair value on a recurring basis. Investments are classified in their entirety based on the lowest level of input that is significant to the fair value measurements as follows:

		Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)
			(Dollars in thousands)	
Investments:				
Fixed income securities	$	61,844	61,844	—
Marketable equity securities		28,377	28,377	—
Common collective funds		91,036	—	91,036
U.S. government securities		34,618	—	34,618
	$	215,875	90,221	125,654

Kaleida has no investments that are valued using Level 3 inputs as of December 31, 2008.

(8) Property and Equipment

A summary of property and equipment at December 31 follows:

		2008	2007
		(Dollars in thousands)	
Land and land improvements	$	21,184	20,855
Buildings, fixtures, and improvements		677,681	629,293
Movable equipment		510,382	483,403
		1,209,247	1,133,551
Less accumulated depreciation and amortization		941,413	882,685
		267,834	250,866
Construction in progress		15,955	25,569
	$	283,789	276,435

In 2006 Kaleida began a construction project to expand its campus at the Millard Fillmore Suburban (Suburban) site and acquisition of certain equipment for Millard Fillmore Gates and the Buffalo General Hospital sites. At December 31, 2008, this project has been substantially completed and was financed with debt and Kaleida equity. For the year ended December 31, 2008 and 2007, Kaleida capitalized, as a component of construction in progress, interest costs of approximately $1,957,000 and $964,000, respectively, related to these projects.

Commitments outstanding at December 31, 2008 for the purchase of goods and services for routine projects totaled approximately $3,800,000.

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

		2008	2007
		(Dollars in thousands)	
Property and equipment	$	80,448	74,996
Less accumulated amortization		44,536	30,806
	$	35,912	44,190

(Continued)

(9) Debt

Debt consists of the following at December 31:

		2008	2007
		(Dollars in thousands)	
Mortgage and building loan payable in monthly installments of $625,000, including interest at 5.25% through August 1, 2023. (a)	$	76,622	80,004
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)		53,012	56,584
Mortgage notes payable in monthly installments of $338,000, including interest at 5.05%, through October 1, 2033. (a)		56,604	32,370
Mortgage notes payable in monthly installments of $107,000, including interest at 5.05%, through February 1, 2032. (a)		17,211	17,790
Mortgage payable in monthly installments of $48,000 including interest at 6.25% through July 1, 2024. (a)		5,708	5,918
Capital lease obligations, less imputed interest of $1,641,000 and $4,117,000 at December 31, 2008 and 2007, respectively. (b)		22,790	30,547
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.		2,841	3,141
Other		7,995	7,472
		242,783	233,826
Less current maturities		22,927	19,470
	$	219,856	214,356

(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 are being used to finance the cost of certain capital improvements. The mortgage notes are insured by HUD. At December 31, 2008, Kaleida has drawn $74,759,000 for costs related to the capital improvements. Final endorsement with HUD is expected in March 31, 2009.

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).

At December 31, 2008, Kaleida was not in compliance with the required debt service coverage ratio. As a result, Kaleida will require HUD/HHS approvals for short-term borrowings, leases or other long-term debt obligations over threshold amounts, and for certain transactions with affiliates in future periods.

(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 the Dormitory Authority of the State of New York (DASNY) as part of their Tax-Exempt Leasing Program (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:

		2008	2007
		(Dollars in thousands)	
Mortgage reserve fund	$	38,546	34,066
TELP escrow		—	1,961
	$	38,546	36,027

Future annual principal payments of long-term debt for the next five years as of December 31, 2008 follows (dollars in thousands):

2009	$	22,927
2010		15,821
2011		14,372
2012		14,586
2013		14,365

Construction costs payable at December 31, 2008 will be paid with proceeds advanced from the HUD insured loan commitment secured in September 2006.

(Continued)

(10) Lease 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 $23,187,000 and $21,728,000 in 2008 and 2007, respectively. Future minimum payments under noncancelable operating leases as of December 31, 2008 having lease terms in excess of one year are as follows (dollars in thousands):

2009	$	17,254
2010		16,081
2011		14,079
2012		12,811
2013		12,748

(11) Pension and Other Postretirement Benefits

(a) *Pension Plans*

Defined Benefit Plan – Kaleida sponsors a defined benefit plan (the Plan) covering substantially all of its eligible employees. The Plan provides 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 defined benefit pension plan's projected benefit obligation and fair value of plan assets at December 31:

		2008	2007
		(Dollars in thousands)	
Change in projected benefit obligation:			
Benefit obligation at beginning of year	$	386,939	396,021
Service cost		14,993	15,739
Interest cost		24,958	22,302
Plan amendments		—	245
Actuarial losses (gains)		20,585	(35,653)
Benefits paid		(12,637)	(11,715)
Benefit obligation at end of year	$	434,838	386,939
Change in plan assets:			
Fair value of plan assets at beginning of year	$	349,292	311,486
Actual return on plan assets		(97,607)	20,871
Employer contributions		16,800	28,650
Benefits paid		(12,637)	(11,715)
Fair value of assets at end of year	$	255,848	349,292

(Continued)

The funded status of the plan and amounts recognized in the consolidated balance sheets at December 31, are as follows:

		2008	2007
		(Dollars in thousands)	
Funded status at end of year:			
Fair value of plan assets	$	255,848	349,292
Projected benefit obligation		434,838	386,939
Pension liability recognized in the consolidated balance sheets at end of year (included as a component of other long-term liabilities)	$	(178,990)	(37,647)
Amount recorded in unrestricted net assets at end of year:			
Net actuarial loss	$	(158,134)	(11,476)
Prior service costs		(644)	(435)
	$	(158,778)	(11,911)

The estimated prior service cost and net actuarial loss that will be amortized from unrestricted net assets in 2009 are approximately $209,000 and $1,842,000, respectively.

The accumulated benefit obligations at the Plan's measurement date for 2008 and 2007 was approximately $379,207,000 and $338,089,000, respectively.

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

		2008	2007
		(Dollars in thousands)	
Service cost	$	14,993	15,739
Interest cost		24,958	22,302
Expected return on plan assets		(28,466)	(24,939)
Amortization of net prior service credit		(209)	(231)
Amortization of actuarial loss		—	3,117
Net periodic pension cost	$	11,276	15,988

(Continued)

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

	2008	2007
Discount rate for benefit obligations	6.20%	6.60%
Discount rate for net pension cost	6.60	5.75
Rate of compensation increase	4.00	4.00
Expected long-term rate of return on plan assets	8.50	8.50

Asset Allocations – Kaleida's pension plan asset allocations at the Plan's measurement date are as follows:

	2008	2007
Asset category:		
Equity securities	65%	71%
Fixed income securities	27	23
Other	8	6
Total	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 – For the plan year ended December 31, 2008, Kaleida has contributed $16,800,000. Expected contributions for the plan year ending December 31, 2009 will be made at a level recommended by Kaleida's consulting actuary and in accordance with ERISA funding requirements.

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

2009	$	19,426
2010		19,580
2011		20,096
2012		21,849
2013		23,643
2014 – 2018		150,706

The expected benefits are based on the same assumptions used to measure Kaleida's benefit obligations at December 31, 2008 and include future employee service.

(Continued)

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 $2,059,000 and $1,882,000 for 2008 and 2007, 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). The following table sets forth the funded status and amounts recognized in the consolidated balance sheets at December 31:

		2008	2007
		(Dollars in thousands)	
Accumulated postretirement obligation at end of year	$	4,389	5,074
Fair value of plan assets at end of year		—	—
Postretirement obligation recognized at end of year included as a component of other long-term liabilities	$	(4,389)	(5,074)

Net postretirement benefit cost was approximately $447,000 and $374,000 for the years ended December 31, 2008 and 2007, respectively. The weighted average assumptions used to determine postretirement benefit cost and obligations at the Plan's measurement date (December 31):

	2008	2007
Discount rate for benefit obligations	6.30%	6.30%
Discount rate for net postretirement cost	6.30	5.75

For measurement purposes, 2008 increases in the per capita cost of covered health care benefits were assumed for medical and prescription drugs at 9.5%. The rate is assumed to decrease gradually to 5% by 2015 and remain at that level thereafter for all classifications. A one-percentage point change in assumed healthcare cost trend rates would not have a material impact on the future cost or benefit obligation.

(12) Asset Retirement Obligations

Kaleida has asset retirement obligations (AROs) arising from regulatory requirements to perform certain asset retirement activities in the event they renovate or demolish buildings in the future. The liability was initially measured at fair value and subsequently is adjusted for accretion expense and changes in the amount or timing of the estimated cash flows. The following table presents the activity for the AROs for the years ended December 31:

		2008	2007
		(Dollars in thousands)	
Balance at beginning of year	$	9,830	9,891
Net obligations settled in current period		(321)	(601)
Accretion expense		540	540
Balance at end of year	$	10,049	9,830

(13) Temporarily and Permanently Restricted Net Assets

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

		2008	2007
		(Dollars in thousands)	
Capital expansion and improvements	$	10,195	9,084
Advancement of medical education and research and healthcare services		40,537	55,115
	$	50,732	64,199

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

		2008	2007
		(Dollars in thousands)	
Funds to be held in perpetuity, the income from which is expendable to support healthcare services, including medical research	$	9,990	14,140
Funds to be held in perpetuity, the income from which is expendable to support pediatric healthcare services		5,064	7,300
	$	15,054	21,440

In 2008 and 2007, net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes of operating expenses of $11,119,000 and $11,610,000, respectively, and purchases of equipment of $1,653,000 and $3,141,000, respectively.

(Continued)

(14) 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:

		2008	2007
		(Dollars in thousands)	
Healthcare services	$	922,265	862,903
General and administrative		162,753	152,277
	$	1,085,018	1,015,180

(15) Commitments and Contingencies

(a) Concentration of Credit Risk

Financial instruments that potentially subject Kaleida to concentrations of credit risk consist primarily of accounts receivable and certain investments. Investments, which include government obligations, marketable equity securities, other alternative investments funds, and fixed income securities, 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 full Commission report 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 Department of Health (DOH) to implement the recommendations, and how the implementation of these recommendations may be timed and funded. The Commission's recommendations include consolidation, closures, conversions, and restructuring of hospital and nursing home systems throughout New York State. As noted above, DOH is charged with implementing these recommendations.

The Commission recommended three significant items impacting acute and long-term care (RHCF) services at Kaleida as follows:

- Closure of Millard Fillmore Gates Hospital – Although the Commission's recommendation was for this Hospital to close, DOH has agreed to the relocation of many of its services to the Buffalo Niagara Medical Campus. This will be done as part of the creation of a comprehensive heart and vascular institute in a building to be constructed immediately adjacent to Buffalo General Hospital. Plans have been developed to carry out this closure and relocation and the organization has received initial approval from DOH and is awaiting final certificate of need approval. Additionally, DOH has awarded Kaleida a $65 million grant to be utilized towards this project. Millard Fillmore Gates Hospital will continue to operate, with minimal disruption, until all services are effectively relocated.

- Conversion of DeGraff Memorial Hospital – The Commission had recommended that DeGraff Memorial Hospital be converted to a residential health care facility. Based upon subsequent consideration, the NYS Commissioner of Health (Commissioner) deferred that recommendation until a further market and need based analysis could be completed. The Commissioner will have until the end of 2011 to reevaluate this recommendation.

- Erie County Medical Center Corporation (ECMCC) and Kaleida Health-Unified Governance Structure – The Commission recommended a unified governance structure be implemented to oversee the operations of Kaleida and ECMCC. In 2007 a single joint board was formed in compliance with this recommendation comprised of representatives from Kaleida, ECMCC, the NYS University at Buffalo School of Medicine and the community, currently operating as Great Lakes Health. Since ECMCC is a public benefit corporation its subordination to Great Lakes Health requires an act of the New York General Assembly, which has yet to occur. Notwithstanding this, Kaleida and ECMCC have agreed contractually (June 2008) to subordinate a number of its prerogatives to Great Lakes Health. These include but are not limited to allowing Great Lakes Health to:

  – Approve and coordinate submission of certificates of need for each organization;

  – Develop a system-wide, consolidated quality improvement program;

  – Approve the operating and capital budgets of each organization;

  – Approve and oversee implementation of strategic plans of each organization; and,

  – Approve the transfer or closure of services between ECMCC and Kaleida.

(c) Collective Bargaining Agreements

A significant portion of Kaleida employees work under collective bargaining agreements, the majority of which expired during 2008. All collective bargaining agreements have been successfully renegotiated and will expire in May 2011.