



KALEIDA HEALTH

Consolidated Financial Statements and
Other Financial Information

December 31, 2011 and 2010

(With Independent Auditors' Report Thereon)

KALEIDA HEALTH
Consolidated Financial Statements and
Other Financial Information
December 31, 2011 and 2010

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KPMG LLP
515 Broadway
Albany, NY 12207-2974

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, 2011 and 2010, 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, 2011 and 2010, 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.

Our audits were conducted for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The accompanying consolidating information as of and for the year ended December 31, 2011, included on pages 35 through 37 is presented for purposes of additional analysis of the basic consolidated financial statements rather than to present the financial position and results of operations of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audit of the 2011 basic consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the 2011 basic consolidated financial statements taken as a whole.

KPMG LLP

April 25, 2012

KALEIDA HEALTH
Consolidated Balance Sheets
December 31, 2011 and 2010
(Dollars in thousands)

Assets	2011	2010
Current assets:		
Cash and cash equivalents	\$ 41,267	60,122
Investments (notes 6 and 7)	139,260	148,795
Accounts receivable:		
Patient, less estimated allowance for doubtful accounts of \$32,161 in 2011 and \$35,494 in 2010 (notes 3 and 4)	152,348	151,456
Other	10,030	8,291
Inventories	20,563	23,419
Prepaid expenses and other current assets	11,752	10,668
Total current assets	<u>375,220</u>	<u>402,751</u>
Assets limited as to use (notes 5, 6, 7, and 9):		
Designated under debt agreements	42,476	50,831
Designated under self-insurance programs	123,920	138,592
Board designated and donor restricted	85,974	85,741
Other	1,187	1,380
	<u>253,557</u>	<u>276,544</u>
Property and equipment, less accumulated depreciation and amortization (notes 8 and 9)	477,556	351,188
Receivable for insurance recoveries (note 5)	9,078	7,809
Grants receivable (note 2)	19,307	47,143
Deferred financing costs, net	12,209	12,933
Other	7,186	6,321
Total assets	<u>\$ 1,154,113</u>	<u>1,104,689</u>

See accompanying notes to consolidated financial statements.

Liabilities and Net Assets	2011	2010
Current liabilities:		
Accounts payable and other accrued expenses	\$ 95,273	91,615
Accrued payroll and related expenses	54,888	54,216
Line of credit (note 9)	10,000	10,000
Estimated third-party payor settlements (note 4)	23,288	27,499
Current portion of long-term debt (note 9)	18,223	18,889
Other current liabilities	9,122	4,427
Total current liabilities	210,794	206,646
Long-term debt, less current portion (note 9)	276,245	226,544
Construction costs payable (note 9)	13,290	11,696
Estimated self-insurance reserves (note 5)	168,328	160,516
Asset retirement obligations (note 12)	13,030	10,685
Pension and postretirement obligations (note 11)	264,767	176,507
Other long-term liabilities	13,235	3,269
Total liabilities	748,895	589,217
	959,689	795,863
Commitments and contingencies (notes 8, 10, and 15)		
Net assets:		
Unrestricted	91,356	180,453
Temporarily restricted (note 13)	87,668	112,973
Permanently restricted (note 13)	15,400	15,400
Total net assets	194,424	308,826
Total liabilities and net assets	\$ 1,154,113	1,104,689

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Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2011 and 2010

(Dollars in thousands)

	<u>2011</u>	<u>2010</u>
Operating revenue:		
Net patient service revenue (notes 3 and 4)	\$ 1,178,419	1,180,088
Other operating revenue (note 6)	18,944	17,982
Net assets released from restrictions for operations (note 13)	5,747	7,703
Total operating revenue	<u>1,203,110</u>	<u>1,205,773</u>
Operating expenses:		
Salaries and benefits	689,218	668,426
Purchased services and other	223,007	211,344
Medical and non-medical supplies	222,993	222,096
Depreciation and amortization	58,664	52,718
Provision for bad debts	18,739	19,759
Interest	10,551	12,662
Total operating expenses	<u>1,223,172</u>	<u>1,187,005</u>
(Loss) income from operations	<u>(20,062)</u>	<u>18,768</u>
Other income (losses):		
Investment income (note 6)	1,707	12,339
Net realized gains (losses) on sales of investments (note 6)	12,469	(189)
Net change in unrealized gains and losses on investments (note 6)	(13,629)	14,917
Restructuring charges, loss on impairment and disposal of assets	(7,453)	(3,409)
Total other (losses) income, net	<u>(6,906)</u>	<u>23,658</u>
(Deficiency) excess of revenue over expenses	<u>\$ (26,968)</u>	<u>42,426</u>

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Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2011 and 2010

(Dollars in thousands)

	<u>2011</u>	<u>2010</u>
Unrestricted net assets:		
(Deficiency) excess of revenue over expenses	\$ (26,968)	42,426
Pension and postretirement related changes other than net periodic cost (note 11)	(92,291)	(32,529)
Contributions for capital acquisitions	—	2,064
Net assets released from restrictions for property acquisitions	29,955	24,582
Other transfers, net	207	46
	<u>(89,097)</u>	<u>36,589</u>
(Decrease) increase in unrestricted net assets		
Temporarily restricted net assets:		
Contributions, bequests, and grants (notes 2(j) and 8)	11,491	18,602
Restricted investment gains	3,107	1,023
Net change in unrealized gains and losses on investments	(3,768)	6,318
Net assets released from restrictions for operations	(5,747)	(7,650)
Net assets released from restrictions for property acquisitions	(29,955)	(24,582)
Other transfers, net (note 2(n))	(433)	4,054
	<u>(25,305)</u>	<u>(2,235)</u>
Decrease in temporarily restricted net assets		
Permanently restricted net assets:		
Contributions	—	4
Restricted investment income	1,714	—
Net change in unrealized gains and losses on investments	(1,940)	—
Net assets released from restrictions for operations	—	(53)
Other transfers, net (note 2(n))	226	(4,100)
	<u>—</u>	<u>(4,149)</u>
Decrease in permanently restricted net assets		
Change in net assets	(114,402)	30,205
Net assets, beginning of year	308,826	278,621
Net assets, end of year	<u>\$ 194,424</u>	<u>308,826</u>

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Cash Flows

Years ended December 31, 2011 and 2010

(Dollars in thousands)

	<u>2011</u>	<u>2010</u>
Operating activities:		
Change in net assets	\$ (114,402)	30,205
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	58,664	52,718
Accretion expense	750	713
Loss on impairment and disposal of assets	—	3,409
Restricted contributions, bequests, and grants	(3,832)	(12,661)
Change in receivable for insurance recoveries	(1,269)	(131)
Change in estimate for asset retirement obligation	1,621	—
Change in interests in limited partnerships	679	(9,484)
Net change in unrealized gains and losses on investments	19,337	(21,235)
Provision for bad debts	18,739	19,759
Pension and postretirement related changes other than net periodic cost	92,291	32,529
Change in operating assets and liabilities:		
Patient accounts receivable	(19,631)	(32,785)
Other receivables, inventories, and prepaid expenses	33	(2,327)
Accounts payable, accrued expenses, and accrued payroll	(2,504)	17,683
Estimated third-party payor settlements	(4,211)	(13,784)
Other assets	(865)	(1,366)
Other liabilities	8,416	(10,123)
Net cash provided by operating activities	<u>53,816</u>	<u>53,120</u>
Investing activities:		
Additions to property and equipment, net of change in construction costs payable	(173,837)	(112,821)
Net sales of investments	12,506	17,704
Net cash used in investing activities	<u>(161,331)</u>	<u>(95,117)</u>
Financing activities:		
Principal payments on debt and capital lease obligations	(23,956)	(18,968)
Proceeds from restricted contributions, bequests, and grants	41,668	20,506
Proceeds from long-term debt	71,260	29,433
Net proceeds from line of credit	—	4,000
Payments for deferred financing fees	(312)	(2,902)
Net cash provided by financing activities	<u>88,660</u>	<u>32,069</u>
Net decrease in cash and cash equivalents	(18,855)	(9,928)
Cash and cash equivalents, beginning of year	60,122	70,050
Cash and cash equivalents, end of year	<u>\$ 41,267</u>	<u>60,122</u>
Supplemental disclosures on cash flow activities:		
Capital lease obligations	\$ 1,731	137
Interest paid	14,478	12,491
Capital acquisitions included in accounts payable	23,940	17,106

See accompanying notes to consolidated financial statements.

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Notes to Consolidated Financial Statements

December 31, 2011 and 2010

(1) Organization

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 Medical Center, Women and Children's Hospital, the Millard Fillmore Hospitals, DeGraff Memorial Hospital, and three hospital based nursing facilities), Waterfront Health Care Center (see note 15(b)), Visiting Nursing Association of WNY, Inc., VNA Home Care Services, Inc., several other subsidiaries, and two charitable foundations that raise funds for Kaleida.

In 2006, the Commission on Health Care Facilities in the 21st Century (Berger Commission) created by the Governor and New York State Legislature issued recommendations on health care capacity and resources in New York State. The Berger Commission report discussed, 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 Berger Commission's recommendations included consolidation, closures, conversions, and restructuring of hospital and nursing home systems throughout New York State, including at Kaleida.

In connection with the recommendations issued by the Berger Commission, Kaleida has undertaken the development of a heart and vascular institute, The Gates Vascular Institute (GVI), located adjacent to Buffalo General Medical Center, and developed plans to carry out the consolidation of services from Millard Fillmore Gates Hospital (Gates) to the Buffalo General Hospital campus within a period of twenty-four months. In March 2012 this consolidation of services occurred. Notes 8 and 9 provide additional information related to the GVI construction and financing.

On December 3, 2011, Kaleida Health consolidated two of its hospital based skilled nursing facilities, Deaconess Skilled Nursing facility and Millard Fillmore Gates Skilled Nursing facility into one newly constructed facility, HighPointe on Michigan Healthcare Facility, located next to the Buffalo General Hospital campus (see notes 8 and 9).

Also, Kaleida and Erie County Medical Center Corporation (ECMCC), pursuant to a recommendation of the Berger Commission, agreed contractually in June 2008 to subordinate certain planning activities and quality improvement programs to Great Lakes Health, a stand-alone not-for-profit 501(c) 3 corporation.

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation

The accompanying consolidated financial statements of Kaleida are presented consistent with the Financial Accounting Standards Board (FASB) *Accounting Standards Codification (ASC) 954, Health Care Entities*, (ASC 954), which addresses the presentation of financial statements for health care entities. In accordance with the provisions of ASC 954, 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 restricted by donors and are reflected as net assets released from restrictions in unrestricted net assets to the extent utilized during the

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period. Permanently restricted net assets are subject to the restrictions of gift instruments requiring that the principal be maintained in perpetuity while permitting the income to be utilized for general and specific purposes.

All significant intercompany transactions between Kaleida and its subsidiaries have been eliminated in consolidation.

Kaleida considers events or transactions that occur after the consolidated balance sheet date, but before the consolidated financial statements are issued, to provide additional evidence relative to certain estimates or to identify matters that require additional disclosure. These consolidated financial statements were issued on April 25, 2012 and subsequent events have been evaluated through that date.

(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 consolidated 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 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 and maintains cash balances in financial institutions in excess of federal deposit insurance limits. As discussed in note 2(o), cash equivalents available for operating purposes are stated at fair value and are considered a Level 1 financial asset.

(d) *Charity Care and Provision for Bad Debts*

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 healthcare coverage, and other collection indicators.

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(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 are reported at fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between willing participants at the measurement date. See notes 2(o) and 7 for a discussion of fair value measurements.

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.

Investment income or loss (including interest, dividends, realized gains and losses on investments, change in 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 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 recorded 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. If impairment indicators exist, Kaleida performs the required analysis and records impairment charges. 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

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the undiscounted cash flows, an impairment loss is measured and recognized based on the fair value of the asset, less costs to sell, or discounted cash flows compared to book value.

Depreciation is generally computed under the straight line method using the half-year convention 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) *Grants Receivable*

In 2006 and 2008, Kaleida was awarded two grants totaling \$77.4 million from the New York State Department of Health (DOH), through the Health Care Efficiency and Affordability Law for New Yorkers program (HEAL NY). The grants were awarded in order to fund the implementation of the recommendations made by the Berger Commission. During 2009 a Grant Disbursement Agreement for \$65 million was finalized with DOH and Kaleida incurred expenditures and received funds under the grant to support the GVI project. During 2010 a Grant Disbursement Agreement for \$12.4 million was finalized with DOH to support the construction of a new skilled nursing facility. The grant proceeds were spent, but not fully reimbursed, for the GVI and skilled nursing facility projects as of December 31, 2011. All funds were reimbursed by February 2012.

During 2011, Kaleida finalized a Grant Disbursement Agreement for a \$10 million grant from the Empire State Development Corporation (ESDC) to assist with funding of the costs of continued investment in the GVI and the Buffalo General Medical Center campus.

(k) *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.

(l) *Self-Insured Programs*

Certain divisions of Kaleida are partially self-insured for medical malpractice, general liability, and workers' compensation costs, with excess liability policies 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.

Kaleida is also self insured for employee health coverage. Kaleida has recorded a provision for estimated claims which is based on Kaleida's own experience and includes the estimated cost of reported claims and claims incurred but not yet reported. To reduce its risk for catastrophic health claims, Kaleida has purchased stop loss coverage.

(m) *Donor Contributions*

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. The gifts are reported as either temporarily or permanently restricted support if they are

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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.

(n) Endowment Funds

Kaleida's permanently restricted net assets consist of individual endowment funds established by donors to support a variety of purposes.

In September 2010, New York State enacted the New York Prudent Management of Institutional Funds Act (NYPMIFA or Act), its version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), to provide clear standards of fund management for those charged with governance of institutional or endowment funds. NYPMIFA updates various provisions of prior New York State law governing fund management. The Act requires covered organizations to take specific actions with respect to appropriation from endowment funds and investment of institutional funds, including adoption of a written investment policy; diversification of investments; and adherence to a specified process to lift donor restrictions, allowable in certain limited circumstances. The Act permits an institution to determine the appropriate level of endowment expenditure, subject to donor-imposed restrictions expressed in the gift instrument. It establishes a rebuttable presumption of imprudence, however, if such expenditure in any year is greater than 7% of the fair market value of an endowment fund established by a gift instrument entered into on or after the effective date of the Act.

Kaleida classifies as permanently restricted net assets (a) the original value of gifts donated to an endowment fund, (b) the original value of subsequent gifts to that fund, and (c) accumulations to the fund made in accordance with the direction, if any, of the applicable donor gift instrument at the time the accumulation is added to the fund. Expendable portions of endowment gifts restricted by donors to specific purposes and any retained income and appreciation thereon is included as a component of temporarily restricted net assets. When the temporary restrictions on these assets have been met, the assets are reclassified to unrestricted net assets pursuant to Kaleida's spending policy.

The enactment and subsequent adoption of NYPMIFA resulted in a reclassification of approximately \$4.1 million between permanently restricted and temporarily restricted net assets on Kaleida's consolidated financial statements as of December 31, 2010.

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December 31, 2011 and 2010

(o) Fair Value Measurement of Financial Instruments

Kaleida estimates fair value based on a valuation framework that uses 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 as defined by ASC 820, *Fair Value Measurements and Disclosures*, are described below:

Level 1: Quoted prices in active markets that are accessible at the measurement date for identical assets and liabilities.

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.

Level 3: Unobservable inputs that are supported by little or no market activity and require significant management judgment or estimation in the determination of fair value.

Kaleida applies the accounting provisions of Accounting Standards Update (ASU) 2009-12, *Investments in Certain Entities that Calculate Net Asset Value per Share (or its Equivalents)* (ASU 2009-12). ASU 2009-12 allows for the estimation of the fair value of investments in certain investment companies for which the investment does not have a readily determinable value by using net asset value (NAV) per share or its equivalent as a practical expedient.

The carrying values of accounts receivable, prepaid expenses and other current assets, accounts payable and line of credit 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, 2011 and 2010 is approximately \$284.8 million and \$234.8 million, respectively. The value of debt was estimated by a 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.

(p) 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. Kaleida recognizes income tax positions when it is more-likely than-not that the position will be sustainable based on the merits of the position. Management has concluded that there are no material uncertain tax positions that need to be recorded.

(q) (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

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healthcare related services. The current operating environment reflects the rapid change in utilization of health care services in the community. Kaleida's proactive implementation of quality and utilization initiatives resulted in volume decreases across the organization to reduce the overall cost to the community. The reduction of services will require the ongoing transformation of the infrastructure and delivery of care to further reduce the cost to the community.

The consolidated statements of operations and changes in net assets include a performance indicator, (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 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 recurring, 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 and peripheral transactions (i.e. impairment charges for Berger Commission mandates, nonrecurring restructuring charges and gains and losses related to disposal of fixed assets) are reported as other income or losses.

(r) Reclassifications

Certain amounts in the 2010 consolidated financial statements have been reclassified to conform to 2011 presentation.

(3) Uncompensated Care

(a) Charity 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.

On April 1, 2010, Kaleida implemented a presumptive charity scoring system in order to determine charity care eligibility. The system uses demographic and public financial information to qualify patient accounts for charity care. The change was made to enhance and accelerate the charity care qualification process which has resulted in an increase in charity care and a reduction in accounts sent to bad debt. In addition, Kaleida makes and receives payments to and from a statewide pool to support the delivery of charity care to patients throughout New York. These net payments are reported as a component of net patient service revenue in the consolidated financial statements.

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Kaleida's net cost of charity care, including payments to and receipts from the statewide pool was approximately \$15.0 million in 2011 and \$13.4 million in 2010 as follows:

	Year ended December 31,	
	2011	2010
	(Dollars in thousands)	
Charity care at cost	\$ 10,561	9,402
Payments to statewide pool	7,557	6,971
Receipts from statewide pool	(3,158)	(2,983)
Cost of charity care, net	<u>\$ 14,960</u>	<u>13,390</u>

The cost of charity care provided was determined based on the application of the ratio of Kaleida's overall cost to patient charges.

(b) Community Benefit

Kaleida offers numerous community benefit programs and services in community-based settings and in its campuses and facilities, in response to the needs of the communities it serves. They include community health fairs, health screenings, health education lectures and workshops for community groups and the general public, school health education programs, consumer health information, facilitated (insurance plan) enrollment services and clinical services such as city school-based health centers, outpatient clinics, adult and pediatric long-term care services, neonatal intensive care services and behavioral health services. Staff members of Kaleida also participate in community leadership efforts by donating significant hours of board service to other not-for-profit organizations. Kaleida supports graduate medical education and offers health professions education support for community members through continuing education programs and scholarships.

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. Kaleida provides service to Medicaid patients at reimbursement levels that are below the cost of care provided.

Kaleida also provided additional uncompensated services of approximately \$18.7 million and \$19.8 million in 2011 and 2010, 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

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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 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 2011 and 2010, Kaleida recorded adjustments for estimated settlements with third-party payors, which resulted in increases to net patient service revenue of approximately \$5.9 million and \$1.7 million, respectively. Net patient service revenue from Medicare and New York State Medicaid programs accounted for approximately 39% and 20%, respectively, of total net patient service revenue for the year ended December 31, 2011, and 39% and 19%, respectively, of total net patient service revenue for the year ended December 31, 2010. Significant concentrations of patient accounts receivable at December 31, 2011 include 14% Medicare, 14% Medicaid, and 48% health maintenance organizations. Significant concentrations of patient accounts receivable at December 31, 2010 include 14% Medicare, 14% Medicaid, and 47% health maintenance organizations.

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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, 2011 and 2010. The estimated liability for self-insured workers' compensation is discounted at 3.0% and 3.5% at December 31, 2011 and 2010, respectively. Estimated self-insurance reserves are approximately \$168 million and \$161 million at December 31, 2011 and 2010, respectively. As of December 31, 2011 and 2010, \$9.1 million and \$7.8 million, respectively, is recoverable from Kaleida's excess liability policies. At December 31, 2011 and 2010, Kaleida has irrevocable secured letters of credit supporting the medical malpractice and workers compensation self-insurance programs totaling approximately \$17.8 million and \$16.9 million, respectively. 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. In addition, Kaleida has established additional security through collateral trust agreements in the amount of \$35.1 million and \$30.1 at December 31, 2011 and 2010, respectively.

At December 31, 2011 and 2010, there were various actions filed against Kaleida by former patients and others seeking compensatory and punitive damages. In 2009, Kaleida secured a surety bond in order to preserve its right to appeal certain judgments filed for ongoing claims. The surety bond is collateralized with an irrevocable letter of credit. The letter of credit is secured with assets within the self insurance trust.

Management believes current estimates for known and unknown claims reflected in the self-insurance accrual are adequate. If the ultimate costs differ from the estimates, such additional amounts will be accrued when known. Excess coverage retroactive to the date of Kaleida's formation has been obtained for incidents reported after December 31, 2000.

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(6) Investments and Assets Limited as to Use

The components of investments and assets limited as to use at December 31 are summarized as follows:

	<u>2011</u>	<u>2010</u>
	(Dollars in thousands)	
Current investments:		
Cash and cash equivalents	\$ 6,930	823
Equity and fixed income mutual funds	35,032	49,305
Marketable equity securities	50,584	67,157
Limited partnerships	46,714	31,510
	<u>139,260</u>	<u>148,795</u>
Assets limited as to use:		
Designated under debt and lease agreements:		
Cash and cash equivalents	10,065	23,411
U.S. government obligations	32,411	27,420
	<u>42,476</u>	<u>50,831</u>
Designated under self-insurance programs:		
Cash and cash equivalents	44,649	39,511
U.S. government obligations	2,077	3,492
Equity and fixed income mutual funds	23,954	33,043
Marketable equity securities	24,543	45,111
Limited partnerships	28,697	17,435
	<u>123,920</u>	<u>138,592</u>
Board designated and donor restricted:		
Cash and cash equivalents	13,151	8,411
U.S. government obligations	259	259
Equity and fixed income mutual funds	19,227	25,685
Marketable equity securities	27,700	34,953
Limited partnerships	25,637	16,433
	<u>85,974</u>	<u>85,741</u>
Other:		
Cash and cash equivalents	1,187	1,380
	<u>253,557</u>	<u>276,544</u>
Total investments	<u>\$ 392,817</u>	<u>425,339</u>

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The components of investment return include the following for the years ended December 31:

	<u>2011</u>	<u>2010</u>
	(Dollars in thousands)	
Other operating revenue:		
Interest and dividends	\$ 2,674	3,256
Other income:		
Investment income (loss):		
Interest and dividends	\$ 2,386	2,855
Change in interests in limited partnerships	(679)	9,484
	<u>\$ 1,707</u>	<u>12,339</u>
Net realized gains (losses) on sales of investments	\$ 12,469	(189)
Net change in unrealized gains and losses on investments	\$ (13,629)	14,917

(7) Fair Value Measurements

The following is a description of the valuation methodologies used by Kaleida for its assets measured at fair value on a recurring basis:

Cash equivalents: Cash equivalents are valued at the NAV reported by the financial institution.

Equity and fixed income securities: Kaleida's equity and fixed income portfolios consist of direct investment in individual equity and fixed income securities and U.S. government obligations that are valued based on quoted market prices (Level 1 measurements). If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments or, if necessary, matrix pricing from a third party pricing vendor to determine fair value (Level 2 measurements). Matrix prices are based on quoted prices for fixed income securities with similar coupons, ratings and maturities, rather than on specific bids and offers for a designated security.

In addition, Kaleida's equity and fixed income portfolios include investments in actively traded mutual funds valued at the closing price on the active market in which the individual funds are traded (Level 1 measurements) and pooled/commingled investment funds where Kaleida owns shares, units, or interests of pooled funds rather than the underlying securities in the fund. The pooled/commingled funds are measured at fair value based on the nature of the underlying investments, timing of the pricing of the fund's NAV and liquidity restrictions for the funds (Level 1 and 2 measurements).

Limited partnerships: Limited partnerships consist of private, domestic and global equities, real assets, fixed income, and hedge funds. Limited partnership investments are typically redeemable with the fund at NAV under the original terms of the partnership agreement and/or subscription agreements. The estimation of fair value of investments in limited partnerships for which the underlying securities do not have a readily determinable value is made using the NAV per share or its equivalent as a practical expedient. Kaleida owns interests in these funds rather than in securities or assets underlying each fund and, therefore, is generally required to consider such investments as Level 2 or Level 3, even though certain underlying securities may not be difficult to value or may be readily marketable.

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The preceding methods may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although Kaleida believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date. Also, because the use of NAV as a practical expedient to estimate fair value of certain investments, the level in the fair value hierarchy in which each fund's fair value measurement is classified is based primarily on Kaleida's ability to redeem its interest in the fund at or near the date of the consolidated balance sheet. Accordingly, the inputs or methodology used for valuing or classifying investments for financial reporting purposes are not necessarily an indication of the risk associated with investing in those investments.

The following tables present Kaleida's investments at December 31, 2011 and 2010 that are measured at fair value on a recurring basis as well as their redemption frequency and notification provisions. The financial assets are classified in their entirety based on the lowest level of input that is significant to the fair value measurements (dollars in thousands):

		2011				Redemption frequency	Days notice
		Total	Level 1	Level 2	Level 3		
Investments:							
Cash and cash equivalents	\$	75,982	75,982	—	—	Daily	Same day
U.S. government obligations		34,747	—	34,747	—	Daily	Same day
Marketable equity securities:							
Large-cap securities		39,760	31,293	8,467	—	Daily-monthly	Same day – 9 days
International securities		63,048	—	63,048	—	Daily-monthly	2 days – 30 days
Equity and fixed income mutual funds		78,221	69,094	9,127	—	Daily-monthly	Same day – 60 days
Limited partnerships:							
Hedge funds		19,402	—	18,345	1,057	Monthly-quarterly	20-95 days
Private equity		2,197	—	—	2,197	See (a) below	See (a) below
Global equity		48,920	—	48,920	—	Monthly - Bi-Monthly	3 days – 30 days
Domestic equity		11,019	—	—	11,019	Annually	60 days
Real assets		3,595	—	—	3,595	See (a) below	See (a) below
Fixed income		15,926	—	15,926	—	Monthly	5-7 days
	\$	392,817	176,369	198,580	17,868		

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		2010					
		Total	Level 1	Level 2	Level 3	Redemption frequency	Days notice
Investments:							
Cash and cash equivalents	\$	73,536	73,536	—	—	Daily	Same day
U.S. government obligations		31,171	—	31,171	—	Daily	Same day
Marketable equity securities:							
Large-cap securities		54,554	42,257	12,297	—	Daily - monthly	Same day – 60 days
International securities		92,667	—	92,667	—	Daily - monthly	2 days – 30 days
Equity and fixed income mutual funds		108,033	98,018	10,015	—	Daily - monthly	Same day – 60 days
Limited partnerships:							
Hedge funds		22,738	—	—	22,738	Quarterly - bi-annually	60-65 days
Private equity		2,114	—	—	2,114	See (a) below	See (a) below
Global equity		24,727	—	24,727	—	Daily - monthly	3 days – 30 days
Domestic equity		12,310	—	—	12,310	Annually	60 days
Real assets		3,489	—	—	3,489	See (a) below	See (a) below
	\$	<u>425,339</u>	<u>213,811</u>	<u>170,877</u>	<u>40,651</u>		

- (a) Certain limited partnership investments include noncontrolling shares or interests in funds where the controlling general partner serves as the investment manager. Such limited partnership shares are typically not eligible for redemption from the fund or general partner, but are typically sold to third party buyers in private transactions that typically can be completed in approximately 90 days. It is the intent of Kaleida to hold these investments until the fund has fully distributed all proceeds to the limited partners and the term of the partnership agreements expire.

Under the terms of certain agreements, Kaleida has committed to contribute a specified level of capital over a defined period of time. Through December 31, 2011, Kaleida has committed to contribute approximately \$7.6 million to such limited partnerships, of which Kaleida has contributed approximately \$7.4 million and has outstanding commitments of \$177,000.

There were no significant transfers into or out of Level 1 and Level 2 fair value measurements during the years ended December 31, 2011 and 2010.

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The following tables present additional information about the changes in Level 3 assets measured at fair value for the years ended December 31 (dollars in thousands):

2011					
	<u>Total</u>	<u>Real assets</u>	<u>Hedge funds</u>	<u>Private equity</u>	<u>Domestic equity</u>
Balance, beginning of year	\$ 40,651	3,489	22,738	2,114	12,310
Purchases	14,497	95	2,970	217	11,215
Sales	(39,194)	(191)	(25,206)	(582)	(13,215)
Realized gains	4,857	17	4,551	289	—
Realized losses	(285)	—	—	—	(285)
Change in unrealized gains and losses	(2,658)	185	(3,996)	159	994
Balance, end of year	<u>\$ 17,868</u>	<u>3,595</u>	<u>1,057</u>	<u>2,197</u>	<u>11,019</u>

2010					
	<u>Total</u>	<u>Real assets</u>	<u>Hedge funds</u>	<u>Private equity</u>	<u>Domestic equity</u>
Balance, beginning of year	\$ 49,404	4,583	21,682	12,447	10,692
Purchases	13,565	2,500	—	11,065	—
Sales	(24,888)	(2,501)	(112)	(22,275)	—
Realized gains	1,208	1	—	1,207	—
Realized losses	(30)	—	(30)	—	—
Change in unrealized gains and losses	1,392	(1,094)	1,198	(330)	1,618
Balance, end of year	<u>\$ 40,651</u>	<u>3,489</u>	<u>22,738</u>	<u>2,114</u>	<u>12,310</u>

Liquidity

The following presents the fair value of Kaleida's investments as of December 31 by redemption period:

	<u>2011</u>	<u>2010</u>
Investments redemption period:		
Daily	\$ 236,466	270,166
Semi – monthly	8,081	13,845
Monthly	106,127	100,676
Bi – monthly	14,653	—
Quarterly	10,679	11,364
Bi – annual	—	11,375
Annual	11,019	12,310
Illiquid	5,792	5,603
Total	<u>\$ 392,817</u>	<u>425,339</u>

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The limitation and restrictions on Kaleida's ability to redeem or sell these investments vary by investment and range from required notice periods for certain limited partnership and hedge funds, to specified terms at inception. Based upon the terms and conditions in effect at December 31, 2011, redemption periods expire at various times through 2013.

(8) Property and Equipment

A summary of property and equipment at December 31 follows:

	2011	2010
	(Dollars in thousands)	
Land and land improvements	\$ 25,827	25,140
Buildings, fixtures, and improvements	768,564	653,819
Movable equipment	606,585	545,724
	1,400,976	1,224,683
Less accumulated depreciation and amortization	1,088,092	985,850
	312,884	238,833
Construction in progress	164,672	112,355
	\$ 477,556	351,188

During 2009, Kaleida began construction of the GVI adjacent to Buffalo General Hospital and in 2010 began construction of a new skilled nursing facility (SNF). The GVI will be a ten story building with an estimated cost of approximately \$291 million. The project is a collaboration between the State University of New York at Buffalo (UB) and Kaleida. It is expected that UB will occupy the top four floors of the GVI and UB will contribute approximately \$118 million to cover construction and fit-up costs associated with that space. Kaleida funded its share of the GVI with \$65 million in HEAL NY grant funding (note 2(j)) and the proceeds from government insured debt of \$100 million and a \$8 million equity contribution (note 9). The completed SNF is a four-story building housing 300 long term care beds with an estimated cost of approximately \$65 million. Kaleida funded this project with \$12.4 million in HEAL NY grant funding and the proceeds from government insured debt of \$51.9 million and a \$600,000 equity contribution (note 9). Commitments outstanding at December 31, 2011, for the construction of the GVI totaled approximately \$41.9 million.

Net property and equipment includes approximately \$14.0 million and \$18.1 million applicable to capital leases at Decembers 31, 2011 and 2010, respectively.

During 2011 and 2010 Kaleida capitalized interest expense of approximately \$3,848,000 and \$719,000, respectively.

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(9) Long-Term Debt

Long-term debt consists of the following at December 31:

	<u>2011</u>	<u>2010</u>
	(Dollars in thousands)	
Mortgage payable in monthly installments of \$625,000, including interest at 5.25% through August 1, 2023. (a)	\$ 65,343	69,301
Mortgage payable in monthly installments of \$314,000 including interest at 3.29% through April 1, 2020. (a)	40,304	45,056
Mortgage notes payable in monthly installments of \$338,000, including interest at 5.05%, through October 1, 2033. (a)	53,519	54,831
Mortgage notes payable in monthly installments of \$107,000, including interest at 5.05%, through February 1, 2032. (a)	16,292	16,746
Mortgage payable in monthly installments of \$48,000 including interest at 6.25% through July 1, 2024. (a)	—	5,246
Mortgage notes payable with interest only payments at 6.35% through February 2012. Once fully drawn, monthly principal and interest will be required through February 1, 2037. (a)	63,817	23,330
Mortgage notes payable with interest only payments at 5.73% through February 2012. Once fully drawn, monthly principal and interest will be required through February 1, 2037. (a)	41,238	10,465
Capital lease obligations, less imputed interest of \$277,000 and \$632,000 at December 31, 2011 and 2010, respectively. (b)	6,471	10,492
Equipment notes payable (c)	1,675	—
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.	1,941	2,241
Other	3,868	7,725
	<u>294,468</u>	<u>245,433</u>
Less current maturities	<u>18,223</u>	<u>18,889</u>
	<u>\$ 276,245</u>	<u>226,544</u>

(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.

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On December 4, 2009, Kaleida secured a loan commitment of approximately \$100.3 million by entering into a new mortgage note and building loan agreement. The proceeds from the loan commitment will be used to finance the cost of the development of the GVI in order to carry out the closure of services and relocation from Gates (see note 1). The mortgage note, when fully drawn, will have a 25 year term, fixed monthly payments and an annual interest rate of 6.35%. The mortgage note is insured by HUD. At December 31, 2011, Kaleida has drawn \$63.8 million for costs related to the GVI project.

On September 1, 2010, Kaleida refinanced the existing mortgage of \$46.2 million maturing in April 2020 related to improvements made to both the Millard Fillmore Gates Hospital and the Millard Fillmore Suburban Hospital. Although the principal amount refinanced remained the same, the mortgage term, interest rate and monthly payment were modified. The lender approved the consolidation and realignment of related collateral. The mortgage remains insured by HUD.

On December 7, 2010, Kaleida secured a loan commitment of approximately \$51.9 million by entering into a new mortgage note and building loan agreement. The proceeds from the loan commitment will be used to finance the cost of the construction of a new skilled nursing facility (SNF). The facility will replace the Gates and Deaconess skilled nursing facilities (see note 1). The mortgage note, when fully drawn, will have a 25 year term, fixed monthly payments and an annual interest rate of 5.73%. The mortgage note is insured by HUD. At December 31, 2011, Kaleida has drawn \$41.2 million for costs related to the skilled nursing project.

On July 28, 2011, Waterfront Health Care Center, Inc. paid the balance on its outstanding mortgage in anticipation of DOH's approval of a voluntary receivership agreement executed with the DOH and a third party receiver (see note 15(b)). The receivership agreement was executed in June 2011 and approved by the DOH in August 2011, with an effective date of August 15, 2011.

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, December 4, 2009, and December 7, 2010. As required under the Mortgage Reserve, Kaleida is required to maintain a certain balance either through deposits or investment earnings. Failure to comply with these requirements may result in oversight activities by HUD.

At December 31, 2011, Kaleida was not in compliance with the required debt service coverage ratio. As a result, Kaleida will require HUD approvals for short-term borrowings, leases or other long-term debt obligations over threshold amounts and for certain transactions with affiliates in future periods.

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Under the terms of the borrowing agreements, Kaleida established certain bank trustee accounts which include the Mortgage Reserve Fund and Kaleida's equity contribution for the GVI project. 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:

	2011	2010
	(Dollars in thousands)	
Mortgage reserve fund	\$ 34,444	39,489
GVI project equity	8,032	8,018
SNF project equity	—	3,324
	<u>\$ 42,476</u>	<u>50,831</u>

Construction costs payable at year end will be paid with proceeds advanced from the HUD insured loan commitments secured by Kaleida in 2010.

(b) *Capital Leases*

The majority of the capital lease obligations represent arrangements entered into with a bank 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).

(c) *Equipment Notes Payable*

In March 2010, Kaleida Health entered into an equipment financing agreement with High Street Developments, LLC. The maximum aggregate principal amount of credit that can be extended under the agreement is \$10 million. Interest is payable monthly and is calculated at the five year tax exempt lease rate minus one quarter of one percent. At December 31, 2011 there was approximately \$1.7 million of borrowings on the financing agreement, which represents two 5 year notes which bear interest at approximately 1.3% payable monthly through October 2016. There were no such borrowings outstanding at December 31, 2010.

Future annual principal payments of long-term debt for the next five years as of December 31, 2011 are as follows (dollars in thousands):

2012	\$ 18,223
2013	18,490
2014	16,593
2015	16,792
2016	17,515

Line of Credit

In October 2009, Kaleida entered into a Revolving Credit Loan Agreement (Loan Agreement) with a financial institution. The Loan Agreement, which was renewed in October 2011 for a two year term,

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requires Kaleida to payoff the outstanding balance annually for a period of twenty business days. The maximum aggregate principal amount of credit that can be extended under the Loan Agreement is \$20 million. Interest is payable monthly and is calculated at the greater of the one day LIBOR rate plus a margin of 2.25% or the one month LIBOR rate plus a margin of 2.25%. Kaleida also pays monthly an unused facility fee equal to 20 basis points per year on the average unused daily balance. DASNY and HUD agreed to subordinate their security interest in the first \$30 million worth of patient accounts receivable to the bank as collateral for borrowings on the Loan Agreement. At December 31, 2011 and 2010, \$10 million was outstanding on the Loan Agreement which bears interest at 2.56% and 3.5% at December 31, 2011 and 2010, respectively.

(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 was approximately \$28.5 million and \$27.5 million in 2011 and 2010, respectively. Future minimum payments under noncancelable operating leases as of December 31, 2011 having lease terms in excess of one year are as follows (dollars in thousands):

2012	\$	17,360
2013		15,098
2014		14,720
2015		14,614
2016		14,540

(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 (ERISA). The amount to be funded is subject to annual review by management and Kaleida's consulting actuary.

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

	<u>2011</u>	<u>2010</u>
	(Dollars in thousands)	
Change in projected benefit obligation:		
Benefit obligation at beginning of year	\$ 557,813	478,339
Service cost	20,983	18,229
Interest cost	30,047	28,083
Actuarial losses	70,967	46,502
Benefits paid	<u>(15,443)</u>	<u>(13,340)</u>
Benefit obligation at end of year	<u>\$ 664,367</u>	<u>557,813</u>
Change in plan assets:		
Fair value of plan assets at beginning of year	\$ 387,600	326,036
Actual return on plan assets	5,586	42,204
Employer contributions	28,481	32,700
Benefits paid	<u>(15,443)</u>	<u>(13,340)</u>
Fair value of assets at end of year	<u>\$ 406,224</u>	<u>387,600</u>

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

	<u>2011</u>	<u>2010</u>
	(Dollars in thousands)	
Funded status at end of year:		
Fair value of plan assets	\$ 406,224	387,600
Projected benefit obligation	<u>664,367</u>	<u>557,813</u>
Pension obligation recognized in the consolidated balance sheets at end of year	<u>\$ (258,143)</u>	<u>(170,213)</u>
Amount recorded in unrestricted net assets at end of year:		
Net actuarial loss	\$ (261,594)	(169,382)
Prior service costs	<u>(1,317)</u>	<u>(1,238)</u>
	<u>\$ (262,911)</u>	<u>(170,620)</u>

The estimated prior service cost and net actuarial loss that will be amortized from unrestricted net assets in 2012 are approximately \$257,000 and \$17.8 million, respectively.

The accumulated benefit obligations at the Plan's measurement date for 2011 and 2010 was approximately \$553 million and \$480 million, respectively.

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December 31, 2011 and 2010

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

	2011	2010
	(Dollars in thousands)	
Service cost	\$ 20,983	18,229
Interest cost	30,047	28,083
Expected return on plan assets	(35,203)	(31,888)
Amortization of net prior service credit	(80)	(191)
Amortization of actuarial loss	8,372	3,792
Net periodic pension cost	<u>\$ 24,119</u>	<u>18,025</u>

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

	2011	2010
Discount rate for benefit obligations	4.70%	5.49%
Discount rate for net pension cost	5.49	6.00
Rate of compensation increase	4.00	4.00
Expected long-term rate of return on plan assets	8.50	8.50

The investment policy specifies the type of investment vehicles appropriate for the plan, asset allocation guidelines, criteria for selection of investment managers, procedures to maintain overall investment performance, as well as investment manager performance. 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 evaluated based on current capital market assumptions and investment allocations.

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The range of target investment allocation percentages at December 31, 2011 are listed below:

Cash	0 – 5%
Equity securities:	
Domestic	2 – 6%
International	6 – 8%
Fixed income securities:	
Diversified Bonds	10 – 12%
High Yield	3 – 5%
Emerging market	2 – 4%
Other:	
Global asset	13 – 15%
Risk parity	13 – 17%
Hedge funds	0 – 17%
Private equity	0 – 15%
Real assets	4 – 11%
Opportunistic funds	0 – 10%

The following tables present Kaleida's defined benefit pension plan's assets at December 31, 2011 and 2010 that are measured at fair value on a recurring basis. The hierarchy and inputs to valuation techniques to measure fair value of the plan's assets are the same as outlined above in note 7 of the consolidated financial statements (dollars in thousands):

		2011					
		Total	Level 1	Level 2	Level 3	Redemption frequency	Days Notice
Investments:							
Cash and cash equivalents	\$	24,890	24,890	—	—	Daily	Same day
Insurance contract		3,593	—	3,593	—	Daily	Same day
Marketable equity securities:							
Large-cap securities		39,608	31,198	8,410	—	Daily-monthly	Same day – 9 days
International securities		71,348	—	71,348	—	Daily-monthly	2 days – 30 days
Equity and fixed income mutual funds		84,406	84,406	—	—	Daily	Same day
Limited partnerships:							
Hedge funds		51,877	—	50,280	1,597	Monthly – semi-annually	20 – 100 days
Private equity		26,782	—	—	26,782	See note 7(a)	See note 7(a)
Global equity		67,327	—	67,327	—	Daily-monthly	3 days – 30 days
Domestic equity		9,634	—	—	9,634	Annually	60 days
Real assets		14,822	—	—	14,822	See note 7(a)	See note 7(a)
Fixed income		11,937	—	11,937	—	Daily	5-7 days
	\$	<u>406,224</u>	<u>140,494</u>	<u>212,895</u>	<u>52,835</u>		

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2010						
	Total	Level 1	Level 2	Level 3	Redemption frequency	Days Notice
Investments:						
Cash and cash equivalents	\$ 17,621	17,621	—	—	Daily	Same day
Insurance contract	3,931	—	3,931	—	Daily	Same day
Marketable equity securities:						
Large-cap securities	62,368	46,939	15,429	—	Daily-monthly	Same day – 60 days
International securities	107,243	—	107,243	—	Daily-monthly	2 days – 30 days
Equity and fixed income mutual funds	87,036	77,089	9,947	—	Daily-monthly	Same day – 60 days
Limited partnerships:						
Hedge funds	32,179	—	—	32,179	Quarterly-bi-annually	60-65 days
Private equity	19,518	—	—	19,518	See note 7(a)	See note 7(a)
Global equity	28,058	—	28,058	—	Daily-monthly	3 days – 30 days
Domestic equity	19,733	—	—	19,733	Annually	60 days
Real assets	9,913	—	—	9,913	See note 7(a)	See note 7(a)
	<u>\$ 387,600</u>	<u>141,649</u>	<u>164,608</u>	<u>81,343</u>		

The insurance contract held within Kaleida's defined benefit plan is recorded at contract value which approximates fair value.

Under the terms of certain agreements, Kaleida has committed to contribute a specified level of capital over a defined period of time. Through December 31, 2011, Kaleida has committed to contribute approximately \$73.7 million to such limited partnerships, of which Kaleida has contributed approximately \$38.1 million and has outstanding commitments of \$35.6 million.

The following tables present additional information about the changes in Level 3 assets measured at fair value for the years ended December 31 follows (dollars in thousands):

2011					
	Total	Real assets	Hedge funds	Private equity	Domestic equity
Balance, beginning of year	\$ 81,343	9,913	32,179	19,518	19,733
Purchases	43,976	3,730	4,373	11,357	24,516
Sales	(80,041)	(760)	(35,607)	(9,057)	(34,617)
Realized gains	12,187	311	8,291	2,251	1,334
Realized losses	(2)	—	—	(2)	—
Change in unrealized gains and losses	(4,628)	1,628	(7,639)	2,715	(1,332)
Balance, end of year	<u>\$ 52,835</u>	<u>14,822</u>	<u>1,597</u>	<u>26,782</u>	<u>9,634</u>

KALEIDA HEALTH

Notes to Consolidated Financial Statements

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	2010				
	Total	Real assets	Hedge funds	Private equity	Domestic equity
Balance, beginning of year	\$ 81,567	8,081	30,596	26,499	16,391
Purchases	26,748	4,500	—	22,248	—
Sales	(34,827)	(670)	(148)	(34,009)	—
Realized gains	2,122	5	—	2,117	—
Realized losses	(40)	—	(40)	—	—
Change in unrealized gains and losses	5,773	(2,003)	1,771	2,663	3,342
Balance, end of year	\$ 81,343	9,913	32,179	19,518	19,733

Contributions – For the plan year ended December 31, 2011, Kaleida has contributed \$28.5 million. Expected contributions for the plan year ending December 31, 2012 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):

2012	\$	17,388
2013		19,494
2014		21,797
2015		24,314
2016		27,029
2017 – 2020		183,334

The expected benefits are based on the same assumptions used to measure Kaleida’s benefit obligations at December 31, 2011 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 \$2.6 million and \$2.5 million for 2011 and 2010, respectively.

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(b) *Retiree Health and Life Insurance Plan*

Kaleida also maintains a contributory retiree health and life insurance plan covering only certain eligible employees of DeGraff Memorial Hospital (DeGraff). The following table sets forth the funded status and amounts recognized in the consolidated balance sheets at December 31:

	<u>2011</u>	<u>2010</u>
	(Dollars in thousands)	
Accumulated postretirement obligation at end of year	\$ 5,796	5,852
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	\$ <u>(5,796)</u>	<u>(5,852)</u>

Net postretirement benefit cost was approximately \$452,000 and \$451,000 for the years ended December 31, 2011 and 2010, respectively. The weighted average assumptions used to determine postretirement benefit cost and obligations at the Plan's measurement date (December 31):

	<u>2011</u>	<u>2010</u>
Discount rate for benefit obligations	4.50%	5.20%
Discount rate for net postretirement cost	5.20	5.80

For measurement purposes, 2011 increases in the per capita cost of covered health care benefits were assumed for medical and prescription drugs at 7.92%. The rate is assumed to decrease gradually on an annual basis. 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) 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:

	<u>2011</u>	<u>2010</u>
	(Dollars in thousands)	
Balance at beginning of year	\$ 10,685	10,217
Net obligations settled in current period	(26)	(245)
Accretion expense	750	713
Adjustment to estimate	1,621	—
Balance at end of year	\$ <u>13,030</u>	<u>10,685</u>

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December 31, 2011 and 2010

As a result of the consolidation of services from Millard Fillmore Gates anticipated in early 2012 as well as the relocation of services from the Deaconess Skilled Nursing facility in December 2011, Kaleida is evaluating re-use options for the buildings and property, which could include demolition. The net book value at December 31, 2011 of the respective buildings is zero.

(13) Temporarily and Permanently Restricted Net Assets

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

	2011	2010
	(Dollars in thousands)	(Dollars in thousands)
Capital expansion and improvements	\$ 54,373	53,678
Advancement of medical education and research and healthcare services	33,295	59,295
	<u>\$ 87,668</u>	<u>112,973</u>

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

	2011	2010
	(Dollars in thousands)	(Dollars in thousands)
Funds to be held in perpetuity, the income from which is expendable to support healthcare services, including medical research	\$ 10,824	10,824
Funds to be held in perpetuity, the income from which is expendable to support pediatric healthcare services	4,576	4,576
	<u>\$ 15,400</u>	<u>15,400</u>

In 2011 and 2010, net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes of operating expenses of \$5.7 million and \$7.7 million, respectively, and purchases of equipment of \$30.0 million and \$24.6 million, respectively.

(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:

	2011	2010
	(Dollars in thousands)	(Dollars in thousands)
Healthcare services	\$ 1,033,725	1,013,584
General and administrative	196,900	173,421
	<u>\$ 1,230,625</u>	<u>1,187,005</u>

KALEIDA HEALTH

Notes to Consolidated Financial Statements

December 31, 2011 and 2010

(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) Disposition of Waterfront Health Care Center

In November 2009, Kaleida filed a request with DOH to close Waterfront Health Care Center (Center). On January 15, 2010, DOH approved the plan of closure. During 2011, Kaleida worked through a process to sell the facility and the operation. In August 2011, Kaleida entered into a voluntary receivership agreement with the intention to sell the facility upon DOH approval. It is anticipated that the transaction will be completed in 2012. In the meantime, the Center is operated at no financial risk to Kaleida by the receiver.

(c) Collective Bargaining Agreements

A significant portion of Kaleida employees work under collective bargaining agreements which were renegotiated in 2011. The new agreements have a duration of two years and will expire in May 2013.

KALEIDA HEALTH
Consolidating Balance Sheet
December 31, 2011
(Dollars in thousands)

Assets	Hospital	Home Care	Foundations	Waterfront and other subsidiaries	Reclasses and eliminations	December 31, 2011 consolidated
Current assets:						
Cash and cash equivalents	\$ 19,750	16,890	1,993	2,634	—	41,267
Investments	57,319	32,245	49,696	—	—	139,260
Accounts receivable:						
Patient, net	133,855	14,320	—	4,173	—	152,348
Other	12,725	1,357	22	443	(4,517)	10,030
Inventories	19,127	788	—	648	—	20,563
Prepaid expenses and other current assets	11,000	520	81	151	—	11,752
Total current assets	<u>253,776</u>	<u>66,120</u>	<u>51,792</u>	<u>8,049</u>	<u>(4,517)</u>	<u>375,220</u>
Assets limited as to use:						
Designated under debt agreements	42,476	—	—	—	—	42,476
Designated under self-insurance programs	119,368	4,552	—	—	—	123,920
Board designated and donor restricted	21,027	—	64,947	—	—	85,974
Other	1,115	—	—	72	—	1,187
	<u>183,986</u>	<u>4,552</u>	<u>64,947</u>	<u>72</u>	<u>—</u>	<u>253,557</u>
Property and equipment, less accumulated depreciation and amortization	462,956	2,414	2	12,184	—	477,556
Receivable from insurance recoveries	9,078	—	—	—	—	9,078
Grants receivable	19,307	—	—	—	—	19,307
Deferred financing costs, net	12,194	—	—	15	—	12,209
Interest in net assets of Foundations	117,663	—	—	—	(117,663)	—
Other	14,521	100	3,280	7,442	(18,157)	7,186
Total assets	<u>\$ 1,073,481</u>	<u>73,186</u>	<u>120,021</u>	<u>27,762</u>	<u>(140,337)</u>	<u>1,154,113</u>

KALEIDA HEALTH
Consolidating Balance Sheet
December 31, 2011
(Dollars in thousands)

Liabilities and Net Assets	Hospital	Home Care	Foundations	Waterfront and other subsidiaries	Reclasses and eliminations	December 31, 2011 consolidated
Current liabilities:						
Accounts payable and other accrued expenses	\$ 90,773	1,389	2,358	1,162	(409)	95,273
Accrued payroll and related expenses	49,588	4,777	—	523	—	54,888
Line of credit	10,000	—	—	—	—	10,000
Estimated third-party payor settlements	21,910	1,202	—	176	—	23,288
Current portion of long-term debt	17,824	—	—	399	—	18,223
Other current liabilities	7,912	119	—	4,665	(3,574)	9,122
Total current liabilities	198,007	7,487	2,358	6,925	(3,983)	210,794
Long-term debt, less current portion	274,147	—	—	2,098	—	276,245
Construction costs payable	13,290	—	—	—	—	13,290
Estimated self-insurance reserves	161,174	4,440	—	2,714	—	168,328
Asset retirement obligations	13,030	—	—	—	—	13,030
Pension and postretirement obligations	264,767	—	—	—	—	264,767
Other long-term liabilities	14,111	—	—	6,516	(7,392)	13,235
Total liabilities	938,526	11,927	2,358	18,253	(11,375)	959,689
Net assets:						
Unrestricted	31,887	61,259	56,684	9,509	(67,983)	91,356
Temporarily restricted	87,668	—	53,520	—	(53,520)	87,668
Permanently restricted	15,400	—	7,459	—	(7,459)	15,400
Total net assets	134,955	61,259	117,663	9,509	(128,962)	194,424
Total liabilities and net assets	\$ 1,073,481	73,186	120,021	27,762	(140,337)	1,154,113

See accompanying independent auditors' report.

KALEIDA HEALTH

Consolidating Statement of Operating Revenue and Expenses

Year ended December 31, 2011

(Dollars in thousands)

	Hospital	Home Care	Foundations	Waterfront and other subsidiaries	Reclasses and eliminations	December 31, 2011 consolidated
Operating revenue:						
Net patient service revenue	\$ 1,077,053	76,769	—	24,597	—	1,178,419
Other operating revenue	16,097	106	2,693	1,133	(1,085)	18,944
Net assets released from restrictions for operations	3,370	—	2,377	—	—	5,747
Total operating revenue	1,096,520	76,875	5,070	25,730	(1,085)	1,203,110
Operating expenses:						
Salaries and benefits	622,922	50,121	1,015	15,349	(189)	689,218
Purchased services and other	206,178	8,531	3,013	6,181	(896)	223,007
Medical and non-medical supplies	208,559	9,023	10	5,401	—	222,993
Depreciation and amortization	56,640	1,254	5	765	—	58,664
Provision for bad debts	16,734	1,494	—	511	—	18,739
Interest	10,228	—	—	323	—	10,551
Total operating expenses	1,121,261	70,423	4,043	28,530	(1,085)	1,223,172
(Loss) income from operations	(24,741)	6,452	1,027	(2,800)	—	(20,062)
Other income (losses):						
Investment income	185	145	1,119	258	—	1,707
Net realized gains on sale of investments	7,585	1,994	2,890	—	—	12,469
Net change in unrealized gains and losses on investments	(7,915)	(2,361)	(3,530)	177	—	(13,629)
Restructuring charges	(7,453)	—	—	—	—	(7,453)
Total other (losses) income, net	(7,598)	(222)	479	435	—	(6,906)
(Deficiency) excess of revenue over expenses	\$ (32,339)	6,230	1,506	(2,365)	—	(26,968)

See accompanying independent auditors' report.