KINDRED HEALTHCARE, INC
Form 10-Q
November 08, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2007

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______ to ______.

Commission file number: 001-14057

KINDRED HEALTHCARE, INC.

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**61-1323993** **(I.R.S. Employer Identification No.)**
680 South Fourth Street	
Louisville, KY **(Address of principal executive offices)**	**40202-2412** **(Zip Code)**

(502) 596-7300

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No þ

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class of Common Stock	**Outstanding at October 31, 2007**
Common stock, $0.25 par value	38,292,212 shares

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

(Unaudited)

(In thousands, except per share amounts)

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Revenues	$ 1,009,459	$ 1,024,144	$ 3,214,693	$ 3,062,082
Salaries, wages and benefits	599,049	567,716	1,805,648	1,669,980
Supplies	109,900	168,379	472,656	494,817
Rent	88,085	78,458	261,030	215,364
Other operating expenses	194,049	168,683	554,070	499,077
Other income	(3,201)		(3,201)	
Depreciation and amortization	30,916	30,808	89,506	86,236
Interest expense	5,014	4,667	11,301	10,849
Investment income	(3,785)	(3,528)	(11,235)	(10,661)
	1,020,027	1,015,183	3,179,775	2,965,662
Income (loss) from continuing operations before income taxes	(10,568)	8,961	34,918	96,420
Provision (benefit) for income taxes	(1,510)	4,397	17,808	41,143
Income (loss) from continuing operations	(9,058)	4,564	17,110	55,277
Discontinued operations, net of income taxes:				
Income (loss) from operations	(4)	(1,752)	(3,304)	1,318
Gain (loss) on divestiture of operations		126	(76,968)	(25)
Net income (loss)	$ (9,062)	$ 2,938	$ (63,162)	$ 56,570
Earnings (loss) per common share:				
Basic:				
Income (loss) from continuing operations	$ (0.23)	$ 0.12	$ 0.43	$ 1.41
Discontinued operations:				
Income (loss) from operations		(0.05)	(0.08)	0.04
Gain (loss) on divestiture of operations			(1.96)	
Net income (loss)	$ (0.23)	$ 0.07	$ (1.61)	$ 1.45
Diluted:				
Income (loss) from continuing operations	$ (0.23)	$ 0.11	$ 0.42	$ 1.34
Discontinued operations:				
Income (loss) from operations		(0.04)	(0.08)	0.03
Gain (loss) on divestiture of operations			(1.90)	
Net income (loss)	$ (0.23)	$ 0.07	$ (1.56)	$ 1.37
Shares used in computing earnings (loss) per common share:				
Basic	39,013	39,014	39,271	39,104

Diluted	39,013	39,769	40,522	41,300

See accompanying notes.

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED BALANCE SHEET

(Unaudited)

(In thousands, except per share amounts)

	September 30, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 17,629	$ 20,857
Cash restricted	5,213	5,757
Insurance subsidiary investments	222,696	227,865
Accounts receivable less allowance for loss of $38,462 September 30, 2007 and $62,064 December 31, 2006	637,839	588,166
Inventories	21,209	49,533
Deferred tax assets	87,951	62,512
Income taxes	14,376	10,652
Other	25,759	28,106
	1,032,672	993,448
Property and equipment	1,057,170	1,027,112
Accumulated depreciation	(514,277)	(475,882)
	542,893	551,230
Goodwill	62,219	107,852
Intangible assets less accumulated amortization of $3,290 September 30, 2007 and $6,925 December 31, 2006	77,990	117,345
Assets held for sale	75,767	9,113
Insurance subsidiary investments	51,530	52,977
Deferred tax assets	121,472	96,252
Other	73,530	87,910
	$ 2,038,073	$ 2,016,127
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 165,575	$ 158,085
Salaries, wages and other compensation	277,979	280,039
Due to third party payors	48,575	27,784
Professional liability risks	66,325	65,497
Other accrued liabilities	99,254	75,522
Long-term debt due within one year	75	71
	657,783	606,998
Long-term debt	235,033	130,090
Professional liability risks	194,882	184,749
Deferred credits and other liabilities	108,337	98,712
Commitments and contingencies		

Stockholders equity:		
Common stock, $0.25 par value; authorized 175,000 shares; issued 38,284 shares September 30, 2007 and 39,978 shares December 31, 2006	9,571	9,994
Capital in excess of par value	785,414	793,054
Accumulated other comprehensive income	2,423	1,246
Retained earnings	44,630	191,284
	842,038	995,578
	$ 2,038,073	$ 2,016,127

See accompanying notes.

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(Unaudited)

(In thousands)

	Three months ended September 30, 2007	Three months ended September 30, 2006	Nine months ended September 30, 2007	Nine months ended September 30, 2006
Cash flows from operating activities:				
Net income (loss)	$ (9,062)	$ 2,938	$ (63,162)	$ 56,570
Adjustments to reconcile net income (loss) to net cash provided by operating activities:				
Depreciation and amortization	30,916	32,673	92,019	91,566
Amortization of stock-based compensation costs	19,547	4,397	27,699	14,360
Provision for doubtful accounts	6,612	10,024	23,494	28,913
Deferred income taxes	(2,129)	657	(17,044)	(14,280)
(Gain) loss on divestiture of discontinued operations		(126)	76,968	25
Other	(650)	(2,868)	(2,165)	(4,317)
Change in operating assets and liabilities:				
Accounts receivable	(84,996)	(56,219)	(130,424)	(182,053)
Inventories and other assets	16,413	(4,679)	13,503	(14,691)
Accounts payable	9,700	(60)	(6,914)	5,979
Income taxes	(14,216)	(16,189)	12,865	3,491
Due to third party payors	16,403	8,731	20,791	1,775
Other accrued liabilities	31,601	43,500	53,101	53,681
Net cash provided by operating activities	20,139	22,779	100,731	41,019
Cash flows from investing activities:				
Purchase of property and equipment	(54,256)	(37,719)	(133,012)	(99,754)
Acquisitions	(22,850)	(11,086)	(238,104)	(134,667)
Sale of assets	1,786	205	81,692	10,510
Purchase of insurance subsidiary investments	(22,484)	(81,207)	(114,363)	(165,487)
Sale of insurance subsidiary investments	28,559	82,725	126,843	177,609
Net change in insurance subsidiary cash and cash equivalents	(7,798)	1,185	(3,117)	(4,288)
Net change in other investments	500	(1,101)	514	743
Other	(3,851)	(2,033)	(7,274)	927
Net cash used in investing activities	(80,394)	(49,031)	(286,821)	(214,407)
Cash flows from financing activities:				
Proceeds from borrowings under revolving credit	413,500	402,800	1,289,300	1,058,100
Repayment of borrowings under revolving credit	(430,500)	(372,100)	(1,184,300)	(884,800)
Repayment of long-term debt	(18)	(321)	(53)	(3,294)
Payment of deferred financing costs	(1,752)	(223)	(2,058)	(1,170)
Proceeds from borrowing related to spin-off transaction	125,000		125,000	
Issuance of common stock	302	178	10,050	143,366
Repurchase of common stock	(49,997)		(49,997)	(194,310)
Other	3,790	(5,763)	(5,080)	(14,570)
Net cash provided by financing activities	60,325	24,571	182,862	103,322

Change in cash and cash equivalents	70	(1,681)	(3,228)	(70,066)
Cash and cash equivalents at beginning of period	17,559	15,035	20,857	83,420
Cash and cash equivalents at end of period	$ 17,629	$ 13,354	$ 17,629	$ 13,354
Supplemental information:				
Interest payments	$ 4,548	$ 2,340	$ 10,777	$ 7,467
Income tax payments	14,000	18,833	17,399	52,758

See accompanying notes.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 BASIS OF PRESENTATION

Business

Kindred Healthcare, Inc. is a healthcare services company that through its subsidiaries operates hospitals, nursing centers and a contract rehabilitation services business across the United States (collectively, the Company). At September 30, 2007, the Company s hospital division operated 83 long-term acute care (LTAC) hospitals in 24 states. The Company s health services division operated 228 nursing centers in 27 states. The Company operated a contract rehabilitation services business which provides rehabilitative services primarily in long-term care settings.

On July 31, 2007, the Company completed the spin-off of its institutional pharmacy business. See Note 2.

In recent years, the Company has completed several transactions related to the divestiture of unprofitable hospitals, nursing centers and other healthcare businesses to improve its future operating results. For accounting purposes, the operating results of these businesses and the gains, losses or impairments associated with these transactions have been classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented. Assets not sold at September 30, 2007 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying unaudited condensed consolidated balance sheet. See Note 3 for a summary of discontinued operations.

Impact of recent accounting pronouncement

In September 2006, the Financial Accounting Standards Board (the FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157 (SFAS 157), Fair Value Measurements, which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The adoption of SFAS 157 is not expected to have a material impact on the Company s financial position, results of operations or liquidity.

Comprehensive income (loss)

The following table sets forth the computation of comprehensive income (loss) (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Net income (loss)	$ (9,062)	$ 2,938	$ (63,162)	$ 56,570
Net unrealized investment gains, net of income taxes	716	846	1,177	743
Comprehensive income (loss)	$ (8,346)	$ 3,784	$ (61,985)	$ 57,313

Other information

The accompanying unaudited condensed consolidated financial statements are prepared in accordance with the instructions for Form 10-Q of Regulation S-X and do not include all of the disclosures normally required by generally accepted accounting principles or those normally required in annual reports on Form 10-K. Accordingly, these financial statements should be read in conjunction with the audited consolidated financial

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 BASIS OF PRESENTATION (Continued)

Other information (Continued)

statements of the Company for the year ended December 31, 2006 filed with the Securities and Exchange Commission (the SEC) on Form 10-K. The accompanying condensed consolidated balance sheet at December 31, 2006 was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the Company s customary accounting practices. Management believes that financial information included herein reflects all adjustments necessary for a fair presentation of interim results and, except as otherwise disclosed, all such adjustments are of a normal and recurring nature.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles and include amounts based upon the estimates and judgments of management. Actual amounts may differ from those estimates.

Reclassifications

Certain prior period amounts have been reclassified to conform with the current period presentation. These changes did not have any impact on the Company s financial position, results of operations or liquidity.

NOTE 2 SPIN-OFF TRANSACTION

On July 31, 2007, the Company completed the spin-off of its former institutional pharmacy business, Kindred Pharmacy Services, Inc. (KPS), and the immediate subsequent combination of KPS with the former institutional pharmacy business of AmerisourceBergen Corporation (AmerisourceBergen) to form a new, independent, publicly traded company named PharMerica Corporation (PharMerica) (the Spin-off Transaction). Immediately prior to the Spin-off Transaction, KPS incurred $125 million of bank debt, the proceeds of which remained with the Company. Immediately after the Spin-off Transaction, the stockholders of the Company and AmerisourceBergen each held approximately 50 percent of the outstanding common stock of PharMerica.

For accounting purposes, the assets and liabilities of KPS were eliminated from the balance sheet of the Company effective at the close of business on July 31, 2007, and beginning August 1, 2007, the future operating results of KPS will no longer be included in the operating results of the Company. In accordance with SFAS No. 144 (SFAS 144), Accounting for the Impairment or Disposal of Long-Lived Assets, the historical operating results of KPS will not be reported as a discontinued operation of the Company because of the significance of the expected continuing cash flows between PharMerica and the Company under pharmacy services contracts for services to be provided by PharMerica to the Company s hospitals and nursing centers. Accordingly, for periods prior to August 1, 2007, the historical operating results of KPS will continue to be included in the historical continuing operations of the Company.

In addition to the pharmacy services contracts noted above, the Company and PharMerica also entered into new agreements for information systems services, transition services and certain tax matters. The Company recorded $3.2 million in other income in the third quarter of 2007 related to the information systems and transition services agreements.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 SPIN-OFF TRANSACTION (Continued)

A summary of the net assets of KPS which were transferred to PharMerica in the Spin-off Transaction follows (in thousands):

Assets:		
Current assets	$ 140,934	
Property and equipment, net	24,008	
Goodwill	45,819	
Intangible assets, net	35,655	
Other long-term assets	19,370	$ 265,786
Liabilities:		
Current liabilities	$ 56,024	
Long-term debt	125,000	
Other long-term liabilities	4,542	185,566
		$ 80,220

The net assets transferred by the Company were recorded as a reduction to retained earnings during the third quarter of 2007.

NOTE 3 DISCONTINUED OPERATIONS

In accordance with SFAS 144, the divestiture of unprofitable businesses discussed in Note 1 has been accounted for as discontinued operations. Accordingly, the results of operations of these businesses for all periods presented and the gains, losses or impairments related to these divestitures have been classified as discontinued operations, net of income taxes, in the accompanying unaudited condensed consolidated statement of operations. At September 30, 2007, the Company held for sale 20 nursing centers and one LTAC hospital.

Facility dispositions

On June 29, 2007, the Company purchased for resale 21 nursing centers and one LTAC hospital (collectively, the Ventas Facilities) previously leased from Ventas, Inc. (Ventas) for $171.5 million (the Facility Acquisitions). In addition, the Company paid Ventas a lease termination fee of $3.5 million.

The Ventas Facilities, which contain 2,634 licensed nursing center beds and 220 licensed hospital beds, generated pretax losses of approximately $10 million for the year ended December 31, 2006.

The Company intends to complete the divestiture of most of the Ventas Facilities by December 31, 2007. The Company expects to generate between $80 million and $90 million in proceeds from the sale of the Ventas Facilities and the related operations. The Company recorded a pretax loss of $112.7 million ($69.3 million net of income taxes) during the nine months ended September 30, 2007 related to these planned divestitures. During the third quarter of 2007, the Company sold one of the Ventas Facilities for approximately $1.8 million.

On January 31, 2007, the Company acquired from Health Care Property Investors, Inc. (HCP) the real estate related to 11 unprofitable leased nursing centers operated by the Company for resale in exchange for the real estate related to three hospitals previously owned by the Company (the HCP Transaction). As part of the HCP Transaction, the Company continues to operate the hospitals under a long-term lease arrangement with HCP. In addition, the Company paid HCP a one-time cash payment of approximately $36 million. The Company also amended its existing master lease with HCP to (1) terminate the current annual rent of approximately $9.9 million on the 11 nursing centers, (2) add the three hospitals to the master lease with a current annual rent of approximately $6.3 million and (3) extend the initial expiration date of the master lease until January 31, 2017

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 3 DISCONTINUED OPERATIONS (Continued)

Facility dispositions (Continued)

except for one hospital which has an expiration date of January 31, 2022. During the nine months ended September 30, 2007, the Company sold all of the nursing centers acquired in the HCP Transaction and received proceeds of $77.9 million.

In addition, the Company terminated a nursing center lease with another landlord during the nine months ended September 30, 2007. The Company recorded a pretax loss related to these divestitures of $13.4 million ($8.2 million net of income taxes) during the nine months ended September 30, 2007.

Discontinued operations summary

Discontinued operations included favorable pretax adjustments of $0.4 million for the third quarter of 2006 and $17.3 million for the nine months ended September 30, 2006 resulting from a change in estimate for professional liability reserves related to prior years.

A summary of discontinued operations follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Revenues	$ 38,920	$ 61,406	$ 128,565	$ 182,960
Salaries, wages and benefits	22,553	32,930	71,913	99,572
Supplies	2,381	3,683	7,878	11,552
Rent	74	5,279	6,160	17,590
Other operating expenses	13,920	20,500	45,471	46,780
Depreciation		1,865	2,513	5,330
Interest expense	1		5	1
Investment income	(2)	(3)	(3)	(9)
	38,927	64,254	133,937	180,816
Income (loss) from operations before income taxes	(7)	(2,848)	(5,372)	2,144
Income tax provision (benefit)	(3)	(1,096)	(2,068)	826
Income (loss) from operations	(4)	(1,752)	(3,304)	1,318
Gain (loss) on divestiture of operations, net of income taxes		126	(76,968)	(25)
	$ (4)	$ (1,626)	$ (80,272)	$ 1,293

The following table sets forth certain discontinued operating data by business segment (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Revenues:				
Hospital division:				
Hospitals	$ 3,677	$ 4,792	$ 11,470	$ 15,160
Ancillary services		1		2
	3,677	4,793	11,470	15,162
Health services division	35,243	56,613	117,095	167,798
	$ 38,920	$ 61,406	$ 128,565	$ 182,960

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 3 DISCONTINUED OPERATIONS (Continued)

Discontinued operations summary (Continued)

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Operating income (loss):				
Hospital division:				
Hospitals	$ 486	$ 1,363	$ 2,018	$ 2,638
Ancillary services		1		1
	486	1,364	2,018	2,639
Health services division	(420)	2,929	1,285	22,417
	$ 66	$ 4,293	$ 3,303	$ 25,056
Rent:				
Hospital division:				
Hospitals	$ 7	$ 295	$ 523	$ 1,307
Ancillary services				
	7	295	523	1,307
Health services division	67	4,984	5,637	16,283
	$ 74	$ 5,279	$ 6,160	$ 17,590
Depreciation:				
Hospital division:				
Hospitals	$	$ 221	$ 198	$ 632
Ancillary services				
		221	198	632
Health services division		1,644	2,315	4,698
	$	$ 1,865	$ 2,513	$ 5,330

A summary of the net assets held for sale follows (in thousands):

	September 30, 2007	December 31, 2006
Long-term assets:		

Property and equipment, net	$ 75,184	$ 8,802
Other	583	311
	75,767	9,113
Current liabilities (included in other accrued liabilities)	(2,430)	(1,376)
	$ 73,337	$ 7,737

NOTE 4 SIGNIFICANT QUARTERLY ITEMS

Operating results for the third quarter of 2007 included a non-cash pretax charge of $17.7 million for compensation costs resulting from the Spin-off Transaction (primarily related to the revaluation of stock options adjusted in the Spin-off Transaction and the vesting of certain stock-based and other compensation), a pretax charge of $3.9 million for professional fees and other costs incurred in connection with the Spin-off Transaction and a pretax charge of $0.9 million for employee severance costs. In addition, the provision for income taxes

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 4 SIGNIFICANT QUARTERLY ITEMS (Continued)

included a net charge of $2.2 million related to income tax items associated with the Spin-off Transaction and the favorable resolution of certain income tax contingencies for prior years.

Operating results for the third quarter of 2006 included pretax income of $1.3 million related to an insurance recovery and a favorable adjustment of a prior year tax dispute, and a pretax charge of $3.5 million for costs incurred in connection with the Spin-off Transaction and the rent reset issue with Ventas. Third quarter 2006 results also included a charge of $0.6 million related to a change in estimate of the Company s annual effective income tax rate.

Operating results for the nine months ended September 30, 2007 included a pretax charge of $10.8 million for professional fees and other costs incurred in connection with the Spin-off Transaction and a pretax charge of $4.3 million for employee severance costs. The Company also recorded a pretax charge of $4.6 million related to an unfavorable judgment rendered in connection with a civil dispute with a hospital vendor. In addition, operating results for the nine months ended September 30, 2007 included pretax income of $5.5 million related to a favorable settlement of a rehabilitation therapy contract dispute from prior years.

Operating results for the nine months ended September 30, 2006 included a $1.3 million pretax gain from an institutional pharmacy joint venture transaction, a pretax charge of $2.7 million related primarily to revisions to prior estimates for accrued contract labor costs in the Company s rehabilitation division, a $3.0 million pretax charge in connection with the settlement of a prior year tax dispute, and a pretax charge of $4.3 million for costs related to investment banking services and the rent reset issue with Ventas.

Operating results for the nine months ended September 30, 2006 included pretax income of $6.1 million related to the favorable settlement of prior year hospital Medicare cost reports.

NOTE 5 ACQUISITIONS

In February 2006, the Company acquired the operations of the LTAC hospitals, skilled nursing facilities and assisted living facilities operated by Commonwealth Communities Holdings LLC and certain of its affiliates (the Commonwealth Transaction). The Commonwealth Transaction was financed primarily through the use of the Company s revolving credit facility. Goodwill recorded in connection with the Commonwealth Transaction aggregated $31.7 million. The purchase price also included identifiable intangible assets of $75.9 million related to the value of acquired certificates of need with indefinite lives and other intangible assets of $5.2 million which will be amortized over approximately three years. The net cash paid through September 30, 2007 includes approximately $7 million of contingent consideration to be held in escrow through February 2008 in accordance with the acquisition agreement. The Company has asserted various claims against the sellers under the acquisition agreement that may result in changes in the allocation of the purchase price.

A summary of the Commonwealth Transaction follows (in thousands):

Fair value of assets acquired, including goodwill and other intangible assets	$ 130,645
Fair value of liabilities assumed	(6,991)
Net cash paid through September 30, 2006	123,654
Additional payment of transaction costs	48
Net cash paid through September 30, 2007	$ 123,702

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 ACQUISITIONS (Continued)

The pro forma effect of the Commonwealth Transaction assuming the transaction occurred on January 1, 2006 follows (in thousands, except per share amounts):

	Nine months ended September 30, 2006
Revenues	$ 3,101,873
Income from continuing operations	55,303
Net income	56,596
Earnings per common share:	
Basic:	
Income from continuing operations	$ 1.41
Net income	$ 1.45
Diluted:	
Income from continuing operations	$ 1.34
Net income	$ 1.37

Pro forma financial data have been derived by combining the historical financial results of the Company and the operations acquired in the Commonwealth Transaction for the period presented.

On July 31, 2007, the Company acquired a combined nursing center and assisted living facility for $20.3 million. Goodwill recorded in connection with the acquisition aggregated $0.7 million. The purchase price also included acquired identifiable intangible assets totaling $0.2 million that will be amortized over approximately ten years.

During the third quarter of 2006, the Company acquired three institutional pharmacies for an aggregate cost of $15.3 million. These three pharmacies were included in the net assets of KPS, which were transferred to PharMerica in the Spin-off Transaction.

The purchase prices of these acquired businesses resulted from negotiations with each of the sellers and were based upon both the historical and expected future cash flows of the respective businesses.

NOTE 6 REVENUES

Revenues are recorded based upon estimated amounts due from patients and third party payors for healthcare services provided, including anticipated settlements under reimbursement agreements with Medicare, Medicaid and other third party payors.

A summary of revenues by payor type follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Medicare	$ 433,427	$ 463,939	$ 1,455,793	$ 1,437,600

Medicaid	274,577	268,693	823,648	778,714
Private and other	373,670	380,642	1,198,701	1,107,332
	1,081,674	1,113,274	3,478,142	3,323,646
Eliminations:				
Rehabilitation	(59,721)	(54,394)	(177,889)	(160,163)
Pharmacy	(12,494)	(34,736)	(85,560)	(101,401)
	(72,215)	(89,130)	(263,449)	(261,564)
	$ 1,009,459	$ 1,024,144	$ 3,214,693	$ 3,062,082

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 7 EARNINGS (LOSS) PER SHARE

Earnings (loss) per common share are based upon the weighted average number of common shares outstanding during the respective periods. The diluted calculation of earnings (loss) per common share includes the dilutive effect of warrants, stock options and non-vested restricted stock.

A computation of earnings (loss) per common share follows (in thousands, except per share amounts):

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Earnings (loss):				
Income (loss) from continuing operations	$ (9,058)	$ 4,564	$ 17,110	$ 55,277
Discontinued operations, net of income taxes:				
Income (loss) from operations	(4)	(1,752)	(3,304)	1,318
Gain (loss) on divestiture of operations		126	(76,968)	(25)
Net income (loss)	$ (9,062)	$ 2,938	$ (63,162)	$ 56,570
Shares used in the computation:				
Weighted average shares outstanding basic computation	39,013	39,014	39,271	39,104
Dilutive effect of certain securities:				
Warrants				1,497
Employee stock options		514	844	435
Non-vested restricted stock		241	407	264
Adjusted weighted average shares outstanding diluted computation	39,013	39,769	40,522	41,300
Earnings (loss) per common share:				
Basic:				
Income (loss) from continuing operations	$ (0.23)	$ 0.12	$ 0.43	$ 1.41
Discontinued operations:				
Income (loss) from operations		(0.05)	(0.08)	0.04
Gain (loss) on divestiture of operations			(1.96)	
Net income (loss)	$ (0.23)	$ 0.07	$ (1.61)	$ 1.45
Diluted:				
Income (loss) from continuing operations	$ (0.23)	$ 0.11	$ 0.42	$ 1.34
Discontinued operations:				
Income (loss) from operations		(0.04)	(0.08)	0.03
Gain (loss) on divestiture of operations			(1.90)	
Net income (loss)	$ (0.23)	$ 0.07	$ (1.56)	$ 1.37

Number of antidilutive stock options and non-vested restricted stock excluded from shares used in the diluted earnings (loss) per share computation	2,611	2,186	128	2,137

As a result of the loss from continuing operations reported by the Company in the third quarter of 2007, approximately 880,000 incremental shares have been excluded from the calculation of diluted earnings (loss) per share because the inclusion of such shares would have been antidilutive.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 BUSINESS SEGMENT DATA

At September 30, 2007, the Company operated three business segments: the hospital division, the health services division and the rehabilitation division. The hospital division operates LTAC hospitals. The health services division operates nursing centers. The rehabilitation division provides rehabilitation services primarily in long-term care settings. The Company defines operating income as earnings before interest, income taxes, depreciation, amortization and rent. Operating income reported for each of the Company s business segments excludes the allocation of corporate overhead.

The Company identifies its segments in accordance with the aggregation provisions of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. This information is consistent with information used by the Company in managing its businesses and aggregates businesses with similar economic characteristics.

The following table sets forth certain data by business segment (in thousands):

	Three months ended September 30, 2007	Three months ended September 30, 2006	Nine months ended September 30, 2007	Nine months ended September 30, 2006
Revenues:				
Hospital division	$ 427,199	$ 402,884	$ 1,324,478	$ 1,264,940
Health services division	508,191	463,944	1,490,225	1,349,582
Rehabilitation division	88,284	76,003	257,328	221,541
Pharmacy division	58,000	170,443	406,111	487,583
	1,081,674	1,113,274	3,478,142	3,323,646
Eliminations:				
Rehabilitation	(59,721)	(54,394)	(177,889)	(160,163)
Pharmacy	(12,494)	(34,736)	(85,560)	(101,401)
	(72,215)	(89,130)	(263,449)	(261,564)
	$ 1,009,459	$ 1,024,144	$ 3,214,693	$ 3,062,082
Income (loss) from continuing operations:				
Operating income (loss):				
Hospital division	$ 82,566	$ 73,890	$ 268,010	$ 281,632
Health services division	75,166	59,784	208,788	170,459
Rehabilitation division	8,309	8,857	27,450	21,549
Pharmacy division	431	16,152	17,557	48,020
Corporate:				
Overhead	(54,954)	(37,683)	(131,254)	(118,274)
Insurance subsidiary	(1,856)	(1,634)	(5,031)	(5,178)
	(56,810)	(39,317)	(136,285)	(123,452)
Operating income	109,662	119,366	385,520	398,208

Rent		(88,085)		(78,458)		(261,030)		(215,364)
Depreciation and amortization		(30,916)		(30,808)		(89,506)		(86,236)
Interest, net		(1,229)		(1,139)		(66)		(188)
Income (loss) from continuing operations before income taxes		(10,568)		8,961		34,918		96,420
Provision (benefit) for income taxes		(1,510)		4,397		17,808		41,143
	$	(9,058)	$	4,564	$	17,110	$	55,277

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 BUSINESS SEGMENT DATA (Continued)

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Rent:				
Hospital division	$ 36,001	$ 31,950	$ 106,778	$ 87,183
Health services division	50,078	44,053	146,302	121,214
Rehabilitation division	1,180	932	3,382	2,698
Pharmacy division	740	1,448	4,325	4,044
Corporate	86	75	243	225
	$ 88,085	$ 78,458	$ 261,030	$ 215,364
Depreciation and amortization:				
Hospital division	$ 11,156	$ 12,142	$ 30,266	$ 34,496
Health services division	13,284	9,949	36,090	27,661
Rehabilitation division	284	127	793	322
Pharmacy division	934	2,594	6,510	6,248
Corporate	5,258	5,996	15,847	17,509
	$ 30,916	$ 30,808	$ 89,506	$ 86,236
Capital expenditures, excluding acquisitions (including discontinued operations):				
Hospital division	$ 23,505	$ 16,535	$ 70,179	$ 46,005
Health services division	13,908	12,849	31,064	29,225
Rehabilitation division	385	146	756	295
Pharmacy division	790	2,581	4,115	6,857
Corporate:				
Information systems	4,668	5,376	14,890	16,848
Other	11,000	232	12,008	524
	$ 54,256	$ 37,719	$ 133,012	$ 99,754

	September 30, 2007	December 31, 2006
Assets at end of period:		
Hospital division	$ 842,244	$ 762,943
Health services division	528,149	427,376
Rehabilitation division	23,630	10,621
Pharmacy division		225,684
Corporate	644,050	589,503
	$ 2,038,073	$ 2,016,127
Goodwill:		
Hospital division	$ 61,550	$ 62,613

Health services division		669		
Pharmacy division				45,239
	$	62,219	$	107,852

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 INSURANCE RISKS

The Company insures a substantial portion of its professional liability risks and workers compensation risks through a wholly owned limited purpose insurance subsidiary. Provisions for loss for these risks are based upon third party actuarially determined estimates.

The allowance for professional liability risks includes an estimate of the expected cost to settle reported claims and an amount, based upon past experiences, for losses incurred but not reported. These liabilities are necessarily based upon estimates and, while management believes that the provision for loss is adequate, the ultimate liability may be in excess of, or less than, the amounts recorded. To the extent that subsequent expected ultimate claims costs vary from historical provisions for loss, future earnings will be charged or credited. See Note 3.

The provision for loss for insurance risks, including the cost of coverage maintained with unaffiliated commercial insurance carriers, follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2007	2006	2007	2006
Professional liability:				
Continuing operations	$ 7,600	$ 12,313	$ 38,415	$ 46,567
Discontinued operations	3,717	4,092	10,187	(3,508)
Workers compensation:				
Continuing operations	$ 8,996	$ 8,469	$ 30,444	$ 31,149
Discontinued operations	521	776	1,716	2,911

A summary of the assets and liabilities related to insurance risks included in the accompanying unaudited condensed consolidated balance sheet follows (in thousands):

	September 30, 2007			December 31, 2006		
	Professional liability	Workers compensation	Total	Professional liability	Workers compensation	Total
Assets:						
Current:						
Insurance subsidiary investments	$ 112,001	$ 110,695	$ 222,696	$ 158,245	$ 69,620	$ 227,865
Reinsurance recoverables	2,300		2,300	2,291		2,291
	114,301	110,695	224,996	160,536	69,620	230,156
Non-current:						
Insurance subsidiary investments	51,530		51,530	52,977		52,977
Reinsurance recoverables	6,368		6,368	8,565		8,565
Deposits	6,250	1,452	7,702	7,250	1,507	8,757
Other		273	273		275	275
	64,148	1,725	65,873	68,792	1,782	70,574
	$ 178,449	$ 112,420	$ 290,869	$ 229,328	$ 71,402	$ 300,730

Liabilities:						
Allowance for insurance risks:						
Current	$ 66,325	$ 26,409	$ 92,734	$ 65,497	$ 27,920	$ 93,417
Non-current	194,882	62,213	257,095	184,749	56,971	241,720
	$ 261,207	$ 88,622	$ 349,829	$ 250,246	$ 84,891	$ 335,137

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 INSURANCE RISKS (Continued)

Provisions for loss for professional liability risks retained by the limited purpose insurance subsidiary have been discounted based upon third party actuarial estimates of claim payment patterns using a discount rate of 5% in each period presented. Amounts equal to the discounted loss provision are funded annually. The Company does not fund the portion of professional liability risks related to estimated claims that have been incurred but not reported. Accordingly, these liabilities are not discounted. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated $273.4 million at September 30, 2007 and $262.9 million at December 31, 2006.

Provisions for loss for workers compensation risks retained by the limited purpose insurance subsidiary are not discounted and amounts equal to the loss provision are funded annually.

NOTE 10 LONG-TERM DEBT

On July 18, 2007, the Company completed certain amendments to its revolving credit facility. Under the terms of the amended and restated revolving credit facility, the aggregate amount of the credit was increased to $500 million and may be further increased to $600 million at the Company s option if certain conditions are met. The term of the amended and restated revolving credit facility was extended by an additional three years until July 2012. The amended and restated revolving credit facility also establishes permitted acquisitions and certain investments by the Company at $500 million in the aggregate and allows for up to $150 million of certain restricted payments including, among other things, the repurchase of common stock and payment of cash dividends. The amended and restated revolving credit facility also allowed for the consummation of the Spin-off Transaction.

Interest rates under the amended and restated revolving credit facility are based, at the Company s option, upon (a) LIBOR plus the applicable margin or (b) the applicable margin plus the higher of the prime rate or 0.5% over the federal funds rate. The applicable margin in the amended and restated revolving credit facility represents a decrease of 75 basis points from the previous pricing.

Outstanding borrowings under the revolving credit facility were $234 million at September 30, 2007.

NOTE 11 CAPITAL STOCK

On August 7, 2007, the Company s Board of Directors authorized up to $100 million in common stock repurchases. The authorization allows for repurchases of up to $50 million of common stock during 2007 and the remainder during 2008. During the third quarter of 2007, the Company expended $50 million to purchase approximately 2.6 million shares of its common stock. The Company intends to finance any additional repurchases from operating cash flows or from borrowings under its revolving credit facility. The authorization includes both open market purchases as well as private transactions.

NOTE 12 INCOME TAXES

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes. The interpretation clarifies the accounting for uncertain income tax issues recognized in an entity s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 12 INCOME TAXES (Continued)

The Company adopted the provisions of FIN 48 on January 1, 2007. As of the date of adoption, the Company s unrecognized tax benefits were $7.4 million. The Company records accrued interest and penalties associated with uncertain tax positions as income tax expense in the consolidated statement of operations. As of January 1, 2007, the Company had $2.1 million of accrued interest related to uncertain tax positions. To the extent the unrecognized income tax benefits become realized or the related accrued interest is no longer necessary, the Company s provision for income taxes would be favorably impacted.

During the third quarter of 2007, the Company reduced its unrecognized tax benefits and related accrued interest by $3.6 million. The deferred tax asset associated with unrecognized tax benefits also was reduced by $1.3 million. As of September 30, 2007, the Company s unrecognized tax benefits totaled $4.5 million and accrued interest related to uncertain tax positions totaled $1.4 million.

The federal statute of limitations remains open for tax years 2000 through 2006. The Internal Revenue Service is currently examining the 2004 and 2005 tax years.

State jurisdictions generally have statutes of limitations ranging from three to five years. The state income tax impact of federal income tax changes remains subject to examination by various states for a period of up to one year after formal notification to the states. The Company currently has various state income tax returns under examination.

Within the next year, the statutes of limitations associated with certain state income tax filing positions will expire and may decrease the amount of unrecognized income tax benefits. A reduction in the Company s income tax liability of up to approximately $2 million for unrecognized income tax benefits and up to $1 million of accrued interest is reasonably possible and may favorably impact the Company s financial position and results of operations.

NOTE 13 CONTINGENCIES

Management continually evaluates contingencies based upon the best available information. In addition, allowances for loss are provided currently for disputed items that have continuing significance, such as certain third party reimbursements and deductions that continue to be claims in current cost reports and tax returns.

Management believes that allowances for losses have been provided to the extent necessary and that its assessment of contingencies is reasonable.

Principal contingencies are described below:

Revenues Certain third party payments are subject to examination by agencies administering the various programs. The Company is contesting certain issues raised in audits of prior year cost reports.

Professional liability risks The Company has provided for loss for professional liability risks based upon actuarially determined estimates. Ultimate claims costs may differ from the provisions for loss. See Notes 3 and 9.

Income taxes The Company is subject to various federal and state income tax audits in the ordinary course of business. Such audits could result in increased tax payments, interest and penalties. In addition, the Company is a party to a tax matters agreement with PharMerica with respect to the Company s rights and obligations related to taxes for periods before and after the Spin-off Transaction.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 13 CONTINGENCIES (Continued)

Litigation The Company is a party to various legal actions (some of which are not insured), and regulatory and other government investigations and sanctions arising in the ordinary course of its business. The Company is unable to predict the ultimate outcome of pending litigation and regulatory and other government investigations. The U.S. Department of Justice (the DOJ), the Centers for Medicare and Medicaid Services (CMS) or other federal and state enforcement and regulatory agencies may conduct additional investigations related to the Company s businesses in the future which may, either individually or in the aggregate, have a material adverse effect on the Company s financial position, results of operations or liquidity.

Other indemnifications In the ordinary course of business, the Company enters into contracts containing standard indemnification provisions and indemnifications specific to a transaction such as a disposal of an operating facility. These indemnifications may cover claims related to employment-related matters, governmental regulations, environmental issues and tax matters, as well as patient, third party payor, supplier and contractual relationships. Obligations under these indemnifications generally are initiated by a breach of the terms of a contract or by a third party claim or event.

NOTE 14 SUBSEQUENT EVENT

On October 10, 2007, the Company acquired the real estate of seven previously leased nursing centers for approximately $102 million. The purchase price was financed by $98 million in borrowings under the Company s revolving credit facility and $4 million in previously funded leasehold and escrow deposits. The annual rents associated with these facilities approximated $8.4 million. The Company will continue to operate these nursing centers.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Cautionary Statement

This Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). All statements regarding the Company s expected future financial position, results of operations, cash flows, financing plans, business strategy, budgets, capital expenditures, competitive positions, growth opportunities, plans and objectives of management and statements containing the words such as anticipate, approximate, believe, plan, estimate, expect, project, could, should, will, intend, may and other similar expressions, are forward-looking statements.

Such forward-looking statements are inherently uncertain, and stockholders and other potential investors must recognize that actual results may differ materially from the Company s expectations as a result of a variety of factors, including, without limitation, those discussed below. Such forward-looking statements are based upon management s current expectations and include known and unknown risks, uncertainties and other factors, many of which the Company is unable to predict or control, that may cause the Company s actual results or performance to differ materially from any future results or performance expressed or implied by such forward-looking statements. These statements involve risks, uncertainties and other factors discussed below and detailed from time to time in the Company s filings with the SEC. Factors that may affect the Company s plans or results include, without limitation:

- the Company s ability to operate pursuant to the terms of its debt obligations and its master leases with Ventas,
- the Company s ability to meet its rental and debt service obligations,
- the Company s ability to complete the resale of the Ventas Facilities,
- adverse developments with respect to the Company s results of operations or liquidity,
- the Company s ability to attract and retain key executives and other healthcare personnel,
- increased operating costs due to shortages in qualified nurses, therapists and other healthcare personnel,
- the effects of healthcare reform and government regulations, interpretation of regulations and changes in the nature and enforcement of regulations governing the healthcare industry,
- changes in the reimbursement rates or methods of payment from third party payors, including the Medicare and Medicaid programs, changes arising from and related to the Medicare prospective payment system for LTAC hospitals (LTAC PPS), the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, and changes in Medicare and Medicaid reimbursements for the Company s nursing centers,
- national and regional economic conditions, including their effect on the availability and cost of labor, materials and other services,

the Company s ability to control costs, particularly labor and employee benefit costs,

the Company s ability to successfully pursue its development activities and successfully integrate new operations, including the realization of anticipated revenues, economies of scale, cost savings and productivity gains associated with such operations,

the increase in the costs of defending and insuring against alleged professional liability claims and the Company s ability to predict the estimated costs related to such claims,

the Company s ability to successfully reduce (by divestiture of operations or otherwise) its exposure to professional liability claims,

the Company s ability to successfully dispose of unprofitable facilities, and

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Cautionary Statement (Continued)

the Company s ability to ensure and maintain an effective system of internal controls over financial reporting.

Many of these factors are beyond the Company s control. The Company cautions investors that any forward-looking statements made by the Company are not guarantees of future performance. The Company disclaims any obligation to update any such factors or to announce publicly the results of any revisions to any of the forward-looking statements to reflect future events or developments.

General

The quarterly items discussed in Note 4 and the business segment data in Note 8 of the accompanying Notes to Condensed Consolidated Financial Statements should be read in conjunction with the following discussion and analysis.

The Company is a healthcare services company that through its subsidiaries operates hospitals, nursing centers and a contract rehabilitation services business across the United States. At September 30, 2007, the Company s hospital division operated 83 LTAC hospitals (6,495 licensed beds) in 24 states. The Company s health services division operated 228 nursing centers (29,204 licensed beds) in 27 states. The Company operated a contract rehabilitation services business which provides rehabilitative services primarily in long-term care settings.

On July 31, 2007, the Company completed the Spin-off Transaction. See Note 2 of the accompanying Notes to Condensed Consolidated Financial Statements.

In recent years, the Company has completed several strategic divestitures to improve its future operating results. For accounting purposes, the operating results of these businesses and the gains, losses or impairments associated with these transactions have been classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented. Assets not sold at September 30, 2007 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying unaudited condensed consolidated balance sheet. See Note 3 of the accompanying Notes to Condensed Consolidated Financial Statements.

Critical Accounting Policies

Management s discussion and analysis of financial condition and results of operations are based upon the Company s consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the use of estimates and judgments that affect the reported amounts and related disclosures of commitments and contingencies. The Company relies on historical experience and on various other assumptions that management believes to be reasonable under the circumstances to make judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates.

The Company believes the following critical accounting policies, among others, affect the more significant judgments and estimates used in the preparation of its consolidated financial statements.

Revenue recognition

The Company has agreements with third party payors that provide for payments to each of its operating divisions. These payment arrangements may be based upon prospective rates, reimbursable costs, established

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Critical Accounting Policies (Continued)

Revenue recognition (Continued)

charges, discounted charges or per diem payments. Net patient service revenue is recorded at the estimated net realizable amounts from Medicare, Medicaid, other third party payors and individual patients for services rendered. Retroactive adjustments that are likely to result from future examinations by third party payors are accrued on an estimated basis in the period the related services are rendered and adjusted as necessary in future periods based upon new information or final settlements.

Operating results for the nine months ended September 30, 2006 included pretax income of $6 million related to the favorable settlement of prior year hospital Medicare cost reports.

See Note 6 of the accompanying Notes to Condensed Consolidated Financial Statements for a summary of the Company s revenues.

Collectibility of accounts receivable

Accounts receivable consist primarily of amounts due from the Medicare and Medicaid programs, other government programs, managed care health plans, commercial insurance companies and individual patients. Estimated provisions for doubtful accounts are recorded to the extent it is probable that a portion or all of a particular account will not be collected.

In evaluating the collectibility of accounts receivable, the Company considers a number of factors, including the age of the accounts, changes in collection patterns, the composition of patient accounts by payor type, the status of ongoing disputes with third party payors and general industry conditions. Actual collections of accounts receivable in subsequent periods may require changes in the estimated provision for loss. Changes in these estimates are charged or credited to the results of operations in the period of the change.

The provision for doubtful accounts totaled $6 million and $9 million for the third quarter of 2007 and 2006, respectively, and totaled $21 million and $26 million for the nine months ended September 30, 2007 and 2006, respectively.

Allowances for insurance risks

The Company insures a substantial portion of its professional liability risks and workers compensation risks through a wholly owned limited purpose insurance subsidiary. Provisions for loss for these risks are based upon third party actuarially determined estimates.

The allowance for professional liability risks includes an estimate of the expected cost to settle reported claims and an amount, based upon past experiences, for losses incurred but not reported. These liabilities are necessarily based upon estimates and, while management believes that the provision for loss is adequate, the ultimate liability may be in excess of, or less than, the amounts recorded. To the extent that subsequent expected ultimate claims costs vary from historical provisions for loss, future earnings will be charged or credited.

Provisions for loss for professional liability risks retained by the limited purpose insurance subsidiary have been discounted based upon third party actuarial estimates of claim payment patterns using a discount rate of 5% in each period presented. Amounts equal to the discounted loss provision are funded annually. The Company does not fund the portion of professional liability risks related to estimated claims that have been incurred but not reported. Accordingly, these liabilities are not discounted. The allowance for professional liability risks

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Critical Accounting Policies (Continued)

Allowances for insurance risks (Continued)

aggregated $261 million at September 30, 2007 and $250 million at December 31, 2006. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated $273 million at September 30, 2007 and $263 million at December 31, 2006.

As a result of improved professional liability underwriting results of the Company s limited purpose insurance subsidiary, the Company received distributions of $37 million and $34 million during the nine months ended September 30, 2007 and 2006, respectively, from its limited purpose insurance subsidiary. These proceeds were used primarily to repay borrowings under the Company s revolving credit facility.

Changes in the number of professional liability claims and the cost to settle these claims significantly impact the allowance for professional liability risks. A relatively small variance between the Company s estimated and ultimate actual number of claims or average cost per claim could have a material impact, either favorable or unfavorable, on the adequacy of the allowance for professional liability risks. For example, a 1% variance in the allowance for professional liability risks at September 30, 2007 would impact the Company s operating income by approximately $3 million. The Company recorded favorable pretax adjustments of approximately $0.4 million and $17 million for the third quarter and nine months ended September 30, 2006, respectively, resulting from a change in estimate for professional liability reserves related to prior years (included in discontinued operations).

The provision for professional liability risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated $8 million and $12 million for the third quarter of 2007 and 2006, respectively, and $39 million and $47 million for the nine months ended September 30, 2007 and 2006, respectively.

Provisions for loss for workers compensation risks retained by the Company s limited purpose insurance subsidiary are not discounted and amounts equal to the loss provision are funded annually. The allowance for workers compensation risks aggregated $89 million at September 30, 2007 and $85 million at December 31, 2006. The provision for workers compensation risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated $8 million for the third quarter of both 2007 and 2006, and $30 million and $31 million for the nine months ended September 30, 2007 and 2006, respectively.

See Note 9 of the accompanying Notes to Condensed Consolidated Financial Statements for a summary of the Company s insurance activities.

Accounting for income taxes

The provision for income taxes is based upon the Company s estimate of annual taxable income or loss for each respective accounting period. The Company recognizes an asset or liability for the deferred tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements. These temporary differences will result in taxable or deductible amounts in future years when the reported amounts of the assets are recovered or liabilities are settled. The Company also recognizes as deferred tax assets the future tax benefits from net operating and capital loss carryforwards. A valuation allowance is provided for these deferred tax assets if it is more likely than not that some portion or all of the net deferred tax assets will not be realized.

The Company s effective income tax rate was 14.3% and 49.1% in the third quarter of 2007 and 2006, respectively, and 51.0% and 42.7% for the nine months ended September 30, 2007 and 2006, respectively. The

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Critical Accounting Policies (Continued)