

Catholic Health East
Consolidated Financial Statements
December 31, 2006 and 2005

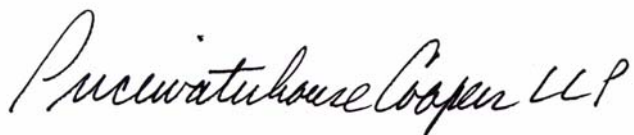
Catholic Health East
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December 31, 2006 and 2005

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Report of Independent Auditors

To the Board of Directors
Catholic Health East

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations and changes in net assets and cash flows present fairly, in all material respects, the financial position of Catholic Health East and its subsidiaries (the "Company") at December 31, 2006 and 2005, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of certain consolidated entities which are represented in the following financial statements for 2006 and 2005 as net assets of \$47,624,000 and \$37,167,000, respectively, and excess of revenues over expenses of \$6,884,000 and \$12,631,000, respectively. In addition, we did not audit the financial statements of certain unconsolidated entities which are represented in the following financial statements for 2006 and 2005 as investments in unconsolidated organizations of \$870,293,000 and \$739,397,000, respectively, and equity in earnings of unconsolidated organizations of \$104,027,000 and \$79,572,000, respectively. Those statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for these entities, is based solely on the reports of the other auditors. We conducted our audits of these statements 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 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, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.



April 18, 2007

Catholic Health East
Consolidated Balance Sheets
As of December 31, 2006 and 2005

(in thousands of dollars)

	2006	2005
Assets		
Current assets		
Cash and cash equivalents	\$245,636	\$276,943
Investments	88,759	104,363
Marketable securities whose use is limited	32,785	27,842
Patient accounts receivable, net of estimated uncollectibles of \$623,127 and \$528,951 for 2006 and 2005, respectively	488,787	496,282
Collateral received on securities pledged	175,300	156,720
Other accounts receivable	92,320	97,838
Prepaid expenses and inventories	119,257	109,521
Assets held for sale	192,516	194,513
Total current assets	<u>1,435,360</u>	<u>1,464,022</u>
Marketable securities whose use is limited		
Board designated funds	641,339	649,397
Trustee held funds	118,581	118,335
Donor restricted funds	81,889	71,955
	<u>841,809</u>	<u>839,687</u>
Property and equipment, net	1,603,726	1,505,540
Equity investments in managed funds	136,316	117,619
Investments in unconsolidated organizations	966,256	809,628
Investments	404,620	358,509
Other assets	162,205	162,373
Total assets	<u><u>\$5,550,292</u></u>	<u><u>\$5,257,378</u></u>
Liabilities and Net Assets		
Current liabilities		
Current portion of long-term debt	\$46,874	\$45,096
Accounts payable and accrued expenses	420,937	414,318
Collateral due broker on securities pledged	175,300	156,720
Estimated third party payor settlements, net	41,537	55,385
Other	141,953	132,278
Liabilities related to assets held for sale	153,231	166,197
	<u>979,832</u>	<u>969,994</u>
Long-term debt, net	1,277,349	1,229,511
Other liabilities	251,843	330,319
Insurance liabilities	219,844	209,285
Deferred revenue from entrance fees	54,863	46,137
Total liabilities	<u>2,783,731</u>	<u>2,785,246</u>
Net assets		
Unrestricted	2,605,574	2,339,922
Temporarily restricted	115,340	90,032
Permanently restricted	45,647	42,178
Total net assets	<u>2,766,561</u>	<u>2,472,132</u>
Total liabilities and net assets	<u><u>\$5,550,292</u></u>	<u><u>\$5,257,378</u></u>

The accompanying notes are an integral part of these consolidated financial statements.

Catholic Health East
Consolidated Statements of Operations
Years Ended December 31, 2006 and 2005

(in thousands of dollars)

	2006	2005
Unrestricted net assets		
Revenues, gains and other support		
Net patient service revenues	\$3,685,209	\$3,506,343
Investment income	110,336	84,420
Equity in earnings of unconsolidated organizations	136,249	79,712
Other operating revenues	244,106	258,541
	<u>4,175,900</u>	<u>3,929,016</u>
Expenses		
Salaries, wages and benefits	2,008,455	1,910,705
Medical supplies	630,825	601,072
Purchased services, professional fees and other expenses	769,155	711,824
Depreciation and amortization	165,639	151,534
Interest	60,598	59,142
Insurance	45,282	50,974
Provision for bad debts	301,205	204,133
	<u>3,981,159</u>	<u>3,689,384</u>
Excess of revenues over expenses before restructuring expenses, impairment losses, nonrecurring charges, loss on extinguishment of debt, change in fair value of interest rate swaps and unrealized gains from managed funds	194,741	239,632
Restructuring expenses and impairment losses	(12,380)	(13,659)
Nonrecurring charges	(599)	0
Loss on extinguishment of debt	(730)	0
Change in fair value of interest rate swaps	11,131	(229)
Unrealized gains from managed funds	7,045	3,732
	<u>7,045</u>	<u>3,732</u>
Excess of revenues over expenses	<u>\$199,208</u>	<u>\$229,476</u>

The accompanying notes are an integral part of these consolidated financial statements.

Catholic Health East
Consolidated Statements of Changes in Net Assets
Years Ended December 31, 2006 and 2005

(in thousands of dollars)

	2006	2005
Unrestricted net assets		
Excess of revenues over expenses	\$199,208	\$229,476
Change in unrealized gains (losses) on investments	20,435	(9,413)
Change in additional minimum pension liability	22,981	(27,653)
Other changes	<u>21,497</u>	<u>12,225</u>
Increase in unrestricted net assets before discontinued operations and cumulative effect of change in accounting principle	264,121	204,635
Loss from discontinued operations	(187)	(14,149)
Cumulative effect of change in accounting principle	<u>1,718</u>	<u>(11,541)</u>
Increase in unrestricted net assets	<u>265,652</u>	<u>178,945</u>
Temporarily restricted net assets		
Contributions	42,295	40,087
Investment income	5,212	5,132
Change in unrealized gains (losses) on investments	301	(249)
Net assets released from restriction	(24,168)	(27,285)
Other changes	<u>1,668</u>	<u>1,013</u>
Increase in temporarily restricted net assets	25,308	18,698
Permanently restricted net assets		
Contributions	457	39
Net realized and unrealized gains on investments	3,622	1,265
Other changes	<u>(610)</u>	<u>100</u>
Increase in permanently restricted net assets	<u>3,469</u>	<u>1,404</u>
Increase in net assets	294,429	199,047
Net assets		
Beginning of year	<u>2,472,132</u>	<u>2,273,085</u>
End of year	<u><u>\$2,766,561</u></u>	<u><u>\$2,472,132</u></u>

The accompanying notes are an integral part of these consolidated financial statements.

Catholic Health East
Consolidated Statements of Cash Flows
Years Ended December 31, 2006 and 2005

(in thousands of dollars)

	2006	2005
Cash flows from operating activities		
Increase in net assets	\$294,429	\$199,047
Adjustments to reconcile increase in net assets to net cash provided by operating activities		
Cumulative change in accounting principle	(1,151)	11,154
Loss from discontinued operations	187	14,149
Loss on extinguishment of debt	730	0
Depreciation and amortization	165,639	151,534
Amortization of deferred entrance fees	(7,221)	(7,209)
Net realized (gains) on investments	(94,654)	(64,968)
Net unrealized (gains) losses on investments	(20,435)	9,715
Unrealized gains on managed funds	(7,045)	(3,732)
Equity in earnings of unconsolidated organizations	(142,551)	(79,712)
Provision for bad debts	301,205	204,133
Gain on sale of assets	(2,726)	(6,366)
Minimum pension liability adjustment, including CHE's share of minimum liability adjustment of unconsolidated organizations	22,981	(27,653)
(Increase) decrease in market value of interest rate swaps	(11,131)	229
Restricted contributions and investment income	(51,887)	(46,274)
Entrance fees received, net of refunds	7,981	7,826
(Increase) decrease in certain assets and liabilities		
Accounts receivable	(293,711)	(241,450)
Other receivables	(28,444)	(34,870)
Inventories	(7,737)	(4,367)
Prepaid and other current assets	17,467	(36,710)
Assets held for sale	1,997	1,880
Accounts payable and accrued expenses	(2,284)	44,717
Salaries and benefits payable	8,903	13,253
Third party payables	(13,848)	8,292
Liabilities related to assets held for sale	(12,966)	4,608
Insurance and other liabilities	(73,596)	88,816
Net cash provided by continuing operating activities	<u>50,132</u>	<u>206,042</u>
Net cash provided by (used in) discontinued operations	<u>574</u>	<u>(1,936)</u>
Net cash provided by operating activities	<u>50,706</u>	<u>204,106</u>
Cash flows from investing activities		
Additions to property and equipment	(252,329)	(269,945)
(Increase) decrease in collateral received on securities pledged	(18,580)	24,167
Net increase in investments and marketable securities whose use is limited	65,865	54,627
Distributions received from unconsolidated organizations	10,494	4,306
Proceeds from sale of long-lived assets	2,898	9,302
Net cash used in investing activities	<u>(191,652)</u>	<u>(177,543)</u>
Cash flows from financing activities		
Proceeds from restricted contributions and investment income received	51,887	46,274
Proceeds from issuance of long-term debt	88,434	1,957
Repayments of long-term debt	(49,262)	(71,747)
Increase (decrease) in payable under collateral received on securities pledged	18,580	(24,167)
Net cash provided by (used in) financing activities	<u>109,639</u>	<u>(47,683)</u>
(Decrease) in cash and cash equivalents	(31,307)	(21,120)
Cash and cash equivalents		
Beginning of year	<u>276,943</u>	<u>298,063</u>
End of year	<u>\$245,636</u>	<u>\$276,943</u>
Supplemental Disclosure		
Interest paid	<u>\$61,159</u>	<u>\$62,415</u>

The accompanying notes are an integral part of these consolidated financial statements.

Catholic Health East

Notes to Consolidated Financial Statements

December 31, 2006 and 2005

1. Organization, Mission and Basis of Presentation

Catholic Health East (CHE, the System, or the Company) was incorporated as a Pennsylvania nonprofit corporation on October 1, 1997. CHE is a catholic, multi-facility health system sponsored by fifteen religious congregations and Hope Ministries. Each sponsoring congregation appoints a representative to the Sponsors Council which maintains certain reserve powers, including the election of the CHE Board of Directors. CHE serves to carry out the health care ministries of the sponsoring congregations. The mission of CHE is to be a community of persons committed to being a transforming, healing presence within the communities it serves.

The consolidated financial statements of CHE include activities of its Regional Health Corporations (RHCs) and related component corporations all of which are wholly or majority owned. These RHCs are located throughout eleven states and the healthcare activities provided by these RHCS include, but are not limited to, general acute care hospitals, long-term care facilities, skilled nursing facilities, behavioral health, and residential facilities for the elderly, physician services, home health, outpatient surgery, and other services. A list of the name and location of each RHC is provided below.

Holy Cross Health Ministries, Inc. Fort Lauderdale, Florida	St. Francis Hospital and Affiliates Wilmington, Delaware
Mercy Health System of Southeastern Pennsylvania Conshohocken, Pennsylvania	Pittsburgh Mercy Health System, Inc. Pittsburgh, Pennsylvania
Saint Joseph's Health System, Inc. Atlanta, Georgia	Mercy Medical Corporation Daphne, Alabama
Our Lady of Lourdes Health Care Services, Inc. Camden, New Jersey	Sisters of Providence Health System, Inc. Springfield, Massachusetts
Mercy Community Health, Inc. West Hartford, Connecticut	Mercy Hospital, Inc. Miami, Florida
Mercy Health System of Maine Portland, Maine	St. Mary's Health Care System, Inc. Athens, Georgia
St. Francis Medical Center Trenton, New Jersey	Saint Joseph of the Pines, Inc. Southern Pines, North Carolina
St. Peter's Health Care Services Albany, New York	St. James Mercy Health Systems, Inc. Hornell, New York
Mercy Uihlein Health Corporation Lake Placid, New York	St. Mary Medical Center Langhorne, Pennsylvania
Maxis Health System Carbondale, Pennsylvania	

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Catholic Health East and certain affiliated nonprofit corporations are generally exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code.

CHE and its RHCs also participate in various joint ventures and partnerships, commonly referred to as joint operating agreements. These arrangements enable CHE to provide healthcare services to the broader community through involvement in larger healthcare organizations or systems.

The consolidated financial statements of CHE include the financial information of the RHCs and component corporations, the System's wholly owned captive insurance company, various philanthropic foundations of which the System maintains control, and various other organizations or corporations.

2. Summary of Significant Accounting Policies

Basis of Consolidation

The consolidated financial statements include the accounts of all entities of CHE. All significant inter-company balances and transactions have been eliminated.

Use of Estimates

The preparation of these consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make assumptions, estimates, and judgments that affect the amounts reported in the financial statements, including the notes thereto, and related disclosures of commitments and contingencies, if any. Management considers critical accounting policies to be those that require more significant judgments and estimates in the preparation of the financial statements including, but not limited to, recognition of net patient service revenues, which includes contractual allowances and provisions for bad debt; estimates for healthcare professional and general liabilities; determination of fair values of certain financial instruments; and assumptions for measurement of pension liabilities. Management relies on historical experience and other assumptions believed to be reasonable relative to the circumstances in making judgments and estimates. Actual results could differ materially from these estimates.

Cash and Cash Equivalents

Cash and cash equivalents include investments in liquid debt instruments with a maturity of three months or less. The carrying value of cash and cash equivalents approximates market value.

Investments and Investment Income

Investments in marketable equity securities with readily determinable fair market values and all investments in debt securities (marketable investments) are measured at fair value based on quoted market prices. Investment income or loss (including realized gains and losses, interest and dividends) is included in excess of revenues over expenses unless the income or loss is restricted by donor or law. Investment income or loss is reported net of investment-related expenses. The change in net unrealized gains and losses on the marketable investments is excluded from excess of revenues over expenses.

Investments also include equity investments in managed funds, which include hedge funds, private partnerships, and other investments. Investments in hedge funds, private partnerships, and other investments (managed funds), of which CHE owns more than five percent of the overall

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investment, are accounted for under the equity method, which approximates fair value. The change in net unrealized gains and losses on managed funds is included in excess of revenues over expenses.

CHE periodically conducts an analysis and evaluates securities for any potential “other than temporary impairment” of investments. If the fair value of an investment is deemed to be other than temporary, an adjustment is made to reduce the cost basis of the investment(s) and is reported as a realized loss in excess of revenues over expenses, unless the underlying investments have donor-imposed restrictions, in which case the adjustment to the cost basis is recorded as a realized loss as part of temporarily restricted net assets. No adjustments are made to the cost basis of these investments for any subsequent recoveries in fair value.

Derivative Financial Instruments

The System recognizes all derivative instruments in the balance sheets at fair value. The change in the fair value of derivatives is recognized as a component of excess of revenues over expenses in the consolidated statement of operations for the years ended December 31, 2006 and 2005.

Marketable Securities Whose Use Is Limited

Marketable securities whose use is limited primarily include marketable securities designated by governance for future capital improvements and other purposes, in accordance with agreements with outside parties, by trustees under bond indenture agreements and self-insurance trust arrangements, and by restrictions.

Inventories

Inventory is valued at the lower of cost (first-in, first-out) or market, net of reserves for obsolescence.

Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is expensed over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Equipment under capital lease obligations is amortized on the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization is included in the depreciation and amortization in the financial statements. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of constructing those assets.

Gifts of long-lived assets such as land, buildings, or equipment are reported as unrestricted support, and are excluded from the excess of revenues over expenses, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or others assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

Long-Lived Assets

CHE systematically evaluates the carrying value of its long-lived assets for impairment when impairment indicators are identified. In the event that the carrying value of a long-lived asset is not supported by the fair value, the System will recognize an impairment loss for the difference. Fair

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value is based on available market prices or discounted cash flows. The System recognized impairment losses of \$7,771,000 and \$3,874,000 in 2006 and 2005, respectively.

Investments in Unconsolidated Organizations

Investments in unconsolidated organizations represent CHE investments in joint operating agreements, joint ventures, or partnerships. The equity method is used to account for these investments.

Deferred Revenue from Advance Fees

Certain RHCs operate residential facilities for the elderly. Fees paid by residents upon entering into continuing care contracts, net of the portion that is refundable to the resident, are recorded as deferred revenue and amortized to income using the straight-line method over the estimated remaining life expectancy of the resident.

Deferred Debt Issuance Costs

Deferred debt issuance costs included in other assets at December 31, 2006 and 2005, totaling \$17,169,000 and \$16,521,000, respectively are amortized using the straight-line method over the life of the related debt, which approximates the effective interest method.

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the System has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained in perpetuity.

Excess of Revenues over Expenses

The statement of operations includes excess of revenues over expenses. Changes in unrestricted net assets which are excluded from excess of revenues over expenses, consistent with industry practice, include unrealized gains and losses on investments other than trading securities; and managed funds, permanent transfers of assets to and from affiliates for other than goods and services, change in additional minimum pension liability, cumulative effect of change in accounting principle, discontinued operations, and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets).

Other Operating Revenues

Other revenue is derived from services other than the provision of health care services or coverage to patients or residents. These revenues consist primarily of federal and state grants, rental income, support services, parking garages, gift shop income, cafeteria income, maintenance fee income, and other miscellaneous income.

Net Patient Service Revenues

Third-party payors (Medicare, Medicaid, and commercial insurance payors) provide payments to the hospitals at amounts different from their established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounts from established charges, and per diem payments. Net patient service revenue is the estimated amount to be realized for services rendered, including estimated retroactive adjustments. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods, as final settlements are determined.

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Net patient service revenues from the Medicare and Medicaid programs, exclusive of managed care, accounted for approximately 33.1% and 7.2%, respectively, of total net patient service revenues in 2006, and 34.7% and 7.5%, respectively of total net patient service revenue in 2005. Compliance with 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. Management believes that adequate provision has been made for adjustments that may result from reviews by third-party payors. Estimated net settlements related to Medicare and Medicaid, collectively, of \$29,774,000 and \$37,455,000 in 2006 and 2005, respectively, are included as a component of current liabilities in the accompanying consolidated balance sheets.

Net patient service revenues include approximately \$35,141,000 and \$30,339,000 in 2006 and 2005, respectively, related to favorable changes in estimates for prior year cost report reopenings, appeals, and tentative and final cost reports, of which some are still subject to audit, additional reopening, and/or appeals.

Allowance for Doubtful Accounts

The System records an allowance for doubtful accounts for estimated losses resulting from the unwillingness of patients to make payments for services. The allowance is determined by analyzing historical data and trends. Accounts receivable are written off against the allowance for doubtful accounts when management determines that recovery is unlikely and collection efforts cease.

Charity Care

CHE provides services to all patients regardless of ability to pay. In accordance with the System's policy, a patient is classified as a charity patient based on income eligibility criteria as established by the *Federal Poverty Guidelines*. Charges for services to patients who meet the System's guidelines for charity care are not reflected in the accompanying combined financial statements. The charges associated with these services for charity care provided by the System approximate \$253,439,000 and \$224,300,000 in 2006 and 2005, respectively. These amounts do not include the provision of bad debts totaling \$301,205,000 and \$204,133,000 in 2006 and 2005, respectively, which is reflected separately in the consolidated statements of operations.

Donor-Restricted Gifts

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit 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 as unrestricted net assets and reported in the statement of operations as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying financial statements.

Adoption of Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" (SFAS 158) which amends FASB Statements No. 87, 88, 106 and

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132(Revised). SFAS 158 requires not-for-profit organizations to recognize the funded status of a benefit plan, either pension or defined benefit postretirement plan, as an asset or liability in the balance sheet. SFAS 158 requires that the status of all overfunded plans be aggregated and recognized as an asset in the balance sheet and the status of all underfunded plans to be aggregated and recognized as a liability in the balance sheet. Additionally, the liability for an underfunded plan, evaluated on a plan-by-plan basis, will be classified as a current liability, a noncurrent liability, or a combination of both. SFAS 158 requires that any asset recognized for an overfunded plan is to be recognized as a noncurrent asset in the statement of financial position. Additionally, SFAS 158 requires actuarial gains or losses and prior service costs or credits are to be recognized as a separate line item(s) within changes in unrestricted net assets. Not-for-profit employers are required to measure plan assets and benefit obligations as of the date of its fiscal year-end balance sheet. The requirement to measure plan assets and benefit obligations as of the date of the fiscal year-end balance sheet is effective for fiscal years ending after December 15, 2008; therefore, Catholic Health East will adopt this component of SFAS 158 effective with the year ending December 31, 2008. Management is currently evaluating the impact of the adoption of SFAS 158.

Disclosure of certain information related to the employers' benefit plans is also required in the footnotes to the financial statements pursuant to SFAS 158. These disclosure requirements are effective as of the end of the fiscal year ending June 15, 2007; therefore, Catholic Health East will adopt this component of SFAS 158 effective with the year ending December 31, 2007.

Effective December 31, 2005, Catholic Health East adopted the provisions of FASB Interpretation No. 47 (FIN 47), *Accounting for Conditional Asset Retirement Obligations*, an interpretation of FASB Statement No. 143 (FAS 143), *Accounting for Asset Retirement Obligations*. FAS 143 provides guidance on accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. Conditional asset retirement obligations are obligations whose settlement may be conditional on a future event. Additionally, the timing and method of settlement may be uncertain. FIN 47 requires conditional asset retirement obligations to be estimated and recognized. The initial adoption of FIN 47 by CHE in 2005 was recorded as a cumulative effect of a change in accounting principle totaling \$11,541,000. No additional conditional asset retirement obligations were recorded in 2006.

Reclassifications

Certain amounts have been reclassified in the prior year's financial statements to conform to the classifications used in the current year.

In 2005, CHE modified its investment policy related to the valuation of equity investments in managed funds to conform with the Financial Accounting Standards Board Emerging Issues Task Force (EITF) No. 03-16, *Accounting for Investments in Limited Liability Companies*. The impact of this policy modification was an increase to excess of revenues over expenses and a reduction to unrestricted unrealized gains (losses) of \$7,045,000 and \$3,732,000 in 2006 and 2005, respectively.

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3. Social Accountability Costs (Unaudited)

In keeping with the mission and purpose of Catholic Health East, to carry out the health care ministries of the sponsoring congregations by serving as a community of persons committed to being a transforming, healing presence within the communities it serves, especially the needs of the poor, the System strives to maximize the provision of services in its communities and in collaboration with other organizations. A portion of CHE's overall operating expense relates to costs incurred in providing and meeting certain community needs for which CHE is not directly compensated. A standard reporting and accountability process is utilized throughout CHE to estimate the net cost of these services, referred to as Social Accountability Costs, which provides a basis of accountability and reporting to the communities served for purposes of disclosing the utilization of resources. Costs reported are net of contributions or grants that have been provided to CHE and designated for these purposes.

The information presented below has been calculated and is presented in accordance with the Catholic Health Association's *A Guide for Planning and Reporting Community Benefits*, Copyright 2006. Social accountability costs for the years ended December 31, 2006 and 2005 are as follows:

Cost of care of the poor	\$55,985	\$52,420
Cost of community benefit programs	56,061	56,296
Volunteer service provided	4,782	20,493
Unpaid cost of Medicaid programs	71,197	69,955
Social accountability costs	<u>\$188,025</u>	<u>\$199,164</u>
Percentage of operating expenses	<u>4.7%</u>	<u>5.4%</u>
Multiple of excess of revenues over expenses before restructuring expenses, impairment losses, nonrecurring charges, loss on extinguishment of debt, change in fair value of interest rate swaps and unrealized gains from managed funds	<u>96.6%</u>	<u>83.1%</u>
Unpaid cost of Medicare programs	<u>\$128,365</u>	<u>\$137,600</u>

The cost of care of the poor is based on the System's estimated net cost of providing services to those unable to pay. The cost of the community benefit programs reflects the costs to develop and provide programs that are developed and provided to meet special community needs that would not otherwise be available. Volunteer service reflects both internal and external services provided to support patient care activities and community programs. The difference between amounts reimbursed to the System under the Medicare and Medicaid programs and the estimated cost of providing care for these respective programs is reflected as an unpaid cost of the program.

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4. Marketable Securities Whose Use Is Limited and Investments

A significant amount of CHE's investments are held and managed in the CHE Consolidated Investment Program (the Program). The Program is structured under a Program Participation Agreement (the Agreement) between each participant RHC and CHE. All investments in the Program are managed under the administration of CHE. Participants' investments held in the Program are assigned a weighted value for the period of time that the funds are invested in the Program. Investment income from the Program, including interest income, dividends, and realized gains and losses on sales of securities, other than temporary declines in market value of investment, and unrealized gains and losses are distributed to participants based on their weighted value of investments. The underlying fair value of investments in the Program, which are traded on national exchanges, is based on the final reported sales price on the last business day of the year. The fair value of investments traded in over-the-counter markets is based on the average of the last recorded bid and asked prices.

The following table summarizes investments and marketable securities whose use is limited and investments:

	December 31,	
	2006	2005
<i>(in thousands of dollars)</i>		
Consolidated investment program		
Cash and cash equivalents	\$218,065	\$214,327
Marketable equity securities	446,147	463,209
Marketable debt securities	254,279	234,474
Managed funds and other	92,419	73,138
	<u>\$1,010,910</u>	<u>\$985,148</u>
Separately invested		
Cash and cash equivalents	\$237,008	\$32,024
Marketable equity securities	179,391	292,929
Marketable debt securities	45,998	78,510
Managed funds and other	30,982	59,409
	<u>\$493,379</u>	<u>\$462,872</u>

CHE participates in a securities lending program wherein some investments are loaned on an overnight basis to various brokers. CHE receives lending fees and earns interest and dividends on the loaned securities. These securities are returnable on demand and are collateralized by cash deposits and U.S. Treasury Obligations. Collateral received is at 100% of the fair value of the securities on loan. CHE is indemnified against borrower default by the financial institution acting as lending agent. At December 31, 2006 and 2005, securities with a fair market value of \$175,300,000 and \$156,720,000, respectively, were loaned under securities lending agreements.

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Investment income and gains for marketable securities whose use is limited, investments and cash and cash equivalents at December 31 are comprised of the following:

<i>(in thousands of dollars)</i>	December 31,	
	2006	2005
Unrestricted net assets		
Investment income (loss)		
Interest and dividends	\$30,651	\$29,976
Net realized gains	79,685	54,444
	<u>\$110,336</u>	<u>\$84,420</u>
Other operating revenues		
Interest and dividends	\$4,380	\$3,773
Net realized gains on investments	14,726	10,524
	<u>\$19,106</u>	<u>\$14,297</u>
Net unrealized gains on managed funds	<u>\$7,045</u>	<u>\$3,732</u>
Other changes in unrestricted net assets		
Net unrealized gains (losses) on investments	<u>\$20,435</u>	<u>(\$9,413)</u>
Temporarily restricted net assets		
Other changes in temporarily restricted net assets		
Investment income (loss)		
Interest and dividends	\$3,779	\$4,441
Net realized gains (losses) on investments	1,433	691
	<u>\$5,212</u>	<u>\$5,132</u>
Net unrealized gains (losses) on investments	<u>\$301</u>	<u>(\$249)</u>
Permanently restricted net assets		
Other changes in permanently restricted net assets		
Net realized and unrealized gains (losses) on investments	<u>\$3,622</u>	<u>\$1,265</u>

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5. Property and Equipment

Property and equipment at December 31, 2006 and 2005 consisted of the following:

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
<i>(in thousands of dollars)</i>		
Land and improvements	\$97,068	\$93,574
Buildings and improvements	1,643,073	1,538,846
Equipment	<u>1,475,695</u>	<u>1,370,775</u>
	3,215,836	3,003,195
Less: Accumulated depreciation and amortization	<u>(1,782,433)</u>	<u>(1,654,545)</u>
	1,433,403	1,348,650
Construction in progress	<u>170,323</u>	<u>156,890</u>
Total	<u>\$1,603,726</u>	<u>\$1,505,540</u>

At December 31, 2006 and 2005, approximately \$242,287,000 and \$210,069,000 of property and equipment, net, is pledged as collateral under various loan agreements. Interest cost, net of related interest income, totaling approximately \$2,112,000 and \$11,226,000 was capitalized to construction in progress during 2006 and 2005, respectively.

6. Investments in Unconsolidated Organizations

Catholic Health East has investments in unconsolidated organizations totaling \$966,256,000 and \$809,628,000 at December 31, 2006 and 2005, respectively. Several significant investments, which are accounted for under the equity method, comprise this balance including, but not limited to, the following:

BayCare Health System

CHE has a fifty percent interest in BayCare Health System Inc. and Affiliates (BayCare), a Florida not-for-profit corporation exempt from state and federal income taxes. BayCare was formed in 1997 pursuant to a Joint Operating Agreement (JOA) among the not-for-profit, tax-exempt members of the Catholic Health East BayCare Participants, Morton Plant Mease Health Care, Inc, and South Florida Baptist Hospital, Inc. (collectively, the Members). BayCare consists of three community health alliances located in the Tampa Bay area of Florida including St. Joseph's-Baptist Healthcare Hospital, St. Anthony's Health Care, and Morton Plant Mease Health Care with an aggregate of approximately 2,900 acute care beds. CHE has the right to appoint nine of the twenty-one members of the Board of Directors of BayCare. At December 31, 2006 and 2005, CHE's recorded investment in BayCare totaled \$806,272,000 and \$688,409,000, excluding wholly owned subsidiaries and other beneficial interests.

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Catholic Health System, Inc.

CHE has a one-third interest in Catholic Health System, Inc. and Subsidiaries (CHS). CHS, formed in 1998, is a not-for-profit integrated delivery healthcare system in Western New York jointly sponsored by the Sisters of Mercy, Ascension Health System, the Franciscan Sisters of St. Joseph, and the Diocese of Buffalo. CHE, Ascension Health System, and the Diocese of Buffalo are the corporate members of CHS. CHS operates several organizations, the most significant of which are four acute care hospitals located in Buffalo, New York, Mercy Hospital of Buffalo, Kenmore Mercy Hospital, Sisters of Charity Hospital, and St. Joseph Hospital. At December 31, 2006 and 2005, CHE's recorded investment in CHS totaled \$19,815,000 and \$17,474,000, respectively.

Condensed consolidated balance sheets of BayCare, including wholly owned foundations and other beneficial interests, and CHS as of December 31, 2006 and 2005 are as follows:

	Baycare		CHS	
	2006	2005	2006	2005
<i>(in thousands of dollars)</i>				
Assets	\$3,188,510	\$2,665,000	\$401,603	\$368,000
Liabilities	\$1,464,917	\$1,177,000	\$342,099	\$316,000
Net assets	\$1,723,593	\$1,488,000	\$59,504	\$52,000

The following amounts have been recognized in the accompanying consolidated statements of operations and changes in net assets related to the investments in BayCare and CHS for the years ended December 31, 2006 and 2005:

	Baycare		CHS	
	2006	2005	2006	2005
<i>(in thousands of dollars)</i>				
Equity in earnings (losses)				
of unconsolidated organizations	\$86,883	\$72,047	\$6,112	\$4,235
Net unrealized gains (losses)				
on investments	21,881	7,803	(52)	351
Other changes in unrestricted				
and restricted net assets	5,358	(2,657)	(4,045)	(4,418)
	\$114,122	\$77,193	\$2,015	\$168

Additionally, certain RHCs have investments in unconsolidated organizations, the most significant of which are investments in Medicaid HMO joint ventures at Mercy Health System of Southeastern Pennsylvania (Mercy SEPA). These investments totaling \$140,169,000 and \$103,412,000 in 2006 and 2005, respectively, represent 97% and 95% of the total investments in unconsolidated organizations of Mercy SEPA in 2006 and 2005, respectively. CHE's proportionate share of the

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income of these investments was \$43,254,000 and \$3,430,000 for the years ended December 31, 2006 and 2005, respectively.

7. Derivative Financial Instruments

CHE has entered into off-balance sheet derivative transactions for the purpose of mitigating interest rate fluctuations and reducing interest expense.

At December 31, 2006, the System had entered into twelve off-balance sheet basis swap agreements with notional amounts totaling \$387 million. Pursuant to these agreements, the System receives a floating taxable rate and pays a floating tax-exempt rate. One of these basis swap agreements with a combined notional amount of \$195 million was entered into during 2006 and extends for a period of twenty years, maturing in June 2025. The remaining eleven basis swap agreements have maturity dates ranging from February 2023 to June 2025. The System has elected not to designate these interest rate swap agreements as hedges for financial reporting purposes. At December 31, 2006 and 2005, the fair value of these interest rate swap agreements was an asset of approximately \$5,834,000 and liability of approximately \$4,891,000, respectively. The change in the fair value of these interest rate swap agreements during 2006 and 2005 is recorded as a component of excess of revenues over expenses in the consolidated statement of operations. The changes in fair value of these interest rate swap agreements during 2006 and 2005 are reflected as an increase of \$10,219,000 and \$806,000, respectively.

At December 31, 2006, the System had entered into ten fixed-to-floating interest rate swap agreements with notional amounts totaling \$195 million. Five of these agreements have extendable options that may be exercised by the counterparty upon maturity. These fixed-to-floating interest rate swap agreements effectively convert a portion of the System's fixed rate debt to a floating rate basis and are not designated as hedges for financial reporting purposes. Four of the fixed-to-floating swap agreements, two with an extendable option, with a combined notional amount of \$100 million, were entered into during 2006 and have maturity dates ranging from January 2009 to February 2016. At December 31, 2006 and 2005, the fair value of these interest rate swap agreements was an asset of approximately \$13,000 and a liability of approximately \$1,012,000, respectively. The change in the fair value of these interest rate swap agreements during 2006 and 2005 is recorded as a component of excess of revenues over expenses in the consolidated statement of operations. In 2006, the change in the fair value of these agreements was an increase of \$912,000. In 2005, the change in the fair value of these agreements was a decrease of \$1,240,000.

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8. Long-Term Debt

At December 31 2006 and 2005, long-term debt consisted of the following (in thousands):

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
Revenue bonds		
Catholic Health East Health System Revenue Bonds		
Series 1998A (4.25% - 5.50%), payable from 2026 through 2028	\$457,113	\$468,557
Series 1998B (4.10% - 5.25%), payable through 2028	101,666	104,240
Series 1998C (4.40% - 5.00%), payable through 2028	36,335	37,260
Series 1998D, variable rate, payable from 2008 through 2028	30,000	30,000
Series 1998E (4.10% - 5.25%), payable through 2029	59,399	60,610
Series 1999F Term Bonds (5.625% - 5.75%), payable in 2020 and 2029	18,610	18,610
Series 1999G (7.62%), payable in 2017	7,256	7,710
Series 2002 Serial Bonds (3.50% - 5.50%), payable through 2032	46,530	47,200
Series 2003A Serial Bonds (2.40% - 5.375%), payable through 2033	46,200	46,705
Series 2003B (2.50% - 5.25%), payable through 2033	32,045	32,660
Series 2003C (2.50% - 5.25%), payable through 2033	15,215	15,510
Series 2003D (2.50% - 5.75%) payable through 2033	18,630	19,360
Series 2004A (3.00% - 5.25%) payable through 2021	13,155	13,785
Series 2004B (3.00% - 5.50%) payable through 2034	59,960	60,862
Series 2004C (4.75% - 5.50%) payable through 2034	18,450	18,449
Series 2006 Serial Bonds ,variable rate	37,600	0
Mercy Health System Revenue Bonds		
Series 2001 Term Bonds (7.375%) payable through 2016	24,830	26,475
City of Daphne - Special Care Facilities Financing Authority		
Series 1997 with an adjustable rate (1.10% at December 31, 2003), payable through 2027	24,400	25,000
Series 2000 with an adjustable rate (1.10% at December 31, 2003), payable annually 2030	16,400	16,800
City of Miami, Florida Health Facilities Authority Revenue Bonds		
Series of 1998A Serial Bonds (variable interest rate)	16,430	17,880
Series of 1994A Serial Bonds (4.75% - 5.25%)	0	41,750
Series 2002 Serial Bonds (4.03%), payable 2032	35,000	35,000
Maine Health & Higher Educational Facilities Authority		
Revenue Refunding Bonds		
Series 1998A Serial Bonds (4.0% - 5.25%), payable through 2028	12,178	12,683
Series 2001A Serial Bonds (3.45% - 4.125%), payable through 2008	373	748
Series 2006H Serial Bonds, variable rate	63,690	0
Other issues under \$10 million	4,850	5,115
Less unamortized discount	(7,754)	(8,133)
	<u>1,188,561</u>	<u>1,154,836</u>

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	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
Mortgages payable		
Dormitory Authority of the State of New York		
DASNY (5.20% to 5.375%), payable through 2020	\$22,740	\$24,095
DASNY (5.47%), payable through 2015	11,886	12,983
DASNY (5.56% to 5.64%), payable from 2024 through 2027	14,639	15,086
DASNY (6.23%), payable through 2024	7,568	7,807
Other mortgages and notes payable under \$5 million payable through 2018 with various rates	14,190	15,353
Notes payable due at various dates through 2027, with various rates	27,137	17,699
Revolving credit agreement, due in 2006	30,042	17,140
Capital lease obligations payable in various monthly amounts	<u>7,460</u>	<u>9,608</u>
	1,324,223	1,274,607
Total long-term debt and obligations under capital leases		
Less current installments	<u>(46,874)</u>	<u>(45,096)</u>
Total long-term debt	<u>\$1,277,349</u>	<u>\$1,229,511</u>

Aggregate maturities of long-term debt and capital lease obligations as of December 31, 2006 are as follows:

(in thousands of dollars)

2006	\$46,874
2007	42,697
2008	39,709
2009	40,461
2010	41,516
Thereafter	1,120,720
Less unamortized discount and imputed interest	<u>(7,754)</u>
	<u>\$1,324,223</u>

On November 1, 2006, CHE issued \$37,600,000 of Series 2006 Bonds through the City of Miami, Florida Health Facilities Authority. The proceeds of this issue were used to provide funds for the current refunding and redemption of the outstanding portion of the City of Miami, Florida, Health Facilities Revenue Refunding Bonds (Mercy Hospital Project), Series 1994A, scheduled for February 15, 2007.

On December 1, 2006, CHE issued \$68,400,000 of Series 2006H Bonds through the Maine Health and Higher Educational Facilities Authority. The proceeds of this issue will be used to finance new capital projects in Portland, Maine.

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Under the Amended and Restated Master Trust Indenture dated January 1, 1998 and amended and restated as of September 30, 2006, Catholic Health East and other members of the Obligated Group are subject to a gross revenue pledge. Additionally, the Obligated Group has agreed to comply with certain covenants including the repayment of principal and interest, notification regarding admission or withdrawal of members of the Obligated Group, to deliver financial statements and other related information by due dates specified, to maintain insurance, and to maintain a long-term debt service coverage of at least 1.10 to 1.00.

In December 2005, CHE entered into a revolving credit loan facility with seven banks. The credit facility totals \$150,000,000 with an option to increase the credit facility to \$200,000,000. Borrowings under this agreement may be repaid at any time, and are payable upon termination of the agreement in December 2010. Amounts outstanding under the revolver classified as current debt in the accompanying consolidated balance sheet are \$1,850,000 and \$8,270,000 as of December 31, 2006 and 2005, respectively.

Pursuant to loan agreements between CHE and various RHCs, promissory notes have been executed by each RHC in amounts equal to the amount of proceeds necessary to defease previously existing debt and provide for capital projects.

The City of Daphne Series 2000 and 1997 Bonds and the City of Miami 1998A Bonds are supported by irrevocable letters of credit which expire in 2011, 2008 and 2007, respectively. CHE is the guarantor for these letters of credit.

9. Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the System has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained in perpetuity. Temporarily restricted net assets at December 31 are available for the following purposes:

<i>(in thousands of dollars)</i>	December 31,	
	2006	2005
Temporarily Restricted Net Assets:		
Education and research	\$7,452	\$6,799
Building and equipment	56,256	34,104
Patient care	11,290	12,680
Cancer Center/research	2,534	971
Education and research grants	91	176
Other	37,717	35,302
	<u>\$115,340</u>	<u>\$90,032</u>

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Permanently restricted net assets at June 30, 2006 and 2005 are restricted as follows:

(in thousands of dollars)

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
Permanently Restricted Net Assets:		
Investments to be held in perpetuity, the income from which is expendable to support health care services (reported as operating income)	\$35,426	\$33,475
Endowments requiring income to be added to the original gift	2,969	2,682
Other	<u>7,252</u>	<u>6,021</u>
	<u>\$45,647</u>	<u>\$42,178</u>

10. Insurance

Professional and general liability risk is insured through Stella Maris Insurance Company, Ltd. a wholly owned, captive insurance company, commercial insurance and reinsurance companies, and self-insured programs. Excess insurance over self-insured amounts and coverage provided by the captive has been purchased from the commercial insurance and reinsurance markets. The excess professional liability coverage is provided on a claims-made basis. There are known claims and incidents that may result in the assertion of additional claims, as well as claims from unknown incidents that may be asserted arising from services provided to patients. CHE has employed independent actuaries to estimate the ultimate costs, if any, of the settlement of such claims. Accrued malpractice losses have been discounted and in management's opinion provide an adequate reserve for loss contingencies.

CHE maintains a self-insurance program for worker's compensation claims. Losses from asserted claims and from unasserted claims identified under CHE's incident reporting systems are accrued based on estimates that incorporate CHE's experience, relevant trends, and other factors. CHE has employed independent actuaries to estimate the ultimate costs, if any, of the settlement of such claims. Accrued workers compensation losses have been discounted and in management's opinion provide an adequate reserve for loss contingencies.

Total amounts accrued under these programs approximate \$231,256,000 and \$218,274,000 at December 31, 2006 and 2005, respectively.

Bank-administered trust and other accounts have been established for the purpose of segregating assets. These trusts are funded based on actuarial estimates and can only be used for payment of malpractice losses, related expenses, and administrative costs of the trusts. Assets of the trusts are included in marketable securities whose use is limited.

The total amount charged to expense for insurance was \$45,282,000 and \$50,974,000 in 2006 and 2005, respectively.

11. Pension Plans

The majority of the System's retirement plans are non-contributory, defined benefit pension plans and vary from one RHC to another, collectively, the "Plans."

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The components of net periodic pension expense for the System's defined benefit pension plans at December 31 are as follows:

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
<i>(in thousands of dollars)</i>		
Service cost	\$35,281	\$36,478
Interest cost on the projected benefit obligation	43,407	40,271
Expected return on plan assets	(46,243)	(42,199)
Amortization of prior service cost	985	1,054
Unrecognized net actuarial loss	11,399	7,607
	<u>\$44,829</u>	<u>\$43,211</u>

The range of assumptions used to determine the benefit obligation as of December 31 is as follows:

	<u>2006</u>		<u>2005</u>	
	<u>From</u>	<u>To</u>	<u>From</u>	<u>To</u>
Discount rates	5.65 %	6.00 %	5.56 %	6.00 %
Rates of increase in future compensation levels	3.75 %	5.60 %	4.00 %	4.25 %
Expected long-term rate of return on plan assets	8.50 %	8.50 %	8.50 %	8.50 %

The range of assumptions used to determine the net periodic pension expense for the years ended December 31, 2006 and 2005 is as follows:

	<u>2006</u>		<u>2005</u>	
	<u>From</u>	<u>To</u>	<u>From</u>	<u>To</u>
Discount rates	5.65 %	6.00 %	5.60 %	6.50 %
Rates of increase in future compensation levels	3.00 %	5.00 %	3.00 %	4.25 %
Expected long-term rate of return on plan assets	7.50 %	8.50 %	8.50 %	8.50 %

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The following table sets forth the changes in benefit obligations, changes in fair value of plan assets, and changes in funded status of the various plans at December 31:

	2006	2005
<i>(in thousands of dollars)</i>		
Changes in benefit obligations		
Projected benefit obligations at beginning of year	\$777,926	\$681,203
Service cost	35,281	36,478
Interest cost	43,407	40,271
Benefits paid	(25,352)	(21,423)
Plan amendments	(1,992)	-
Curtailement	(669)	-
Change in assumptions	(2,356)	358
Actuarial loss	(16,870)	41,039
Projected benefit obligations, end of year	<u>\$809,375</u>	<u>\$777,926</u>
Change in plan assets		
Fair value of plan assets at beginning of year	\$542,739	\$477,402
Actual return on plan assets	65,250	40,295
Contributions by plan sponsors	62,126	46,893
Benefits paid	(25,352)	(21,423)
Administrative costs	(284)	(428)
Fair value of plan assets at end of year	<u>\$644,479</u>	<u>\$542,739</u>
Funded status of plans	(\$165,894)	(\$231,850)
Unrecognized prior service cost	11,092	6,232
Unrecognized net loss	139,006	193,012
Minimum pension liability	(67,045)	(107,844)
Intangible pension asset	(31,514)	(7,956)
(Accrued) pension costs	<u>(\$114,355)</u>	<u>(\$148,406)</u>
Amounts recognized in the balance sheet consist of:		
Prepaid benefit cost	\$52,904	\$26,685
Accrued benefit cost	(31,514)	(40,465)
Intangible assets	203	(7,956)
Minimum pension liability	(67,045)	(107,844)
Net amount recognized	<u>(\$45,452)</u>	<u>(\$129,580)</u>

As of December 31, 2006 and 2005, certain plans had accumulated benefit obligations in excess of the fair market value of plan assets. Accordingly, CHE recognized minimum pension liabilities of \$67,045,000 and \$107,844,000, respectively. For the years ended December 31, 2006 and 2005, the net adjustment to the additional minimum pension liabilities was a decrease of \$22,981,000 and

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an increase of \$27,653,000, respectively recorded as part of unrestricted net assets in the consolidated statements of operations and changes in net assets.

Accumulated benefit obligation for CHE was \$697,616,000 and \$691,145,000 at December 31, 2006 and 2005, respectively.

Net periodic pension expense for the System's defined contribution plans totaled \$42,372,000 and \$26,847,000 in 2006 and 2005, respectively.

Investment Policy and Asset Allocations- In developing the expected rate of return on assets assumption, CHE evaluates historical returns, the level of expected returns on risk-free investments (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested, and the expectations for future returns of each asset class. The expected rate of return for each asset class is then weighted based on the target asset allocation to develop the expected long-term rate of return on assets assumption for the portfolio. This methodology was utilized to develop the long-term rate of return assumptions at December 31, 2006 and 2005.

The weighted average plan asset allocations by asset category as of December 31 are as follows:

	2006	2005
Asset category		
Cash and cash equivalents	6.8 %	9.7 %
Marketable equity securities	66.8 %	61.6 %
Marketable debt securities	15.5 %	19.4 %
Managed funds other	10.9 %	9.3 %
	<u>100.0 %</u>	<u>100.0 %</u>

The portfolio is diversified among a mix of assets including large and small cap, domestic and foreign equities, fixed income, alternatives (a fund of hedge funds), and cash. Asset mix is targeted to a specific allocation, either intermediate or long-term, that is established by evaluating expected return, standard deviation, and correlation of various assets against the plan's long-term objectives. Asset performance is monitored quarterly and rebalanced if asset classes exceed explicit ranges. The investment policy governs permitted types of investments, and outlines specific benchmarks and performance percentiles. The Investment Subcommittee of the Stewardship Committee of the CHE Board oversees the pension investment program and monitors investment performance. Risk is closely monitored through the evaluation of portfolio holdings and tracking the beta and standard deviation of the portfolio performance. The use of derivative financial instruments as an investment vehicle is specifically limited.

Contributions- Expected contributions to the defined benefit plans in 2007 are approximately \$60,244,000.

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Estimated Future Benefit Payments

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

(in thousands of dollars)

2007	\$26,485
2008	30,491
2009	31,638
2010	33,913
2011	38,648
2012-2015	264,969
	<u>\$426,144</u>

12. Concentration of Credit Risk

CHE grants credit without collateral to its patients, most of whom are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at December 31 was as follows:

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
Managed care	32.8 %	31.7 %
Medicare	26.8 %	25.4 %
Medicaid	9.2 %	12.3 %
Self-pay	11.9 %	13.3 %
Other third-party payors	9.7 %	7.7 %
Commercial	9.6 %	9.6 %
	<u>100.0 %</u>	<u>100.0 %</u>

In addition, CHE invests its cash and cash equivalents primarily with banks and financial institutions. These deposits may be in excess of federally insured limits. Management believes that the credit risk related to these deposits is minimal.

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13. Commitments and Contingencies

The RHCs are defendants in various lawsuits relating primarily to rendering of health care services. In each instance, management of the respective RHCs is of the opinion that the liability, if any, resulting there from will be covered by insurance or will not have a material adverse impact on the consolidated financial statements of CHE. In addition, certain CHE entities have been contacted by governmental agencies regarding alleged violations of practices for certain services. Management of the respective RHCs has performed, with the advice and assistance of outside legal counsel, an evaluation of billing practices and compliance with related laws and regulations. In the opinion of management, after consultation with outside legal counsel, the ultimate outcome of these matters will not have a material adverse impact on the consolidated financial statements of CHE.

14. Leases

The RHCs lease office space and certain equipment under noncancelable operating leases. Rental expense was approximately \$60,620,000 and \$55,917,000 in 2006 and 2005, respectively.

Future minimum lease payments for all noncancelable leases as of December 31, 2006 are as follows:

(in thousands of dollars)

2007	\$36,959
2008	31,276
2009	26,514
2010	19,972
2011	15,235
Thereafter	60,250
	<u>\$190,206</u>

15. Functional Expenses

CHE provides general health care services to residents within their geographic location including acute care, skilled nursing, outpatient care, home healthcare, physician practices, and behavioral services. Expenses related to providing these services at December 31 are as follows:

(in thousands of dollars)

	December 31,	
	2006	2005
Health care services	\$3,239,104	\$2,971,922
General and administrative	742,055	717,462
	<u>\$3,981,159</u>	<u>\$3,689,384</u>

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16. Fair Value of Financial Instruments

The following methods and assumptions were used by CHE in estimating the fair value of its financial instruments:

Cash and Cash Equivalents: The carrying amount reported in the consolidated balance sheets for cash and cash equivalents approximates fair value.

Marketable Securities Whose Use Is Limited and Investments: Fair values, which are the amounts reported in the balance sheet, are based on quoted market prices, if available, or estimated using quoted market prices for similar securities.

Accounts Payable and Accrued Expenses: The carrying amount reported in the balance sheet for accounts payable and accrued expenses approximates its fair value.

Estimated Third-Party Payor Settlements: The carrying amount reported in the balance sheet for estimated third-party payor settlements approximates its fair value.

Long-Term Debt: Quoted market prices or estimates using discounted cash flow analyses, based on the participating facility's incremental borrowing rates for similar types of borrowing arrangements. The fair value of the System's long-term debt, based on quoted market prices, at December 31, 2006 and 2005 was \$1,296,681,000 and \$1,210,408,000, respectively, compared to the carrying value of \$1,324,223,000 and \$1,274,607,000, respectively. This excludes capital leases, notes payable, and mortgage notes.

Derivative Financial Instruments: Quoted market price of these or similar instruments.

At December 31, 2006, the carrying amount approximates the fair values of financial instruments recorded as assets.

17. Restructuring Expenses, Impairment Losses and Nonrecurring Charges

During 2006 and 2005, several RHCs approved restructuring plans designed to reduce ongoing operating costs. The plans primarily involve the reduction of workforce, the elimination of small unprofitable business lines, and the divestiture/closure of certain physician practices and ambulatory care clinics. Total restructuring costs and impairment losses associated with carrying out the above plans were \$12,380,000 and \$13,659,000 in 2006 and 2005, respectively. Total nonrecurring charges were \$599,000 for the year ended December 31, 2006.

18. Assets Held for Sale and Discontinued Operations

In accordance with SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*, the System classified certain long-lived assets as "held for sale" in fiscal years 2006 and 2005.

During 2006, CHE and Pittsburgh Mercy Health System (PMHS) announced that a letter of intent had been signed with the University of Pittsburgh Medical Center (UPMC) to transfer ownership of The Mercy Hospital of Pittsburgh (MHP), Mercy Primary Care Center (MPCC), Emergency

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Medical Association (EMA), and Health Association of Western PA (HAW), collectively, the “Disposal Group” to UPMC. This transaction is expected to be completed in June 2007. All related assets, liabilities, and gains or losses from operations for the Disposal Group have been accounted for as discontinued operations as of and for the years ended December 31, 2006 and 2005. For the years ended December 31, 2006 and 2005, the net operating loss of the Disposal Group was \$187,000 and \$14,149,000, respectively.

Details of the assets held for sale, the related liabilities, and discontinued operations are provided below:

<i>(in thousands of dollars)</i>	2006	2005
Assets Held for Sale and Related Liabilities		
Patient accounts receivable, net	\$31,770	\$35,352
Property, plant, and equipment, net	127,497	120,852
Other assets	33,249	38,309
Total assets	<u>\$192,516</u>	<u>\$194,513</u>
Current liabilities	\$47,148	\$54,947
Other long-term liabilities	106,083	111,250
Total liabilities	<u>\$153,231</u>	<u>\$166,197</u>
Total revenues from discontinued operations	\$353,770	\$316,861
Net loss from discontinued operations	(\$187)	(\$14,149)

19. Subsequent Events

Charitable Contribution- On March 16, 2007, the System concluded a transaction that resulted in the receipt of certain land, buildings, and equipment in Broward County, Florida that will further the mission of the System. Certain properties were received as a charitable contribution while other properties were purchased at an amount less than the fair market value, resulting in an additional contribution. The estimated fair market value of the land, buildings, and equipment is approximately \$64 million. In connection with the transaction, the System executed a promissory note in the amount of \$44 million, payable with interest through maturity in 2023. The System will record an unrestricted contribution of approximately \$17 million for the year ended December 31, 2007 in connection with this transaction.

Debt Refinancing- In April 2007, the System issued \$333.4 million of synthetically fixed rate debt the proceeds of which were used to advance refund \$327.0 million of existing fixed rate debt. The refunded series were issued in the states of Massachusetts (Series 1998B and Series 2002B), Pennsylvania (Series 2004C and Series 2004B), New Jersey (Series 1998B, Series 1998E, and Series 2003A), and Georgia (Series 1998A and Series 2002C). A total of nine series of outstanding bonds were refunded partially or entirely. The average coupon on the new debt is 4.384% as compared to 5.195% on the refunded debt.