



**DIAKON  
AND CONTROLLED AFFILIATES**

Consolidated Financial Statements and Schedules

December 31, 2008 and 2007

(With Independent Auditors' Report Thereon)

**DIAKON  
AND CONTROLLED AFFILIATES**

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## **Independent Auditors' Report**

The Board of Directors  
Diakon:

We have audited the accompanying consolidated balance sheets of Diakon and controlled affiliates (collectively, the Corporation), as of December 31, 2008 and 2007, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Diakon and controlled affiliates as of December 31, 2008 and 2007, and the results of their operations and changes in net assets and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The 2008 consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position and results of operations and changes in net assets (deficit) of the individual entities. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

**KPMG LLP**

April 16, 2009

**DIAKON  
AND CONTROLLED AFFILIATES**

Consolidated Balance Sheets

December 31, 2008 and 2007

<b>Assets</b>	<b>2008</b>	<b>2007</b>
	<hr/>	<hr/>
Current assets:		
Cash and cash equivalents	\$ 7,251,883	10,136,220
Investments	41,437,516	—
Assets limited as to use	15,172,937	3,149,584
Accounts receivable (net of allowance for doubtful accounts of \$839,000 and \$773,000 in 2008 and 2007, respectively):		
Patients and residents	11,770,789	9,613,087
Other client services	4,994,456	3,984,003
Estimated third-party payor settlements	1,290,915	996,939
Prepaid expenses and other assets	1,707,105	2,305,820
	<hr/>	<hr/>
Total current assets	83,625,601	30,185,653
Investments	—	66,468,508
Assets limited as to use, net of current portion	99,177,008	163,383,031
Investments in joint ventures	647,540	5,657,357
Land, buildings, and equipment, net	188,231,335	169,840,008
Other assets:		
Deferred debt issuance costs, net	1,185,687	8,033,410
Receivables from charitable gift annuities	961,720	1,003,644
Funds held in trust by others and beneficial interest in trust	25,122,847	35,349,148
Other assets	5,878,301	6,139,478
	<hr/>	<hr/>
Total assets	\$ 404,830,039	486,060,237
	<hr/> <hr/>	<hr/> <hr/>

**DIAKON  
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Consolidated Balance Sheets

December 31, 2008 and 2007

<b>Liabilities and Net Assets</b>	<b>2008</b>	<b>2007</b>
	<u>                    </u>	<u>                    </u>
Current liabilities:		
Lines of credit	\$ 5,570,918	3,342,918
Accounts payable – trade	4,265,353	4,296,232
Accrued expenses	17,417,331	16,201,461
Deposits – patients and residents	1,039,633	948,709
Deferred revenue	559,311	641,330
Estimated third-party payor settlements	1,097,778	1,015,223
Current maturities of long-term debt	39,323,678	3,697,655
Total current liabilities	<u>69,274,002</u>	<u>30,143,528</u>
Pension liability	18,603,108	8,367,253
Swap agreements	20,172,008	8,032,251
Deferred revenue – entrance agreements	60,039,033	60,086,998
Deferred gain on sale of assets	1,256,304	1,551,904
Other long-term liabilities	1,488,358	3,894,506
Long-term debt, less current maturities	163,569,378	200,956,981
Total liabilities	<u>334,402,191</u>	<u>313,033,421</u>
Net assets:		
Unrestricted	33,501,478	122,219,692
Temporarily restricted	4,014,588	8,426,541
Permanently restricted	32,911,782	42,380,583
Total net assets	<u>70,427,848</u>	<u>173,026,816</u>
Total liabilities and net assets	<u>\$ 404,830,039</u>	<u>486,060,237</u>

See accompanying notes to consolidated financial statements.

**DIAKON  
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Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2008 and 2007

	<b>2008</b>	<b>2007</b>
Operating revenues, gains and other support:		
Patient and resident service revenue, net of contractual allowances	\$ 127,296,604	120,002,570
Patient and resident service revenue – nursing home assessment (note 3)	2,759,103	2,405,703
Amortization of entrance fees	8,087,312	8,036,163
Grants	13,855,545	13,344,934
Other fees and services	10,476,844	9,262,581
Statewide Adoption and Permanency Network revenue	20,470,336	18,487,937
Investment income, net of expenses	7,703,363	14,767,668
Contributions and bequests	1,554,364	1,694,611
Net assets released from restrictions – operations	1,657,896	2,724,420
Gain on disposal of assets	338,413	1,094,042
Total operating revenues, gains and other support	194,199,780	191,820,629
Expenses:		
Salaries and wages	71,401,941	68,802,809
Employee benefits	16,459,276	14,397,625
Other expenses	64,608,350	63,846,445
Other expenses – Statewide Adoption and Permanency Network	19,598,075	17,677,865
Nursing home assessment (note 3)	1,784,389	1,375,252
Interest	10,794,812	10,584,597
Depreciation and amortization	12,485,683	12,107,766
Realignment costs	1,585,500	—
Total expenses	198,718,026	188,792,359
Operating (loss) income	(4,518,246)	3,028,270
Equity in (losses) gains of joint ventures	(2,757,866)	1,367,565
Unrealized loss on other-than-temporary impairment of investments	(47,715,878)	—
Decrease in fair value of swap agreements	(12,677,842)	(2,977,222)
Loss from early extinguishment of debt	(7,179,013)	(2,071,866)
Deficit of operating revenues, gains and other support over expenses	(74,848,845)	(653,253)
Other changes:		
Pension-related changes other than net periodic pension costs	(10,235,855)	(740,079)
Equity in losses of joint ventures	(2,251,951)	(1,012,937)
Unrealized losses on investments	(2,151,393)	(319,291)
Increase in fair value of swap agreements	538,085	441,349
Net assets released from restrictions – capital	231,745	762,260
Total other changes	(13,869,369)	(868,698)
Decrease in unrestricted net assets	(88,718,214)	(1,521,951)

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Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
Temporarily restricted net assets:		
Contributions and bequests	\$ 1,496,765	2,113,794
Investment income, net of expenses	287,536	1,095,965
Unrealized losses on investments	(4,120,422)	(305,337)
Net assets released from restrictions – operations	(1,657,896)	(2,724,420)
Net assets released from restrictions – capital	(231,745)	(762,260)
Change in beneficial interest in trust	(186,191)	(75,312)
Decrease in temporarily restricted net assets	<u>(4,411,953)</u>	<u>(657,570)</u>
Permanently restricted net assets:		
Contributions and bequests	286,326	63,408
(Decrease) increase in fair value of funds held in trust by others	(9,755,127)	591,999
(Decrease) increase in permanently restricted net assets	<u>(9,468,801)</u>	<u>655,407</u>
Decrease in net assets	(102,598,968)	(1,524,114)
Net assets, beginning of year	<u>173,026,816</u>	<u>174,550,930</u>
Net assets, end of year	<u>\$ 70,427,848</u>	<u>173,026,816</u>

See accompanying notes to consolidated financial statements.

**DIAKON  
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Consolidated Statements of Cash Flows  
Years ended December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
Cash flows from operating activities:		
Decrease in net assets	\$ (102,598,968)	(1,524,114)
Adjustments to reconcile decrease in net assets to net cash (used in) provided by operating activities:		
Net realized losses (gains) on investments	442,090	(6,969,335)
Net unrealized losses on investments	6,271,815	624,628
Unrealized loss on other-than-temporary impairment of investments	47,715,878	—
Depreciation and amortization	12,485,683	12,107,766
Increase in pension liability	10,235,855	825,073
Amortization of entrance fees	(8,087,312)	(8,036,163)
Proceeds from entrance fees	7,430,650	15,456,063
Amortization of deferred gain on sale of assets	(295,600)	(295,601)
Change in funds held in trust by others and beneficial interest in trust	10,007,060	(492,233)
Loss on swap agreements	12,139,757	2,535,873
Gain in equity earnings of joint ventures	5,009,817	(354,628)
Gain on disposal of assets	—	(798,441)
Loss on early extinguishment of debt	7,179,013	2,071,866
Provision for bad debts	481,021	466,111
Restricted contributions and investment income	(412,730)	(548,747)
Change in assets and liabilities:		
Accounts receivable	(3,534,413)	1,848,131
Estimated third-party payor settlements	(211,421)	307,423
Prepaid expenses and other current assets	58,813	4,849,499
Contributions and charitable gift/remainder trusts	277,366	149,064
Other assets	(144,317)	(172,542)
Accounts payable, accrued expenses, and other liabilities	(2,419,314)	252,201
Deposits – patients and residents	90,924	(393,532)
Net cash (used in) provided by operating activities	<u>2,121,667</u>	<u>21,908,362</u>
Cash flows from investing activities:		
Purchase of investments and assets limited as to use	(27,720,708)	(203,489,347)
Proceeds from sales of investments and assets limited as to use	50,504,587	146,945,498
Purchase of property and equipment	(29,261,529)	(23,533,470)
Proceeds from disposal of assets	—	1,523,533
Net cash used in investing activities	<u>(6,477,650)</u>	<u>(78,553,786)</u>
Cash flows from financing activities:		
Payment of long-term debt	(1,761,580)	(45,608,878)
Proceeds from bond issuance	—	111,035,927
Payment of debt issuance costs	—	(3,923,064)
Net proceeds from lines of credit	2,228,000	2,924,918
Proceeds from restricted contributions and investment income	396,529	602,726
Proceeds from entrance fees	2,935,520	2,874,942
Refunds on entrance fees	(2,326,823)	(2,725,417)
Net cash provided by financing activities	<u>1,471,646</u>	<u>65,181,154</u>
Net (decrease) increase in cash and cash equivalents	(2,884,337)	8,535,730
Cash and cash equivalents, beginning of year	<u>10,136,220</u>	<u>1,600,490</u>
Cash and cash equivalents, end of year	<u>\$ 7,251,883</u>	<u>10,136,220</u>

See accompanying notes to consolidated financial statements.

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Notes to Consolidated Financial Statements

December 31, 2008 and 2007

**(1) Summary of Significant Accounting Policies**

**(a) Organization**

Diakon is a private, nonprofit charitable organization recognized by the Internal Revenue Service as a 501(c)(3) corporation and is exempt from federal income taxation under the group exemption of the Evangelical Lutheran Church in America (ELCA). Diakon is the sole member of Diakon Lutheran Social Ministries and Controlled Entities (DLSM), Diakon Lutheran Fund (DLF), and Diakon Housing and Development, Inc. Diakon is affiliated with ELCA through Lutheran Services in America (LSA), the membership alliance of Lutheran social ministry organizations and church bodies. Diakon has a relationship with the following participating synods: Delaware-Maryland, Lower Susquehanna, Northeastern Pennsylvania, Southeastern Pennsylvania, and Upper Susquehanna. Through a cooperative agreement, it also serves in the Allegheny Synod (collectively, the Synods). In accordance with Diakon's bylaws, the bishops of the Synods elect the majority of the Diakon's board of directors. The bishops of the Synods also elect the majority of DLSM's board of directors. The board of Diakon, in its role as sole member, appoints the boards for DLF and Diakon Housing and Development, Inc.

**(b) Description of Controlled Affiliates**

DLSM, the operating entity for the retirement living and family and community ministries of Diakon, is a Pennsylvania nonprofit corporation recognized as a charitable organization under Section 501(c)(3) of the Internal Revenue Code and is exempt from federal income taxation under the group exemption of ELCA. DLSM provides both senior living and health services and family and community ministry services in Pennsylvania, Maryland, and Delaware. DLSM is also the prime contractor for the Pennsylvania Statewide Adoption and Permanency Network under a contract with the Pennsylvania Department of Public Welfare (the SWAN Contract).

The following table details the number of beds/units operated by DLSM:

	<b>Total</b>
Nursing beds	999
Assisted living beds	632
Independent living units	909
HUD housing units	335
Total	2,875

DLF, a 501(c)(3) corporation, is authorized by its charter to provide management of DLSM's investment and solicit contributions only for services to children, youth, and family programs. In the absence of donor restrictions, DLF has discretionary control over the amounts, timing, and use of its distributions to children and family programs, and may not distribute funds for any other programs. DLF is a supporting organization to DLSM's children, youth, and family services programs.

Diakon Housing and Development, Inc. is a 501(c)(3) corporation that operates in East Baltimore to purchase vacant buildings and rehabilitate them for use as affordable housing.

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**(c) Basis of Consolidation**

The accompanying consolidated financial statements have been prepared to focus on Diakon and all controlled affiliated organizations (collectively, the Corporation) as a whole. All material intercompany transactions have been eliminated.

**(d) Basis of Accounting**

The accompanying consolidated financial statements are prepared on the accrual basis of accounting and present balances and transactions according to the existence or absence of donor-imposed restrictions.

Revenues are reported as increases in unrestricted net assets unless use of the related assets is limited by donor-imposed restrictions. Expenses are reported as decreases in unrestricted net assets. Gains and losses on investments and other assets or liabilities are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulation or by law. Expirations of temporary restrictions on net assets (i.e., the donor-stipulated purpose has been fulfilled and/or the stipulated time period has lapsed) are reported as net assets released from restrictions in the consolidated statements of operations and changes in net assets.

There are three classes of net assets – permanently restricted, temporarily restricted, and unrestricted.

*Permanently restricted net assets* are net assets subject to donor-imposed stipulations that are required to be maintained permanently by the Corporation. Generally, the donors of these assets permit the institution to use all or part of the income earned on related investments for general or specific purposes. Permanently restricted net assets consist principally of funds held in trust by others.

*Temporarily restricted net assets* are net assets subject to donor-imposed stipulations that may or will be met by actions of the Corporation and/or the passage of time.

*Unrestricted net assets* are net assets not subject to donor-imposed stipulations.

**(e) Cash and Cash Equivalents**

Cash and cash equivalents include repurchase agreements and other interest-bearing instruments with an original maturity of three months or less, excluding amounts classified as assets limited as to use.

**(f) Investments and Investment Income**

Investments are measured at fair value in the consolidated balance sheets.

Certain investments and assets limited as to use are maintained in investment pools (pooled funds). To equitably allocate investment income, including gains and losses, each participating fund is assigned a number of units using the market value method.

Investment income and gains and losses on the sale of investments are added to or deducted from the appropriate net asset classification depending on the existence of donor-imposed restrictions.

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A decline in market value of any investment below its cost basis that is deemed to be other-than-temporary results in a reduction in carrying amount to the fair value. The impairment is recognized as a loss and a new cost basis for the investment is established. For the years ended December 31, 2008 and 2007, there were \$47,715,878 and \$0 other-than-temporary declines recognized as unrealized losses on other-than-temporary impairment of investments, respectively.

**(g) *Assets Limited as to Use***

Assets limited as to use include assets set aside by the board of directors for future capital improvements and other designated purposes, over which the board retains control and may, at its discretion, subsequently use for other purposes; assets held by trustees under mortgage agreements with agencies of the U.S. government; assets held by trustees under bond indentures; and donor and other restricted funds. Investment income and gains and losses on assets limited as to use are included in investment income.

**(h) *Investments in Joint Ventures***

The Corporation accounts for the equity interest it has in not-for-profit and for-profit joint ventures where it has joint control and economic interest with another organization by reflecting a pro rata share of the venture as an investment under the equity method of accounting. Changes in the venture's equity have been reflected in the consolidated statements of operations and changes in net assets as equity in gains (losses) of joint ventures and classified consistent with the characteristics of the joint venture's activities.

Investments in joint ventures represents investment in 50% or less owned entities, including a continuing care retirement community and an information technology joint venture.

**(i) *Land, Buildings, and Equipment***

Land, buildings, and equipment are recorded at cost. The cost of maintenance and repairs is expensed as incurred, whereas significant renewals and betterments are capitalized. Depreciation is calculated on the straight-line method over the estimated useful lives of the depreciable assets.

Depreciable lives are determined as follows:

Land improvements	10 to 25 years
Buildings	10 to 40 years
Furniture and equipment	3 to 20 years
Vehicles	4 to 7 years
Leasehold improvements	7 to 15 years

Gifts of long-lived assets such as land, buildings, or equipment are reported as unrestricted support 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 other assets that must be used to acquire long-lived assets are reported as restricted support. Absent

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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.

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

**(j) *Impairment of Long-Lived Assets***

Long-lived assets, such as property and equipment and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized in the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the consolidated balance sheets and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held-for-sale would be presented separately in the appropriate asset and liability sections of the consolidated balance sheets.

**(k) *Deferred Debt Issuance Costs and Other Assets***

Debt issuance costs are amortized over the period the obligation is outstanding. Amortization expense was \$102,983 and \$529,123 in 2008 and 2007, respectively. Accumulated amortization as of December 31, 2008 and 2007 totaled \$233,115 and \$1,166,125, respectively.

The Corporation remarketed the Series B 2007 bonds and Series D 2003 bonds on February 14, 2008 and February 29, 2008, respectively. Additionally, the Corporation redeemed the Series A 1998 bonds on February 7, 2007. As a result of these transactions, losses from early extinguishment of debt of \$7,179,013 and \$2,071,866 were recognized in 2008 and 2007, respectively, primarily related to the write-off of unamortized deferred debt issuance costs.

Other assets include goodwill of approximately \$5,593,000 related to the acquisition of a continuing care retirement community, which is being amortized over a period of 21 years. Amortization expense for this asset was approximately \$266,000 in 2008 and 2007 and accumulated amortization totaled approximately \$754,000 at December 31, 2008 and \$488,000 at December 31, 2007.

**(l) *Receivables from Charitable Gift Annuities***

Independent trustees maintain charitable gift annuities for which the Corporation has been named beneficiary of the corpus and will receive these funds upon the death of the annuitant.

**(m) *Funds Held in Trust by Others and Beneficial Interest in Trust***

DLSM, or its predecessor entities, and DLF (the beneficiaries) have been named as the beneficiaries of a number of trusts that are administered and controlled by independent trustees. The trusts are recorded as contribution revenue when the beneficiaries are notified of the trust's existence. The

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beneficiaries receive the earnings from these trusts whose principal is to be held in perpetuity. The earnings from the trusts are recorded as investment income.

Funds held in trust by others and the beneficial interest in trust are valued at the fair value of the underlying investments. The change in the fair value of funds held in trust by others is reported as a change in permanently restricted net assets and the change in the fair value of the beneficial interest in trust is reported as a change in temporarily restricted net assets. Lifecare residents of Twining Village requiring financial assistance have been named as the beneficiaries of a trust administered and controlled by independent trustees.

**(n) Self Insurance**

Accrued expenses include a provision for estimated self-insured workers' compensation claims for both reported claims not yet paid and claims incurred but not reported.

**(o) Deposits – Patients and Residents**

Deposits – patients and residents represents security deposits paid in advance to cover possible costs when patients and residents vacate their apartments or personal care units. These deposits are taken into income only if earned upon the termination of a rental agreement. Deposits – patients and residents also includes nursing home patients' funds held in safekeeping by the Corporation for the patients' personal use.

**(p) Pension Benefits**

The Corporation has a noncontributory defined benefit pension plan covering substantially all of its employees upon their retirement. The benefits are based on years of service and the employee's compensation.

The Corporation records annual amounts relating to its pension plan based on calculations that incorporate various actuarial and other assumptions, including discount rates, mortality, assumed rates of return, compensation increases, and turnover rates. The Corporation reviews its assumptions on an annual basis and makes modifications to the assumptions based on current rates and trends when it is appropriate to do so. The effect of modifications to those assumptions is recorded as an other change in unrestricted net assets and amortized to net periodic cost over future periods using the corridor method. The Corporation believes that the assumptions utilized in recording its obligations under its plan are reasonable based on its experience and market conditions.

The net periodic costs are recognized as employees render the services necessary to earn the pension benefits. The funded status of the plan is reported in the consolidated balance sheet as of December 31, 2008 and 2007 in accordance with FASB Statement No. 158 (Statement 158), *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, which requires companies to recognize the funded status of defined benefit pension and other postretirement plans as a net asset or liability and to recognize changes in that funded status in the year in which the changes occur through other changes in unrestricted net assets to the extent those changes are not included in the net periodic cost.

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**(q) *Derivative Instruments***

Derivative financial instruments are used to limit interest rate exposure on variable rate debt. The Corporation has entered into interest rate swaps to limit its exposure to interest rate changes on its variable rate revenue bonds. Hedge accounting has not been elected; therefore, variations in fair value are marked-to-market and reported outside of the Corporation's intermediate measure of operating performance and within its performance indicator in the consolidated statements of operations and changes in net assets except as noted below.

Statement of Position 02-2 (SOP 02-2), *Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Healthcare Organizations, and Clarification of the Performance Indicator*, clarified that the performance indicator reported by not-for-profit healthcare organizations is analogous to income from continuing operations of a for-profit enterprise. The Corporation adopted the provisions of SOP 02-2 as of January 1, 2003. As a result, the only derivative activity reported outside the performance indicator after January 1, 2003 is the activity associated with effective cash flow hedges and gains that represent a recovery of losses previously recognized outside the performance indicator.

**(r) *Entrance Agreement Contracts***

Entrance fees paid by residents of the Corporation's independent living units, including certain cottages and apartments, are recorded as deferred revenue. A resident, upon termination of occupancy, is entitled to receive a refund of a portion of the entrance fee pursuant to the terms of the contract, which is required to be paid only upon the subsequent receipt of an entrance fee from a new resident for that independent living unit. These entrance fee agreements guarantee occupancy rights to residents for life; for three facilities, there are lifetime healthcare services provided under the provisions of the agreements.

The nonrefundable portion of entrance fees as stated in each contract is deferred and amortized to revenue over the estimated life expectancy of each resident; whereas the portion of entrance fees refundable only upon reoccupancy is amortized to revenue on a straight-line basis over the remaining estimated useful life of the facility.

The amount of entrance fees, which is refundable to residents at December 31, 2008 and 2007 under contractual refund provisions, was approximately \$43,000,000 and \$46,000,000, respectively. Proceeds and refunds of refundable entrance fees are classified as financing activities in the consolidated statements of cash flows.

**(s) *Conditional Asset Retirements***

The Corporation has evaluated its facilities to determine if it has a liability for the fair value of a conditional asset retirement obligation. The types of asset retirement obligations evaluated are those for which an entity has a legal obligation to perform an asset retirement activity; however, the timing and (or) method of settling the obligation is conditional on a future event that may or may not be within the control of the entity. No material conditional asset retirement obligations have been identified by the Corporation.

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Notes to Consolidated Financial Statements

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**(t) *Obligation to Provide Future Services to Continuing Care Residents***

The Corporation annually calculates the present value of the net cost of future services using a discount rate of 6% and compares that amount with the balance of deferred revenue from advance fees. If the present value of the net cost of future services and the use of facilities exceeds the deferred revenue from acquisition fees, a liability would be recorded (obligation to provide future services and use of facilities) with the corresponding charge to income. As a result of the calculation, the present value of the net cost of future services did not exceed deferred revenue; accordingly, no obligation was recorded at December 31, 2008 and 2007.

**(u) *Income Taxes***

Diakon and its controlled affiliates are not-for-profit corporations as described in Section 501(c)(3) of the Internal Revenue Code and are exempt from federal income taxes.

The Corporation adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), on January 1, 2007. FIN 48 prescribes a threshold of more likely than not for recognition and derecognition of tax positions taken or expected to be taken in a tax return. FIN 48 also recognizes related guidance on measurement, classification, interest and penalties, and disclosure. The implementation of FIN 48 had no impact on the Corporation's consolidated balance sheet or statement of operations and changes in net assets. The Corporation does not believe that there are any unrecognized tax benefits or liabilities that should be recorded.

**(v) *Patient and Resident Service Revenue***

Patient and resident service revenue is reported at the estimated net realizable amount to be received from patients, residents, and others including Medicare, Medicaid, and other third-party payors for services rendered. The Corporation derives a significant portion of its revenues from federal and state reimbursement programs. These reimbursements are subject to audit. All of the skilled nursing facilities operated by the Corporation are certified to receive benefits under Medicare and Medicaid, with the exception of Twining Manor, which is not certified to receive benefits under Medicaid.

Skilled nursing services provided to Medicare beneficiaries are paid under terms of a prospective payment system at predetermined rates based on clinical, diagnostic, and other factors.

Nursing services provided to Medicaid beneficiaries are paid at prospectively determined rates per day. These rates vary according to a resident classification system that is based on clinical diagnostic and other factors, and the reimbursement methodology is subject to various limitations and adjustments. The Corporation's current concentration of skilled nursing facilities in Pennsylvania exposes it to the risk of changes in Medicaid reimbursement in this state.

Revenues from Medicare and Medicaid represent approximately 41% and 43% of patient and resident service revenue, net of contractual allowances, for the years ended December 31, 2008 and 2007, respectively. Medicare and Medicaid receivables represent approximately 67% and 61% of patient and resident accounts receivable at December 31, 2008 and 2007, respectively.

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**(w) Contributions and Donor Restrictions**

Contributions received with donor-imposed restrictions that are met in the same year as received are reported as increases in temporarily restricted net assets, and reclassified to unrestricted net assets as net assets released from restrictions.

Contributions, including unconditional promises to give, if any, are recognized as revenues in the period received. Conditional promises to give are not recognized until they become unconditional, that is when the conditions on which they depend are substantially met. Contributions of assets other than cash are recorded at their estimated fair value as of the date of contributions. Contributions to be received after one year are discounted at an appropriate discount rate commensurate with the risks involved. An allowance for uncollectible contributions receivable is provided based upon management's judgment including such factors as prior collection history, type of contributions, and nature of fund-raising activity.

**(x) Charity Care and Support of Those in Need**

The Corporation provides charity care and other support of those in need to many of the programs and individuals that it serves. In addition, DLF provides support of children's and family programs.

The Corporation maintains records to identify and monitor the amount of charity care it provides. These records include charges foregone, based on established rates, for services and supplies furnished under its charity care policy, and the estimated cost of those services and supplies.

Support of those in need includes services provided to persons who cannot afford healthcare because of inadequate resources and/or who are uninsured or underinsured.

A number of programs operated by the Corporation's Family and Community Ministries (FCM) do not receive sufficient funding from the sponsoring organizations or from program fees to meet the needs of the people they serve. The Corporation has elected to underwrite the operating deficits of certain programs in order to serve as many of the identified needs as possible.

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The following is a summary of the value of the Corporation's support of these programs during the years ended December 31, 2008 and 2007:

	<b>2008</b>	<b>2007</b>
Medical assistance cost in excess of contractual reimbursement	\$ 6,592,271	6,057,842
Charity care in support of those in need	1,839,006	1,972,123
FCM programs supported by DLSM (charity care):		
Children's services	2,460,515	1,908,526
Behavioral health	1,234,969	990,207
Family life and congregation	515,558	459,329
Community services	426,125	249,168
Home services for seniors	206,064	236,510
	<u>4,843,231</u>	<u>3,843,740</u>
Total	<u>\$ 13,274,508</u>	<u>11,873,705</u>

**(y) Operating Income**

The consolidated statements of operations and changes in net assets include an intermediate measure of operations labeled as "operating (loss) income." Changes in the performance indicator which are excluded from this measure include joint venture equity changes reported within the joint venture's performance indicator, changes in the fair value of swap agreements, unrealized losses on other-than-temporary impairment of investments and losses on the early extinguishment of debt.

During 2008, the Corporation realigned certain Ministry Support and operating department management and staffing. As a result, nonrecurring costs related to severance payments, outplacement assistance, extended benefit eligibility, other benefits and lease and property costs were incurred. Such costs have been recognized in a line item entitled "realignment costs" within the consolidated statements of operations and changes in net assets for the year ended December 31, 2008.

**(z) Performance Indicator**

The consolidated statements of operations and changes in net assets include a performance indicator of operations labeled as "deficit of operating revenues, gains, and other support over expenses." Changes in unrestricted net assets which are excluded from this measure include unrealized losses on investments, pension-related changes other than net periodic pension costs, joint venture equity changes reported outside the venture's performance indicator, derivative gains that represent a recovery of accumulated losses previously recognized outside the performance indicator, and net assets released from restrictions for capital purposes.

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***(aa) Use of Estimates***

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and the current economic environment has increased the degree of uncertainty inherent in those estimates and assumptions.

***(bb) Statutory Reserve Requirement***

The Pennsylvania Continuing Care Provider Registration and Disclosure Act requires a statutory reserve equivalent to the greater of the total of debt service payments due during the next 12 months on account of any loan or 10% of the projected annual operating expenses of the facilities exclusive of depreciation, computed only on the proportional share of financing or operating expenses that is applicable to residents under entrance agreement contracts. This statutory reserve requirement is considered to be fulfilled from board-designated funds included within assets limited as to use and unrestricted cash and investments.

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**(2) Assets Limited as to Use and Investments**

The composition of assets limited as to use at December 31 is set forth in the following table:

	<u>2008</u>	<u>2007</u>
Under bond indentures for debt service reserve fund:		
Cash and short-term investments	\$ 7,351,465	9,596,378
U.S. government obligations and corporate bonds	12,921,319	13,502,952
Under bond indentures for construction projects:		
Cash and short-term investments	35,032,441	56,878,007
Workers' compensation trust:		
Cash and short-term investments	—	200
Endowment funds:		
Cash and short-term investments	252,451	132,689
Fixed income securities	2,091,429	1,769,748
Equity securities	5,856,417	5,902,273
Donor and other restricted funds:		
Cash and short-term investments	970,580	1,524,445
Equity securities	720,170	4,877,052
Fixed income securities	858,421	2,227,895
By board for designated purposes:		
Funded depreciation:		
Cash and short-term investments	115,355	270,436
Equity securities	1,198,205	1,918,912
Fixed income securities	755,005	1,129,441
Entrance fees and other designated purposes:		
Cash and short-term investments	4,786,587	5,486,494
U.S. government obligations and corporate bonds	434,306	3,502,851
Equity securities	25,155,171	36,392,688
Fixed income securities	15,850,623	21,420,154
Total assets limited as to use	<u>114,349,945</u>	<u>166,532,615</u>
Less assets limited as to use – required for current liabilities	<u>15,172,937</u>	<u>3,149,584</u>
Assets limited as to use, net of current portion	<u>\$ 99,177,008</u>	<u>163,383,031</u>

A summary of investments at December 31 is as follows:

	<u>2008</u>	<u>2007</u>
Cash and short-term investments	\$ 2,094,424	3,171,083
Equity securities	26,084,146	44,431,728
Fixed income securities	13,258,946	18,865,697
	<u>\$ 41,437,516</u>	<u>66,468,508</u>

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The combined composition of assets limited as to use and investments at December 31 is as follows:

	<u>2008</u>		<u>2007</u>	
Cash and short-term investments	\$ 50,603,303	32.5%	\$ 77,059,732	33.1%
U.S. government obligations and corporate bonds	13,355,625	8.6	17,005,803	7.3
Equity securities	59,014,109	37.9	93,522,653	40.1
Fixed income securities	32,814,424	21.0	45,412,935	19.5
	<u>\$ 155,787,461</u>	<u>100.0%</u>	<u>\$ 233,001,123</u>	<u>100.0%</u>

Total investment income for the years ended December 31 consists of the following:

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Total 2008</u>	<u>Total 2007</u>
Deficit of operating revenues, gains and other support over expenses:				
Interest and dividends, net of expenses	\$ 8,080,325	352,664	8,432,989	8,894,298
Net realized (losses) gains on investments	<u>(376,962)</u>	<u>(65,128)</u>	<u>(442,090)</u>	<u>6,969,335</u>
Investment income	7,703,363	287,536	7,990,899	15,863,633
Unrealized loss on other-than-temporary impairment of investments	(47,715,878)	—	(47,715,878)	—
Other changes in net assets:				
Unrealized losses on investments	(2,151,393)	—	(2,151,393)	(319,291)
Changes in unrealized losses on temporarily and permanently restricted net assets	<u>—</u>	<u>(4,120,422)</u>	<u>(4,120,422)</u>	<u>(305,337)</u>
Total investment return (loss)	<u>\$ (42,163,908)</u>	<u>(3,832,886)</u>	<u>(45,996,794)</u>	<u>15,239,005</u>

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A summary of investments with fair values below cost prior to the recognition of the unrealized loss on other-than-temporary impairment of investments as of December 31, 2008 is as follows:

	<u>Less than 12 months</u>		<u>12 months or longer</u>		<u>Total</u>	
	<u>Fair value</u>	<u>Unrealized losses</u>	<u>Fair value</u>	<u>Unrealized losses</u>	<u>Fair value</u>	<u>Unrealized losses</u>
Description of securities:						
Fixed income mutual funds	\$ —	—	30,294,243	14,871,043	30,294,243	14,871,043
Equity mutual funds	<u>37,436,569</u>	<u>19,734,823</u>	<u>15,780,887</u>	<u>13,110,012</u>	<u>53,217,456</u>	<u>32,844,835</u>
Total temporarily impaired securities	<u>\$ 37,436,569</u>	<u>19,734,823</u>	<u>46,075,130</u>	<u>27,981,055</u>	<u>83,511,699</u>	<u>47,715,878</u>

Due to the level of unrealized declines in fair value over an extended period of time and ongoing uncertainty created by current market conditions, management deemed the value of all investment securities with fair values below cost basis to be other-than-temporarily impaired at December 31, 2008 and has reduced the carrying value to equal the fair value at that date.

**(3) Third-Party Reimbursement**

The Corporation's nursing care facilities primarily derive their revenues from private-pay, Medicare, and Medicaid patients. Private-pay rates are established on the basis of the cost of delivering services and competitive considerations and, as such, are essentially market driven. In contrast, Medicare and Medicaid payment rates are regulated by the federal and state governments. As a result, the industry is sensitive to related legislative changes and is affected by reductions in governmental spending for these programs.

The Centers for Medicare and Medicaid Services (CMS) have approved a Pennsylvania State Plan implementing a Nursing Home Assessment (the Assessment). The Assessment requires all Pennsylvania nursing homes, except for county homes, to pay a fee to the Department of Public Welfare (DPW) based upon all non-Medicare days. DPW makes supplemental payments back to nursing home facilities based upon a standard rate per Medicaid day claimed. Total nursing home assessment revenues and expenses were \$2,759,103 and \$1,784,389 for 2008, respectively, and \$2,405,703 and \$1,375,252 for 2007, respectively.

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**(4) Land, Buildings, and Equipment**

Land, buildings, and equipment and accumulated depreciation at December 31 are as follows:

	<u>2008</u>	<u>2007</u>
Land	\$ 18,893,296	18,893,296
Land improvements	19,677,309	12,209,323
Buildings	214,362,987	202,201,536
Furniture and equipment	49,296,460	44,119,224
Vehicles	<u>1,050,587</u>	<u>1,050,587</u>
	303,280,639	278,473,966
Accumulated depreciation	<u>(136,275,397)</u>	<u>(124,289,699)</u>
	167,005,242	154,184,267
Construction in progress	<u>21,226,093</u>	<u>15,655,741</u>
	<u>\$ 188,231,335</u>	<u>169,840,008</u>

Depreciation expense for the years ended December 31, 2008 and 2007 was \$11,986,340 and \$11,208,921, respectively.

Construction in progress as of December 31, 2008 and 2007 is principally capitalized costs related to the repositioning of the Corporation's Senior Living Service campuses.

In 2002, the Corporation completed a sale/leaseback transaction related to an office building and land with an unrelated third party. The gross sales price was \$4,800,000, and the Corporation deferred a gain on the sale of approximately \$3,240,000. At the time of the sale, the Corporation entered into an operating lease agreement with the purchasers of the property to lease the office building for a term of eleven (11) years. The initial annual lease payment was \$492,782, payable monthly. Subsequent annual payments increase two and one-half percent each year throughout the term of the lease. During 2008 and 2007, approximately \$295,600 of the gain was amortized and recognized within gain on disposal of assets in the consolidated statements of operations and changes in net assets.

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**(5) Long-Term Debt**

The following is a summary of long-term debt at December 31:

	<u>2008</u>	<u>2007</u>
Bonds payable – Series A 2007	\$ 61,955,000	61,955,000
Bonds payable – Series B 2007	46,350,000	46,350,000
Bonds payable – Series A 2003	5,140,000	5,250,000
Bonds payable – Series B 2003	—	825,000
Bonds payable – Series C 2003	10,365,000	10,440,000
Bonds payable – Series D 2003	42,355,000	42,615,000
Bonds payable – Series E 2003	20,145,000	20,230,000
Mortgages payable:		
U.S. government agencies	9,579,099	9,879,849
Commercial banks	5,390,040	5,460,256
	<u>201,279,139</u>	<u>203,005,105</u>
Less current maturities of bonds and mortgages payable	(39,323,678)	(3,697,655)
Unamortized premium	1,613,917	1,649,531
	<u>\$ 163,569,378</u>	<u>200,956,981</u>

**(a) Bonds Payable**

On January 30, 2007, the Cumberland County (PA) Municipal Authority (the Cumberland Authority) issued \$109,355,000 of Series 2007 bonds on behalf of the Diakon Lutheran Social Ministries Obligated Group (the Obligated Group) to finance the costs of various capital projects and to retire the Series A 1998 bonds. The Obligated Group consists of the Diakon Lutheran Social Ministries entity, excluding the following assets/liabilities and activities: Frostburg Heights HUD community, Lutherwood HUD community, and the Medical Arts Building in Allentown.

The 2007 bonds consist of two series more fully described as follows:

Series A 2007 – \$61,955,000 of tax-exempt fixed rate bonds due in varying annual installments beginning January 1, 2025 ranging in amounts from \$1,880,000 to \$11,905,000 with the final principal payment due on January 1, 2036. These bonds were issued at a fixed tax-exempt interest rate of 5.00%. The initial bond purchasers paid a premium upon issue of \$1,680,925, which is being amortized ratably over the life of the issue, to yield an effective interest rate of 4.81%.

Series B 2007 – \$47,400,000 of tax-exempt bonds issued as tax-exempt auction (variable) rate certificates insured by Radian Asset Assurance, Inc. (Radian) until maturity and due in varying annual installments ranging in amounts from \$1,900,000 to \$4,125,000 with the final principal payment due on January 1, 2025. Through February 13, 2008 the interest rate on these bonds was a tax-exempt auction rate established under certain dutch auction procedures described in the trust indenture for the Series B 2007 bonds. On February 14, 2008, the remaining

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outstanding balance of the Series B 2007 issue (\$46,350,000) was remarketed as tax-exempt variable rate demand bonds secured by a letter of credit issued by Wachovia Bank, National Association, which expires September 30, 2010. As a result of the remarketing, an early extinguishment of debt was recognized.

The 2007 bonds were issued pursuant to the terms of a 1998 Master Trust Indenture (the Master Indenture), which was supplemented and amended to allow for, among other things, the issuance of the 2007 bonds. The effect of these amendments was to consolidate the entities comprising the Obligated Group and to grant to the 2007 bondholders and credit providers equal standing and security with the 2003 bondholders and credit providers. In addition, these amendments changed the financial covenants with which the Obligated Group must comply, the manner in which certain of the covenants are calculated, and modified other restrictive covenants. In addition to the Master Indenture, the Obligated Group has agreed to comply with the terms of a Loan and Agency Agreement and an Amended and Restated Reimbursement Credit and Security Agreement, which also require that financial covenants be met and establish certain restrictive covenants, similar to those found in the Master Indenture.

To secure the required loan payments for the 2007 bonds, the Obligated Group has granted the Cumberland Authority and the County Commissioners of Washington County, MD (the Washington issuer) (issuer of the 2003 Series E bonds) a parity security interest in their gross receipts and a parity first lien mortgage on substantially all of the Obligated Group's property and equipment. Further, a trustee for the Cumberland Authority and the Washington issuer holds certain funds for the benefit of the holders of the outstanding 2007 and 2003 bonds. Such funds are included in assets limited as to use in the accompanying consolidated financial statements.

On September 30, 2003, the Cumberland Authority issued \$62,535,000 of Series 2003 bonds on behalf of the Obligated Group to finance the cost of various capital projects and acquisitions and to refinance various existing short-term and long-term debt obligations. The bonds consist of four series more fully described as follows:

Series A – \$5,555,000 of tax-exempt variable rate demand bonds secured by a letter of credit that expires on September 29, 2011 issued by Wachovia Bank, National Association and due in varying annual installments ranging from \$110,000 to \$295,000 with the final principal payment due on January 1, 2033. The interest rate is a tax-exempt weekly rate defined as the variable rate of interest equal to the minimum rate of interest necessary for the remarketing agent to sell the Series A 2003 bonds at par plus accrued interest.

Series B – \$3,375,000 of taxable variable rate demand bonds secured by a letter of credit that expires on September 29, 2010 issued by Wachovia Bank, National Association and due in varying annual installments with a final installment of \$825,000 on January 1, 2008. The interest rate is a taxable weekly rate defined as the variable rate of interest equal to the minimum rate of interest necessary for the remarketing agent to sell the Series B 2003 bonds at par plus accrued interest.

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Series C – \$10,605,000 of taxable variable rate demand bonds secured by a letter of credit that expires on September 29, 2011 issued by Wachovia Bank, National Association and due in varying annual installments ranging from \$460,000 to \$870,000 with the final principal payment due on January 1, 2033. The interest rate is a tax-exempt weekly rate defined as the variable rate of interest equal to the minimum rate of interest necessary for the remarketing agent to sell the Series C 2003 bonds at par plus accrued interest.

Series D – \$43,000,000 of tax-exempt bonds issued as tax-exempt auction (variable) rate certificates insured by Radian until maturity and due in varying annual installments ranging from \$260,000 to \$3,310,000 with the final principal payment due on January 1, 2033. Through February 28, 2008, the interest rate on these bonds was a tax-exempt auction rate established under certain dutch auction procedures described in the trust indenture for the Series B 2007 bonds. On February 29, 2008, the remaining outstanding balance of the 2003D issue (\$42,615,000) was remarketed as tax-exempt variable rate demand bonds, secured by a letter of credit issued by Wachovia Bank, National Association, which expires on September 30, 2010. As a result of the remarketing, an early extinguishment of debt was recognized.

Series E – \$20,465,000 On September 30, 2003, the Washington Issuer issued the Series E of 2003 Bonds on behalf of the Obligated Group to finance the cost of various capital projects and acquisitions and to refinance various existing long-term debt obligations. These bonds are tax-exempt variable rate demand bonds secured by a letter of credit that expires on September 29, 2011, issued by Wachovia Bank, National Association and are due in varying annual installments ranging from \$365,000 to \$3,130,000 with the final principal payment due on January 1, 2033. The interest rate is a tax-exempt weekly rate defined as the variable rate of interest equal to the minimum rate of interest necessary for the remarketing agent to sell the Series E 2003 bonds at par plus accrued interest.

Collectively the 2003 Series A, B, C, D, and E are referred to herein as “the 2003 Bonds.”

The 2003 Bonds were issued pursuant to the terms of the Master Indenture, which was supplemented and amended to allow for, among other things, the issuance of the 2003 Bonds. The Master Indenture has been supplemented and amended as indicated above in connection with the 2007 bond issue. In addition to the Master Indenture, the Obligated Group agreed to comply with the terms of the Reimbursement, Credit, and Security Agreement, which was also amended and restated in connection with the 2007 bond issue.

With respect to the Series D 2003 bonds, the Obligated Group entered into an interest rate swap agreement through January 1, 2033 (the maturity date of the Series D 2003 bonds) whereby the Obligated Group agreed to receive a variable rate of interest equal to 71% of United States Dollar – One-Month LIBOR (USD – One-Month LIBOR) and pay a fixed rate of interest of 3.685% per annum on a beginning notional amount of \$43,000,000, which is equal to the initial principal amount of the Series D 2003 bonds and amortizes on the same schedule as the Series D 2003 bonds.

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Should the Corporation be required to access the letter of credit liquidity facilities securing the 2003 Series A, C, D and E and 2007 Series B variable rate demand bonds due to an inability to remarket the bonds, the Corporation would be required to repay such draws over periods that are shorter than the stated maturity terms of the bonds. The amounts classified as current maturities of long-term debt in the accompanying consolidated balance sheet at December 31, 2008 are those payments that would be due within one year of the consolidated balance sheet date assuming the Corporation's inability to remarket outstanding variable rate demand bonds.

The following is a summary of the annual maturities of long-term debt for the next five years assuming that the bonds will be repaid based on their original maturity schedules and assuming that liquidity facilities have been accessed due to the inability to remarket the bonds:

	<b>Scheduled maturity</b>	<b>Assumes liquidity facility accessed</b>
2009	\$ 3,552,346	39,323,678
2010	3,765,904	71,973,573
2011	9,306,940	19,517,940
2012	4,826,297	421,297
2013	4,273,485	458,485
Thereafter	175,554,167	69,584,166
	\$ 201,279,139	201,279,139

**(b) Mortgages Payable**

At December 31, 2008 and 2007, mortgages payable to the U.S. Department of Housing and Urban Development (HUD) consisted of four mortgages. These mortgages are collateralized by property and equipment, which is excluded from the Obligated Group, and bear interest at rates ranging from 6.79% to 9.25%. Monthly payments, including interest, total \$96,569.

Under the terms of certain regulatory agreements, DLSM is required to deposit residual revenue, as defined, into residual receipts accounts on an annual basis. Disbursements from these accounts must be approved by HUD. The balance in the residual receipts accounts was \$331,606 and \$328,797 at December 31, 2008 and 2007, respectively. These residual receipts accounts are classified as cash and assets limited as to use in the accompanying consolidated financial statements at December 31, 2008 and 2007, respectively.

On August 9, 2004, the Corporation obtained a \$5,600,000 mortgage on its Medical Arts Building. This is a nonrecourse loan collateralized only by this property and its rental proceeds. This property is excluded from the Obligated Group. The mortgage bears interest at a fixed rate of 6.13%. Monthly payments are \$34,044 until August 11, 2011, when the remaining outstanding balance of \$5,170,302 is payable.

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**(c) Interest**

The amount of cash paid for interest (including net amount of swap payments and annual fees for security agreements) was \$10,678,289 and \$8,897,439 for the years ended December 31, 2008 and 2007, respectively. These amounts are net of capitalized interest of approximately \$387,000 and \$405,000 for the respective years.

The effective interest rates paid for the years ended December 31 are as follows:

	2008	2007
DLSM Obligated Group	5.00%	4.70%
Obligations outside of the Obligated Group	7.90	7.90
Combined	5.21	4.93

**(6) Lines of Credit**

DLSM obtained a \$10,500,000 secured bank line of credit. The line of credit bears interest at the bank's prime rate (3.25% and 7.25% at December 31, 2008 and 2007, respectively), and expires on September 30, 2009. Amounts ranging from \$1,249,000 to \$9,500,000 and from \$0 to \$7,666,000 were outstanding for various periods during 2008 and 2007, respectively, and \$5,057,000 and \$2,946,000 was outstanding at December 31, 2008 and 2007, respectively. In addition to the line of credit, the borrowers had unused outstanding letters of credit issued by the same bank in the amount of \$8,524,223 and \$10,602,555 at December 31, 2008 and 2007, respectively. The bank line of credit is secured on a parity basis with the 2007 and 2003 bonds consisting of security interest in the borrowers' gross receipts and a first lien mortgage on substantially all of the borrowers' property and equipment.

On January 30, 2007, Diakon Housing and Development, Inc. obtained a secured line of credit from the ELCA Mission Fund in the amount of \$400,000. The line bears interest at a fixed rate of 6.25% and expires on May 1, 2010. Amounts ranging from \$388,013 to \$396,918 and from \$0 to \$396,918 were outstanding at various times during 2008 and 2007, respectively, and \$394,206 and \$396,918 was outstanding at December 31, 2008 and 2007, respectively. The ELCA Mission Fund's line of credit is secured by a \$400,000 investment in an ELCA Mission Fund money market account made by Diakon Housing and Development, Inc.

On February 14, 2008, DLSM reduced its secured, revolving line of credit from Wachovia Bank, National Association from \$60,000,000 to \$30,000,000. The line bears interest at the bank's prime rate (3.25% and 7.25% at December 31, 2008 and 2007, respectively), and expires on January 30, 2010. No amounts were drawn or outstanding at any time during 2008. Up to one-half of this revolving line of credit may be used to provide direct pay letters of credit to provide credit enhancement to future bond issues. This revolving line of credit is secured on a parity basis with the 2007 and 2003 bonds consisting of security interest in the Obligated Group's gross receipts and a first lien mortgage on substantially all of the Obligated Group's property and equipment.

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**(7) Derivative Instruments**

The Obligated Group is subject to credit risk and market risk as a result of using derivative products to manage exposures to changes in interest rates. Credit risk is the failure of the counterparty on the derivative instrument to perform under the terms of the derivative instrument. Depending on interest rate movements, one party will owe the other party a payment under the applicable derivative contract. The Obligated Group attempts to manage the credit or repayment risk in derivative instruments by entering into transactions with high-quality counterparties rated “A” or better by Moody’s Investor Service. The swap payments and termination payments under the derivative agreements are secured by master note agreements on parity with the outstanding debt obligations in the amounts provided in such corresponding master note obligations.

Market risk is the adverse effect on the value of a financial instrument that results from a change in interest rates. The market risk associated with derivative contracts is managed by establishing and monitoring internal parameters and reviews that limit the types and degree of market risk that may be undertaken. Neither the Obligated Group nor the counterparties to these agreements are required to deposit collateral dependent on the market valuation of the derivatives contract. The Obligated Group has fixed interest rate payments under interest rate swap agreements with aggregate notional amounts totaling \$92,640,000.

DLSM entered into an interest rate swap agreement with respect to a portion of the Series A 1998 bonds through January 1, 2028 (the original maturity date of the Series A 1998 bonds) whereby the Obligated Group agreed to receive a variable rate of interest equal to 67% of USD – One-Month LIBOR and to pay a fixed rate of 4.06% per annum on a portion of the original aggregate principal amount of Series A 1998 bonds subject to amortization on the same basis as the Series A 1998 bonds in the years 2012 and 2028. The notional amount of this interest rate swap agreement is currently \$37,445,000. There are no cash or collateral posting requirements in connection with this interest rate swap agreement. The fair value of this interest rate swap agreement as of December 31, 2008 and 2007 is a liability of \$6,890,394 and \$3,198,034, respectively.

On January 1, 2003, DLSM entered into a second interest rate swap agreement that requires the Obligated Group to make semiannual payments (commencing on January 1, 2003 and ending January 1, 2023) at a fixed interest rate of 6.875% per annum on the amortizing notional principal amount of \$12,580,000 (the notional amount), which was equal to the amortizing principal of the Series A 1993 bonds, which were not callable until January 1, 2003. This interest rate swap currently obligates the counterparty to make monthly payments to the Obligated Group (commencing on January 1, 2003) at a variable rate of interest equal to SIFMA Swap Index plus 0.10% per annum on the notional amount. The notional amount of this swap at December 31, 2008 is \$12,580,000. The fair value of this derivative instrument as of December 31, 2008 and 2007 is a liability in the consolidated balance sheets totaling \$3,859,475 and \$3,426,533, respectively.

On September 30, 2003, the outstanding balance of the Series A 1993 bonds was repaid and on February 9, 2007 the Series A 1998 bonds were repaid. The interest rate swaps have remained in effect and are being used to manage the Obligated Group’s exposure to variable rate debt. As previously described in note 5 – Long-Term Debt, on September 30, 2003 the Obligated Group entered into a third interest rate swap agreement with Lehman Brothers Special Financing Inc. (LBSFI) having a notional amount of

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\$42,355,000 to manage interest rate exposure related to its variable interest rate payment obligations on the Series D 2003 bonds. There are no cash or collateral requirements in connection with this agreement. The fair value of this derivative instrument as of December 31, 2008 and 2007 is a liability of \$9,422,139 and \$1,407,684, respectively.

LBSFI filed for bankruptcy on October 3, 2008. The LBSFI bankruptcy filing constituted a default on the part of LBSFI under the interest rate swap agreement. As a result, the Obligated Group is entitled to exercise certain specified remedies under the interest rate swap agreement, including early termination of the interest rate swap. The Obligated Group attempted to secure an acceptable replacement for LBSFI in anticipation of terminating the interest rate swap agreement but to date has not been able to do so. The interest rate swap remains outstanding and the Obligated Group is continuing to perform its obligations thereunder.

On December 16, 2008 the Bankruptcy Court entered an order establishing procedures for the assumption and assignment of LBSFI derivatives contracts, including the interest rate swap agreement. This order has the effect of enabling LBSFI to assign the interest rate swap agreement to a third party without the consent of and without any continuing liability or obligation to the Obligated Group. To date the Obligated Group (i) has not been notified by LBSFI of any proposed assignee of the interest rate swap agreement pursuant to the bankruptcy court order; and (ii) has not been able to secure a counterparty to replace LBSFI.

See note 19, Fair Value, for additional discussion related to the fair value assumptions utilized in relation to the Corporation's interest rate swap agreement with LBSFI.

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The following summarizes the changes in fair values for each of the above derivative instruments reported in the consolidated statements of operations and changes in net assets for the years ended December 31, 2008 and 2007:

	<u>Within performance indicator</u>	<u>Outside performance indicator</u>	<u>Total</u>
Accumulated swap liability, December 31, 2006	\$ (3,920,463)	(1,575,915)	(5,496,378)
Series A 1993 bonds	(691,983)	441,349	(250,634)
Series A 1998 bonds	(998,152)	—	(998,152)
Series D 2003 bonds	(1,287,087)	—	(1,287,087)
2007 change in fair value	<u>(2,977,222)</u>	<u>441,349</u>	<u>(2,535,873)</u>
Accumulated swap liability, December 31, 2007	<u>(6,897,685)</u>	<u>(1,134,566)</u>	<u>(8,032,251)</u>
Series A 1993 bonds	(971,026)	538,085	(432,941)
Series A 1998 bonds	(3,692,361)	—	(3,692,361)
Series D 2003 bonds	(8,014,455)	—	(8,014,455)
2008 change in fair value	<u>(12,677,842)</u>	<u>538,085</u>	<u>(12,139,757)</u>
Accumulated swap liability, December 31, 2008	<u>\$ (19,575,527)</u>	<u>(596,481)</u>	<u>(20,172,008)</u>

**(8) Pension Benefits**

The Corporation has a noncontributory defined benefit pension plan covering substantially all of its employees upon their retirement. The benefits are based on years of service and the employee's compensation. Contributions provide for benefits earned to date as well as benefits expected to be earned in the future. The measurement date used for the defined benefit plan is December 31.

Actuarial gains and losses are generally amortized subject to the corridor, over the average remaining service life of the Corporation's active employees.

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The following table sets forth the pension benefit obligation, fair value of plan assets, and funded status at December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Benefit obligation at December 31	\$ 62,699,938	58,107,199
Fair value of plan assets at December 31	<u>44,096,830</u>	<u>49,739,946</u>
Funded status at end of year	<u>\$ (18,603,108)</u>	<u>(8,367,253)</u>
Amounts recognized in the consolidated balance sheet:		
Noncurrent liabilities	\$ (18,603,108)	(8,367,253)
Unrestricted net assets	<u>21,501,896</u>	<u>11,266,041</u>
Net amount recognized	<u>\$ 2,898,788</u>	<u>2,898,788</u>

Amounts recognized in unrestricted net assets consist of:

	<u>2008</u>	<u>2007</u>
Net actuarial loss	\$ (21,498,718)	(11,261,275)
Prior service costs	<u>(3,178)</u>	<u>(4,766)</u>
	<u>\$ (21,501,896)</u>	<u>(11,266,041)</u>

The accumulated benefit obligation for the pension plan was \$57,526,991 and \$53,506,340 at December 31, 2008 and 2007, respectively.

Other changes in plan asset and benefit obligations recognized in unrestricted net assets for the years ended December 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
Net loss	\$ (10,237,443)	(741,667)
Prior service cost	<u>1,588</u>	<u>1,588</u>
Total recognized in unrestricted net assets	<u>\$ (10,235,855)</u>	<u>(740,079)</u>
Total recognized in net periodic benefit cost and unrestricted net assets	<u>\$ (12,386,569)</u>	<u>(2,850,073)</u>

The net loss for the defined benefit pension plan that will be amortized from unrestricted net assets into net periodic benefit cost over the next fiscal year is \$1,692,080.

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The following summarizes the components of net periodic benefit costs recognized for the years ended December 31:

	<u>2008</u>	<u>2007</u>
Service cost	\$ 2,568,752	2,378,379
Interest cost	3,538,713	3,218,905
Expected return on plan assets	(4,328,461)	(4,080,651)
Amortization of prior service costs	1,588	1,588
Amortization of net loss	370,122	591,773
Net periodic benefit cost	<u>\$ 2,150,714</u>	<u>2,109,994</u>

The following summarizes the benefit cost, employer contribution, and benefits paid by the pension plan for the years ended December 31:

	<u>2008</u>	<u>2007</u>
Benefit cost	\$ 2,150,714	2,109,994
Employer contribution	2,150,714	2,025,000
Benefits paid	2,470,503	2,318,435

Weighted average assumptions used to determine benefit obligations at December 31, 2008 and 2007 were as follows:

	<u>2008</u>	<u>2007</u>
Discount rate	6.10%	6.00%
Rate of compensation increase	3.50	3.50

Weighted average assumptions used to determine net benefit cost for the years ended December 31, 2008 and 2007 were as follows:

	<u>2008</u>	<u>2007</u>
Discount rate	6.50%	6.00%
Expected long-term rate of return on plan assets	8.70	8.70
Rate of compensation increase	3.50	3.50

The expected long-term rate of return is based on the portfolio as a whole and not on the sum of the returns on individual asset categories. The return is based exclusively on historical returns, without adjustments.

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The asset allocation of the Corporation's pension plan assets at December 31, 2008 and 2007 were as follows:

	<b>2008</b>	<b>2007</b>
Asset category:		
Equity mutual funds	44%	40%
Fixed income mutual funds	46	50
Hedge fund of funds	10	10
Total	100%	100%

The Corporation's investment policies and strategies for the pension benefit plan use target allocations for the individual asset categories. The Corporation's investment goals are to generate returns that are sufficient to meet the plan's obligations while preserving capital. As part of this investment strategy the Corporation has invested ten percent of the pension plan assets into a hedge fund of funds. Its risk management policies permit investments in mutual funds. The Corporation addresses diversification by the use of mutual fund investments whose underlying investments are in domestic and international fixed income securities and domestic and international equity securities. These mutual funds are readily marketable and can be sold to fund benefit payment obligations as they become payable.

The Corporation expects to contribute \$3,000,000 to its pension plan in 2009.

The estimated benefit payments, which reflect expected future service, as appropriate, are as follows:

2009	\$ 2,579,664
2010	2,773,987
2011	3,047,773
2012	3,312,925
2013	3,573,680
2014 – 2018	22,479,466
Total	\$ 37,767,495

The Corporation also has a defined contribution plan for certain employees. Contributions recognized as expense for this plan were approximately \$687,000 and \$630,000 for the years ended December 31, 2008 and 2007, respectively.

The Corporation established a Supplemental Executive Retirement Plan (SERP), which is a nonqualified defined benefit plan under which the Corporation will pay supplemental retirement benefits to key executives in addition to amounts received under the Corporation's pension plan. The annual cost for this plan was \$592,802 and \$540,000 for the years ended December 31, 2008 and 2007, respectively. These amounts are not included in the determination of net periodic pension cost shown above. The SERP is not funded, and the liability for this plan was \$209,000 and \$2,397,300 as of December 31, 2008 and 2007, respectively. The liability is included in accrued expenses as of December 31, 2008 and included in the Corporation's other long-term liabilities as of December 31, 2007.

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**(9) Temporarily Restricted Net Assets**

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

	<b>2008</b>	<b>2007</b>
Beneficial interest in charitable remainder trusts and beneficial interest in trust	\$ 1,177,293	1,582,724
Charitable gift annuities – ELCA	961,720	1,003,644
Capital additions	71,181	1,147,108
DLF – Educational and Children’s Programs	1,369,383	2,184,165
Accumulated gains on endowment and other specific purposes	430,011	2,508,900
Total	\$ 4,009,588	8,426,541

Temporarily restricted net assets are released from donor restrictions by incurring expenses satisfying the restrictions specified by donors related principally to program and time restrictions.

**(10) Permanently Restricted Net Assets**

Permanently restricted net assets at December 31 are held in perpetuity, the income from which is expendable for the following purposes:

	<b>2008</b>	<b>2007</b>
Funds held in trust by others – income restricted for:		
Support of programs at designated facilities	\$ 17,372,748	24,606,790
Staff and resident programs	129,610	192,556
DLF – Educational and Children’s Programs	6,443,197	8,967,078
Program operations in Maryland	60,000	60,000
Endowment and other purposes	8,700,586	8,414,339
DLF – Educational and Children’s Programs	205,641	139,820
	\$ 32,911,782	42,380,583

The Corporation’s endowment consists of approximately 24 individual funds established for a variety of purposes and consists of only donor-restricted endowment funds. Net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

The Corporation has interpreted the laws of the Commonwealth of Pennsylvania as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, the Corporation classifies as permanently restricted net assets the original value of gifts donated to the permanent endowment and the original value of subsequent gifts to the permanent endowment. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the organization in a manner consistent with the laws of the Commonwealth of Pennsylvania. In accordance

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with the laws of the Commonwealth of Pennsylvania, the Corporation considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

- (1) The duration and preservation of the fund
- (2) The purposes of the organization and the donor-restricted endowment fund
- (3) General economic conditions
- (4) The possible effect of inflation and deflation
- (5) The expected total return from income and the appreciation of investments
- (6) Other resources of the organization
- (7) The investment policies of the organization

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or the laws of the Commonwealth of Pennsylvania require the Corporation to retain as a fund of perpetual duration. Deficiencies of this nature that are reported in unrestricted net assets were \$367,219 as of December 31, 2008. These deficiencies resulted from unfavorable market fluctuations that occurred during 2008. There were no such deficiencies as of December 31, 2007.

The Corporation has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of the endowment assets in relation to inflation trends. Endowment assets include those assets of donor-restricted funds that the organization must hold in perpetuity. Under this policy, the endowment assets are invested in a manner that is intended to produce results that approximate the price and yield results of the S&P 500 index while assuming a moderate level of investment risk.

To satisfy its long-term rate-of-return objectives, the Corporation relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). The Corporation targets a diversified asset allocation that places a greater emphasis on equity-based investments to achieve its long-term return objectives within prudent risk constraints.

**(11) Medical Malpractice Claims Coverage**

The Corporation maintains professional liability and umbrella liability coverage on a combined basis. The Corporation believes it has adequate insurance coverage for all asserted claims, and it has no knowledge of unasserted claims that would exceed its insurance coverage. Effective January 1, 2003, the Corporation switched from an occurrence to a claims-made policy for medical malpractice.

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**(12) Self-Insurance**

The Corporation participates in a self-insured program for its workers' compensation insurance. In the case of catastrophes or other events that would cause excessive workers' compensation claims, the Corporation is reinsured for losses in excess of \$350,000 per occurrence. Workers' compensation costs are accrued based upon an estimated liability for reported claims and an estimated liability for claims incurred but not reported and approximated \$1,933,000 and \$2,070,000 as of December 31, 2008 and 2007, respectively. In addition, the Corporation maintains a \$6,400,000 irrevocable standby letter of credit to secure future obligations under the terms of this self-insured program.

The Corporation's health insurance benefits program is a guaranteed retrospectively rated cost plan whereby the Corporation's liability is subject to a range of potential exposure with a limited maximum amount. Total health benefit accrued expenses approximated \$1,375,000 and \$546,000 at December 31, 2008 and 2007, respectively, and are reported within the accrued expenses caption of the consolidated balance sheets.

**(13) Functional Expenses**

Expenses by functional classification for the years ended December 31 are as follows:

	<b>2008</b>	<b>2007</b>
Senior Living Services	\$ 124,291,153	118,584,190
Family and Community Ministries	28,152,034	25,714,266
Statewide Adoption and Permanency Network	20,470,336	18,487,937
Ministry Support Services and management	25,804,503	26,005,966
	\$ 198,718,026	188,792,359

Ministry Support and management costs include fund-raising expenses of \$2,055,114 and \$1,848,262 for the years ended December 31, 2008 and 2007, respectively.

**(14) Operating Results by Line of Service**

Services provided are broken down into the following lines of service:

Senior Living Services (SLS) includes retirement communities offering various levels of care including skilled nursing, assisted living, and independent living communities.

Family and Community Ministries (FCM) offers a wide range of services to children, seniors, families, and other members of the community. Children's services include foster care, adoption, a day-care center, and wilderness programs for adjudicated juveniles. Other services include: congregational-based support and counseling for families, senior centers, a parish nurse program, employee assistance programs, hospice, and other services.

Affordable Housing includes independent living programs, financed with HUD mortgages, as well as costs associated with planning for development of other affordable housing programs.

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Ministry Support Services revenues consist of interest income and unrestricted contributions, and expenses consist of nonprogram costs, depreciation, and costs of pursuing program support, after the allocation of program-specific support and administrative costs.

The following table details operating results by line of service for the year ended December 31, 2008:

	<u>SLS</u>	<u>FCM</u>	<u>Affordable Housing</u>	<u>Ministry Support Services</u>	<u>Total</u>
Patient, grant, and fee for service revenue	\$ 131,840,007	26,482,623	3,116,068	1,036,710	162,475,408
Statewide Adoption and Permanency Network revenue	—	20,470,336	—	—	20,470,336
Other income	1,835,682	110,380	69,524	9,238,450	11,254,036
Total revenues	<u>133,675,689</u>	<u>47,063,339</u>	<u>3,185,592</u>	<u>10,275,160</u>	<u>194,199,780</u>
Direct expenses	115,469,449	30,178,696	1,804,815	5,928,735	153,381,695
Realignment costs	—	—	250,000	1,335,500	1,585,500
Direct expenses – Statewide Adoption and Permanency Network	—	20,470,336	—	—	20,470,336
Interest	7,189,885	—	867,156	2,737,771	10,794,812
Depreciation and amortization	10,077,422	488,746	511,979	1,407,536	12,485,683
Total expenses	<u>132,736,756</u>	<u>51,137,778</u>	<u>3,433,950</u>	<u>11,409,542</u>	<u>198,718,026</u>
Operating income (loss)	<u>\$ 938,933</u>	<u>(4,074,439)</u>	<u>(248,358)</u>	<u>(1,134,382)</u>	<u>(4,518,246)</u>

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The following table details operating results by line of service for the year ended December 31, 2007:

	<u>SLS</u>	<u>FCM</u>	<u>Affordable Housing</u>	<u>Ministry Support Services</u>	<u>Total</u>
Patient, grant, and fee for service revenue	\$ 124,683,469	24,305,991	3,051,047	1,011,444	153,051,951
Statewide Adoption and Permanency Network revenue	—	18,487,937	—	—	18,487,937
Other income	3,528,711	696,532	79,394	15,976,104	20,280,741
Total revenues	<u>128,212,180</u>	<u>43,490,460</u>	<u>3,130,441</u>	<u>16,987,548</u>	<u>191,820,629</u>
Direct expenses	110,126,031	27,537,978	2,139,260	7,808,790	147,612,059
Direct expenses – Statewide Adoption and Permanency Network	—	18,487,937	—	—	18,487,937
Interest	6,126,223	—	883,717	3,574,657	10,584,597
Depreciation and amortization	9,489,640	495,848	504,563	1,617,715	12,107,766
Total expenses	<u>125,741,894</u>	<u>46,521,763</u>	<u>3,527,540</u>	<u>13,001,162</u>	<u>188,792,359</u>
Operating income (loss)	<u>\$ 2,470,286</u>	<u>(3,031,303)</u>	<u>(397,099)</u>	<u>3,986,386</u>	<u>3,028,270</u>

**(15) Current Vulnerability Due to Certain Concentrations**

Luther Meadows Corporation, U.P. Heilman House, Inc., and Lutherwood and Frostburg Heights Apartments, facilities owned and operated by DLSSM, each operate rental housing communities (the Communities) under Regulatory Agreements with HUD. In addition, the Communities are subject to Section 8 Housing Assistance Payments Program Contracts (the Contracts).

The Communities' operations are concentrated in the multifamily real estate market. In addition, the Communities operate in a heavily regulated environment. The operations of the Communities are subject to the administrative directives, rules and regulations of federal, state, and local regulatory agencies, including, but not limited to, HUD. Such administrative directives, rules, and regulations are subject to change by an act of Congress or an administrative change mandated by HUD. Such changes may occur with little notice or inadequate funding to pay for the related cost, including the additional administrative burden, to comply with a change.

At December 31, 2008 and 2007, the Communities owed other Diakon programs approximately \$579,000 and \$126,000, respectively, which is eliminated in consolidation.

**(16) Transactions with Affiliated Organizations and Individuals**

The Corporation utilized Prelude Systems, Inc. (Prelude) for information technology services for the years ended December 31, 2008 and 2007. The Corporation had approximately \$355,000 and \$319,000 in

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outstanding payables to Prelude at December 31, 2008 and 2007, respectively. As of December 31, 2008 and 2007, the Corporation's equity interest in Prelude is 46%. This joint venture is accounted for under the equity method of accounting.

For the year ended December 31, 2007, the Corporation paid for complete dietary services for its dietary operations to an organization whose principal officer was also a member of the DLSM board of directors. At December 31, 2007, the Corporation had approximately \$76,600 in outstanding payables to this vendor.

**(17) Commitments and Contingencies**

The Corporation has entered into various construction contracts related to SLS campus repositioning activities. Contractual commitments at December 31, 2008 total approximately \$17,400,000.

From time to time, the Corporation is involved in claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Corporation's consolidated financial position or results of operations.

**(18) Operating Leases**

The Corporation has a number of leased facilities to conduct its operations, all of which are operating leases, which expire over the next 5 years. The Corporation also has a number of leases covering certain equipment and vehicles, which are also operating leases. Additionally, an administrative building is being leased through 2012.

The approximate future minimum annual rentals on noncancelable leases in effect at December 31, 2008, which have initial or remaining terms of more than one year, are as follows:

2009	\$	2,159,243
2010		1,695,642
2011		1,436,609
2012		850,222
2013		<u>36,664</u>
	\$	<u><u>6,178,380</u></u>

Total rental expenses approximated \$2,581,000 and \$2,559,000 in 2008 and 2007, respectively.

**(19) Fair Value**

**(a) Financial Instruments**

*Cash and cash equivalents, investments, assets limited as to use, accounts receivable, estimated third-party payor settlements, funds held in trust by others, beneficial interest in trusts, other assets, accounts payable, accrued expenses, deposits, lines of credit and other noncurrent liabilities* – The carrying amounts reported in the consolidated balance sheets approximate the related fair values.

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The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Those fair value measurements maximize the use of observable inputs. However, in situations where there is little, if any, market activity for the asset or liability at the measurement date, the fair value measurement reflects the Corporation's own judgments about the assumptions that market participants would use in pricing the asset or liability. Those judgments are developed by the Corporation based on the best information available in the circumstances.

The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

*Cash and cash equivalents, accounts receivable, estimated third-party payor settlements, other assets, accounts payable, accrued expenses, deposits, and lines of credit* – The carrying amounts, at face value or cost plus accrued interest, approximate fair value because of the short maturity of these instruments.

*Investments and assets limited as to use* – The carrying amounts are based primarily on quoted market prices at the reporting date.

*Charitable remainder trusts, funds held in trust by others, and beneficial interest in trust* – The carrying amounts are based on quoted market process for securities held by the trusts.

*Swap Agreements* – The carrying amount for swap agreements is a fair value estimate based on the anticipated discounted cash flows using indicative mid-market levels as of December 31, 2008, adjusted to reflect counterparty nonperformance risk of both the Corporation and the counterparty for all swaps except those with LBSFI. They are derived from proprietary models based upon financial principles and reasonable estimates about relevant future market conditions. The valuation methodology is believed to be consistent with accepted practice in the market for interest rate swap agreements.

Due to the uncertain conditions identified in note 7, Derivative Instruments, and those created by current credit market conditions, the carrying amount of the LBSFI swap agreement is a fair value estimate based on the anticipated discounted cash flows using indicative mid-market levels as of December 31, 2008, without adjustment to reflect counterparty nonperformance risk and it is reasonably possible that the estimated fair value of the Corporation's interest rate swap agreement with LBSFI will change in the near term and that change could be material.

**(b) Long-Term Debt**

*Mortgages payable* – The fair value of mortgages payable is measured using quoted market prices when such market prices are available. If quoted market prices are not available, the fair value is determined by discounting future cash flows of each instrument at rates that reflect, among other things, market interest rates and the Corporation's credit standing.

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*Bonds payable* – The fair value of variable rate bonds payable is based on current interest rates for bonds of similar nature and maturities. The carrying amounts included in long-term debt in the consolidated balance sheets for bonds payable approximate fair value. Fixed rate bond fair value is determined by discounting future cash flows of each instrument at rates that reflect, among other things, market interest rates and the Corporation's credit standing.

The carrying amount and fair value of the Corporation's long-term debt approximated \$202,893,056 and \$176,191,917, respectively, at December 31, 2008 and \$204,654,636 and \$195,383,531, respectively at December 31, 2007.

(c) ***Fair Value Hierarchy***

The Corporation adopted Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (Statement 157) on January 1, 2008 for fair value measurements of financial assets and financial liabilities and for fair value measurements of nonfinancial items that are recognized or disclosed at fair value in the financial statements on a recurring basis. Statement 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Corporation has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are unobservable inputs for the asset or liability.

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

**DIAKON  
AND CONTROLLED AFFILIATES**

Notes to Consolidated Financial Statements

December 31, 2008 and 2007

The following table presents assets and liabilities that are measured at fair value on a recurring basis (including items that are required to be measured at fair value and items for which the fair value option has been elected) at December 31, 2008:

	<b>Quoted prices in active markets for identical assets Level 1</b>	<b>Significant other observable inputs Level 2</b>	<b>Significant inputs unobservable inputs Level 3</b>	<b>Total</b>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b>Assets:</b>				
Investments and assets limited as to use	\$ 155,787,461	—	—	155,787,461
Total	<u>\$ 155,787,461</u>	<u>—</u>	<u>—</u>	<u>155,787,461</u>
<b>Liabilities:</b>				
Interest rate swap agreements	\$ —	20,172,008	—	20,172,008
Total	<u>\$ —</u>	<u>20,172,008</u>	<u>—</u>	<u>20,172,008</u>

**DIAKON  
AND CONTROLLED AFFILIATES**

Schedule of Consolidating Information, Balance Sheet

December 31, 2008

Assets	DLSM Obligated Group	Nonobligated Group			Consolidating entries	Total
		Diakon	Diakon Lutheran Fund	Other		
Current assets:						
Cash and cash equivalents	\$ 5,214,127	—	—	2,037,756	—	7,251,883
Investments	29,192,581	—	11,819,231	425,704	—	41,437,516
Assets limited as to use	15,172,937	—	—	—	—	15,172,937
Accounts receivable (net of allowance for doubtful accounts):						
Patients and residents	11,770,789	—	—	—	—	11,770,789
Other client services	3,947,595	—	59,776	987,085	—	4,994,456
Estimated third-party payor settlements	1,290,915	—	—	—	—	1,290,915
Prepaid expenses and other assets	1,588,040	—	55	119,010	—	1,707,105
Total current assets	68,176,984	—	11,879,062	3,569,555	—	83,625,601
Investments	—	—	—	—	—	—
Assets limited as to use, net of current portion	97,685,152	—	1,491,856	—	—	99,177,008
Investment in subsidiary	—	400,000	—	—	(400,000)	—
Investments in joint ventures	647,540	—	—	—	—	647,540
Land, buildings, and equipment, net	177,472,659	—	—	10,758,676	—	188,231,335
Other assets:						
Deferred debt issuance costs, net	1,093,362	—	—	92,325	—	1,185,687
Receivables from charitable gift annuities	961,720	—	—	—	—	961,720
Funds held in trust by others and beneficial interest in trust	18,679,650	—	6,443,197	—	—	25,122,847
Other assets	5,878,301	—	—	—	—	5,878,301
Total assets	\$ 370,595,368	400,000	19,814,115	14,420,556	(400,000)	404,830,039

**DIAKON  
AND CONTROLLED AFFILIATES**

Schedule of Consolidating Information, Balance Sheet

December 31, 2008

Liabilities and Net Assets (Deficit)	DLSM Obligated Group	Nonobligated Group			Consolidating entries	Total
		Diakon	Diakon Lutheran Fund	Other		
Current liabilities:						
Demand note payable	\$ 5,057,000	—	—	513,918	—	5,570,918
Accounts payable – trade	4,066,195	—	—	199,158	—	4,265,353
Accrued expenses	17,265,500	—	—	151,831	—	17,417,331
Deposits – patients and residents	912,750	—	—	126,883	—	1,039,633
Deferred revenue	548,286	—	—	11,025	—	559,311
Estimated third-party payor settlements	1,097,778	—	—	—	—	1,097,778
Current maturities of long-term debt	38,926,332	—	—	397,346	—	39,323,678
Total current liabilities	67,873,841	—	—	1,400,161	—	69,274,002
Pension liability	18,603,108	—	—	—	—	18,603,108
Swap agreements	20,172,008	—	—	—	—	20,172,008
Deferred revenue – entrance agreements	60,039,033	—	—	—	—	60,039,033
Deferred gain on sale of assets	1,256,304	—	—	—	—	1,256,304
Other long-term liabilities	1,484,239	—	—	4,119	—	1,488,358
Long-term debt, less current maturities	148,997,585	—	—	14,571,793	—	163,569,378
Total liabilities	318,426,118	—	—	15,976,073	—	334,402,191
Net assets (deficit):						
Unrestricted	23,275,761	400,000	11,781,234	(1,555,517)	(400,000)	33,501,478
Temporarily restricted	2,645,202	—	1,369,386	—	—	4,014,588
Permanently restricted	26,248,287	—	6,663,495	—	—	32,911,782
Total net assets (deficit)	52,169,250	400,000	19,814,115	(1,555,517)	(400,000)	70,427,848
Total liabilities and net assets (deficit)	\$ 370,595,368	400,000	19,814,115	14,420,556	(400,000)	404,830,039

See accompanying independent auditors' report.

**DIAKON  
AND CONTROLLED AFFILIATES**

Schedule of Consolidating Information, Statement of Operations and Changes in Net Assets (Deficit)

Year ended December 31, 2008

	DLSM Obligated Group	Nonobligated Group			Subtotal	Consolidating entries	Total
		Diakon	Diakon Lutheran Fund	Other			
Operating revenues, gains and other support:							
Patient and resident service revenue, net of contractual allowances	\$ 127,296,604	—	—	—	127,296,604	—	127,296,604
Patient and resident service revenue, nursing home assessment	2,759,103	—	—	—	2,759,103	—	2,759,103
Amortization of entrance fees	8,087,312	—	—	—	8,087,312	—	8,087,312
Grants from Diakon Lutheran Fund	2,100,004	—	—	—	2,100,004	(2,100,004)	—
Grants	12,044,248	—	—	1,811,297	13,855,545	—	13,855,545
Other fees and services	8,728,115	—	—	2,393,657	11,121,772	(644,928)	10,476,844
Statewide Adoption and Permanency Network revenue	20,470,336	—	—	—	20,470,336	—	20,470,336
Investment income, net of expenses	7,235,838	—	437,888	29,637	7,703,363	—	7,703,363
Contributions and bequests	1,497,875	—	52,123	4,366	1,554,364	—	1,554,364
Net assets released from restrictions – operations	1,657,896	—	—	—	1,657,896	—	1,657,896
Gain (loss) on disposal of assets	341,009	—	—	(2,596)	338,413	—	338,413
Total operating revenues, gains and other support	192,218,340	—	490,011	4,236,361	196,944,712	(2,744,932)	194,199,780
Expenses:							
Salaries and wages	71,020,649	—	—	381,292	71,401,941	—	71,401,941
Employee benefits	16,359,682	—	—	99,594	16,459,276	—	16,459,276
Other expenses	63,445,538	—	2,100,004	1,807,740	67,353,282	(2,744,932)	64,608,350
Other expenses – Statewide Adoption and Permanency Network	19,598,075	—	—	—	19,598,075	—	19,598,075
Nursing home assessment	1,784,389	—	—	—	1,784,389	—	1,784,389
Interest	9,589,581	—	—	1,205,231	10,794,812	—	10,794,812
Depreciation and amortization	11,658,896	—	—	826,787	12,485,683	—	12,485,683
Realignment costs	1,335,500	—	—	250,000	1,585,500	—	1,585,500
Total expenses	194,792,310	—	2,100,004	4,570,644	201,462,958	(2,744,932)	198,718,026
Operating loss	(2,573,970)	—	(1,609,993)	(334,283)	(4,518,246)	—	(4,518,246)
Equity in losses of joint ventures	(2,757,866)	—	—	—	(2,757,866)	—	(2,757,866)
Unrealized loss on other-than-temporary impairment of investments	(41,820,154)	—	(5,895,724)	—	(47,715,878)	—	(47,715,878)
Decrease in fair value of swap agreements	(12,677,842)	—	—	—	(12,677,842)	—	(12,677,842)
Loss from early extinguishment of debt	(7,179,013)	—	—	—	(7,179,013)	—	(7,179,013)
Deficit of operating revenues, gains and other support over expenses	(67,008,845)	—	(7,505,717)	(334,283)	(74,848,845)	—	(74,848,845)
Other changes:							
Pension-related changes other than net periodic pension costs	(10,235,855)	—	—	—	(10,235,855)	—	(10,235,855)
Equity in losses of joint ventures	(2,251,951)	—	—	—	(2,251,951)	—	(2,251,951)
Unrealized losses on investments	(625,756)	—	(1,525,637)	—	(2,151,393)	—	(2,151,393)
Increase in fair value of swap agreements	538,085	—	—	—	538,085	—	538,085
Net assets released from restrictions – capital	231,745	—	—	—	231,745	—	231,745
Total other changes	(12,343,732)	—	(1,525,637)	—	(13,869,369)	—	(13,869,369)
Decrease in unrestricted net assets (deficit)	(79,352,577)	—	(9,031,354)	(334,283)	(88,718,214)	—	(88,718,214)

**DIAKON  
AND CONTROLLED AFFILIATES**

Schedule of Consolidating Information, Statement of Operations and Changes in Net Assets (Deficit)

Year ended December 31, 2008

	<b>DLSM Obligated Group</b>	<b>Nonobligated Group</b>			<b>Subtotal</b>	<b>Consolidating entries</b>	<b>Total</b>
		<b>Diakon</b>	<b>Diakon Lutheran Fund</b>	<b>Other</b>			
Temporarily restricted net assets:							
Contributions and bequests	\$ 1,496,765	—	—	—	1,496,765	—	1,496,765
Investment income, net of expenses	276,314	—	11,222	—	287,536	—	287,536
Unrealized losses on investments	(3,294,418)	—	(826,004)	—	(4,120,422)	—	(4,120,422)
Net assets released from restrictions – continuing operations	(1,657,896)	—	—	—	(1,657,896)	—	(1,657,896)
Net assets released from restrictions – capital	(231,745)	—	—	—	(231,745)	—	(231,745)
Change in beneficial interest in trust	(186,191)	—	—	—	(186,191)	—	(186,191)
Decrease in temporarily restricted net assets	(3,597,171)	—	(814,782)	—	(4,411,953)	—	(4,411,953)
Permanently restricted net assets:							
Contributions and bequests	286,326	—	—	—	286,326	—	286,326
Decrease in fair value of funds held in trust by others	(7,296,989)	—	(2,458,138)	—	(9,755,127)	—	(9,755,127)
Decrease in permanently restricted net assets	(7,010,663)	—	(2,458,138)	—	(9,468,801)	—	(9,468,801)
Decrease in net assets	(89,960,411)	—	(12,304,274)	(334,283)	(102,598,968)	—	(102,598,968)
Net assets (deficit), beginning of year	142,129,661	400,000	32,118,389	(1,221,234)	173,426,816	(400,000)	173,026,816
Net assets (deficit), end of year	\$ 52,169,250	400,000	19,814,115	(1,555,517)	70,827,848	(400,000)	70,427,848

See accompanying independent auditors' report.