KPMG

KALEIDA HEALTH

Consolidated Financial Statements

December 31, 2017 and 2016

(With Independent Auditors' Report Thereon)

KALEIDA HEALTH

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KPMG

KPMG LLP
500 Seneca Street
Suite 600
Buffalo, New York 14204

Independent Auditors' Report

To the Board of Directors
Kaleida Health:

We have audited the accompanying consolidated financial statements of Kaleida Health (Kaleida), which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of operations and changes in net assets, and cash flows for each of the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the financial statements of Upper Allegany Health Services, which consists of Bradford Regional Medical Center and Olean General Hospital, both wholly owned subsidiaries, whose statements reflect total assets constituting 11% of consolidated total assets as of December 31, 2017, and total operating revenue constituting 6% of consolidated total operating revenue for the year ending December 31, 2017. Those statements were audited by other auditors, whose report have been furnished to us, and our opinion, insofar as it relates to the amounts included for Upper Allegany Health Services, is based solely on the reports of the other auditors. 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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, 2017 and 2016, and results of its operations and changes in net assets, and its cash flows for each of the years then ended, in accordance with U.S. generally accepted accounting principles.

KPMG LLP

April 30, 2018

KALEIDA HEALTH

Consolidated Balance Sheets

December 31, 2017 and 2016

(Dollars in thousands)

Assets		**2017**	**2016**
Current assets:			
Cash and cash equivalents	$	37,385	45,783
Investments (notes 6 and 7)		213,383	176,970
Accounts receivable:			
Patient, less estimated allowance for doubtful accounts of $31,004 in 2017 and $32,009 in 2016		251,977	195,458
Other (note 9)		34,213	28,386
Grants receivable		16,243	16,243
Estimated third-party payor receivables (note 4)		14,120	14,452
Inventories		42,379	33,857
Prepaid expenses and other current assets		28,284	20,775
Total current assets		637,984	531,924
Assets limited as to use (notes 5, 6, 7, and 10):			
Designated under debt agreements		40,892	45,276
Designated under self-insurance programs		101,174	102,152
Board designated and donor restricted		142,864	85,049
Other		2,006	1,919
		286,936	234,396
Property and equipment, less accumulated depreciation and amortization (notes 8 and 10)		755,078	595,950
Grants receivable		—	2,585
Other (note 9)		69,796	63,181
Total assets	$	1,749,794	1,428,036

(Continued)

KALEIDA HEALTH

Consolidated Balance Sheets

December 31, 2017 and 2016

(Dollars in thousands)

Liabilities and Net Assets		2017	2016
Current liabilities:			
Accounts payable and other accrued expenses	$	149,355	119,881
Accrued payroll and related expenses		68,144	54,674
Construction costs payable		11,269	12,306
Estimated third-party payor settlements (note 4)		22,598	19,677
Current portion of long-term debt (note 10)		36,546	25,193
Line of credit (note 6)		10,000	—
Other current liabilities		9,786	7,820
Total current liabilities		307,698	239,551
Long-term debt, less current portion (note 10)		407,291	336,519
Estimated self-insurance reserves (note 5)		155,410	154,127
Asset retirement obligations (note 13)		11,185	13,601
Pension and postretirement obligations (note 12)		359,876	288,441
Other long-term liabilities (note 4)		3,241	4,852
		937,003	797,540
Total liabilities		1,244,701	1,037,091
Commitments (notes 8 and 11)			
Net assets:			
Unrestricted:			
Available for operations		740,425	583,659
Provision for future benefit costs (note 12)		(381,845)	(298,785)
Total unrestricted		358,580	284,874
Temporarily restricted (note 14)		101,550	85,831
Permanently restricted (note 14)		44,963	20,240
Total net assets		505,093	390,945
Total liabilities and net assets	$	1,749,794	1,428,036

See accompanying notes to consolidated financial statements.

KALEIDA HEALTH

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2017 and 2016

(Dollars in thousands)

		2017	2016
Operating revenue:			
Patient service revenue, net of contractual allowances and discounts (notes 3 and 4)	$	1,621,831	1,466,437
Less provision for bad debts		19,937	16,765
Net patient service revenue		1,601,894	1,449,672
Other operating revenue (notes 6 and 15)		55,875	41,418
Net assets released from restrictions for operations (note 14)		8,693	5,555
Total operating revenue		1,666,462	1,496,645
Operating expenses:			
Salaries and benefits		922,538	846,628
Purchased services and other		325,327	273,213
Medical and nonmedical supplies		311,052	267,129
Depreciation and amortization		66,433	65,809
Interest		13,797	13,599
Total operating expenses		1,639,147	1,466,378
Income from operations		27,315	30,267
Other income:			
Investment income (note 6)		22,779	8,852
Net realized gains on sales of investments (note 6)		2,863	6,288
Net change in unrealized gains on investments (note 6)		8,520	2,858
Loss on impairment and disposal of assets (note 8)		(12,198)	—
Total other income, net		21,964	17,998
Excess of revenue over expenses, before effect of affiliation, net		49,279	48,265

(Continued)

KALEIDA HEALTH

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2017 and 2016

(Dollars in thousands)

		2017	2016
Excess of revenue over expenses, before effect of affiliation	$	49,279	48,265
Effect of affiliation (note 17)		41,584	—
Excess of revenues over expenses, after effect of affiliation		90,863	48,265
Unrestricted net assets:			
Pension and postretirement related changes other than net periodic cost (note 12)		(50,212)	(42,555)
Contributions for capital acquisitions		12,588	19,586
Net assets released from restrictions for capital expenditures		16,721	21,787
Other, net		3,746	526
Increase in unrestricted net assets		73,706	47,609
Temporarily restricted net assets:			
Contributions, bequests, and grants		5,314	5,249
Restricted investment income		9,342	4,405
Effect of affiliation (note 17)		20,218	—
Net change in unrealized gains on investments		6,259	292
Net assets released from restrictions for operations		(8,693)	(5,555)
Net assets released from restrictions for capital expenditures		(16,721)	(21,787)
Increase (decrease) in temporarily restricted net assets		15,719	(17,396)
Permanently restricted net assets:			
Contributions		509	507
Effect of affiliation (note 17)		24,214	—
Increase in permanently restricted net assets		24,723	507
Increase in net assets		114,148	30,720
Net assets, beginning of year		390,945	360,225
Net assets, end of year	$	505,093	390,945

See accompanying notes to consolidated financial statements.

KALEIDA HEALTH

Consolidated Statements of Cash Flows

Years ended December 31, 2017 and 2016

(Dollars in thousands)

		2017	2016
Operating activities:			
Change in net assets	$	114,148	30,720
Adjustments to reconcile change in net assets to net cash provided by operating activities:			
Depreciation and amortization		66,433	65,809
Effect of affiliation		(86,016)	—
Loss on impairment and disposal of assets		12,198	—
Accretion expense		785	430
Restricted contributions and bequests		(23,334)	(14,765)
Restricted grants		(2,415)	(19,266)
Change in interests in other investments		(20,850)	(3,596)
Net change in unrealized gains on investments		(14,779)	(3,150)
Net realized gains and losses on investments		(12,205)	(10,693)
Provision for bad debts		19,937	16,765
Pension and postretirement related changes other than net periodic cost		50,212	42,555
Change in operating assets and liabilities:			
Patient accounts receivable		(76,455)	(24,183)
Estimated third-party payor receivables		332	7,452
Other receivables, inventories, and prepaid expenses		(21,858)	(12,678)
Accounts payable, accrued expenses, accrued payroll, and construction costs payable		41,907	10,293
Estimated third-party payor settlements		2,921	(3,578)
Other assets		(6,615)	7,086
Other liabilities		19,661	(22,008)
Net cash provided by operating activities		64,007	67,193
Investing activities:			
Additions to property and equipment, net of change in capital acquisitions included in accounts payable		(159,805)	(138,754)
Purchases of investments		(168,066)	(477,485)
Proceeds from sales of investments		188,005	475,689
Change in cash restricted for use		(439)	878
Cash paid for acquisitions		—	(1,100)
Capital contributions to joint venture		—	(300)
Net cash used in investing activities		(140,305)	(141,072)
Financing activities:			
Principal payments on debt and capital lease obligations		3,620	(19,724)
Proceeds from restricted contributions and bequests		23,334	14,765
Proceeds from line of credit		10,000	—
Proceeds from restricted grants		5,000	5,000
Proceeds from long-term debt		26,581	55,207
Payments for deferred financing fees		(635)	(813)
Net cash provided by financing activities		67,900	54,435
Net decrease in cash and cash equivalents		(8,398)	(19,444)
Cash and cash equivalents, beginning of year		45,783	65,227
Cash and cash equivalents, end of year	$	37,385	45,783
Supplemental disclosures on cash flow activities:			
Capital lease obligations	$	49,872	12,923
Interest paid		17,377	16,491
Capital acquisitions included in accounts payable		12,967	11,943

See accompanying notes to consolidated financial statements.

(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 Suburban Hospital, DeGraff Memorial Hospital, and two hospital based nursing facilities), Visiting Nursing Association of WNY, Inc., VNA Home Care Services, Inc., General Physician, P.C. and its subsidiaries (General Physicians), Great Lakes Physicians, P.C. (Great Lakes), several other subsidiaries, and two charitable foundations that raise funds for Kaleida.

Effective July 3, 2017, Kaleida entered into an affiliation agreement with Upper Allegheny Health Services (UAHS), in which Kaleida became the active parent and sole corporate member of UAHS. UAHS is a not-for-profit management holding corporation and the sole corporate member of Olean General Hospital (Olean), which provides inpatient, outpatient and emergency care services for residents of the southern tier of western New York, and Bradford Regional Medical Center (BRMC) and its controlled subsidiaries, which provide acute inpatient, outpatient, long-term nursing care, and home care services primarily to residents of Northwest Pennsylvania. The affiliation was consummated to enhance their common mission of promoting the health of the communities they serve. For the period from July 3, 2017 through December 31, 2017, the effect of this affiliation is included within the accompanying consolidated financial statements as of and for the year ended December 31, 2017 (see note 17).

(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 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.

The consolidated financial statements include the accounts of Kaleida and its wholly owned subsidiaries and those financial statements where Kaleida controls professional corporations in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 810, *Consolidation*. 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 available to be issued on April 30, 2018 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 assets acquired through business combinations, asset impairment losses, the allowance for doubtful accounts, estimated third-party payor settlements, self-insurance reserves, 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 deposited in short-term interest-bearing accounts. 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(m), 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 by commercial and government insurance plans. Patient accounts receivable is reported net of the estimated allowance for doubtful accounts. Additions to the estimated allowance for doubtful accounts are made by means of the provision for bad debts. The provision for bad debts primarily relates to patients without insurance and to those that are either underinsured or without the necessary resources to pay coinsurance and deductible balances. 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. Net patient service revenue from Medicare and New York State Medicaid, and commercial insurance plans accounted for approximately 39%, 21% and 40%, of total net patient service revenue for the year ended December 31, 2017 and 38%, 22% and 40% for the year ended December 31, 2016. Significant concentrations of patient accounts receivable at December 31, 2017 include 17% Medicare, 10% Medicaid, and 40%

commercial insurance plans. Significant concentrations of patient accounts receivable at December 31, 2016 include 16% Medicare, 10% Medicaid, and 38% commercial insurance plans. Kaleida is dependent on these payors to carry out its operating activities.

(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(m) 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 other investments, and change in unrealized gains and losses) is included in 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, and funds generated by and used to support operations 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 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.

(Continued)

Depreciation is generally computed under the straight line method using date of service for buildings, fixtures and improvements, and the half-year convention for moveable equipment 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 50 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.

Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

(j) 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 and pharmaceutical coverage. Kaleida has recorded a provision for estimated claims which is based on Kaleida's own experience and includes the estimated ultimate cost of reported claims and claims incurred but not yet reported.

(k) 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.

(l) Endowment Funds

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

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.

(Continued)

(m) 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)* and ASU 2015-07, *Disclosures for Investments in Certain Entities that Calculate NAV per Share (or its Equivalent) (ASU 2015-07)*. 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. ASU 2015-07 removes the requirement to classify within the fair value hierarchy table in Levels 2 or 3 investments in certain funds measured at NAV or its equivalent as a practical expedient to estimate fair value.

(n) Goodwill

Goodwill is an asset representing the future economic benefit arising from assets acquired in a business combination that are not separately identified and recognized. Goodwill is reviewed for impairment at least annually in accordance with the provisions of ASC Topic 350, *Intangibles – Goodwill and Other*. In September 2011, the FASB issued ASU 2011-08, *Intangibles-Goodwill and Other (Topic 350): Testing Goodwill for Impairment.* This ASU permits an entity to make a qualitative assessment (step zero analysis) of whether it is more likely than not that a reporting unit's fair value is less than its carrying amount before applying a two-step quantitative goodwill impairment test. If an entity concludes it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, it need not perform the two-step quantitative impairment test.

If considered necessary, under the first step, the fair value of the reporting unit is compared with its carrying value (including goodwill). If the fair value of the reporting unit is less than its carrying value, an indication of impairment exists for the reporting unit and the enterprise must perform step two of the impairment test (measurement). Under step two, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation and the residual fair value after this allocation is the implied fair value of the reporting unit goodwill. Fair value of the reporting unit is determined using a discounted cash flow analysis. If the fair value of the reporting unit exceeds its carrying value, step two does not need to be performed.

Accordingly, Kaleida performed a step zero analysis in the current and the prior year. This qualitative assessment considers various factors. Under this analysis Kaleida determined that it is more likely than not that the fair value of the reporting unit exceeds its carrying value. Based on this analysis, a further goodwill impairment assessment was not required to be performed. No impairment losses have been recorded in 2017 or 2016.

(o) Debt Issuance Costs

Kaleida has capitalized various costs associated with obtaining long-term financing. Debt issuance costs and original issue discounts are amortized over the period the related obligation is outstanding, generally using the interest method.

(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.

On December 22, 2017, the President signed into law H.R. 1, originally known as the Tax Cuts and Jobs Act. The new law includes several provisions that result in changes to the tax treatment of tax-exempt organizations and their donors. Kaleida has reviewed these provisions and the potential impact and concluded the enactment of H.R. 1 will not have a material effect on the operations of the organization.

(q) Excess of Revenue over Expenses, after Effect of Affiliation

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.

The consolidated statements of operations and changes in net assets include a performance indicator, the excess of revenue over expenses, after the effect of affiliation. Changes in unrestricted net assets which are excluded from the excess of revenue over expenses consistent with generally accepted accounting principles 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 various funds, are reported as operating revenue and expenses in the determination of Kaleida's operating results. Investment trading activities and peripheral transactions (i.e. nonrecurring restructuring charges and gains and losses related to the disposal or impairment of fixed assets) are reported as other income or losses.

(r) *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, equity securities, other alternative investments funds, and fixed income mutual funds, 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 commercial insurance plans. Kaleida has not historically incurred any significant concentrated credit losses in the normal course of business.

(s) *Reclassifications*

Certain amounts in the 2016 consolidated financial statements have been reclassified to conform to 2017 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.

To enhance and accelerate the charity care qualification process, Kaleida utilizes 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. 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 patient service revenue in the consolidated financial statements.

Kaleida's net cost of charity care, including payments to and receipts from the statewide pool was approximately $11.3 million in 2017 and $9.6 million in 2016 as follows:

		Year ended December 31	
		2017	2016
		(Dollars in thousands)	
Charity care at cost	$	6,303	4,676
Payments to statewide pool		8,588	8,796
Receipts from statewide pool		(3,566)	(3,870)
Cost of charity care, net	$	11,325	9,602

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

(Continued)

(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, including medically underserved populations. Programs and services 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 pediatric 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 a large 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.

(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 State All Patient Defined Diagnosis Related Groups (APR-DRGs) for Medicaid and other NonMedicare 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 New York State Public Health Law, all NonMedicare 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).

Kaleida has entered into an agreement with the Center for Medicare and Medicaid Services under the Bundled Payments for Care Improvement initiative. This initiative is comprised of four broadly defined models of care, which link payments for multiple services beneficiaries receive during an episode of care. Under the initiative, organizations enter into payment arrangements that include financial and performance accountability for episodes of care. Kaleida participates in Model 2, which involves a retrospective bundled payment arrangement where actual expenditures are reconciled against a target price for an episode of care. Under this payment model, Medicare continues to make fee-for-service (FFS) payments to providers and suppliers furnishing services to beneficiaries in Model 2 episodes. The total expenditures for a beneficiary's episode is later reconciled against a bundled payment amount (the target price) determined by CMS. A payment or recoupment amount is then made by Medicare reflecting the aggregate performance compared to the target price. In Model 2, the episode of care includes a Medicare beneficiary's inpatient stay in the acute care hospital, post-acute care and all related services during the episode of care, which for Kaleida ends 90 days after hospital discharge. Of the available 48 different clinical episodes to participate in, Kaleida Health has selected 6 episodes.

(b) Skilled Nursing and Home Health Care Services

Net patient service revenue for skilled nursing services under the Medicaid program is based on a statewide pricing system using the Resource Utilization Group (RUGs) patient classification system. DOH calculates direct and indirect portions of Kaleida's rate by blending equally a statewide and a peer group component determined by DOH using 2007 filed cost report data as the base year for allowable costs. Capital and noncomparable costs are based on facility specific costs. Also, the direct portion of Kaleida's rate is adjusted twice annually for changes in the intensity of services provided to the nursing home residents. With respect to long-term care, New York State began transitioning Medicaid patients into managed care programs in 2011, after the state's Medicaid Redesign Team recommended care management for all as a means of reducing costs while maintaining quality. Medicaid recipients of long-term care moved into managed care in 2012. This required providers to negotiate long-term care agreements with managed-care plans to provide services to people who need long-term care services and support. Also, in 2014, New York State began enrolling individuals in the Managed long-term care program. This program focused on the chronically ill or disabled and began with Medicare/Medicaid dual-eligible beneficiaries. This program was expanded to a voluntary program for certain qualifying individuals.

Home health care services for Medicare are reimbursed under a prospective payment system (PPS) basis, 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. Local Medicare Advantage plans utilize a modified version of the PPS reimbursement methodology. Effective May 1, 2012, Medicaid began reimbursing for certified home health care visits on a per episode basis similar to Medicare. For all other 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 2017 and 2016, Kaleida recorded adjustments for estimated settlements with third-party payors, which resulted in increases to net patient service revenue of approximately \$5.3 million and \$3.0 million, respectively.

(Continued)

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 substantial 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 self-insured workers' compensation is discounted at 3.13% at December 31, 2017 and 2016. Estimated self-insurance reserves are approximately $155.4 million and $154.1 million at December 31, 2017 and 2016, respectively. As of December 31, 2017 and 2016, there are no material amounts recoverable from Kaleida's excess liability policies.

At December 31, 2017 and 2016, Kaleida has irrevocable secured letters of credit supporting the medical malpractice and workers compensation self-insurance programs totaling approximately $4.4 million at December 31, 2017 and 2016, respectively. The annual fee for the letters of credit ranges between 75 and 85 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 on self-insured investments in the amount of $38.5 million and $37.9 million at December 31, 2017 and 2016, respectively.

At December 31, 2017 and 2016, 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.

(6) Investments and Assets Limited as to Use

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

	2017	2016
	(Dollars in thousands)	
Current investments:		
Cash and cash equivalents	$ 2,389	4,460
Equity and fixed income mutual funds	42,442	30,339
Equity securities	92,453	83,832
Other investments	76,099	58,339
	213,383	176,970
Assets limited as to use:		
Designated under debt agreements:		
Cash and cash equivalents	2,645	2,949
U.S. government obligations	38,247	42,327
	40,892	45,276
Designated under self-insurance programs:		
Cash and cash equivalents	4,844	4,380
Equity and fixed income mutual funds	50,974	51,807
Equity securities	24,428	23,547
Other investments	20,928	22,418
	101,174	102,152
Board designated and donor restricted:		
Cash and cash equivalents	8,374	6,675
U.S. government obligations	1,285	259
Equity and fixed income mutual funds	16,593	13,513
Equity securities	82,835	38,240
Other investments	33,777	26,362
	142,864	85,049
Other:		
Cash and cash equivalents	2,006	1,919
	286,936	234,396
Total investments and assets limited as to use	$ 500,319	411,366

(Continued)

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

		2017	2016
		(Dollars in thousands)	
Other operating revenue:			
Interest and dividends	$	8,181	2,712
Other income:			
Investment income:			
Interest and dividends		1,929	5,256
Change in interests in other investments		20,850	3,596
	$	22,779	8,852
Net realized gains on sales of investments	$	2,863	6,288
Net change in unrealized gains and losses on investments		8,520	2,858

(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 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 or 2 measurements).

Other investments: Other investments consist of private, domestic and global equities, real assets, fixed income, and hedge funds. Other 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 other investments 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 and reported separately from investments categorized in Level 1, 2, or 3 in the hierarchy table. 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.

(Continued)

The following tables set forth Kaleida's consolidated financial assets that were accounted for at fair value on a recurring basis and those in which NAV issued as a practical expedient as of December 31, 2017 and December 31, 2016. Investments are classified in their entirety based on the lowest level of input that is significant to the fair value measurement and include related strategy, liquidity, and funding commitments (dollars in thousands):

	2017					
	NAV or equivalent	Level 1	Level 2	Total	Redemption period frequency	Days notice
Investments:						
Cash and cash equivalents	$ —	20,257	—	20,257	Daily	Same day
U.S. government obligations	—	—	39,533	39,533	Daily	Same day
Equity securities:						
Large-cap securities	—	166,019	—	166,019	Daily – monthly	Same day – 9 days
International securities	13,775	19,922	—	33,697	Daily – monthly	2 – 30 days
Equity and fixed income mutual funds	—	110,009	—	110,009	Daily	Same day
Other investments:						
Hedge funds	30,899	—	—	30,899	Monthly – see (a) below	10 days – See (a) below
Private equity	46,553	—	—	46,553	Quarterly – see (a) below	45 days – See (a) below
Global equity	38,920	—	—	38,920	Monthly	3 – 15 days
Domestic equity	10,516	—	—	10,516	Monthly – annually	30 – 60 days
Fixed Income	3,917	—	—	3,917	See (a) below	See (a) below
	$ 144,580	316,207	39,533	500,319		

	2016					
	NAV or equivalent	Level 1	Level 2	Total	Redemption period frequency	Days notice
Investments:						
Cash and cash equivalents	$ —	20,383	—	20,383	Daily	Same day
U.S. government obligations	—	—	42,586	42,586	Daily	Same day
Equity securities:						
Large-cap securities	59	114,833	—	114,892	Daily – monthly	Same day – 9 days
International securities	14,796	15,931	—	30,727	Daily – monthly	2 – 30 days
Equity and fixed income mutual funds	—	95,659	—	95,659	Daily	Same day
Other investments:						
Hedge funds	24,175	—	—	24,175	Monthly – see (a) below	10 days – See (a) below
Private equity	34,770	—	—	34,770	Quarterly – see (a) below	45 days – See (a) below
Global equity	34,922	—	—	34,922	Monthly	3 – 15 days
Domestic equity	13,154	—	—	13,154	Monthly – annually	30 – 60 days
Real assets	98	—	—	98	See (a) below	See (a) below
	$ 121,974	246,806	42,586	411,366		

(a) Certain investments include noncontrolling shares or interests in funds where the controlling general partner serves as the investment manager. Such 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, 2017, Kaleida has committed to contribute approximately $38.8 million to such investments, of which Kaleida has contributed approximately $21.9 million and has outstanding commitments of $16.9 million.

There were no significant transfers into or out of Level 1 and Level 2 fair value measurements during the years ended December 31, 2017 and 2016.

(8) Property and Equipment

A summary of property and equipment at December 31 follows:

	2017	2016
	(Dollars in thousands)	
Land and land improvements	$ 34,835	26,498
Buildings, fixtures, and improvements	1,071,810	845,473
Movable equipment	962,975	670,622
	2,069,620	1,542,593
Less accumulated depreciation and amortization	1,352,597	1,162,243
	717,023	380,350
Construction in progress	38,055	215,600
	$ 755,078	595,950

During 2017, Kaleida completed the construction of the John R. Oishei Children's Hospital adjacent to the Buffalo General Medical Center. The hospital is being financed through mortgage proceeds (note 10), philanthropy, equipment financing, grant awards and hospital equity. Total estimated cost for the project is approximately $268.0 million with commitments outstanding at December 31, 2017 of approximately $8.0 million.

Further, Kaleida sold the former Women and Children's Hospital site and surrounding property in November 2017. Additionally, effective October 1, 2017, Kaleida has reduced the level of services being offered at DeGraff Memorial Hospital.

Accordingly, Kaleida has recorded charges of approximately $12.2 million related to these activities, which has been reflected as a component of other income within the consolidated statements of operations and changes in net assets.

Commitments outstanding at December 31, 2017, for routine capital projects totaled approximately $28.8 million.

Net property and equipment includes approximately $13.4 million and $10.1 million applicable to capital leases at December 31, 2017 and 2016.

During 2017 and 2016 Kaleida capitalized net interest expense of approximately $8.2 million and $2.9 million, respectively.

(9) Other Assets

		2017	2016
		(Dollars in thousands)	
Long term pledges receivable, net (a)	$	6,020	10,878
Note receivable		3,125	3,000
Equity investments in joint ventures (b)		23,474	18,283
Goodwill (c)		27,492	27,492
Other		9,685	3,528
	$	69,796	63,181

(a) Long term pledges receivable include donor contributions that are not expected to be collected within one year. These amounts are reported at their present value and consisted of the following at December 31:

		2017	2016
		(Dollars in thousands)	
Gross pledges receivable	$	6,409	11,583
Less discount and reserve		(389)	(705)
	$	6,020	10,878

Total pledges receivable, which includes $6.0 million and $7.0 million of current pledges receivable included within other receivables on the consolidated balance sheets at December 31, 2017 and 2016, respectively, are expected to be realized in the following periods:

		2017	2016
		(Dollars in thousands)	
Less than one year	$	5,982	7,873
One year to five years		4,422	9,787
More than five years		789	187
	$	11,193	17,847

(Continued)

(b) Investments in partnerships and joint ventures in which Kaleida owns more than 20% but less than 80% or has significant influence on operations are accounted for using the equity method of accounting. Kaleida recognizes its proportionate share of income or loss from their partnership and joint venture investments in the current period and records this income or loss as an increase or decrease in the related investment.

(c) In recent years, General Physicians and Great Lakes Physicians have purchased the assets of several primary care and specialty physician practices. There were no acquisitions during 2017. During 2016, such practices were acquired for consideration totaling $1.1 million, which resulted in the recognition of goodwill of approximately $1.0 million.

(10) Long-Term Debt

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

		2017	2016
		(Dollars in thousands)	
Mortgage notes payable for GVI in monthly installments of $539,000, including interest at 4.24%, through February 1, 2037. (a)	$	84,727	87,535
Mortgage notes payable for HighPointe SNF in monthly installments of $325,000, including interest at 5.73%, through February 1, 2037. (a)		45,395	46,662
Mortgage notes payable for BGMC in monthly installments of $545,000, including interest at 2.44% through August 1, 2023. (a)		34,597	40,222
Mortgage notes payable for MFH in monthly installments of $514,000, including interest at 3.29% through November 1, 2017 and $314,000, including interest at 3.29% through April 1, 2020. (a)		8,461	14,050
Mortgage notes payable for MFS in monthly installments of $338,000, including interest at 4.00%, through October 1, 2033. (a)		44,039	45,983
Mortgage notes payable for BGMC Cath Lab in monthly installments of $107,000, including interest at 3.95%, through February 1, 2032. (a)		12,943	13,611
Mortgage notes payable for John R. Oishei Children's Hospital with interest only payments at 4.18% through October 2017. Thereafter, monthly installments of $645,000, including interest at 4.18% through October 1, 2042. (a)		127,555	101,462
Industrial Development bond payable in monthly fixed principal installments of $25,000 plus interest at 2.21% through January 2013. Thereafter, varying monthly principal and interest installments through June 2018		141	—

(Continued)

		2017	2016
		(Dollars in thousands)	
McKean County Hospital Authority Revenue Refunding Bonds, Series 2005. (b)	$	12,140	—
Industrial Development Agency Revenue Bonds held by bank, varying annual payments of principal plus interest at 2.5%h through October 2030, secured by related property and equipment and Hospital gross receipts. (b)		10,315	—
Capital lease obligations, less imputed interest of $4,234,897 and $2,136,742 at December 31, 2017 and 2016, respectively.(c)		36,260	19,930
Equipment notes payable (d)		32,300	2,761
Other		5,590	585
		454,463	372,801
Debt issuance costs		10,626	11,089
		443,837	361,712
Less current maturities		36,546	25,193
	$	407,291	336,519

(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 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 were used to finance the cost of constructing and equipping the Gates Vascular Institute (GVI). The mortgage note has a 25 year term, fixed monthly payments and an annual interest rate of 6.35%.

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 were used to finance the cost of constructing and equipping Highpointe SNF. The mortgage note has a 25 year term, fixed monthly payments and an annual interest rate of 5.73%.

On September 19, 2012, Kaleida refinanced the existing mortgage of $62.2 million maturing in August 2023 related to improvements made to the Buffalo General Medical Center. Although the principal amount refinanced and mortgage term remained the same, the interest rate and monthly payment were modified. This refinancing was not determined to be a significant modification for financial reporting purposes.

On December 9, 2014, Kaleida secured a loan commitment of approximately $120.0 million by entering into a new mortgage note and building loan agreement. The proceeds from the loan commitment are being used to finance the cost of the construction of the John R. Oishei Children's Hospital adjacent to the Buffalo General Medical Center. Effective November 2017, the new facility replaced the Women and Children's Hospital of Buffalo located on Bryant Street. The mortgage note, when fully drawn, will have a 25 year term, fixed monthly payments and an annual interest rate of 4.18%. In October 2017, HUD returned Kaleida equity contributions securing future project costs and increased the amount of the approved mortgage note by approximately $7.5 million. The mortgage note is insured by HUD and at December 31, 2017, Kaleida has drawn $127.5 million for costs related to the John R. Oishei Children's Hospital project.

On July 22, 2015, Kaleida refinanced the existing mortgage of $48.2 million maturing in October 2033 related to improvements made to the Millard Fillmore Suburban Hospital and the existing mortgage of $14.5 million maturing in February 2032 related to cardiac catheterization laboratory equipment. Although the principal amount refinanced and mortgage term remained the same, the interest rate and monthly payment were modified. This refinancing was not determined to be a significant modification for financial reporting purposes.

On October 28, 2016, Kaleida refinanced the existing mortgage of $87.8 million maturing in February 2037 related to the construction and equipping of the Gates Vascular Institute (GVI). Although the principal amount refinanced and mortgage term remained the same, the interest rate and monthly payment were modified. This refinancing was not determined to be a significant modification for financial reporting purposes.

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, December 7, 2010, September 19, 2012, December 9, 2014, July 22, 2015, and October 28, 2016. As required under the Mortgage Reserve Fund Agreement, 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, 2017 and 2016, Kaleida was in compliance with all applicable debt agreement provisions.

Under the terms of the borrowing agreements, Kaleida established certain bank trustee accounts which include the Mortgage Reserve Fund. Included in the accompanying consolidated balance sheets, classified as assets limited as to use, is Kaleida's balance in this fund at December 31 as follows:

	2017	2016
	(Dollars in thousands)	
Mortgage reserve fund	$ 40,893	45,276

(b) *Upper Allegheny Health Services*

The McKean County Hospital Authority Revenue Refunding Bonds, Series 2005 (the "2005 Bonds") in the original amount of $23.3 million bear interest at 3.50% to 5.25%, are due in graduated installments through October 1, 2030, and are secured by a pledge of and security in the gross revenues of Bradford Regional Medical Center. The 2005 Bonds are insured by ACA Financial Guaranty Corporation (ACA), and the bond agreements contain various financial ratios and covenants with which the Bradford Regional Medical Center is required to comply. These financial ratios include the maintenance of a debt service coverage ratio and days' cash on hand. At December 31, 2017, the Bradford Regional Medical Center did not comply with certain covenants. Waivers were obtained for the appropriate periods, and the loans are presented at December 31, 2017 according to original terms.

On January 12, 2018, the Bradford Regional Medical Center defeased and replaced the 2005 Bonds in part with a $10.5 million bank term note payable in varying monthly amounts of principal plus interest at 4.62% through January 2025, balloon payment of $8.2 million is then due. The loan agreement (along with other UAHS loans) contains various covenants, certain of which pertain to the maintenance of financial ratios, and potential limitations on indebtedness.

The Industrial Development Agency Revenue Bonds and bank term loan agreements contain various covenants, certain of which pertain to the maintenance of financial ratios, and potential limitations on indebtedness.

(c) Capital Leases

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) as well as by private financing institutions. Capital lease obligations increased in 2017 as a result of the equipment necessary for the new John R. Oishei Children's Hospital.

(d) Equipment Notes Payable

In March 2016, Kaleida Health entered into an equipment financing agreement with EB-5 Childrens, LLC and PPNP Investors, LLC. The maximum aggregate principal amount of credit that can be extended under the agreement is $50.0 million. There was approximately $32.2 million of borrowings on the financing agreement at December 31, 2017 which represents a 7 year note which bears interest at approximately 2.0% payable monthly through August 2023.

Future annual principal payments of long-term debt and capital leases for the next five years as of December 31, 2017 are as follows (dollars in thousands):

2018	$	36,546
2019		35,839
2020		34,047
2021		30,960
2022		29,644

Lines 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 2013, October 2015, and again in November 2017 for a six-month term, requires Kaleida to pay off the outstanding balance annually for a period of twenty calendar days. The maximum aggregate principal amount of credit that can be extended under the Loan Agreement is $40.0 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. HUD agreed to subordinate its security interest in the first $50.0 million worth of patient accounts receivable to the bank as collateral for borrowings on the Loan Agreement. Total borrowings outstanding were $10.0 million and $0 at December 31, 2017 and 2016.

UAHS also has available a $2,000,000 bank demand line of credit for working capital with interest payable at LIBOR plus 2.15%, secured by bank deposits. No amounts were outstanding on the line at December 31, 2017.

(11) 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 $46.5 million and $40.0 million in 2017 and 2016, respectively. Future minimum payments under noncancelable operating leases as of December 31, 2017 having lease terms in excess of one year are as follows (dollars in thousands):

2018	$	35,362
2019		29,083
2020		26,581
2021		25,747
2022		25,171

(12) Pension and Other Postretirement Benefits

(a) Kaleida Pension Plans

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.

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

		2017	2016
		(Dollars in thousands)	
Change in projected benefit obligation:			
Benefit obligation at beginning of year	$	824,934	753,691
Service cost		25,116	24,879
Interest cost		30,995	30,096
Plan amendments		—	(234)
Actuarial losses		98,308	40,802
Benefits paid		(26,346)	(24,300)
Benefit obligation at end of year	$	953,007	824,934
Change in plan assets:			
Fair value of plan assets at beginning of year	$	544,875	501,348
Actual return on plan assets		83,586	32,927
Employer contributions		33,435	34,900
Benefits paid		(26,346)	(24,300)
Fair value of assets at end of year	$	635,550	544,875

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

		2017	2016
		(Dollars in thousands)	
Funded status at end of year:			
Fair value of plan assets	$	635,550	544,875
Projected benefit obligation		953,007	824,934
Pension obligation recognized in the consolidated balance sheets at end of year	$	(317,457)	(280,059)
Amount recorded in unrestricted net assets at end of year for future pension cost:			
Net actuarial loss	$	(343,367)	(295,635)
Prior service costs		105	115
	$	(343,262)	(295,520)

The estimated prior service credit and net actuarial loss that will be amortized from unrestricted net assets in 2018 as a component of net periodic pension cost are approximately $11,000 and $14.9 million, respectively.

(Continued)

The accumulated benefit obligations at the Plan's measurement date for 2017 and 2016 was approximately $880.0 million and $766.0 million, respectively.

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

		2017	2016
		(Dollars in thousands)	
Service cost	$	25,116	24,879
Interest cost		30,995	30,096
Expected return on plan assets		(47,954)	(45,160)
Amortization of net prior service (credit) cost		(11)	197
Amortization of actuarial loss		14,944	11,309
Net periodic pension cost	$	23,090	21,321

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

	2017	2016
Discount rate for benefit obligations	3.76 %	4.45 %
Discount rate for net pension cost	4.45	4.77
Rate of compensation increase for benefit obligations	3.00	3.00
Rate of compensation increase for net pension cost	3.00	3.00
Expected long-term rate of return on plan assets	8.00	8.00

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.

The range of target investment allocation percentages at December 31, 2017 are listed below:

Cash	0–5%
Equity securities:	
Domestic	10–20%
International	10–20%
Fixed income securities:	
Diversified bonds	4–20%
Emerging market	0–8%
Other:	
Global asset	4–11%
Risk parity	7–15%
Hedge funds	0–15%
Private equity	0–37%
Real assets	4–16%
Opportunistic funds	0–12%

The following tables present Kaleida's defined benefit pension plan's assets at December 31, 2017 and 2016 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):

	2017					
	NAV or equivalent	Level 1	Level 2	Total	Redemption period frequency	Days Notice
Investments:						
Cash and cash equivalents	$ —	16,815	—	16,815	Daily	Same day
Insurance contract	—	—	1,891	1,891	Daily	Same day
Equity securities:						
Large-cap securities	—	46,138	—	46,138	Daily – monthly	Same day – 9 days
International securities	32,336	22,924	—	55,260	Daily – monthly	2 – 30 days
Equity and fixed income mutual funds	—	178,310	—	178,310	Daily	Same day
Other investments:						
Hedge funds	61,674	—	—	61,674	Monthly – See note 7(a)	20 days – See note 7(a)
Private equity	125,524	—	—	125,524	Quarterly - See note 7(a)	60 days - See note 7(a)
Global equity	127,270	—	—	127,270	Monthly	3 – 15 days
Domestic equity	11,760	—	—	11,760	Monthly – annually	30 – 60 days
Real assets	2,307	—	—	2,307	See note 7(a)	See note 7(a)
Fixed income	8,598	—	—	8,598	Annually	180 days
	$ 369,469	264,187	1,891	635,550		

	2016					
	NAV or equivalent	Level 1	Level 2	Total	Redemption period frequency	Days Notice
Investments:						
Cash and cash equivalents	$ —	11,979	—	11,979	Daily	Same day
Insurance contract	—	—	2,097	2,097	Daily	Same day
Equity securities:						
Large-cap securities	—	42,596	—	42,596	Daily – monthly	Same day – 9 days
International securities	27,446	17,569	—	45,015	Daily – monthly	2 – 30 days
Equity and fixed income mutual funds	—	148,303	—	148,303	Daily	Same day
Other investments:						
Hedge funds	59,099	—	—	59,099	Monthly – See note 7(a)	20 days – See note 7(a)
Private equity	108,098	—	—	108,098	Quarterly - See note 7(a)	60 days - See note 7(a)
Global equity	104,744	—	—	104,744	Monthly	3 – 15 days
Domestic equity	14,359	—	—	14,359	Monthly – annually	30 – 60 days
Real assets	6,102	—	—	6,102	See note 7(a)	See note 7(a)
Fixed income	2,483	—	—	2,483	Annually	180 days
	$ 322,331	220,447	2,097	544,875		

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, 2017, Kaleida has committed to contribute approximately $241.2 million to such investments, of which Kaleida has contributed approximately $169.3 million and has outstanding commitments of $71.9 million.

Contributions – For the calendar year ended December 31, 2017, Kaleida has contributed $33.4 million. Expected contributions for the plan year ending December 31, 2018 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):

2018	$ 31,451
2019	34,381
2020	37,368
2021	40,545
2022	43,464
2023–2027	259,073

The expected benefits are based on the same assumptions used to measure Kaleida's benefit obligations at December 31, 2017 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 $4.2 million and $4.1 million for 2017 and 2016, respectively.

(b) Upper Allegany Health System

Olean sponsors a noncontributory defined benefit pension plan covering substantially all employees. The Hospital's policy is to contribute on an annual basis an amount equal to the minimum funding standards of the Employee Retirement Income Security Act of 1974. In addition, Bradford Regional Medical Center sponsors a noncontributory defined benefit pension plan covering substantially all employees active through March 31, 2011. The Medical Center's policy is to contribute on an annual basis an amount equal to the minimum funding standards of the Employee Retirement Income Security Act of 1974.

Olean General Hospital partially froze the defined benefit pension plan effective April 1, 2011 by freezing all non-union participant benefits as of that date. An enhanced defined contribution Section 403(b) savings incentive plan replaced the pension benefits for non-union employees. Bradford Medical Center froze the defined benefit pension plan effective April 1, 2011 by freezing all participant benefits as of that date. An enhanced defined contribution Section 403(b) savings incentive plan replaced the pension benefits.

The following table provides the changes in the projected benefit obligation and plan assets from July 3, 2017 to December 31, 2017:

		Olean	Bradford	Total
			(Dollars in thousands)	
Change in projected benefit obligation:				
Benefit obligation at beginning of year	$	35,304	34,040	69,344
Service cost		365	—	365
Interest cost		626	649	1,275
Actuarial losses (gains)		2,100	996	3,096
Benefits paid		(631)	(518)	(1,149)
Benefit obligation at end of year	$	37,764	35,167	72,931
Change in plan assets:				
Fair value of plan assets at beginning of the year	$	19,103	18,714	37,817
Actual return on plan assets		941	1,084	2,025
Employer contributions		808	549	1,357
Benefits paid		(631)	(518)	(1,149)
Fair value of assets at end of year	$	20,221	19,829	40,050

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

		Olean	Bradford	Total
			(Dollars in thousands)	
Funded status at end of year:				
Fair value of plan assets	$	20,221	19,829	40,050
Projected benefit obligation		(37,764)	(35,167)	(72,931)
Pension obligation recognized in the consolidated balance sheets at end of year	$	(17,543)	(15,338)	(32,881)
Amount recorded in unrestricted net assets at end of year for future pension cost:				
Net actuarial loss	$	(19,306)	(19,277)	(38,583)
	$	(19,306)	(19,277)	(38,583)

The net periodic pension expense recognized for Olean and Bradford was approximately $555,000 and $209,000, respectively for the period from July 3, 2017 to December 31, 2017.

The weighted average assumptions used to determine pension cost for both Olean and Bradford included (a) discount rate of 3.5%-3.75%; and (b) expected return on plan assets of 7.5%. The weighted average assumptions used to determine the projected plan obligation for both Olean and Bradford included: (a) discount rate of 4.0%; and (b) compensation increase between 0%–3.4%.

The Hospital's pension plan target allocation, by asset category, are as follows:

	Olean target allocation
Asset category:	
Equity securities	25%–80%
Debt securities	15%–40%
Cash and equivalents	0%–10%
Other (partnership and common collective trust)	0%–30%

The Medical Center's pension plan target allocation, by asset category, are as follows:

	Bradford target allocation
Asset category:	
Cash equivalents	— %
Equity securities	40
Debt securities	25
Flexible capital	20
Inflation hedging	15
	100 %

The following table presents Olean and Bradford's defined benefit pension plan assets at December 31, 2017 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):

	Olean		Bradford		
	NAV or equivalent	Level 1	NAV or equivalent	Level 1	Total
Cash equivalents	$ —	2,854	—	466	3,320
Equity securities	—	8,127	—	9,024	17,151
Debt securities	—	3,783	—	4,165	7,948
Flexible capital	2,189	—	2,429	—	4,618
Inflation hedging	32,678	—	3,744	—	36,422
	$ 34,867	14,764	6,173	13,655	69,459

Level 1 investments may be redeemed daily with a day's notice. Investments valued at NAV represent limited partnerships interests (may only be redeemed annually with notice of 65–90 days) and a common collective trust that may be redeemed daily.

(Continued)

Olean General Hospital expects to contribute $1,955,511 to its pension plan during the annual period ending December 31, 2018. The following benefit payments, which reflect expected future service costs, are expected to be paid:

2018	$	2,898
2019		2,770
2020		2,523
2021		2,656
2022		2,500
Thereafter through 2027		11,312
	$	24,659

Bradford Medical Center expects to contribute $1,509,926 to its pension plan during the annual period ending December 31, 2018. The following benefit payments are expected to be paid:

2018	$	1,149
2019		1,257
2020		1,351
2021		1,446
2022		1,527
Thereafter through 2027		8,850
	$	15,580

(c) 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:

		2017	**2016**
		(Dollars in thousands)	
Accumulated postretirement obligation at end of year	$	(7,654)	(7,702)
Fair value of plan assets at end of year		—	—
Postretirement obligation recognized at end of year included as a component of pension and postretirement obligations	$	(7,654)	(7,702)

(Continued)

Net postretirement benefit cost was approximately $522,000 and $323,000 for the years ended December 31, 2017 and 2016, respectively. The weighted average assumptions used to determine postretirement benefit cost and obligations at the Plan's measurement date (December 31):

	2017	2016
Discount rate for benefit obligations	3.53 %	3.95 %
Discount rate for net postretirement cost	3.95	4.28

For measurement purposes, 2017 increases in the per capita cost of covered health care benefits were assumed for medical and prescription drugs at 6.5%. 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.

(d) Collective Bargaining Agreements

A significant portion of Kaleida employees work under collective bargaining agreements which were renegotiated in 2016. The new agreements have a duration of three years and will expire in May 2019.

(13) 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:

		2017	2016
		(Dollars in thousands)	
Balance at beginning of year	$	13,601	13,218
Net obligations settled in current period		(3,201)	(47)
Accretion expense		785	430
Balance at end of year	$	11,185	13,601

(14) Temporarily and Permanently Restricted Net Assets

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

		2017	2016
		(Dollars in thousands)	
Capital expansion and improvements	$	14,570	26,229
Advancement of medical education and research and healthcare services		86,980	59,602
	$	101,550	85,831

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

		2017	2016
		(Dollars in thousands)	
Funds to be held in perpetuity, the income from which is expendable to support healthcare services, including medical research	$	39,039	14,824
Funds to be held in perpetuity, the income from which is expendable to support pediatric healthcare services		5,924	5,416
	$	44,963	20,240

In 2017 and 2016, net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes of operating expenses of approximately $8.7 million and $5.6 million, respectively, and capital expenditures of $16.7 million and $21.8 million, respectively.

(15) Other Operating Revenue

Components of other operating revenue for the years ended December 31 are as follows:

		2017	2016
		(Dollars in thousands)	
Grant revenue	$	16,103	11,321
Unrestricted contributions		3,173	3,119
Rental revenue		3,764	4,081
Rebate and other miscellaneous revenue		25,688	13,680
Pharmaceutical discount program revenue		7,147	9,217
	$	55,875	41,418

(16) 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:

		2017	2016
		(Dollars in thousands)	
Healthcare services	$	1,405,101	1,319,740
General and administrative		234,046	146,638
	$	1,639,147	1,466,378

(Continued)

(17) Affiliation

As discussed in note 1, effective July 3, 2017, Kaleida finalized an affiliation agreement with UAHS. Among its various terms and conditions, Kaleida became the sole corporate member of UAHS. No consideration was transferred in connection with the affiliation under the affiliation agreement.

The affiliation has been accounted for as an acquisition under ASC 954-810, which provides the accounting guidance for healthcare organization business combinations. ASC 954-810 establishes principles and requirements in determining whether a not-for-profit entity combination is a merger or acquisition and the associated accounting treatment. This transaction qualifies as an acquisition of a business, and therefore the net assets acquired are to be recorded at fair value. The fair value used for current assets acquired and current liabilities assumed generally represents the carrying value due to their current nature, and includes patient accounts and other receivables, investments, and assets limited as to use, and various accrued liabilities. The fair value of property and equipment was determined with the assistance of a third party valuation firm that used a combination of discounted cash flow models and comparable market transactions, considering the highest and best use of the property by market participants.

The following table summarizes the assets acquired and liabilities assumed as of July 3, 2017:

Assets acquired:		
Current	$	69,026
Long-term		125,830
Total assets		194,856
Liabilities assumed:		
Current		43,935
Long-term		64,905
Total liabilities		108,840
Net assets acquired	$	86,016

The value of the net assets acquired have been recognized in Kaleida's 2017 consolidated statement of operations and changes in net assets as a component of unrestricted net assets and as a component of the changes in temporarily or permanently restricted net assets based on the nature of restrictions of those net assets.

The UAHS net patient service revenue and decrease in net assets for the period from affiliation through December 31, 2017, included in the accompanying consolidated financial statement, was $89.7 million and $2.7 million, respectively.

The following table presents revenue, earnings, and net assets of the consolidated entity as if the affiliation with UAHS had occurred effective January 1, 2016.

	Total operating revenue	Excess of operating revenue over operating expenses	Unrestricted net assets	Temporarily restricted net assets	Permanently restricted net assets
Supplemental proforma information for year ending December 31, 2017	$ 1,757,341	23,819	358,580	101,550	44,963
Supplemental proforma information for year ending December 31, 2016	1,681,241	24,627	341,662	103,857	44,934