



**DIAKON LUTHERAN SOCIAL MINISTRIES
AND CONTROLLED AFFILIATES**

Consolidated Financial Statements

December 31, 2006 and 2005

(With Independent Auditors' Report Thereon)

**DIAKON LUTHERAN SOCIAL MINISTRIES
AND CONTROLLED AFFILIATES**

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Independent Auditors' Report

The Board of Directors
Diakon Lutheran Social Ministries:

We have audited the accompanying consolidated balance sheets of Diakon Lutheran Social Ministries (Diakon) and controlled affiliates (collectively, the Corporation), as of December 31, 2006 and 2005, 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 Lutheran Social Ministries and controlled affiliates as of December 31, 2006 and 2005, 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.

As discussed in the Notes 1(cc) and 9 to the consolidated financial statements, the Corporation adopted the recognition and disclosure provisions of Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, as of December 31, 2006.

KPMG LLP

March 28, 2007

**DIAKON LUTHERAN SOCIAL MINISTRIES
AND CONTROLLED AFFILIATES**

Consolidated Balance Sheets

December 31, 2006 and 2005

Assets	2006	2005
Current assets:		
Cash and cash equivalents	\$ 1,600,490	15,295,200
Assets limited as to use – required for current liabilities	4,408,741	—
Accounts receivable (net of allowance for doubtful accounts of approximately \$1,056,000 and \$1,352,000, respectively):		
Patients and residents	9,282,539	7,486,969
Other client services	6,250,090	3,975,960
Other	2,753,323	342,334
Estimated third-party payor settlements	1,496,755	1,192,046
Prepaid expenses and other assets	4,756,086	1,464,884
Total current assets	30,548,024	29,757,393
Investments	66,217,590	98,306,098
Assets limited as to use, net of current portion	99,686,744	99,816,931
Investments in joint ventures	5,799,737	2,498,699
Land, buildings, and equipment, net	158,597,190	107,501,188
Other assets:		
Deferred debt issuance costs, net	6,711,335	6,955,208
Receivables from charitable gift annuities	1,210,109	1,086,075
Beneficial interest in charitable remainder trusts	666,371	627,976
Funds held in trust by others and beneficial interest in trust	34,187,123	31,338,060
Other assets	6,136,133	1,902,746
Total assets	\$ 409,760,356	379,790,374

**DIAKON LUTHERAN SOCIAL MINISTRIES
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Consolidated Balance Sheets

December 31, 2006 and 2005

Liabilities and Net Assets	2006	2005
	<u> </u>	<u> </u>
Current liabilities:		
Demand note payable	\$ 418,000	—
Accounts payable – trade	8,541,293	7,158,075
Accrued expenses	12,503,843	10,289,416
Deposits – patients and residents	1,342,241	854,301
Deferred revenue	313,954	158,164
Estimated third-party payor settlements	1,207,616	1,363,243
Current maturities of long-term debt	3,234,332	3,132,092
	<u>27,561,279</u>	<u>22,955,291</u>
Pension liability	7,542,180	4,469,334
Swap agreements	5,496,378	7,185,388
Deferred revenue – entrance agreements	52,517,573	38,044,898
Deferred gain on sale of assets	1,847,505	2,143,106
Other long-term liabilities	4,251,256	5,515,860
Long-term debt, less current maturities	135,993,255	139,222,986
	<u>235,209,426</u>	<u>219,536,863</u>
Net assets:		
Unrestricted	123,741,643	114,566,475
Temporarily restricted	9,084,111	6,493,793
Permanently restricted	41,725,176	39,193,243
	<u>174,550,930</u>	<u>160,253,511</u>
Total liabilities and net assets	<u>\$ 409,760,356</u>	<u>379,790,374</u>

See accompanying notes to consolidated financial statements.

**DIAKON LUTHERAN SOCIAL MINISTRIES
AND CONTROLLED AFFILIATES**

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2006 and 2005

	2006	2005
Operating revenues, gains and other support:		
Patient and resident service revenue, net of contractual allowances	\$ 114,188,101	99,156,350
Patient and resident service revenue, nursing home assessment (note 3)	2,427,678	6,102,950
Amortization of entrance fees	6,533,405	4,973,649
Grants	12,905,592	12,972,867
Other fees and services	6,858,620	6,944,058
Statewide Adoption Network revenue	22,217,143	21,911,206
Contributions and bequests	1,202,749	1,887,885
Investment income, net of expenses	21,472,845	7,406,510
Net assets released from restrictions – operations	1,145,667	978,434
Total operating revenues, gains and other support	188,951,800	162,333,909
Expenses:		
Salaries and wages	64,735,206	58,794,399
Employee benefits and other staff costs	14,439,799	13,790,567
Other expenses	58,848,394	49,344,068
Other expenses – Statewide Adoption Network	21,305,951	20,683,897
Nursing home assessment (note 3)	2,057,501	5,299,274
Interest	6,938,004	6,552,212
Depreciation and amortization	10,546,093	8,814,391
Total expenses	178,870,948	163,278,808
Income (loss) from continuing operations	10,080,852	(944,899)
Discontinued operations (note 21):		
(Loss) income from discontinued operations	(113,144)	4,884,511
Gain from sale of discontinued operations	—	46,960,294
(Loss) income from discontinued operations	(113,144)	51,844,805
Operating income	9,967,708	50,899,906
Equity in gains of joint ventures	2,293,403	965,634
Increase (decrease) in fair value of swap agreements	1,029,459	(2,106,841)
Excess of operating revenues, gains and other support over expenses	13,290,570	49,758,699
Other changes:		
Decrease (increase) in minimum pension liability	3,711,657	(2,372,701)
Effect of adoption of recognition provision of FASB Statement No. 158	(4,309,503)	—
Equity in gains (losses) of joint ventures	1,007,635	(84,683)
Unrealized (losses) gains on investments	(5,378,511)	3,314,504
Increase in fair value of swap agreements	659,551	2,825,622
Net assets released from restrictions – capital	193,769	146,525
Total other changes	(4,115,402)	3,829,267
Increase in unrestricted net assets	9,175,168	53,587,966

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Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Temporarily restricted net assets:		
Contributions and bequests	\$ 1,472,016	896,963
Investment income, net of expenses	2,027,106	153,295
Unrealized (losses) gains on investments	(557,613)	650,768
Net assets released from restrictions – continuing operations	(1,145,667)	(978,434)
Net assets released from restrictions – discontinued operations	—	(30,887)
Net assets released from restrictions – capital	(193,769)	(146,525)
Change in beneficial interest in trust	988,245	—
Increase in temporarily restricted net assets	<u>2,590,318</u>	<u>545,180</u>
Permanently restricted net assets:		
Contributions and bequests	300,358	239,704
Increase in fair value of funds held in trust by others	<u>2,231,575</u>	<u>665,714</u>
Increase in permanently restricted net assets	<u>2,531,933</u>	<u>905,418</u>
Increase in net assets	14,297,419	55,038,564
Net assets, beginning of year	<u>160,253,511</u>	<u>105,214,947</u>
Net assets, end of year	<u>\$ 174,550,930</u>	<u>160,253,511</u>

See accompanying notes to consolidated financial statements.

**DIAKON LUTHERAN SOCIAL MINISTRIES
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Consolidated Statements of Cash Flows

Years ended December 31, 2006 and 2005

	2006	2005
Cash flows from operating activities:		
Increase in net assets	\$ 14,297,419	55,038,564
Adjustments to reconcile increase in net assets to net cash used in operating activities from continuing operations:		
Net cash provided by discontinued operations	—	(4,580,401)
Net realized gains on investments	(16,088,490)	(2,210,395)
Net unrealized losses (gains) on investments	5,936,124	(3,643,075)
Depreciation and amortization	10,546,093	9,154,866
Amortization of entrance fees	(6,533,405)	(5,032,033)
Amortization of deferred gain on sale of assets	(295,601)	(295,600)
Change in funds held in trust by others and beneficial interest in trust	(2,849,063)	(665,714)
Gain on swap agreements	(1,689,011)	(718,781)
Gain in equity earnings of joint ventures	(3,301,037)	(880,950)
Gain on disposal of fixed assets	(54,332)	(14,139)
Gain on sale of discontinued operations	—	(46,960,294)
Provision for bad debts	223,305	337,667
Restricted contributions and investment income	(2,653,813)	(931,409)
Change in assets and liabilities:		
Accounts receivable	(3,558,221)	6,727,703
Estimated third-party payor settlements	(460,336)	535,006
Prepaid expenses and other current assets	(5,502,496)	1,025,182
Contributions and charitable gift/remainder trusts	(162,429)	24,644
Other assets	1,081,944	(1,400,659)
Accounts payable, accrued expenses and other liabilities	1,010,818	(5,958,927)
Deposits – patients and residents	100,354	(65,886)
Net cash used in operating activities from continuing operations	(9,952,177)	(514,631)
Cash flows from investing activities:		
Purchase of investments and assets limited as to use	(113,219,179)	(148,491,145)
Proceeds from sales of investments and assets limited as to use	158,491,440	67,081,823
Net cash paid for Twining Village	(27,977,163)	—
Purchase of property and equipment	(29,383,832)	(11,341,098)
Proceeds from the sale of discontinued operations, net	—	75,361,122
Net cash used in discontinued operations	—	27,131
Net cash used in investing activities from continuing operations	(12,088,734)	(17,362,167)

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Consolidated Statements of Cash Flows

Years ended December 31, 2006 and 2005

	2006	2005
Cash flows from financing activities:		
Payment of long-term debt	\$ (3,127,491)	(2,906,516)
Payment of debt issuance costs	(74,946)	—
Net proceeds from line of credit	418,000	—
Proceeds from restricted contributions and investment income	2,662,975	1,316,440
Proceeds from entrance fees	11,400,194	6,465,707
Refunds on entrance fees	(2,932,531)	(3,013,286)
Net cash used in discontinued operations	—	4,553,270
Net cash provided by financing activities from continuing operations	8,346,201	6,415,615
Net decrease in cash and cash equivalents	(13,694,710)	(11,461,183)
Cash and cash equivalents, beginning of year	15,295,200	26,756,383
Cash and cash equivalents, end of year	\$ 1,600,490	15,295,200
Supplemental schedule of noncash investing and financing activities:		
The Corporation acquired certain assets and liabilities of Twining Services Corporation. In conjunction with the acquisition, liabilities were assumed as follows:		
Fair value of assets acquired	\$ 43,258,163	—
Net cash paid	(27,977,163)	—
Liabilities assumed	\$ 15,281,000	—
The Corporation sold certain assets and liabilities of nine of its service locations. The following summarizes the transaction:		
Sales agreement	\$ —	82,000,000
Transaction costs paid	—	(6,638,878)
Proceeds from sale of discontinued operations, net	—	75,361,122
Entrance fee liabilities assumed by purchaser	—	2,784,099
Contingent liabilities assumed by Corporation	—	(1,500,000)
Net book value of assets sold	—	(29,684,927)
Gain on sale of discontinued operations	\$ —	46,960,294

See accompanying notes to consolidated financial statements.

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(1) Summary of Significant Accounting Policies

(a) Organization

Diakon Lutheran Social Ministries (DLSM) is the sole member of Lutheran Services Northeast and Controlled Entities (LSN), Tressler Lutheran Services and Controlled Entities (TLS), and Diakon Lutheran Fund (DLF). DLSM is affiliated with the Evangelical Lutheran Church in America (ELCA) through Lutheran Services in America (LSA), the membership alliance of Lutheran social ministry organizations and the church bodies. DLSM has a relationship with the following participating ELCA synods: Delaware-Maryland, Lower Susquehanna, Northeastern Pennsylvania, Southeastern Pennsylvania, and Upper Susquehanna. In accordance with DLSM’s bylaws, the bishops of the synods elect the majority of the DLSM board of directors. The Board of DLSM, in its role as sole member, appoints the boards for LSN, TLS, and DLF.

(b) Description of Controlled Affiliates

LSN is a not-for-profit corporation that operates continuing care retirement communities, retirement communities, and nursing homes, as well as a variety of other human service and social ministry programs designed to meet the needs of children, families, and the elderly. LSN operations are located in Eastern Pennsylvania and include the operations of The Lutheran Home at Topton, Pennsylvania (LHT), The Lutheran Welfare Service of Northeastern Pennsylvania, Inc. (LWS), and Hospice Saint John (HSJ). LHT includes the accounts of The Lutheran Home at Topton, Pennsylvania and its controlled entities, U. P. Heilman House, Inc. and Luther Meadows Corporation.

TLS is a not-for-profit corporation that operates nursing homes, continuing care retirement communities, retirement villages (including affiliated organizations; Susquehanna Housing, Inc. and Perry Village, Inc.), and also provides a variety of other human service and social ministry programs designed to meet the needs of children, families, and the elderly in Central Pennsylvania, Maryland, and Delaware.

The following table details the number of beds/units that operate under each entity:

	<u>LSN</u>	<u>TLS</u>	<u>Total</u>
Nursing beds	406	601	1,007
Assisted living beds	285	350	635
Independent living units	334	555	889
HUD housing units	225	110	335
Total	<u>1,250</u>	<u>1,616</u>	<u>2,866</u>

DLF, a 501(c)(3) corporation, is authorized by its charter to 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, TLS, and LSN children, youth, and family services programs.

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Notes to Consolidated Financial Statements

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(c) Basis of Consolidation

These consolidated financial statements have been prepared to focus on DLSSM and all controlled affiliated organizations (the Corporation) as a whole. All material intercompany transactions have been eliminated.

(d) Basis of Accounting

These 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) 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.

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

TLS, LSN, and DLF (the beneficiaries) have been named as a beneficiary of a number of trusts which 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 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. The value of the trust was recognized upon the acquisition of Twining Village as a beneficial interest in trust.

(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 trustee under bond indentures; and assets held by trustees under terms of resident care contracts. Investment income and gains and losses on assets limited as to use are included in investment income in unrestricted net assets.

(h) *Net Patient and Resident Services Revenue*

Net patient and resident services 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 35% and 39% of patient and resident service revenue, net of contractual allowances for the years ended December 31, 2006 and

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2005, respectively. Medicare and Medicaid receivables represent approximately 50% and 46% of patient and resident accounts receivable at December 31, 2006 and 2005, respectively.

(i) Charity Care and Support of Those in Need

The Corporation provides charity care, subsidies 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 and contractual subsidies 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.

Subsidies and support of those in need include services provided to persons who cannot afford health care 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.

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

	2006	2005
Medical assistance cost in excess of contractual reimbursement – subsidy	\$ 6,517,045	4,282,163
Charity care in support of those in need	1,732,549	1,494,822
FCM programs supported by DLSM (charity care):		
Children's services	2,951,158	2,029,971
Behavioral health	968,626	853,672
Family life and congregation	594,662	601,307
Community services	442,510	239,522
Home Health	6,550	415,795
	4,963,506	4,140,267
Total charity care and subsidies provided	\$ 13,213,100	9,917,252

(j) Investments and Investment Income

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

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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 (losses) on sale of investments are added to (deducted from) the appropriate net asset classification depending on the existence of donor-imposed restrictions.

A decline in market value of any investment below cost that is deemed to be other than temporary results in a reduction in carrying amount to fair value. The impairment is charged to realized losses and a new cost basis for the investment is established. For the years ended December 31, 2006 and 2005, there were no declines charged to realized losses.

(k) Operating Income

The consolidated statements of operations and changes in net assets include an intermediate measure of operations labeled as “operating income.” Changes in the performance indicator, which are excluded from this measure, include joint venture equity changes reported within the venture’s performance indicator, and changes in the fair value of swap agreements.

(l) Performance Indicator

The consolidated statements of operations and changes in net assets include a performance indicator of operations labeled as “excess of operating revenues, gains and other support over expenses.” Changes in unrestricted net assets, which are excluded from this measure, include unrealized gains on investments, changes in the minimum pension liability, the effect of adoption of FASB Statement No. 158, 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.

(m) 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

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assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

(n) *Costs of Borrowing*

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.

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

Debt issuance costs are amortized over the period the obligation is outstanding. Amortization expense was \$318,820 and \$314,946 in 2006 and 2005, respectively. Accumulated amortization as of December 31, 2006 and 2005 totaled \$1,956,993 and \$1,638,173, respectively.

Other assets include an advance nonrefundable lease deposit for office space in Baltimore, Maryland. This deposit is being amortized on a straight line basis over the life of the lease. Amortization expense for this asset was \$16,667 in 2006 and 2005. Accumulated advance lease deposit amortization as of December 31, 2006 and 2005 totaled \$133,335 and \$116,668, respectively.

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 \$222,000 in 2006 and \$0 in 2005 and accumulated amortization totaled approximately \$222,000 at December 31, 2006 and \$0 at December 31, 2005.

(p) *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.

(q) *Income Taxes*

Diakon Lutheran Social Ministries and 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.

(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 health care services provided under the provisions of the agreements.

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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 useful life of the facility.

The amount of entrance fees which is refundable to residents at December 31, 2006 and 2005 under contractual refund provisions was approximately \$38,000,000 and \$29,000,000, respectively.

(s) *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.

(t) *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.

(u) *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.

(v) *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.

(w) *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.

(x) *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

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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, *Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator* (SOP 02-2), clarifies that the performance indicator reported by not-for-profit health care 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.

(y) *Impairment of Long-Lived Assets*

Long-lived assets, such as property, plant, 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.

(z) *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, 2006 and 2005.

(aa) *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 prorata 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.

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

(bb) 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 are 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.

(cc) 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 beginning in 2006 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.

Effective December 31, 2006, the Corporation adopted the recognition and disclosure provisions of FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (Statement 158), 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. The funded status reported on the balance sheet as of December 31, 2006 under Statement 158 was measured as the difference between the fair value of plan assets and the benefit obligation. The adoption of Statement 158 did not impact the Corporation's compliance with debt covenants or its cash position. The incremental effect of applying Statement 158 to the Corporation's financial position as of December 31, 2006 is described more fully in note 9.

(dd) Reclassifications

Certain prior period amounts have been reclassified to conform with the current period consolidated financial statement presentation.

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(2) Assets Limited as to Use and Investments

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

	<u>2006</u>	<u>2005</u>
Under agreement with U.S. government agencies as mortgagors (principally held by trustee):		
Cash and short-term investments	\$ 1,145,560	1,016,649
Fixed income securities	—	207,923
Under bond indentures for debt service reserve fund:		
Cash and short-term investments	2,376,451	1,617,747
U.S. government obligations and corporate bonds	3,322,025	3,876,604
Under bond indentures for construction projects:		
Cash and short-term investments	20,172,599	26,403,047
U.S. government obligations and corporate bonds	—	5,469,367
Fixed income securities	86,553	4,282,890
Workers' compensation trust:		
Cash and short-term investments	200	200
Endowment funds:		
Cash and short-term investments	59,445	324,399
U.S. government obligations and corporate bonds	—	465
Fixed income securities	1,804,590	1,837,665
Equity securities	5,634,364	5,271,409
Donor and other restricted funds:		
Cash and short-term investments	632,363	927,858
U.S. government obligations and corporate bonds	—	1,483
Equity securities	1,641,192	2,911,866
Fixed income securities	4,820,417	2,086,226
Other	18,027	17,396
By board for designated purposes:		
Funded depreciation:		
Cash and short-term investments	93,493	139,813
U.S. government obligations and corporate bonds	—	14,178
Equity securities	1,858,228	1,463,752
Fixed income securities	1,212,331	1,232,376
Entrance fees and other designated purposes:		
Cash and short-term investments	3,238,776	2,407,925
U.S. government obligations and corporate bonds	4,403,308	199,457
Equity securities	31,101,854	20,592,324
Fixed income securities	20,291,227	17,337,289
Other	182,482	176,623
Total assets limited as to use	<u>104,095,485</u>	<u>99,816,931</u>
Less assets limited as to use required for current liabilities	<u>4,408,741</u>	<u>—</u>
Assets limited as to use, net of current portion	<u>\$ 99,686,744</u>	<u>99,816,931</u>

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A summary of investments at December 31 follows:

	<u>2006</u>	<u>2005</u>
Cash and short-term investments	\$ 1,409,363	31,267,066
U.S. Government obligations and corporate bonds	—	158,819
Equity securities	43,521,834	37,085,509
Fixed income securities	21,286,393	29,794,704
	<u>\$ 66,217,590</u>	<u>98,306,098</u>

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

	<u>2006</u>		<u>2005</u>	
Cash and short-term investments	\$ 28,832,932	16.9%	64,104,706	32.4%
U.S. Government obligations and corporate bonds	7,725,333	4.5	9,720,373	4.9
Equity securities	86,263,356	50.7	67,324,860	34.0
Fixed income securities	47,290,946	27.8	56,779,072	28.6
Other	200,508	0.1%	194,018	0.1
	<u>\$ 170,313,075</u>	<u>100.0%</u>	<u>198,123,029</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 2006</u>	<u>Total 2005</u>
Investment income, net of expenses	\$ 7,079,994	331,467	7,411,461	5,671,607
Net realized gains on investments	14,392,851	1,695,639	16,088,490	2,210,395
Net unrealized (losses) gains on investments	(5,378,511)	(557,613)	(5,936,124)	3,643,075
Total investment income	<u>\$ 16,094,334</u>	<u>1,469,493</u>	<u>17,563,827</u>	<u>11,525,077</u>

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A summary of investments with fair values below cost as of December 31, 2006 follows:

	Less than 12 months		12 months or longer		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Description of securities:						
Fixed income mutual funds	\$ —	—	46,361,363	845,271	46,361,363	845,271
U.S. Treasury obligations and direct obligations of U.S. Government agencies	3,978,308	44,104	1,518,728	40,756	5,497,036	84,860
Subtotal debt securities	<u>3,978,308</u>	<u>44,104</u>	<u>47,880,091</u>	<u>886,027</u>	<u>51,858,399</u>	<u>930,131</u>
Equity mutual funds	<u>9,460,935</u>	<u>517,734</u>	<u>—</u>	<u>—</u>	<u>9,460,935</u>	<u>517,734</u>
Total temporarily impaired securities	<u>\$ 13,439,243</u>	<u>561,838</u>	<u>47,880,091</u>	<u>886,027</u>	<u>61,319,334</u>	<u>1,447,865</u>

Approximately 58% of the unrealized losses shown above are in the Fixed Income Mutual Fund category. The market value of these funds will continue to fluctuate with the value of the assets in the funds. The value of the assets in the funds is affected by a number of factors, including interest rates, and the value of the funds is generally expected to change inversely to changes in interest rates. The assets in the funds are generally high quality fixed income instruments and, therefore, we do not believe the value of the mutual fund impairment is other than temporary.

Direct obligations of the U.S. Government and its various agencies represent 6% of the unrealized losses shown above. This loss position is also due to the rise in interest rates since these securities were purchased. The Corporation intends to hold these securities until their maturity and, as such, anticipates receiving the full face value of the security.

Approximately 36% of the unrealized loss is within the Equity mutual fund category. This unrealized loss represents the value of one fund which invests in high quality, small cap companies which management believes are temporarily undervalued. The decline in market versus cost has occurred over a very short term period. Given the nature of equity markets and volatility, we do not believe that the value of the mutual fund impairment is other than temporary.

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A summary of investments with fair values below cost as of December 31, 2005 follows:

	Less than 12 months		12 months or longer		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Description of securities:						
Fixed income mutual funds	\$ 46,371,738	734,844	—	—	46,371,738	734,844
U.S. Treasury obligations and direct obligations of U.S. Government agencies	1,132,599	6,873	4,103,405	90,409	5,236,004	97,282
Corporate bonds	6,461,079	53,434	147,867	7,704	6,608,946	61,138
Subtotal debt securities	<u>53,965,416</u>	<u>795,151</u>	<u>4,251,272</u>	<u>98,113</u>	<u>58,216,688</u>	<u>893,264</u>
Equity mutual funds	3,346,352	18,535	—	—	3,346,352	18,535
Common stocks	449,507	16,594	57,030	8,058	506,537	24,652
Subtotal equity securities	<u>3,795,859</u>	<u>35,129</u>	<u>57,030</u>	<u>8,058</u>	<u>3,852,889</u>	<u>43,187</u>
Total temporarily impaired securities	<u>\$ 57,761,275</u>	<u>830,280</u>	<u>4,308,302</u>	<u>106,171</u>	<u>62,069,577</u>	<u>936,451</u>

Nearly 80% of the unrealized losses shown above are in the Fixed Income Mutual Fund category. The market value of these funds will continue to fluctuate with the value of the assets in the funds. The value of the assets in the funds is affected by a number of factors, including interest rates, and the value of the funds is generally expected to change inversely to changes in interest rates. The assets in the funds are generally high quality fixed income instruments and, therefore, we do not believe the value of the mutual fund impairment is other than temporary.

Direct obligations of the U.S. Government and its various agencies represent ten percent of the unrealized losses shown above. This loss position is also due to the rise in interest rates since these securities were purchased. These funds were invested on a total return basis to mature to meet an estimated payment schedule for various capital projects or for the Debt Service Reserve Fund. The Corporation intends to hold these securities until their maturity and, as such, anticipates receiving the full face value of the security.

(3) Third-Party Reimbursement

The nursing care facilities owned by LSN and TLS 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.

In January 2005, the Centers for Medicare and Medicaid Services (CMS) approved a Pennsylvania State Plan implementing a Nursing Home Assessment (the Assessment). The Assessment was retroactive to July 1, 2003 and 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

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nursing home assessment revenues and expenses reported in 2006 and 2005 continuing operations are \$2,427,678 and \$2,057,501 for 2006, respectively, and \$6,102,950 and \$5,299,274, for 2005, respectively. The chart below illustrates the approximate net increase in revenues broken down by the timeframe to which the Assessment relates.

	2006	2005
July 1, 2003 – December 31, 2003	\$ —	348,000
January 1, 2004 – December 31, 2004	—	531,000
January 1, 2005 – December 31, 2005	—	(76,000)
January 1, 2006 – December 31, 2006	370,000	—
	\$ 370,000	803,000

LSN and TLS have entered into agreements with the Pennsylvania Department of Public Welfare and the County Commissioners of Pennsylvania to receive specified payments for Medicaid reimbursements through June 30, 2005, and in return, have agreed to withdraw and/or not file or pursue any appeals, claims, or proceedings relating to the facility's case-mix rates or Medicaid reimbursement for the above time period. Diakon recognized approximately \$0 and \$274,000 in revenue in the years ended December 31, 2006 and 2005, respectively, as a result of these agreements.

(4) Land, Buildings, and Equipment

Land, buildings, and equipment and accumulated depreciation at December 31:

	2006	2005
Land	\$ 18,130,313	10,605,313
Land improvements	11,769,243	10,774,973
Buildings	184,441,908	153,574,146
Furniture and equipment	38,312,692	31,000,720
Vehicles	1,050,537	1,001,089
	253,704,693	206,956,241
Accumulated depreciation	(113,866,910)	(104,560,903)
	139,837,783	102,395,338
Construction in progress	18,759,407	5,105,850
	\$ 158,597,190	107,501,188

Depreciation expense as of December 31, 2006 and 2005 is \$9,949,326 and \$8,474,431, respectively.

Construction in progress as of December 31, 2006 and 2005 is principally capitalized costs related to the repositioning of the Corporation's Senior Living Service campuses.

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In 2002, TLS completed a sale/leaseback transaction for its 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, TLS 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 is \$492,782, payable monthly. Subsequent annual payments increase two and one-half percent each year throughout the term of the lease. During 2006 and 2005, \$295,601 of the gain was amortized and included within other fees and services in the consolidated statements of operations and changes in net assets.

(5) Beneficial Interest in Remainder Trust

The Corporation has been named the beneficiary of a remainder trust. The fair value of this trust approximates \$666,400 and \$628,000 at December 31, 2006 and 2005, respectively. The trust will be distributed to the Corporation in 2010.

(6) Long-term Debt

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

	<u>2006</u>	<u>2005</u>
Bonds payable – Series A 2003	\$ 5,355,000	5,455,000
Bonds payable – Series B 2003	1,690,000	2,545,000
Bonds payable – Series C 2003	10,490,000	10,560,000
Bonds payable – Series D 2003	42,820,000	42,915,000
Bonds payable – Series E 2003	20,310,000	20,390,000
Bonds payable – Series A 1998	42,880,000	44,490,000
Mortgages payable:		
U.S. government agencies	10,156,378	10,410,981
Commercial banks	5,526,209	5,589,097
	<u>139,227,587</u>	<u>142,355,078</u>
Current maturities:		
Bonds and mortgages payable	<u>(3,234,332)</u>	<u>(3,132,092)</u>
	<u>\$ 135,993,255</u>	<u>139,222,986</u>

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Annual maturities of long-term debt for the next five years are as follows:

2007	\$	3,234,332
2008		3,367,358
2009		3,488,572
2010		3,592,450
2011		3,749,225
Thereafter		121,795,650
	\$	139,227,587

(a) Bonds Payable – 2003

On September 30, 2003, the Cumberland County (PA) Municipal Authority (the Cumberland Authority) issued \$62,535,000 of Series 2003 bonds on behalf of LSN and TLS (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 September 29, 2008 issued by Wachovia Bank, National Association

Series B – \$3,375,000 of taxable variable rate demand bonds secured by a letter of credit that expires September 29, 2008 issued by Wachovia Bank, National Association

Series C – \$10,605,000 of taxable variable rate demand bonds secured by a letter of credit that expires September 29, 2008 issued by Wachovia Bank, National Association

Series D – \$43,000,000 of tax exempt auction (variable) rate certificates insured by Radian Asset Assurance, Inc. until maturity.

On September 30, 2003, the County Commissioners of Washington County, Maryland (the Washington Issuer) issued \$20,465,000 of Series E of 2003 bonds on behalf of LSN and TLS (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 September 29, 2008, issued by Wachovia Bank, National Association and are referred to as Series E of the 2003 bond issue. Collectively the 2003 Series A, B, C, D, and E are referred to herein as “the 2003 Bonds”.

The LSN/TLS Obligated Group for purposes of the Series D bonds (the Insured Obligated Group) consists of LSN, TLS, LHT, LWS, and HSJ, with the following exclusions: the Frostburg HUD community, Perry Village, Inc., and Susquehanna Housing, Inc. from TLS; U. P. Heilman House, Inc., Luther Meadows Corporation, and the Medical Office Building assets/related liabilities and activities from LHT; and the Lutherwood HUD community from LWS. The Obligated Group for purposes of the Series A, B, C, and E bonds (the Letter of Credit Obligated Group) consists of the Insured Obligated Group plus DLMS which is included only with respect to the Reimbursement,

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Credit and Security Agreement with Wachovia Bank, National Association and is not directly obligated to the bondholders.

The 2003 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 2003 Bonds. The effect of these amendments was to add TLS to the LSN Obligated Group (LSN, LHT, LWS, and HSJ, with the following exclusions: U.P. Heilman House, Inc., Luther Meadows Corporation, and the Lutherwood HUD community) and grant to the 2003 bondholders and credit providers equal standing and security with the 1998 bondholders and credit providers. In addition these amendments changed the financial covenants with which the obligated groups must comply, the manner in which certain of those covenants are calculated, and modified other restrictive covenants. In addition, to the Master Indenture, the Borrowers and DLSSM have agreed to comply with the terms of the Reimbursement, Credit, and Security Agreement which also requires that similar financial covenants be met and establishes certain restrictive covenants.

To secure the required loan payments for the 2003 bonds, the Borrowers have granted the Cumberland Authority, the Washington Issuer, and the Berks County Industrial Development Authority (the Berks Authority), issuer of the 1998 Bonds, a parity security interest in their gross receipts and a parity first lien mortgage on substantially all of the Borrowers' property and equipment. Further, a trustee for the Cumberland Authority, Washington Issuer, and the Berks Authority holds certain funds for the benefit of the holders of the outstanding 2003 and 1998 Bonds. Such funds are included in assets limited as to use in the accompanying consolidated financial statements.

The Series A 2003 Bonds are due in varying annual installments ranging from \$100,000 to \$295,000 with the final principal payment due 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. The letter of credit facility provided by Wachovia Bank, National Association provides liquidity and credit support for these variable rate bonds.

The Series B 2003 Bonds are due in varying annual installments ranging from \$825,000 to \$865,000 with the final principal payment due 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. The letter of credit facility provided by Wachovia Bank, National Association provides liquidity and credit support for these variable rate bonds.

The Series C 2003 Bonds are due in varying annual installments ranging from \$50,000 to \$870,000 with the final principal payment due January 1, 2033. The interest rate through June 30, 2005 was 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 C 2003 Bonds at par plus accrued interest. On July 1, 2005, the obligated group exercised its option to convert the bonds to a tax-exempt weekly rate. After July 1, 2005, 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

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2003 Bonds at par plus accrued interest. The letter of credit facility provided by Wachovia Bank, National Association provides liquidity and credit support for these variable rate bonds.

The Series D 2003 Bonds are due in varying annual installments ranging from \$95,000 to \$3,310,000 with the final principal payment due January 1, 2033. The interest rate is a tax-exempt auction rate established under certain dutch auction procedures described in the Trust Indenture for the Series D 2003 Bonds. With respect to the Series D 2003 Bonds, the Insured Obligated Group entered into an interest rate swap agreement through January 1, 2033 (the maturity date of the Series D 2003 Bonds) whereby the Insured Obligated Group agreed to receive a variable rate of interest equal to 71% of LIBOR and pay a fixed rate of interest of 3.685% 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.

The Series E 2003 Bonds are due in varying annual installments ranging from \$80,000 to \$3,130,000 with the final principal payment due 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. The letter of credit facility provided by Wachovia Bank, National Association provides liquidity and credit support for these variable rate bonds.

(b) Bonds Payable – 1998

In December 1998, the Berks County Industrial Development Authority (the Berks Authority) issued \$55,530,000 of its Series A of 1998 tax exempt variable rate health care revenue bonds (the Series A 1998 Bonds) and \$6,255,000 of its federally taxable variable rate health care revenue bonds (the Series B 1998 Bonds) (collectively, the 1998 Bonds) for LSN to provide funds to finance the cost of various capital projects of LSN, LHT, and LWS and to refinance various existing long-term debt obligations.

Series A 1998 Bonds are due in varying annual installments ranging from \$1,540,000 to \$3,055,000, with final payment due in January 2027. The interest rate, determined by the remarketing agent, 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 1998 Bonds at a price of par plus accrued interest. LSN has entered into standby bond purchase agreements to provide liquidity for the Series A 1998 Bonds which expires January 31, 2007. With respect to a portion of the Series A 1998 Bonds, the LSN Obligated Group entered into an interest rate swap agreement through January 1, 2028 (the original maturity date of the Series A 1998 Bonds) whereby the LSN Obligated Group agreed to receive a variable rate of interest equal to 67% of LIBOR and to pay a fixed rate of 4.06% 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 the swap agreement is currently \$37,445,000. The Series A 1998 Bonds were optionally redeemed on February 9, 2007 (see note 23).

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(c) Mortgages Payable

At December 31, 2006 and 2005, 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 LSN/TLS Obligated Group, and bear interest at rates ranging from 6.79% to 9.25%. Monthly payments, including interest, total \$96,569.

On April 30, 2005, the Corporation sold nine facilities (see note 21). As part of that sale, the purchaser agreed to assume the mortgage fee for one of these facilities. Under the terms of the Regulatory Agreements, LSN and TLS are 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 \$196,862 and \$178,286 at December 31, 2006 and 2005, respectively. These residual receipts accounts are classified as assets limited as to use, under Regulatory Agreement, in the accompanying consolidated financial statements.

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 LSN/TLS 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 \$5,136,036 is payable.

(d) Interest

The amount of actual cash paid for interest (including net amount of swap payments and annual fees for security agreements) was \$6,856,941 and \$6,567,690 during the years ended December 31, 2006 and 2005, respectively. These amounts are net of capitalized interest of approximately \$30,000 and \$55,000 for the respective years.

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

	2006	2005
LSN/TLS Obligated Group	4.60%	4.43%
Operations outside of the Obligated Group	7.89	7.93
Combined	4.97	4.83

(7) Demand Notes

DLSM, LSN, TLS, LHT, LWS, and HSJ (the Borrowers) obtained a \$10,500,000 secured bank line of credit. The line of credit bears interest at the bank's prime rate (8.25% and 7.25% at December 31, 2006 and 2005, respectively) and expires on September 30, 2008. Amounts ranging from \$0 to \$5,635,000 were outstanding for various periods during 2006 and \$418,000 was outstanding at December 31, 2006. There were no borrowings on the line of credit during 2005, and no balance was outstanding at December 31, 2005. In addition to the line of credit, the Borrowers had outstanding letters of credit issued by the same bank in the amount of \$11,302,555 and \$7,950,000 at December 31, 2006 and 2005, respectively. The bank line of credit is secured on a parity basis with the 2003 bonds consisting of security interest in the

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Borrowers' gross receipts and a first lien mortgage on substantially all of the borrowers' property and equipment.

(8) Derivative Instruments

The LSN/TLS 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 counter party 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 LSN/TLS Obligated Group attempts to manage the credit or repayment risk in derivative instruments by entering into transactions with high-quality counter parties rated "A" or better by Moody's Investor Service. Except for the Series 2003 D Bonds, the swap payments and termination payments under the derivative agreements are not on parity with the outstanding debt 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 interest rate 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 LSN/TLS Obligated Group, nor the counter parties to these agreements are required to deposit collateral dependent on the market valuation of the derivatives contract. Therefore, a negative market valuation of these instruments will not have an adverse impact on the cash flow of the LSN/TLS Obligated Group. The LSN/TLS Obligated Group has fixed interest rate payments under interest rate swap agreements with notional amounts of \$92,845,000 of its outstanding debt.

On September 30, 2003 the LSN/TLS Obligated Group entered into an interest rate swap agreement with a notional amount of \$42,820,000 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, 2006 and 2005 is a liability of \$120,597 and \$949,863, respectively.

LSN entered into an interest rate swap agreement to manage interest rate exposure related to its variable interest rate payment obligations on \$37,445,000 of the Series A 1998 Bonds. There are no cash or collateral requirements in connection with this interest rate swap agreement. The fair value of this interest rate swap agreement as of December 31, 2006 and 2005 is a liability of \$2,199,882 and \$2,922,585, respectively.

During 1999 in connection with the Series A 1993 Bonds, LSN sold an option to enter into an interest rate swap (the Swap) on January 1, 2003 in return for an upfront payment of \$1,475,000 (the Option Payment). This option was exercised by the counter party effective January 1, 2003. The terms of the Swap, among other things (1) obligates LSN 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; and (2) obligates the counter party to make monthly payments to LSN (commencing on January 1, 2003) at a variable rate of interest (the Variable Payments) equal to a weekly tax-exempt floating rate (the Weekly Rate) on the notional amount. The notional amount of this swap at December 31, 2006 is \$12,580,000. The fair value of this derivative instrument as of

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December 31, 2006 and 2005 is a liability in the consolidated balance sheets totaling \$3,175,899 and \$3,312,940, respectively.

On September 30, 2003, the outstanding balance of the Series A 1993 Bonds was repaid with a portion of the proceeds of the 2003 Bonds bearing interest at a tax-exempt variable rate. The swap has remained in effect and is being used to manage the LSN/TLS Obligated Group's exposure to variable rate debt.

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, 2006 and 2005.

	<u>Within performance indicator</u>	<u>Outside performance indicator</u>	<u>Total</u>
Accumulated Swap Liability, December 31, 2004	\$ (2,843,081)	(5,061,088)	(7,904,169)
Series A 1993 Bonds	(575,037)	926,301	351,264
Series A 1998 Bonds	(1,545,740)	1,899,321	353,581
Series D 2003 Bonds	13,936	—	13,936
2005 change in fair value	<u>(2,106,841)</u>	<u>2,825,622</u>	<u>718,781</u>
Accumulated Swap Liability, December 31, 2005	(4,949,922)	(2,235,466)	(7,185,388)
Series A 1993 Bonds	(522,510)	659,551	137,041
Series A 1998 Bonds	722,703	—	722,703
Series D 2003 Bonds	829,266	—	829,266
2006 change in fair value	<u>1,029,459</u>	<u>659,551</u>	<u>1,689,010</u>
Accumulated Swap Liability, December 31, 2006	<u>\$ (3,920,463)</u>	<u>(1,575,915)</u>	<u>(5,496,378)</u>

(9) 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.

As discussed in note 1(cc), effective December 31, 2006, the Corporation adopted the recognition and disclosure provisions of Statement 158, which requires companies to recognize the funded status of defined benefit pension and other postretirement plans as a net asset or liability on its balance sheet.

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, 2006 and 2005:

	2006	2005
Benefit obligation at December 31	\$ 54,539,163	52,894,784
Fair value of plan assets at December 31	46,996,983	44,185,497
Funded status at end of year	\$ (7,542,180)	(8,709,287)
Amounts recognized in the balance sheet consist of:		
Noncurrent liabilities	\$ (7,542,180)	(4,469,334)
Unrestricted net assets	10,525,962	9,928,116
Net amount recognized	\$ 2,983,782	5,458,782

Amounts recognized in unrestricted net assets consist of:

	2006	2005
Minimum pension liability	\$ —	(9,928,116)
Net actuarial loss	(10,519,608)	—
Prior service costs	(6,354)	—
	\$ (10,525,962)	(9,928,116)

The accumulated benefit obligation for the pension plan was \$50,229,660 and \$48,654,831 at December 31, 2006 and 2005, respectively. Net periodic pension cost recognized in 2006 and 2005 was \$2,634,920 and \$2,076,923, respectively.

The incremental effect of applying Statement 158 to the Corporation's financial position as of December 31, 2006 was as follows:

	Before application of Statement 158	Adjustments	After application of Statement 158
Noncurrent assets	\$ 382,196,114	(2,983,782)	379,212,332
Liability for pension benefits – Noncurrent portion	6,216,459	1,325,721	7,542,180
Total liabilities	233,883,705	1,325,721	235,209,426
Unrestricted net assets	128,051,146	(4,309,503)	123,741,643

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The recognition provisions of Statement 158 had no effect on the operating income or excess of operating revenues, gains and other support over expenses for the periods presented.

Other changes in plan asset and benefit obligations recognized in unrestricted net assets in 2006 and 2005 are as follows:

	2006	2005
Adjustment to minimum liability	\$ 3,711,657	(2,372,701)
Net loss	(10,519,608)	—
Prior service cost	(6,354)	—
Elimination of minimum liability	6,216,459	—
Total recognized in unrestricted net assets	\$ (597,846)	(2,372,701)
Total recognized in net periodic benefit cost and unrestricted net assets	\$ (3,232,766)	(4,449,624)

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 \$562,855.

Weighted average assumptions used to determine benefit obligations at December 31, 2006 and 2005 were as follows:

	2006	2005
Discount rate	6.00%	5.75%
Rate of compensation increase	3.50	3.50

Weighted average assumptions used to determine net benefit cost for the years ended December 31, 2006 and 2005 were as follows:

	2006	2005
Discount rate	5.75%	6.00%
Expected long-term rate of return on plan assets	8.70	9.00
Rate of compensation increase	3.50	3.25

The Corporation's overall expected long-term rate of return on assets is 8.7%. 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 following summarizes the benefit cost, employer contribution and benefits paid by the pension plan for the year ended December 31:

	<u>2006</u>	<u>2005</u>
Benefit cost	\$ 2,634,920	2,076,923
Employer contribution	159,920	5,086,000
Benefits paid	2,288,154	3,473,446

The asset allocation of the Corporation's pension plan assets at December 31, 2006 and 2005 were as follows:

	<u>Plan assets at December 31</u>	
	<u>2006</u>	<u>2005</u>
Asset category:		
Equity mutual funds	46%	51%
Fixed income mutual funds	44	49
Cash	10	—
Total	<u>100%</u>	<u>100%</u>

The Corporation's investment policies and strategies for the pension benefit plan uses 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. 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 Company expects to contribute \$2,209,000 to its pension plan in 2007.

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

2007	\$ 2,120,865
2008	2,281,673
2009	2,449,486
2010	2,677,504
2011	2,895,607
2012 – 2016	18,511,101
	<u>\$ 30,936,236</u>

On April 30, 2005 the Corporation sold nine Senior Living Service Facilities. As a result of the sale, 378 previously nonvested employees became vested in the pension plan and these employees, along with 481 employees who were vested as of January 1, 2005, were terminated and became inactive participants of the

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plan. Of these, 412 elected to receive a lump-sum distribution from the plan as of December 31, 2005. Accordingly, the Corporation recognized a curtailment and settlement of the pension plan and a gain of \$6,000 resulting from the curtailment and settlement.

The Corporation also has defined contribution plans for certain employees. Contributions expensed for these plans were approximately \$552,000 and \$549,000 for the years ended December 31, 2006 and 2005, 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 \$763,000 and \$492,000 for the years ended December 31, 2006 and 2005, 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 \$1,935,000 and \$1,172,000 as of December 31, 2006 and 2005, respectively, and is included in the Corporation's other long-term liabilities.

(10) Temporarily Restricted Net Assets

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

	<u>2006</u>	<u>2005</u>
Charitable gift annuities – ELCA	\$ 1,210,109	1,086,075
Contributions receivable	353,579	44,329
Accumulated gains on endowment and other specific purposes	3,518,361	2,701,522
Capital additions	306,617	190,008
Diakon Lutheran Fund – Educational and Children Programs	2,040,830	1,843,883
Beneficial interest in charitable remainder trusts and beneficial interest in trust	<u>1,654,615</u>	<u>627,976</u>
Total	<u>\$ 9,084,111</u>	<u>6,493,793</u>

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.

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(11) 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:

	2006	2005
Funds held in trust by others – income restricted for:		
Support of programs at designated facilities	\$ 24,320,059	23,074,701
Staff and resident programs	186,405	179,183
Diakon Lutheran Fund – Educational and Children’s Programs	8,707,118	8,084,176
Program operations in Maryland	60,000	60,000
Endowment and other purposes	8,336,284	7,679,873
Diakon Lutheran Fund – Educational and Children’s Programs	115,310	115,310
	\$ 41,725,176	39,193,243

(12) 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 which would exceed its insurance coverage. Effective January 1, 2003, the Corporation switched from an occurrence to a claims made policy for medical malpractice.

(13) 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 \$2,800,000 and \$5,300,000 as of December 31, 2006 and 2005, respectively. In addition, the Corporation maintains a \$7,800,000 irrevocable stand-by letter of credit to secure future obligations under the terms of this self-insured program.

Effective January 1, 2004, the Corporation’s health insurance benefits program is a guaranteed retrospectively rated cost plan where the Corporation’s liability is a range of potential exposure with a limited maximum amount. Total health benefit receivables/(accrued expenses) approximated \$1,418,000 and \$1,300,000 at December 31, 2006 and 2005, respectively, and are reported within the consolidated balance sheets.

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(14) Unrestricted Net Assets – Expenses

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

	2006	2005
Senior Living Services	\$ 110,809,774	95,153,344
Family and Community Ministries	24,201,235	23,086,219
Statewide Adoption Network	22,217,143	21,911,206
Ministry Support and management	21,642,796	23,128,039
	\$ 178,870,948	163,278,808

Ministry Support and management costs include fund raising expenses of \$1,234,346 and \$1,424,601 for the years ended December 31, 2006 and 2005, respectively.

(15) 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.

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.

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The following table details operating results by line of service for the year ended December 31, 2006:

	<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	\$ 116,917,362	22,043,244	3,009,095	943,695	142,913,396
Statewide adoption network revenue	—	22,217,143	—	—	22,217,143
Other income	<u>1,145,709</u>	<u>930,722</u>	<u>59,825</u>	<u>21,685,005</u>	<u>23,821,261</u>
Total revenues	<u>118,063,071</u>	<u>45,191,109</u>	<u>3,068,920</u>	<u>22,628,700</u>	<u>188,951,800</u>
Direct expenses	104,971,269	26,058,840	1,652,634	6,486,965	139,169,708
Direct expenses – Statewide Adoption Network	—	22,217,143	—	—	22,217,143
Depreciation	8,066,474	472,505	488,162	922,185	9,949,326
Interest and amortization	<u>5,244,779</u>	—	<u>905,966</u>	<u>1,384,026</u>	<u>7,534,771</u>
Total expenses	<u>118,282,522</u>	<u>48,748,488</u>	<u>3,046,762</u>	<u>8,793,176</u>	<u>178,870,948</u>
Income (loss) from continuing operations	<u>\$ (219,451)</u>	<u>(3,557,379)</u>	<u>22,158</u>	<u>13,835,524</u>	<u>10,080,852</u>

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The following table details operating results by line of service for the year ended December 31, 2005:

	<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	\$ 105,548,482	20,602,031	2,907,657	1,091,704	130,149,874
Statewide adoption network revenue	—	21,911,206	—	—	21,911,206
Other income	<u>1,658,840</u>	<u>1,004,625</u>	<u>50,131</u>	<u>7,559,233</u>	<u>10,272,829</u>
Total revenues	<u>107,207,322</u>	<u>43,517,862</u>	<u>2,957,788</u>	<u>8,650,937</u>	<u>162,333,909</u>
Direct expenses	90,786,859	24,831,560	1,853,150	8,529,428	126,000,997
Direct expenses – Statewide Adoption Network	—	21,911,206	—	—	21,911,206
Depreciation	6,657,769	431,786	475,311	909,565	8,474,431
Interest and amortization	<u>3,714,484</u>	<u>—</u>	<u>936,469</u>	<u>2,241,221</u>	<u>6,892,174</u>
Total expenses	<u>101,159,112</u>	<u>47,174,552</u>	<u>3,264,930</u>	<u>11,680,214</u>	<u>163,278,808</u>
Income (loss) from continuing operations	<u>\$ 6,048,210</u>	<u>(3,656,690)</u>	<u>(307,142)</u>	<u>(3,029,277)</u>	<u>(944,899)</u>

(16) Current Vulnerability Due to Certain Concentrations

Luther Meadows Corporation, U.P. Heilman House, Inc., and Lutherwood, a division of LWS, and Frostburg Heights Apartments, a facility owned and operated by TLS, 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).

According to Section 8 revised regulations, if HUD determines at any time that assets held in the residual receipts accounts are more than the amount needed for each Communities' operations and reserve requirements, HUD may require that excess amounts be placed in an account to be used to reduce housing assistance payments or for other Communities' purposes. Upon termination of the Contracts, any excess amounts in the residual receipts accounts must be remitted to HUD. As of December 31, 2006, the residual receipts balance totaled \$196,360.

Under the terms of the Contracts, HUD authorizes the maximum rental revenue to be received by the Corporation. In 2006, the maximum rental revenue totaled \$2,862,363 and in 2007, this amount has been increased to \$2,913,188.

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,

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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, 2006 and 2005, the Communities owed Diakon, TLS and LSN approximately \$234,000 and \$357,000, respectively.

(17) Transactions with Affiliated Organizations and Individuals

The Corporation utilized Prelude Systems, Inc. (Prelude) for information technology services for the years ended December 31, 2006 and 2005. The Corporation had approximately \$0 and \$190,000 in outstanding payables to Prelude at December 31, 2006 and 2005, respectively. As of December 31, 2006 and 2005, the Corporation's equity interest in Prelude is 46%. This joint venture is accounted for under the equity method of accounting.

For the years ended December 31, 2006 and 2005, the Corporation paid for complete dietary services for its dietary operations to an organization whose principal officer is also a member of the DLSM board of directors. At December 31, 2006 and 2005, the Corporation had approximately \$1,262,000 and \$903,000, respectively, in outstanding payables to this vendor.

A member of Diakon's board of directors is an employee of Diakon's chief legal counsel. Diakon had approximately \$212,000 and \$99,000 in outstanding payables to this firm at December 31, 2006 and 2005, respectively.

(18) Commitments and Contingencies

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 financial position or results of operations.

(19) 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, the administrative building is being leased for an initial term of 11 years.

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The approximate future minimum annual rentals on noncancelable leases in effect at December 31, 2006, which have initial or remaining terms of more than one year, are as follows:

2007	\$	1,821,366
2008		1,296,447
2009		985,802
2010		738,946
2011		613,114
Thereafter		625,674
	\$	6,081,349

Total rental expenses approximated \$3,040,000 and \$2,886,000 in 2006 and 2005, respectively.

(20) Fair Value of Financial Instruments

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

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

Investments and assets limited as to use –The fair values are based primarily on quoted market prices of the investments.

Charitable remainder trusts, funds held in trust by others, beneficial interest in trust, and estimated third-party payor settlements – The carrying amounts reported in the consolidated balance sheets for contributions receivable, funds held in trust by others, beneficial interest in trust, and estimated third-party payor settlements approximate fair value.

Mortgages payable – The carrying amount included in long-term debt in the consolidated balance sheets for mortgages payable at December 31, 2006 and 2005 approximates \$15,683,000 and \$16,000,000, respectively, and its fair value at December 31, 2006 and 2005 approximates \$17,824,000 and \$18,100,000, respectively.

Bonds payable – Fair value of 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.

(21) Discontinued Operations

The Corporation has completed a strategic process, which resulted in a decision to refocus its resources and reshape its ministry to concentrate on retirement living communities that provide a continuum of services and on family and community ministries. As a result, the Corporation entered into a Definitive Purchase Agreement with Tandem Health Care on February 15, 2005 to sell the free standing nursing care, assisted living and independent living facilities' land, building and equipment at nine service locations in Pennsylvania and Maryland effective May 1, 2005. The net book value of these assets as of May 1, 2005

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was \$29,684,927 and the gain on sale of these assets was \$46,960,294. The Corporation established a benevolent care liability of \$1,500,000 to cover benevolent care of residents at the sold facilities as of May 1, 2005.

The following table contains financial information regarding these facilities for the four months ended April 30, 2005:

Unrestricted revenues and other support:	
Patient and resident service revenue, net of contractual allowances	\$ 24,768,677
Patient and resident service revenue, nursing home assessment	9,620,661
Amortization of entrance fees	58,384
Other fees and services	101,245
Contributions and bequests	13,720
Investment income, net of expenses	4,992
Net assets released from restrictions	30,887
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Total unrestricted revenues and other support	34,598,566
Expenses:	
Salaries and wages	9,819,319
Employee benefits and other staff costs	2,942,461
Other expenses	7,902,018
Nursing home assessment	8,357,062
Interest	352,721
Depreciation	340,474
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Total expenses	29,714,055
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Income from discontinued operations	\$ 4,884,511
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General corporate overhead costs that were previously allocated to these facilities approximating \$2,060,000 are excluded from income from discontinued operations reported in 2005. Rather, these costs are reported as expenses from continuing operations.

(22) Acquisition

On March 1, 2006, TLS acquired certain assets and liabilities of Twining Services Corporation (Twining Village) through an asset purchase agreement and accounted for the acquisition using the purchase method as proscribed by APB 16. The results of Twining Village's operations have been included in the consolidated financial statements since that date. Twining Village is a continuing care retirement community providing independent living services, assisted living services, skilled nursing services and certain community services. This acquisition enhances the Corporation's commitment to provide quality senior living alternatives throughout Pennsylvania, Maryland and Delaware.

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The following table summarizes the approximate fair market value of the assets acquired and liabilities assumed at the date of acquisition. TLS has obtained third-party valuations for the fixed assets acquired and the contractual liabilities assumed.

Current assets	\$	2,721,000
Assets limited as to use, net of current portion		7,317,000
Land, buildings and equipment		29,250,000
Goodwill		5,593,000
Total assets acquired	\$	<u>44,881,000</u>
Current liabilities	\$	2,355,000
Long-term liabilities		12,926,000
Total liabilities assumed	\$	<u>15,281,000</u>

(23) Subsequent Events

Effective January 1, 2007, Lutheran Services Northeast (LSN), The Lutheran Home at Topton, Pennsylvania (LHT), The Lutheran Welfare Service of Northeastern Pennsylvania, Inc. (LWS) and Hospice Saint John (HSJ) were merged into Tressler Lutheran Services (TLS) and Tressler Lutheran Services was renamed Diakon Lutheran Social Ministries. Additionally, the entity previously known as Diakon Lutheran Social Ministries was renamed Diakon.

On January 29, 2007, the Cumberland County (PA) Municipal Authority (the Cumberland Authority) issued its 2007 Series A and Series B bonds on behalf of Diakon Lutheran Social Ministries. The bonds consist of two series, more fully described as follows:

Series A of 2007 – \$61,995,000 of 5% fixed rate revenue bonds secured by a pledge of the gross receipts of the Obligated Group, which consists of Diakon Lutheran Social Ministries, and by first lien mortgages granted under the 1998 Master Indenture, as supplemented and amended, with respect to certain real property of the Obligated Group on a parity with all other obligations issued and to be issued under the Master Indenture. The Series A of 2007 bonds are payable in full upon maturity of \$10,395,000 due January 1, 2027 and \$51,560,000 due January 1, 2036. Interest is payable on January 1 and July 1 of each year. The proceeds of the Series A of 2007 bonds are to be used to fund the acquisition, construction, renovation, improvement and equipping of existing skilled nursing, assisted living and independent living facilities owned by Diakon Lutheran Social Ministries, the funding of a debt service reserve fund for the Series A of 2007 bonds and the payment of a portion of the costs and expenses of issuing the Series A of 2007 bonds.

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Series B of 2007 – \$47,400,000 of auction (variable) rate securities secured by a pledge of the gross receipts of the Obligated Group, which consists of Diakon Lutheran Social Ministries and by first lien mortgages granted under the 1998 Master Indenture, as supplemented and amended, with respect to certain real property of the Obligated Group on a parity with all other obligations issued and to be issued under the Master Indenture. Additionally, the principal and interest on the Series B of 2007 Bonds are insured in accordance with the terms of a financial guaranty insurance policy issued by Radian Asset Assurance Inc. The Series B of 2007 bonds are subject to redemption in part prior to their stated maturity from sinking fund installments ranging from \$1,050,000 to \$4,125,000 on January 1 of each year beginning in 2008 and continuing until 2025, the year of maturity. The bonds accrue interest at an auction rate, subject to a maximum interest rate of the lesser of 12% per annum or the maximum interest rate permitted by law, with the initial auction period approximating 35 days. The proceeds of the Series B of 2007 bonds were used to refund the Berks County Industrial Development Authority's Variable Rate Demand Bonds, Series A of 1998 on February 9, 2007, the funding of a debt service reserve fund for the Series B of 2007 bonds and the payment of a portion of the costs and expenses of issuing the Series B of 2007 bonds.

As noted above, the Corporation's Series A 1998 bonds were optionally redeemed on February 9, 2007 at a redemption price of 100% of the principal amount thereof plus interest accrued to the redemption date. The Corporation recognized a loss on the early extinguishment of debt of approximately \$2,072,000 on that date as a result of the write-off of unamortized bond issuance costs.