KINDRED HEALTHCARE, INC
Form 10-Q
November 06, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2012

OR

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

For the transition period from to .

Commission file number: 001-14057

KINDRED HEALTHCARE, INC.

(Exact name of registrant as specified in its charter)

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

(502) 596-7300

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨	Smaller reporting company ¨

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

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

Class of Common Stock	**Outstanding at October 31, 2012**
Common stock, $0.25 par value	53,284,528 shares

KINDRED HEALTHCARE, INC.

FORM 10-Q

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

(Unaudited)

(In thousands, except per share amounts)

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Revenues	$ 1,525,792	$ 1,514,062	$ 4,641,590	$ 3,999,075
Salaries, wages and benefits	912,924	900,570	2,765,332	2,344,398
Supplies	106,594	107,514	326,127	294,254
Rent	108,449	105,511	323,958	292,641
Other operating expenses	305,988	305,305	929,947	851,806
Other income	(2,775)	(2,815)	(8,221)	(8,480)
Impairment charges	3,911	26,712	5,107	26,712
Depreciation and amortization	50,600	46,947	149,092	117,367
Interest expense	26,668	25,790	79,962	54,675
Investment income	(229)	(37)	(796)	(789)
	1,512,130	1,515,497	4,570,508	3,972,584
Income (loss) from continuing operations before income taxes	13,662	(1,435)	71,082	26,491
Provision (benefit) for income taxes	5,753	(2,342)	29,364	9,848
Income from continuing operations	7,909	907	41,718	16,643
Discontinued operations, net of income taxes:				
Income from operations	47	1,119	143	1,527
Loss on divestiture of operations	(349)		(349)	
Income (loss) from discontinued operations	(302)	1,119	(206)	1,527
Net income	7,607	2,026	41,512	18,170
(Earnings) loss attributable to noncontrolling interests	(41)	(241)	(253)	180
Income attributable to Kindred	$ 7,566	$ 1,785	$ 41,259	$ 18,350
Amounts attributable to Kindred stockholders:				
Income from continuing operations	$ 7,868	$ 666	$ 41,465	$ 16,823
Income (loss) from discontinued operations	(302)	1,119	(206)	1,527
Net income	$ 7,566	$ 1,785	$ 41,259	$ 18,350
Earnings per common share:				
Basic:				
Income from continuing operations	$ 0.15	$ 0.01	$ 0.79	$ 0.37
Discontinued operations:				
Income from operations		0.02		0.03
Loss on divestiture of operations	(0.01)		(0.01)	
Net income	$ 0.14	$ 0.03	$ 0.78	$ 0.40

Diluted:				
Income from continuing operations	$ 0.15	$ 0.01	$ 0.79	$ 0.37
Discontinued operations:				
Income from operations		0.02		0.03
Loss on divestiture of operations	(0.01)		(0.01)	
Net income	$ 0.14	$ 0.03	$ 0.78	$ 0.40
Shares used in computing earnings per common share:				
Basic	51,676	51,329	51,648	44,577
Diluted	51,709	51,406	51,675	44,934

See accompanying notes.

KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands)

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Net income	$ 7,607	$ 2,026	$ 41,512	$ 18,170
Other comprehensive income (loss):				
Available-for-sale securities:				
Change in unrealized investment gains (losses)	559	(2,220)	1,562	(1,782)
Reclassification of (gains) losses realized in net income		195	(85)	36
Net change	559	(2,025)	1,477	(1,746)
Interest rate swaps:				
Change in unrealized loss	(25)		(1,288)	
Reclassification of losses realized in net income, net of payments	5		206	
Net change	(20)		(1,082)	
Income tax expense related to items of other comprehensive income (loss)	(186)	708	(18)	611
Other comprehensive income (loss)	353	(1,317)	377	(1,135)
Comprehensive income	7,960	709	41,889	17,035
(Earnings) loss attributable to noncontrolling interests	(41)	(241)	(253)	180
Comprehensive income attributable to Kindred	$ 7,919	$ 468	$ 41,636	$ 17,215

See accompanying notes.

KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED BALANCE SHEET

(Unaudited)

(In thousands, except per share amounts)

	September 30, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 35,695	$ 41,561
Cash restricted	5,344	5,551
Insurance subsidiary investments	79,642	70,425
Accounts receivable less allowance for loss of $31,630 September 30, 2012 and $29,746 December 31, 2011	1,050,077	994,700
Inventories	31,787	31,060
Deferred tax assets	24,641	17,785
Income taxes	6,424	39,513
Other	32,477	32,687
	1,266,087	1,233,282
Property and equipment	2,144,499	1,975,063
Accumulated depreciation	(1,041,036)	(916,022)
	1,103,463	1,059,041
Goodwill	1,146,801	1,084,655
Intangible assets less accumulated amortization of $32,915 September 30, 2012 and $16,581 December 31, 2011	446,165	447,207
Assets held for sale	4,103	5,612
Insurance subsidiary investments	118,256	110,227
Other	212,952	198,469
Total assets	$ 4,297,827	$ 4,138,493
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable	$ 208,213	$ 216,801
Salaries, wages and other compensation	392,564	407,493
Due to third party payors	39,820	37,306
Professional liability risks	48,931	46,010
Other accrued liabilities	148,882	130,693
Long-term debt due within one year	8,787	10,620
	847,197	848,923
Long-term debt	1,610,888	1,531,882
Professional liability risks	236,296	217,717
Deferred tax liabilities	20,537	17,955
Deferred credits and other liabilities	211,109	191,771
Noncontrolling interests-redeemable		9,704
Commitments and contingencies		
Equity:		
Stockholders equity:		
Common stock, $0.25 par value; authorized 175,000 shares; issued 53,271 shares September 30, 2012 and 52,116 shares December 31, 2011	13,318	13,029

Capital in excess of par value	1,142,923	1,138,189
Accumulated other comprehensive loss	(1,092)	(1,469)
Retained earnings	180,426	139,172
	1,335,575	1,288,921
Noncontrolling interests-nonredeemable	36,225	31,620
Total equity	1,371,800	1,320,541
Total liabilities and equity	$ 4,297,827	$ 4,138,493

See accompanying notes.

KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(Unaudited)

(In thousands)

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Cash flows from operating activities:				
Net income	$ 7,607	$ 2,026	$ 41,512	$ 18,170
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	50,600	46,947	149,092	117,367
Amortization of stock-based compensation costs	3,132	3,505	8,011	9,611
Amortization of deferred financing costs	2,375	2,141	7,091	5,231
Payment of lender fees related to debt issuance				(46,232)
Provision for doubtful accounts	9,117	7,793	22,654	22,049
Deferred income taxes	(1,235)	(2,286)	(18,140)	(4,975)
Impairment charges	3,911	26,712	5,107	26,712
Loss on divestiture of discontinued operations	349		349	
Other	732	(3,063)	3,077	(3,766)
Change in operating assets and liabilities:				
Accounts receivable	13,175	(27,497)	(67,913)	(108,072)
Inventories and other assets	(5,490)	6,304	(20,897)	3,649
Accounts payable	5,281	(831)	(7,252)	386
Income taxes	6,366	(6,881)	37,097	20,792
Due to third party payors	12,627	1,143	1,688	4,698
Other accrued liabilities	32,942	10,505	29,611	52,186
Net cash provided by operating activities	141,489	66,518	191,087	117,806
Cash flows from investing activities:				
Routine capital expenditures	(25,939)	(36,595)	(76,804)	(95,263)
Development capital expenditures	(15,177)	(44,152)	(38,175)	(69,570)
Acquisitions, net of cash acquired	(71,440)	(50,928)	(139,308)	(710,907)
Sale of assets			1,110	1,714
Purchase of insurance subsidiary investments	(9,692)	(8,867)	(30,890)	(25,904)
Sale of insurance subsidiary investments	8,063	10,398	30,073	37,587
Net change in insurance subsidiary cash and cash equivalents	(685)	(826)	(15,171)	(4,870)
Change in other investments	1,003		1,454	1,000
Other	(25)	(663)	(1,029)	(692)
Net cash used in investing activities	(113,892)	(131,633)	(268,740)	(866,905)
Cash flows from financing activities:				
Proceeds from borrowings under revolving credit	364,600	533,200	1,329,300	1,633,300
Repayment of borrowings under revolving credit	(390,400)	(474,700)	(1,244,900)	(1,749,800)
Proceeds from issuance of senior unsecured notes				550,000
Proceeds from issuance of term loan, net of discount				693,000
Repayment of other long-term debt	(2,665)	(2,545)	(7,976)	(348,233)
Payment of deferred financing costs	(288)	(1,855)	(601)	(8,715)
Contribution made by noncontrolling interest			200	
Distribution made to noncontrolling interests			(3,521)	
Purchase of noncontrolling interests	(715)	(7,292)	(715)	(7,292)

Issuance of common stock				3,019
Other		3		747
Net cash provided by (used in) financing activities	(29,468)	46,811	71,787	766,026
Change in cash and cash equivalents	(1,871)	(18,304)	(5,866)	16,927
Cash and cash equivalents at beginning of period	37,566	52,399	41,561	17,168
Cash and cash equivalents at end of period	$ 35,695	$ 34,095	$ 35,695	$ 34,095
Supplemental information:				
Interest payments	$ 12,856	$ 5,839	$ 60,490	$ 12,783
Income tax payments (refunds)	472	10,848	10,318	(2,435)
Issuance of common stock in RehabCare acquisition				300,426
Financing costs paid in connection with RehabCare acquisition				13,074

See accompanying notes.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 BASIS OF PRESENTATION

Business

Kindred Healthcare, Inc. is a healthcare services company that through its subsidiaries operates long-term acute care (LTAC) hospitals, inpatient rehabilitation hospitals (IRFs), nursing and rehabilitation centers, assisted living facilities, a contract rehabilitation services business and a home health and hospice business across the United States (collectively, the Company or Kindred). At September 30, 2012, the Company s hospital division operated 117 LTAC hospitals and six IRFs in 26 states. The Company s nursing center division operated 224 nursing and rehabilitation centers and six assisted living facilities in 27 states. The Company s rehabilitation division provided rehabilitation services primarily in hospitals and long-term care settings. The Company s home health and hospice division provided home health, hospice and private duty services from 102 locations in 10 states.

In recent years, the Company has completed several transactions related to the divestiture of unprofitable hospitals and nursing and rehabilitation centers to improve its future operating results. For accounting purposes, the operating results of these businesses and the losses associated with these transactions have been classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented. Assets not sold at September 30, 2012 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying unaudited condensed consolidated balance sheet. See Note 5 for a summary of discontinued operations.

Recently issued accounting requirements

In July 2012, the Financial Accounting Standards Board (the FASB) issued authoritative guidance related to testing indefinite-lived intangible assets for impairment. The main provisions of the guidance state that an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount. If an entity determines it is not more likely than not that the fair value of an indefinite-lived intangible is less than its carrying amount, then performing the one-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the indefinite-lived intangible asset impairment test. The guidance is effective for all interim and annual reporting periods beginning after September 15, 2012. Early adoption is permitted. The adoption of the guidance is not expected to have a material impact on the Company s business, financial position, results of operations or liquidity.

In September 2011, the FASB issued authoritative guidance related to testing goodwill for impairment. The main provisions of the guidance state that an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step goodwill impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform Step 1 of the goodwill impairment test. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance is not expected to have a material impact on the Company s business, financial position, results of operations or liquidity.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 BASIS OF PRESENTATION (Continued)

Recently issued accounting requirements (Continued)

In July 2011, the FASB issued authoritative guidance related to the presentation and disclosure of patient service revenue, provision for bad debts, and the allowance for doubtful accounts for certain healthcare entities. The provisions of the guidance require healthcare entities that recognize significant amounts of patient service revenue at the time services are rendered, even though they do not assess a patient s ability to pay, to present the provision for bad debts related to those revenues as a deduction from patient service revenue (net of contractual allowances and discounts), as opposed to an operating expense. All other entities would continue to present the provision for bad debts as an operating expense. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance did not have an impact on the Company s business, financial position, results of operations or liquidity.

In June 2011, the FASB issued authoritative guidance related to the presentation of other comprehensive income. The provisions of the guidance state that an entity has the option to present the total of comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The statement(s) should be presented with equal prominence to the other primary financial statements. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

In December 2011, the FASB amended its authoritative guidance issued in June 2011 related to the presentation of other comprehensive income. The provisions indefinitely defer the requirement to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented, for both interim and annual financial statements. All other requirements of the June 2011 update were not impacted by the amendment which remains effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

In May 2011, the FASB issued authoritative guidance related to fair value measurements. The provisions of the guidance result in applying common fair value measurement and disclosure requirements in both United States generally accepted accounting principles and International Financial Reporting Standards. The amendments primarily change the wording used to describe many of the requirements in generally accepted accounting principles for measuring and disclosing information about fair value measurements. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 BASIS OF PRESENTATION (Continued)

Equity

The following table sets forth the changes in equity attributable to noncontrolling interests and equity attributable to Kindred stockholders for the nine months ended September 30, 2012 and 2011 (in thousands):

For the nine months ended September 30, 2012:	**Redeemable noncontrolling interests**	**Amounts attributable to Kindred stockholders**	**Nonredeemable noncontrolling interests**	**Total equity**
Balance at December 31, 2011	$ 9,704	$ 1,288,921	$ 31,620	$ 1,320,541
Comprehensive income:				
Net income	140	41,259	113	41,372
Other comprehensive income		377		377
	140	41,636	113	41,749
Shares tendered by employees for statutory tax withholdings upon issuance of common stock		(1,856)		(1,856)
Income tax provision in connection with the issuance of common stock under employee benefit plans		(2,453)		(2,453)
Stock-based compensation amortization		8,011		8,011
Contribution made by noncontrolling interest			200	200
Distribution made to noncontrolling interests	(571)		(2,950)	(2,950)
Purchase of noncontrolling interests	(2,031)	1,316		1,316
Reclassification of noncontrolling interests	(7,242)		7,242	7,242
Balance at September 30, 2012	$	$ 1,335,575	$ 36,225	$ 1,371,800
For the nine months ended September 30, 2011:				
Balance at December 31, 2010	$	$ 1,031,759	$	$ 1,031,759
Acquired noncontrolling interests	23,869		23,990	23,990
Comprehensive income (loss):				
Net income (loss)	346	18,350	(526)	17,824
Other comprehensive loss		(1,135)		(1,135)
	346	17,215	(526)	16,689
Issuance of common stock in connection with employee benefit plans		3,019		3,019
Shares tendered by employees for statutory tax withholdings upon issuance of common stock		(3,360)		(3,360)
Income tax benefit in connection with the issuance of common stock under employee benefit plans		403		403
Stock-based compensation amortization		9,611		9,611
Equity consideration for RehabCare Merger (as defined in Note 2 below)		300,426		300,426

Purchase of noncontrolling interests				(1,010)		(6,282)		(7,292)
Reclassification of noncontrolling interests		(14,589)				14,589		14,589
Balance at September 30, 2011	$	9,626	$	1,358,063	$	31,771	$	1,389,834

The purchase of redeemable noncontrolling interests for the nine months ended September 30, 2012 resulted from a cash payment of $0.7 million and a gain of $1.3 million that was recorded as an increase to equity.

The reclassification between noncontrolling interests for the nine months ended September 30, 2012 and 2011 resulted from minority ownership interests containing put rights in connection with the RehabCare Merger (as defined in Note 2 below) that expired.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 BASIS OF PRESENTATION (Continued)

Derivative financial instruments

In December 2011, the Company entered into two interest rate swap agreements to hedge its floating interest rate on an aggregate of $225.0 million of outstanding Term Loan Facility (as defined in Note 2 below) debt. The interest rate swaps have an effective date of January 9, 2012, and expire on January 11, 2016. The Company is required to make payments based upon a fixed interest rate of 1.8925% calculated on the notional amount of $225.0 million. In exchange, the Company will receive interest on $225.0 million at a variable interest rate that is based upon the three-month London Interbank Offered Rate (LIBOR), subject to a minimum rate of 1.5%. The Company determined the interest rate swaps continue to be effective cash flow hedges at September 30, 2012. The fair value of the interest rate swaps recorded in other accrued liabilities was $2.1 million and $0.8 million at September 30, 2012 and December 31, 2011, respectively.

Other information

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q of Regulation S-X and do not include all of the disclosures normally required by generally accepted accounting principles or those normally required in annual reports on Form 10-K. Accordingly, these financial statements should be read in conjunction with the audited consolidated financial statements of the Company for the year ended December 31, 2011 filed with the Securities and Exchange Commission (the SEC) on Form 10-K. The accompanying condensed consolidated balance sheet at December 31, 2011 was derived from audited consolidated financial statements, but does not include all disclosures required by generally accepted accounting principles.

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

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

Reclassifications

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

NOTE 2 REHABCARE ACQUISITION

On June 1, 2011, the Company completed the acquisition of RehabCare Group, Inc. and its subsidiaries (RehabCare) (the RehabCare Merger). Upon consummation of the RehabCare Merger, each issued and outstanding share of RehabCare common stock was converted into the right to receive 0.471 of a share of Kindred common stock and $26 per share in cash, without interest (the Merger Consideration). Kindred issued approximately 12 million shares of its common stock in connection with the RehabCare Merger. The purchase price totaled $962.8 million and was comprised of $662.4 million in cash and $300.4 million of Kindred common stock at fair value. The Company also assumed $355.7 million of long-term debt in the RehabCare Merger, of which $345.4 million was refinanced on June 1, 2011. The operating results of RehabCare have been included in the accompanying unaudited condensed consolidated financial statements of the Company since June 1, 2011.

At the RehabCare Merger date, the Company acquired 32 LTAC hospitals, five IRFs, approximately 1,200 rehabilitation therapy sites of service and 102 hospital-based inpatient rehabilitation units.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 REHABCARE ACQUISITION (Continued)

Operating results in the third quarter of 2011 included transaction costs totaling $4.0 million and severance costs totaling $1.3 million related to the RehabCare Merger. Operating results for the nine months ended September 30, 2011 included transaction costs totaling $27.0 million, financing costs totaling $13.8 million and severance costs totaling $16.2 million related to the RehabCare Merger. In the accompanying unaudited condensed consolidated statement of operations, transaction costs were included in other operating expenses, financing costs were included in interest expense and severance costs were included in salaries, wages and benefits.

In connection with the RehabCare Merger, the Company entered into a new $650 million senior secured asset-based revolving credit facility (the ABL Facility) and a new $700 million senior secured term loan facility (the Term Loan Facility) (collectively, the New Credit Facilities). The Company also completed the private placement of $550 million of senior notes due 2019 (the Notes). The Company used proceeds from the New Credit Facilities and the Notes to pay the Merger Consideration, repay all amounts outstanding under the Company s and RehabCare s previous credit facilities and to pay transaction costs. The amounts outstanding under the Company s and RehabCare s former credit facilities that were repaid at the RehabCare Merger closing were $390.0 million and $345.4 million, respectively. The New Credit Facilities had an incremental facility capacity in an aggregate amount between the two facilities of $200 million. The Company executed the incremental capacity of $200 million in October 2012. See Note 17.

In connection with the New Credit Facilities and the Notes, the Company paid $46.2 million of lender fees related to debt issuance that were capitalized as deferred financing costs during 2011 and paid $13.1 million of other financing costs that were charged to interest expense during 2011.

Pro forma information

The unaudited pro forma net effect of the RehabCare Merger assuming the acquisition occurred as of January 1, 2010 is as follows (in thousands, except per share amounts):

	Three months ended September 30, 2011	Nine months ended September 30, 2011
Revenues	$ 1,514,062	$ 4,604,597
Income from continuing operations attributable to Kindred	4,509	66,536
Income attributable to Kindred	5,628	71,106
Earnings per common share:		
Basic:		
Income from continuing operations	$ 0.09	$ 1.28
Net income	$ 0.11	$ 1.37
Diluted:		
Income from continuing operations	$ 0.09	$ 1.27
Net income	$ 0.11	$ 1.36

The unaudited pro forma financial data has been derived by combining the historical financial results of the Company and the operations acquired in the RehabCare Merger for the period presented. The unaudited pro forma financial data includes transaction, financing and severance costs totaling $79.8 million incurred by both the Company and RehabCare in connection with the RehabCare Merger. These costs have been eliminated from the results of operations for 2011 and were reflected as expenses incurred as of January 1, 2010 for purposes of the pro forma financial presentation. Revenues and earnings before interest, income taxes and transaction-related costs associated with RehabCare aggregated $1.1 billion and $92.5 million, respectively, for the nine months ended September 30, 2012 and aggregated $457.1 million and

$40.1 million, respectively, from the date of the RehabCare Merger through September 30, 2011.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 3 OTHER ACQUISITIONS

The following is a summary of the Company s other significant acquisition activities. The operating results of the acquired businesses have been included in the accompanying unaudited condensed consolidated financial statements of the Company from the respective acquisition dates. The purchase price of the acquired businesses and acquired leased facilities resulted from negotiations with each of the sellers that were based upon both the historical and expected future cash flows of the respective businesses and real estate values. Each of these acquisitions was financed through operating cash flows or borrowings under the Company s ABL Facility. Unaudited pro forma financial data related to the acquired businesses have not been presented because the acquisitions are not material, either individually or in the aggregate, to the Company s consolidated financial statements.

During the third quarter of 2012, the Company acquired two home health and hospice businesses for $71.4 million, which included $12.1 million of accounts receivable, $1.1 million of other assets, $1.4 million of property and equipment, $58.2 million of goodwill, $18.1 million of identifiable intangible assets, $10.4 million of current liabilities, $7.2 million of deferred income tax liabilities and $1.9 million of other long-term liabilities. During the third quarter of 2011, the Company acquired a home health and hospice business for $50.9 million, which included $9.8 million of accounts receivable, $1.4 million of other assets, $0.9 million of property and equipment, $33.9 million of goodwill, $11.2 million of identifiable intangible assets and $6.3 million of deferred income tax and other liabilities.

During the nine months ended September 30, 2012, the Company acquired the real estate of two previously leased hospitals for $67.9 million. Annual rent associated with the hospitals aggregated $5.5 million. During the nine months ended September 30, 2011, the Company acquired the real estate of a previously leased hospital for $8.0 million. Annual rent associated with the hospital aggregated $0.9 million. During the nine months ended September 30, 2011, the Company also acquired a home health company for $9.5 million, which included $0.1 million of property and equipment, $7.5 million of goodwill and $1.9 million of identifiable intangible assets.

The fair value of each of the acquisitions noted above was measured primarily using discounted cash flow methodologies which are considered Level 3 inputs (as described in Note 14).

NOTE 4 IMPAIRMENT CHARGES

In connection with the planned divestiture of a LTAC hospital, a pretax impairment charge for intangible assets and property and equipment of $3.2 million was recorded in the third quarter of 2012. See Note 14.

On July 29, 2011, the Centers for Medicare and Medicaid Services (CMS) issued final rules which, among other things, significantly reduced Medicare payments to nursing centers and changed the reimbursement for the provision of group rehabilitation therapy services to Medicare beneficiaries beginning October 1, 2011 (the 2011 CMS Rules). In connection with the preparation of the Company s operating results for the third quarter of 2011, the Company determined that the impact of the 2011 CMS Rules was a triggering event in the third quarter of 2011 and accordingly tested the recoverability of its nursing and rehabilitation centers reporting unit goodwill, intangible assets and property and equipment asset groups impacted by the reduced Medicare payments. The Company recorded pretax impairment charges aggregating $26.7 million in the third quarter of 2011. The charges included $6.1 million of goodwill (which represented the entire nursing and rehabilitation centers reporting unit goodwill) and $20.6 million of property and equipment. The Company recorded pretax impairment charges aggregating $0.7 million and $1.9 million in the third quarter of 2012 and for the nine months ended September 30, 2012, respectively, for necessary property and equipment expenditures in impaired nursing and rehabilitation center asset groups.

These charges reflected the amount by which the carrying value of these assets exceeded their estimated fair value. The impairment charges did not impact the Company s cash flows or liquidity.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 DISCONTINUED OPERATIONS

In accordance with the authoritative guidance for the impairment or disposal of long-lived assets, the divestitures of unprofitable businesses discussed in Note 1 have been accounted for as discontinued operations. Accordingly, the results of operations of these businesses for all periods presented and the losses associated with these transactions have been classified as discontinued operations, net of income taxes, in the accompanying unaudited condensed consolidated statement of operations. At September 30, 2012, the Company held for sale two hospitals.

A summary of discontinued operations follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Revenues	$ 185	$ 848	$ 519	$ 1,025
Salaries, wages and benefits	(6)	(77)	(198)	(393)
Supplies		2	3	(1)
Rent	33	28	92	86
Other operating expenses (income)	82	(924)	389	(1,149)
Depreciation				
Interest expense				
Investment income				
	109	(971)	286	(1,457)
Income from operations before income taxes	76	1,819	233	2,482
Provision for income taxes	29	700	90	955
Income from operations	47	1,119	143	1,527
Loss on divestiture of operations, net of income taxes	(349)		(349)	
	$ (302)	$ 1,119	$ (206)	$ 1,527

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

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Revenues:				
Hospital division	$ 18	$ 846	$ 219	$ 822
Nursing center division	167	2	300	203
	$ 185	$ 848	$ 519	$ 1,025
Operating income (loss):				
Hospital division	$ (249)	$ 633	$ (620)	$ (65)

Nursing center division	358	1,214	945	2,633
	$ 109	$ 1,847	$ 325	$ 2,568
Rent:				
Hospital division	$ 33	$ 28	$ 91	$ 86
Nursing center division			1	
	$ 33	$ 28	$ 92	$ 86

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 DISCONTINUED OPERATIONS (Continued)

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

	September 30, 2012	December 31, 2011
Long-term assets:		
Property and equipment, net	$ 4,096	$ 5,607
Other	7	5
	4,103	5,612
Current liabilities (included in other accrued liabilities)	(10)	(118)
	$ 4,093	$ 5,494

NOTE 6 REVENUES

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Medicare	$ 628,385	$ 629,279	$ 1,949,367	$ 1,761,847
Medicaid	268,869	269,804	798,291	791,933
Medicare Advantage	116,385	111,322	353,364	304,777
Other	596,588	583,406	1,800,100	1,378,835
	1,610,227	1,593,811	4,901,122	4,237,392
Eliminations	(84,435)	(79,749)	(259,532)	(238,317)
	$ 1,525,792	$ 1,514,062	$ 4,641,590	$ 3,999,075

NOTE 7 EARNINGS PER SHARE

Earnings per common share are based upon the weighted average number of common shares outstanding during the respective periods. The diluted calculation of earnings per common share includes the dilutive effect of stock options. The Company follows the provisions of the authoritative guidance for determining whether instruments granted in share-based payment transactions are participating securities, which requires that unvested restricted stock that entitles the holder to receive nonforfeitable dividends before vesting be included as a participating security in the basic and diluted earnings per common share calculation pursuant to the two-class method.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 7 EARNINGS PER SHARE (Continued)

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

	Three months ended September 30,				Nine months ended September 30,			
	2012		2011		2012		2011	
	Basic	Diluted	Basic	Diluted	Basic	Diluted	Basic	Diluted
Earnings:								
Amounts attributable to Kindred stockholders:								
Income from continuing operations:								
As reported in Statement of Operations	$ 7,868	$ 7,868	$ 666	$ 666	$ 41,465	$ 41,465	$ 16,823	$ 16,823
Allocation to participating unvested restricted stockholders	(200)	(200)	(10)	(10)	(874)	(873)	(287)	(284)
Available to common stockholders	$ 7,668	$ 7,668	$ 656	$ 656	$ 40,591	$ 40,592	$ 16,536	$ 16,539
Discontinued operations, net of income taxes:								
Income from operations:								
As reported in Statement of Operations	$ 47	$ 47	$ 1,119	$ 1,119	$ 143	$ 143	$ 1,527	$ 1,527
Allocation to participating unvested restricted stockholders	(1)	(1)	(17)	(17)	(3)	(3)	(26)	(26)
Available to common stockholders	$ 46	$ 46	$ 1,102	$ 1,102	$ 140	$ 140	$ 1,501	$ 1,501
Loss on divestiture of operations:								
As reported in Statement of Operations	$ (349)	$ (349)	$	$	$ (349)	$ (349)	$	$
Allocation to participating unvested restricted stockholders	9	9			7	7		
Available to common stockholders	$ (340)	$ (340)	$	$	$ (342)	$ (342)	$	$
Net income:								
As reported in Statement of Operations	$ 7,566	$ 7,566	$ 1,785	$ 1,785	$ 41,259	$ 41,259	$ 18,350	$ 18,350
Allocation to participating unvested restricted stockholders	(192)	(192)	(27)	(27)	(870)	(869)	(313)	(310)
Available to common stockholders	$ 7,374	$ 7,374	$ 1,758	$ 1,758	$ 40,389	$ 40,390	$ 18,037	$ 18,040
Shares used in the computation:								
Weighted average shares outstanding basic computation	51,676	51,676	51,329	51,329	51,648	51,648	44,577	44,577
Dilutive effect of employee stock options		33		77		27		357

Adjusted weighted average shares outstanding diluted computation		51,709		51,406		51,675		44,934
Earnings per common share:								
Income from continuing operations	$ 0.15	$ 0.15	$ 0.01	$ 0.01	$ 0.79	$ 0.79	$ 0.37	$ 0.37
Discontinued operations:								
Income from operations			0.02	0.02			0.03	0.03
Loss on divestiture of operations	(0.01)	(0.01)			(0.01)	(0.01)	$	$
Net income	$ 0.14	$ 0.14	$ 0.03	$ 0.03	$ 0.78	$ 0.78	$ 0.40	$ 0.40
Number of antidilutive stock options excluded from shares used in the diluted earnings per common share computation		1,710		2,769		1,710		1,226

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 BUSINESS SEGMENT DATA

The Company is organized into four operating divisions: the hospital division, the nursing center division, the rehabilitation division and the home health and hospice division. The expansion of the Company s home health and hospice operations and changes to the Company s organizational structure have led the Company to segregate its home health and hospice business into a separate division. The Company s home health and hospice division was previously included in the rehabilitation division. Based upon the authoritative guidance for business segments and after giving consideration to the Company s business segments after the RehabCare Merger, the operating divisions represent five reportable operating segments, including (1) hospitals, (2) skilled nursing and rehabilitation centers, (3) skilled nursing-based rehabilitation contract therapy services, (4) hospital-based rehabilitation contract therapy services and (5) home health and hospice services. These reportable operating segments are consistent with information used by the Company s Chief Executive Officer and Chief Operating Officer to assess performance and allocate resources. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies. Prior period segment information has been restated to conform with the current period presentation.

For segment purposes, the Company defines operating income as earnings before interest, income taxes, depreciation, amortization and rent. Operating income reported for each of the Company s operating segments excludes impairment charges, transaction costs and the allocation of corporate overhead.

Operating income for the hospital division for the nine months ended September 30, 2012 included severance costs of $2.6 million and other miscellaneous costs of $2.3 million incurred in connection with the closing of a regional office and four LTAC hospitals and the cancellation of a sub-acute unit project, and $5.0 million for employment-related lawsuits.

Operating income for the nursing center division in the third quarter of 2012 and for the nine months ended September 30, 2012 included employee retention costs of $0.6 million and $1.3 million, respectively, incurred in connection with the decision to allow the leases to expire for 54 nursing and rehabilitation centers leased from Ventas, Inc. (Ventas).

Rent expense for the hospital division included $0.6 million and $3.5 million in the third quarter of 2012 and for the nine months ended September 30, 2012, respectively, incurred in connection with the closing of four LTAC hospitals.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 BUSINESS SEGMENT DATA (Continued)

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

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Revenues:				
Hospital division	$ 714,738	$ 684,781	$ 2,209,980	$ 1,837,180
Nursing center division	534,188	571,226	1,614,151	1,706,897
Rehabilitation division:				
Skilled nursing rehabilitation services	253,459	252,574	764,097	528,438
Hospital rehabilitation services	71,899	69,811	219,647	130,592
	325,358	322,385	983,744	659,030
Home health and hospice division	35,943	15,419	93,247	34,285
	1,610,227	1,593,811	4,901,122	4,237,392
Eliminations:				
Skilled nursing rehabilitation services	(55,534)	(57,922)	(171,023)	(172,590)
Hospital rehabilitation services	(27,097)	(20,528)	(83,169)	(62,459)
Nursing and rehabilitation centers	(1,804)	(1,299)	(5,340)	(3,268)
	(84,435)	(79,749)	(259,532)	(238,317)
	$ 1,525,792	$ 1,514,062	$ 4,641,590	$ 3,999,075
Income from continuing operations:				
Operating income (loss):				
Hospital division	$ 138,762	$ 125,701	$ 440,942	$ 342,551
Nursing center division	70,928	89,592	207,466	270,474
Rehabilitation division:				
Skilled nursing rehabilitation services	19,659	27,575	56,794	52,712
Hospital rehabilitation services	16,977	15,606	50,953	28,971
	36,636	43,181	107,747	81,683
Home health and hospice division	3,645	1,107	8,775	650
Corporate:				
Overhead	(45,883)	(48,806)	(133,334)	(130,922)
Insurance subsidiary	(545)	(750)	(1,627)	(1,772)
	(46,428)	(49,556)	(134,961)	(132,694)
Impairment charges	(3,911)	(26,712)	(5,107)	(26,712)
Transaction costs	(482)	(6,537)	(1,564)	(45,567)

Operating income		199,150		176,776		623,298		490,385
Rent		(108,449)		(105,511)		(323,958)		(292,641)
Depreciation and amortization		(50,600)		(46,947)		(149,092)		(117,367)
Interest, net		(26,439)		(25,753)		(79,166)		(53,886)
Income (loss) from continuing operations before income taxes		13,662		(1,435)		71,082		26,491
Provision (benefit) for income taxes		5,753		(2,342)		29,364		9,848
	$	7,909	$	907	$	41,718	$	16,643

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 BUSINESS SEGMENT DATA (Continued)

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Rent:				
Hospital division	$ 55,391	$ 52,737	$ 165,477	$ 137,033
Nursing center division	50,290	49,862	150,457	148,808
Rehabilitation division:				
Skilled nursing rehabilitation services	1,309	1,811	4,060	4,860
Hospital rehabilitation services	2	95	119	156
	1,311	1,906	4,179	5,016
Home health and hospice division	805	358	2,029	798
Corporate	652	648	1,816	986
	$ 108,449	$ 105,511	$ 323,958	$ 292,641
Depreciation and amortization:				
Hospital division	$ 23,110	$ 21,612	$ 68,579	$ 52,462
Nursing center division	13,564	12,655	39,534	37,486
Rehabilitation division:				
Skilled nursing rehabilitation services	2,791	2,699	8,143	4,574
Hospital rehabilitation services	2,328	2,372	6,975	3,288
	5,119	5,071	15,118	7,862
Home health and hospice division	1,137	324	2,960	547
Corporate	7,670	7,285	22,901	19,010
	$ 50,600	$ 46,947	$ 149,092	$ 117,367
Capital expenditures, excluding acquisitions (including discontinued operations):				
Hospital division:				
Routine	$ 9,015	$ 12,919	$ 28,455	$ 36,872
Development	14,334	39,964	35,572	54,164
	23,349	52,883	64,027	91,036
Nursing center division:				
Routine	4,965	10,572	12,611	26,727
Development	843	4,113	2,603	15,140
	5,808	14,685	15,214	41,867
Rehabilitation division:				
Skilled nursing rehabilitation services:				
Routine	707	255	1,602	669
Development				

	707	255	1,602	669
Hospital rehabilitation services:				
Routine	125	81	231	178
Development				
	125	81	231	178
Home health and hospice division:				
Routine	160	41	429	99
Development		75		266
	160	116	429	365
Corporate:				
Information systems	10,842	11,516	32,901	29,089
Other	125	1,211	575	1,629
	$ 41,116	$ 80,747	$ 114,979	$ 164,833

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 BUSINESS SEGMENT DATA (Continued)

	September 30, 2012	December 31, 2011
Assets at end of period:		
Hospital division	$ 2,115,518	$ 2,056,103
Nursing center division	615,364	638,078
Rehabilitation division:		
Skilled nursing rehabilitation services	452,105	425,499
Hospital rehabilitation services	338,614	347,491
	790,719	772,990
Home health and hospice division	200,771	104,374
Corporate	575,455	566,948
	$ 4,297,827	$ 4,138,493
Goodwill:		
Hospital division	$ 747,777	$ 745,411
Rehabilitation division:		
Skilled nursing rehabilitation services	107,899	107,026
Hospital rehabilitation services	168,019	167,753
	275,918	274,779
Home health and hospice division	123,106	64,465
	$ 1,146,801	$ 1,084,655

NOTE 9 INSURANCE RISKS

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

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011

Professional liability:				
Continuing operations	$ 19,261	$ 15,953	$ 58,828	$ 50,584
Discontinued operations	(128)	(897)	(372)	(1,718)
Workers compensation:				
Continuing operations	$ 15,633	$ 15,908	$ 46,428	$ 43,057
Discontinued operations	(55)	(120)	(343)	(640)

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 INSURANCE RISKS (Continued)

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

	September 30, 2012			December 31, 2011		
	Professional liability	Workers compensation	Total	Professional liability	Workers compensation	Total
Assets:						
Current:						
Insurance subsidiary investments	$ 47,898	$ 31,744	$ 79,642	$ 44,678	$ 25,747	$ 70,425
Reinsurance recoverables	3,632		3,632	323		323
Other		150	150		150	150
	51,530	31,894	83,424	45,001	25,897	70,898
Non-current:						
Insurance subsidiary investments	51,934	66,322	118,256	39,048	71,179	110,227
Reinsurance and other recoverables	54,422	75,006	129,428	44,356	64,704	109,060
Deposits	3,977	1,574	5,551	3,643	1,623	5,266
Other		41	41		42	42
	110,333	142,943	253,276	87,047	137,548	224,595
	$ 161,863	$ 174,837	$ 336,700	$ 132,048	$ 163,445	$ 295,493
Liabilities:						
Allowance for insurance risks:						
Current	$ 48,931	$ 36,095	$ 85,026	$ 46,010	$ 32,198	$ 78,208
Non-current	236,296	153,995	390,291	217,717	138,489	356,206
	$ 285,227	$ 190,090	$ 475,317	$ 263,727	$ 170,687	$ 434,414

Provisions for loss for professional liability risks retained by the Company s limited purpose insurance subsidiary have been discounted based upon actuarial estimates of claim payment patterns using a discount rate of 1% to 5% depending upon the policy year. The discount rate was 1% for the 2012 and 2011 policy years. The discount rates are based upon the risk free interest rate for the respective year. Amounts equal to the discounted loss provision are funded annually. The Company does not fund the portion of professional liability risks related to estimated claims that have been incurred but not reported. Accordingly, these liabilities are not discounted. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated $287.8 million at September 30, 2012 and $266.5 million at December 31, 2011.

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

NOTE 10 INSURANCE SUBSIDIARY INVESTMENTS

The Company maintains investments, consisting principally of cash and cash equivalents, debt securities, equities and certificates of deposit for the payment of claims and expenses related to professional liability and workers compensation risks. These investments have been categorized as available-for-sale and are reported at fair value.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 10 INSURANCE SUBSIDIARY INVESTMENTS (Continued)

The cost for equities, amortized cost for debt securities and estimated fair value of the Company s insurance subsidiary investments follows (in thousands):

	September 30, 2012				December 31, 2011			
	Cost	Unrealized gains	Unrealized losses	Fair value	Cost	Unrealized gains	Unrealized losses	Fair value
Cash and cash equivalents (a)	$ 134,048	$	$	$ 134,048	$ 118,877	$	$	$ 118,877
Debt securities:								
Corporate bonds	22,683	158	(12)	22,829	23,134	163	(48)	23,249
Debt securities issued by U.S. government agencies	17,509	116		17,625	18,173	120	(5)	18,288
U.S. Treasury notes	4,320	5		4,325	3,867	10		3,877
Debt securities issued by foreign governments	625	1		626	625	8		633
Commercial mortgage-backed securities					137	6		143
	45,137	280	(12)	45,405	45,936	307	(53)	46,190
Equities by industry:								
Consumer	2,171	797	(37)	2,931	2,171	329	(45)	2,455
Industrials	2,039	327	(82)	2,284	2,039	248	(111)	2,176
Technology	1,482	300	(103)	1,679	1,482	215	(99)	1,598
Healthcare	1,474	167	(16)	1,625	1,474	77	(72)	1,479
Financial services	1,419	250	(137)	1,532	1,419	89	(227)	1,281
Other	2,554	711	(175)	3,090	2,554	345	(209)	2,690
	11,139	2,552	(550)	13,141	11,139	1,303	(763)	11,679
Certificates of deposit	5,302	2		5,304	3,905	3	(2)	3,906
	$ 195,626	$ 2,834	$ (562)	$ 197,898	$ 179,857	$ 1,613	$ (818)	$ 180,652

(a) Includes $2.2 million of money market funds at both September 30, 2012 and December 31, 2011.

The Company s investment policy governing insurance subsidiary investments precludes the investment portfolio managers from selling any security at a loss without prior authorization from the Company. The investment managers also limit the exposure to any one issue, issuer or type of investment. The Company intends, and has the ability, to hold insurance subsidiary investments for a long duration without the necessity of selling securities to fund the underwriting needs of its insurance subsidiary. This ability to hold securities allows sufficient time for recovery of temporary declines in the market value of equity securities and the par value of debt securities as of their stated maturity date.

The Company considered the severity and duration of its unrealized losses at September 30, 2012 for various investments held in its insurance subsidiary investment portfolio and determined that these unrealized losses were temporary and did not record any impairment losses related to these investments. The Company considered the severity and duration of its unrealized losses at September 30, 2011 and recognized a $0.2 million pretax other-than-temporary impairment in the third quarter of 2011 for various investments held in its insurance subsidiary investment portfolio.

As a result of deterioration in professional liability and workers compensation underwriting results of the Company s limited purpose insurance subsidiary in 2011, the Company made a capital contribution of $8.6 million during the nine months ended September 30, 2012 to its limited purpose insurance subsidiary. Conversely, as a result of improved professional liability underwriting results of the Company s limited purpose insurance subsidiary in 2010, the Company received a distribution of $3.5 million during the nine months ended September 30, 2011 from its limited purpose insurance subsidiary. These transactions were completed in accordance with applicable regulations. Neither the capital contribution nor the distribution had any impact on earnings.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 11 LEASES

On April 27, 2012, the Company provided Ventas with notices to renew the master lease agreements for 19 nursing and rehabilitation centers and six LTAC hospitals (collectively, the Renewal Facilities) for an additional five years. The current lease term for the Renewal Facilities is scheduled to expire in April 2013.

Under its master lease agreements with Ventas, the Company had 73 nursing and rehabilitation centers and 16 LTAC hospitals within ten separate renewal bundles subject to lease renewals. Each renewal bundle contains both nursing and rehabilitation centers and LTAC hospitals. The master lease agreements require that the Company renew all or none of the facilities within a renewal bundle.

The Company has renewed three renewal bundles containing the Renewal Facilities. The Renewal Facilities contain 2,178 licensed nursing and rehabilitation center beds and 616 licensed hospital beds and generated revenues of approximately $434 million for the year ended December 31, 2011. The current annual rent for the Renewal Facilities approximates $46 million.

The Company did not renew seven renewal bundles containing 54 nursing and rehabilitation centers and ten LTAC hospitals. These facilities contain 6,140 licensed nursing and rehabilitation center beds and 1,066 licensed hospital beds and generated revenues of approximately $790 million for the year ended December 31, 2011. The current annual rent for these facilities approximates $77 million.

On May 24, 2012, the Company entered into a new master lease agreement with Ventas for the ten LTAC hospitals that the Company had previously announced it did not intend to renew. The new master lease agreement will be effective on May 1, 2013 and will have a term of ten years with three five-year renewal options. The annual rent for the new lease will be $28 million and is subject to annual increases based on the increase in the consumer price index (subject to an annual 4% cap). The current annual rent for these ten LTAC hospitals approximates $22 million. These ten LTAC hospitals contain 1,066 licensed hospital beds and generated revenues of approximately $276 million for the year ended December 31, 2011. The terms of the new master lease agreement are substantially similar to the terms of the other master lease agreements between Kindred and Ventas.

On May 24, 2012, the Company and Ventas also entered into a separate agreement to provide Ventas with more flexibility to accelerate the transfer of the 54 nursing and rehabilitation centers currently leased by the Company that are scheduled to expire on April 30, 2013. The Company will continue to operate these nursing and rehabilitation centers and include them in its results from continuing operations through the expiration of the lease term in April 2013.

NOTE 12 INCOME TAXES

The provision for income taxes in the third quarter of 2011 and for the nine months ended September 30, 2011 included a favorable adjustment of $3.3 million related to the resolution of certain income tax contingencies from prior years.

The federal statute of limitations remains open for tax years 2009 through 2011. In July 2011, the Company resolved federal income tax audits for the 2007 through 2009 tax years. The Company is currently under examination by the Internal Revenue Service (the IRS) for the 2010 through 2012 tax years. The Company has been accepted into the IRS s Compliance Assurance Process (CAP) for the 2012 tax year. CAP is an enhanced, real-time review of a company s tax positions and compliance. The Company expects participation in CAP to improve the timeliness of its federal tax examinations.

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

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 13   CONTINGENCIES

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

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

Principal contingencies are described below:

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

Professional liability risks The Company has provided for losses for professional liability risks based upon management s best available information including actuarially determined estimates. Ultimate claims costs may differ from the provisions for loss. See Note 9.

Income taxes The Company is subject to various federal and state income tax audits in the ordinary course of business. Such audits could result in increased tax payments, interest and penalties.

Litigation The Company is a party to various legal actions (some of which are not insured), and regulatory and other governmental audits and investigations in the ordinary course of business. The Company cannot predict the ultimate outcome of pending litigation and regulatory and other governmental audits and investigations. These matters could potentially subject the Company to sanctions, damages, recoupments, fines and other penalties. The U.S. Department of Justice (the DOJ), CMS or other federal and state enforcement and regulatory agencies may conduct additional investigations related to the Company s businesses in the future which may, either individually or in the aggregate, have a material adverse effect on the Company s business, financial position, results of operations and liquidity. See Note 16.

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

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 14 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

The Company follows the provisions of the authoritative guidance for fair value measurements, which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles.

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The guidance related to fair value measures establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. Treasury, other U.S. Government and agency asset backed debt securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 14 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

The Company s assets and liabilities measured at fair value on a recurring and non-recurring basis and any associated losses are summarized below (in thousands):

	Fair value measurements			Assets/liabilities	Total
	Level 1	Level 2	Level 3	at fair value	losses
September 30, 2012:					
Recurring:					
Assets:					
Available-for-sale debt securities:					
Corporate bonds	$	$ 22,829	$	$ 22,829	$
Debt securities issued by U.S. government agencies		17,625		17,625	
U.S. Treasury notes	4,325			4,325	
Debt securities issued by foreign governments		626		626	
	4,325	41,080		45,405	
Available-for-sale equity securities	13,141			13,141	
Money market funds	5,974			5,974	
Certificates of deposit		5,304		5,304	
Total available-for-sale investments	23,440	46,384		69,824	
Deposits held in money market funds	348	3,977		4,325	
	$ 23,788	$ 50,361	$	$ 74,149	$
Liabilities:					
Interest rate swaps	$	$ (2,103)	$	$ (2,103)	$
Non-recurring:					
Assets:					
Hospital available for sale	$	$	$ 107	$ 107	$ (569)
Property and equipment			366	366	(2,577)
Intangible assets Medicare license			632	632	(2,530)
	$	$	$ 1,105	$ 1,105	$ (5,676)
Liabilities	$	$	$	$	$
December 31, 2011:					
Recurring:					
Assets:					
Available-for-sale debt securities:					
Corporate bonds	$	$ 23,249	$	$ 23,249	$
Debt securities issued by U.S. government agencies		18,288		18,288	

U.S. Treasury notes	3,877			3,877	
Debt securities issued by foreign governments		633		633	
Commercial mortgage-backed securities		143		143	
	3,877	42,313		46,190	
Available-for-sale equity securities	11,679			11,679	
Money market funds	6,263			6,263	
Certificates of deposit		3,906		3,906	
Total available-for-sale investments	21,819	46,219		68,038	
Deposits held in money market funds	353	3,643		3,996	
	$ 22,172	$ 49,862	$	$ 72,034	$
Liabilities:					
Interest rate swaps	$	$ (815)	$	$ (815)	$
Non-recurring:					
Assets:					
Hospital available for sale	$	$	$ 1,200	$ 1,200	$ (1,490)
Property and equipment			6,604	6,604	(22,836)
Goodwill nursing and rehabilitation centers					(6,080)
Goodwill skilled nursing rehabilitation services			107,026	107,026	(45,999)
Intangible assets certificates of need			1,000	1,000	(54,366)
	$	$	$ 115,830	$ 115,830	$ (130,771)
Liabilities	$	$	$	$	$

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 14 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

Recurring measurements

The Company s available-for-sale investments held by its limited purpose insurance subsidiary consist of debt securities, equities, money market funds and certificates of deposit. These available-for-sale investments and the insurance subsidiary s cash and cash equivalents of $131.8 million as of September 30, 2012 and $116.7 million as of December 31, 2011, classified as insurance subsidiary investments, are maintained for the payment of claims and expenses related to professional liability and workers compensation risks.

The Company also has available-for-sale investments totaling $3.7 million related to a deferred compensation plan that is maintained for certain of the Company s current and former employees.

The fair value of actively traded debt and equity securities and money market funds are based upon quoted market prices and are generally classified as Level 1. The fair value of inactively traded debt securities and certificates of deposit are based upon either quoted market prices of similar securities or observable inputs such as interest rates using either a market or income valuation approach and are generally classified as Level 2. The Company s investment advisors obtain and review pricing for each security. The Company is responsible for the determination of fair value and as such the Company reviews the pricing information from its advisors in determining reasonable estimates of fair value. Based upon the Company s internal review procedures, there were no adjustments to the prices during the three or nine months ended September 30, 2012 or September 30, 2011.

The Company s deposits held in money market funds consist primarily of cash and cash equivalents held for general corporate purposes.

The fair value of the derivative liability associated with the interest rate swaps is estimated using industry-standard valuation models, which are Level 2 measurements. Such models project future cash flows and discount the future amounts to a present value using market-based observable inputs, including interest rate curves.

The following table presents the carrying amounts and estimated fair values of the Company s financial instruments. The carrying value is equal to fair value for financial instruments that are based upon quoted market prices or current market rates. The Company s long-term debt is based upon Level 2 inputs.

	September 30, 2012		December 31, 2011	
(In thousands)	**Carrying value**	**Fair value**	**Carrying value**	**Fair value**
Cash and cash equivalents	$ 35,695	$ 35,695	$ 41,561	$ 41,561
Cash restricted	5,344	5,344	5,551	5,551
Insurance subsidiary investments	197,898	197,898	180,652	180,652
Tax refund escrow investments	207	207	211	211
Long-term debt, including amounts due within one year (excluding capital lease obligations totaling $1.5 million and $3.9 million at September 30, 2012 and December 31, 2011, respectively)	1,618,211	1,599,741	1,538,557	1,406,751

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 14 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

Non-recurring measurements

At September 30, 2012, the Company reviewed the indefinite-lived and long-lived assets related to the planned divestiture and pending offer for a LTAC hospital and determined its indefinite-lived Medicare license and property and equipment were impaired. As a result, the Company recorded a pretax impairment charge of $3.2 million in the third quarter of 2012. The impairment charge did not impact the Company s cash flows or liquidity. The fair value of the assets were measured using a Level 3 input of the pending offer.

In September 2012, the Company reduced the fair value of a hospital held for sale based upon a pending offer, which resulted in a pretax loss of $0.5 million recorded in discontinued operations. The primary reason for the reduction was the general deterioration in the real estate market where the hospital is located. The fair value of the asset was measured using a Level 3 input of the pending offer.

On July 29, 2011, CMS issued the 2011 CMS Rules. In connection with the preparation of the Company s operating results for the third quarter of 2011, the Company determined that the impact of the 2011 CMS Rules was a triggering event in the third quarter of 2011 and accordingly tested the recoverability of its nursing and rehabilitation centers reporting unit goodwill, intangible assets and property and equipment asset groups impacted by the reduced Medicare payments. The Company recorded pretax impairment charges aggregating $26.7 million in the third quarter of 2011. The charges included $6.1 million of goodwill (which represented the entire nursing and rehabilitation centers reporting unit goodwill) and $20.6 million of property and equipment. The Company recorded pretax impairment charges aggregating $0.7 million and $1.9 million in the third quarter of 2012 and for the nine months ended September 30, 2012, respectively, for necessary property and equipment expenditures in impaired nursing and rehabilitation center asset groups. These charges reflected the amount by which the carrying value of certain assets exceeded their estimated fair value. The fair value of goodwill was measured using both Level 2 and Level 3 inputs such as discounted cash flows, market multiple analysis, replacement costs and sales comparison methodologies. The fair value of property and equipment was measured using Level 3 inputs such as replacement costs factoring in depreciation, economic obsolesce and inflation trends.

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION

The accompanying unaudited condensed consolidating financial information has been prepared and presented pursuant to SEC Regulation S-X, Rule 3-10, Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered. The Company s Notes issued on June 1, 2011 are fully and unconditionally guaranteed, subject to certain customary release provisions, by substantially all of the Company s domestic 100% owned subsidiaries. The equity method has been used with respect to the parent company s investment in subsidiaries.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

The following unaudited condensed consolidating financial data presents the financial position of the parent company/issuer, the guarantor subsidiaries and the non-guarantor subsidiaries as of September 30, 2012 and December 31, 2011, and the respective results of operations and cash flows for the three and nine months ended September 30, 2012 and September 30, 2011.

Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)

	Three months ended September 30, 2012				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Revenues	$	$ 1,432,310	$ 118,594	$ (25,112)	$ 1,525,792
Salaries, wages and benefits		866,926	45,998		912,924
Supplies		97,762	8,832		106,594
Rent		100,877	7,572		108,449
Other operating expenses	1	283,278	47,821	(25,112)	305,988
Other income		(2,775)			(2,775)
Impairment charges		3,911			3,911
Depreciation and amortization		48,015	2,585		50,600
Management fees		(2,994)	2,994		
Intercompany interest (income) expense from affiliates	(26,840)	23,556	3,284		
Interest expense (income)	26,544	(4,895)	5,019		26,668
Investment income		(39)	(190)		(229)
Equity in net income of consolidating affiliates	(7,356)			7,356	
	(7,651)	1,413,622	123,915	(17,756)	1,512,130
Income (loss) from continuing operations before income taxes	7,651	18,688	(5,321)	(7,356)	13,662
Provision for income taxes	85	5,484	184		5,753
Income (loss) from continuing operations	7,566	13,204	(5,505)	(7,356)	7,909
Discontinued operations, net of income taxes:					
Income from operations		47			47
Loss on divestiture of operations		(349)			(349)
Loss from discontinued operations		(302)			(302)
Net income (loss)	7,566	12,902	(5,505)	(7,356)	7,607
Earnings attributable to noncontrolling interests			(41)		(41)
Income (loss) attributable to Kindred	$ 7,566	$ 12,902	$ (5,546)	$ (7,356)	$ 7,566

Comprehensive income (loss)	$	7,919	$	12,902	$	(5,142)	$	(7,719)	$	7,960
Comprehensive income (loss) attributable to Kindred	$	7,919	$	12,902	$	(5,183)	$	(7,719)	$	7,919

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Operations and Comprehensive Income (Loss) (Continued)

	Three months ended September 30, 2011				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Revenues	$	$ 1,424,647	$ 111,847	$ (22,432)	$ 1,514,062
Salaries, wages and benefits	130	860,448	39,992		900,570
Supplies		98,846	8,668		107,514
Rent		97,901	7,610		105,511
Other operating expenses	23	284,598	43,116	(22,432)	305,305
Other income		(2,815)			(2,815)
Impairment charges		26,712			26,712
Depreciation and amortization		43,865	3,082		46,947
Management fees		(3,469)	3,469		
Intercompany interest (income) expense from affiliates	(26,379)	22,409	3,970		
Interest expense	25,454	123	213		25,790
Investment (income) loss		(4,621)	4,584		(37)
Equity in net income of consolidating affiliates	(1,282)			1,282	
	(2,054)	1,423,997	114,704	(21,150)	1,515,497
Income (loss) from continuing operations before income taxes	2,054	650	(2,857)	(1,282)	(1,435)
Provision (benefit) for income taxes	269	(2,621)	10		(2,342)
Income (loss) from continuing operations	1,785	3,271	(2,867)	(1,282)	907
Income from discontinued operations, net of income taxes		1,119			1,119
Net income (loss)	1,785	4,390	(2,867)	(1,282)	2,026
Earnings attributable to noncontrolling interests			(241)		(241)
Income (loss) attributable to Kindred	$ 1,785	$ 4,390	$ (3,108)	$ (1,282)	$ 1,785
Comprehensive income (loss)	$ 468	$ 4,390	$ (4,184)	$ 35	$ 709
Comprehensive income (loss) attributable to Kindred	$ 468	$ 4,390	$ (4,425)	$ 35	$ 468

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Operations and Comprehensive Income (Loss) (Continued)

	Nine months ended September 30, 2012				
(In thousands)	**Parent company/ issuer**	**Guarantor subsidiaries**	**Non-guarantor subsidiaries**	**Consolidating and eliminating adjustments**	**Consolidated**
Revenues	$	$ 4,355,502	$ 361,423	$ (75,335)	$ 4,641,590
Salaries, wages and benefits	70	2,634,490	130,772		2,765,332
Supplies		298,156	27,971		326,127
Rent		300,982	22,976		323,958
Other operating expenses	4	859,423	145,855	(75,335)	929,947
Other income		(8,221)			(8,221)
Impairment charges		5,107			5,107
Depreciation and amortization		140,313	8,779		149,092
Management fees		(9,371)	9,371		
Intercompany interest (income) expense from affiliates	(83,087)	72,953	10,134		
Interest expense (income)	79,405	(14,535)	15,092		79,962
Investment income		(131)	(665)		(796)
Equity in net income of consolidating affiliates	(38,601)			38,601	
	(42,209)	4,279,166	370,285	(36,734)	4,570,508
Income (loss) from continuing operations before income taxes	42,209	76,336	(8,862)	(38,601)	71,082
Provision for income taxes	950	27,895	519		29,364
Income (loss) from continuing operations	41,259	48,441	(9,381)	(38,601)	41,718
Discontinued operations, net income taxes:					
Income from operations		143			143
Loss on divestiture of operations		(349)			(349)
Loss from discontinued operations		(206)			(206)
Net income (loss)	41,259	48,235	(9,381)	(38,601)	41,512
Earnings attributable to noncontrolling interests			(253)		(253)
Income (loss) attributable to Kindred	$ 41,259	$ 48,235	$ (9,634)	$ (38,601)	$ 41,259
Comprehensive income (loss)	$ 41,636	$ 48,235	$ (8,421)	$ (39,561)	$ 41,889

Comprehensive income (loss) attributable to Kindred	$ 41,636	$ 48,235	$ (8,674)	$ (39,561)	$ 41,636

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Operations and Comprehensive Income (Loss) (Continued)

	Nine months ended September 30, 2011				
(In thousands)	**Parent company/ issuer**	**Guarantor subsidiaries**	**Non-guarantor subsidiaries**	**Consolidating and eliminating adjustments**	**Consolidated**
Revenues	$	$ 3,879,843	$ 184,025	$ (64,793)	$ 3,999,075
Salaries, wages and benefits	401	2,290,765	53,232		2,344,398
Supplies		282,713	11,541		294,254
Rent	3	282,524	10,114		292,641
Other operating expenses	70	823,368	93,161	(64,793)	851,806
Other income		(8,480)			(8,480)
Impairment charges		26,712			26,712
Depreciation and amortization		112,897	4,470		117,367
Management fees		(4,627)	4,627		
Intercompany interest (income) expense from affiliates	(61,317)	56,017	5,300		
Interest expense	54,228	144	303		54,675
Investment (income) loss		(6,212)	5,423		(789)
Equity in net income of consolidating affiliates	(14,225)			14,225	
	(20,840)	3,855,821	188,171	(50,568)	3,972,584
Income (loss) from continuing operations before income taxes	20,840	24,022	(4,146)	(14,225)	26,491
Provision for income taxes	2,490	7,194	164		9,848
Income (loss) from continuing operations	18,350	16,828	(4,310)	(14,225)	16,643
Income from discontinued operations, net of income taxes		1,527			1,527
Net income (loss)	18,350	18,355	(4,310)	(14,225)	18,170
Loss attributable to noncontrolling interests			180		180
Income (loss) attributable to Kindred	$ 18,350	$ 18,355	$ (4,130)	$ (14,225)	$ 18,350
Comprehensive income (loss)	$ 17,215	$ 18,355	$ (5,445)	$ (13,090)	$ 17,035
Comprehensive income (loss) attributable to Kindred	$ 17,215	$ 18,355	$ (5,265)	$ (13,090)	$ 17,215

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Balance Sheet

(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
	As of September 30, 2012				
ASSETS					
Current assets:					
Cash and cash equivalents	$	$ 27,327	$ 8,368	$	$ 35,695
Cash restricted		5,344			5,344
Insurance subsidiary investments			79,642		79,642
Accounts receivable, net		983,541	66,536		1,050,077
Inventories		28,811	2,976		31,787
Deferred tax assets		24,641			24,641
Income taxes		6,280	144		6,424
Other		28,692	3,785		32,477
		1,104,636	161,451		1,266,087
Property and equipment, net		1,053,256	50,207		1,103,463
Goodwill		884,045	262,756		1,146,801
Intangible assets, net		423,490	22,675		446,165
Assets held for sale		4,103			4,103
Insurance subsidiary investments			118,256		118,256
Investment in subsidiaries	305,236			(305,236)	
Intercompany	2,598,977			(2,598,977)	
Deferred tax assets	815		11,870	(12,685)	
Other	46,148	104,873	61,931		212,952
	$ 2,951,176	$ 3,574,403	$ 689,146	$ (2,916,898)	$ 4,297,827
LIABILITIES AND EQUITY					
Current liabilities:					
Accounts payable	$	$ 191,618	$ 16,595	$	$ 208,213
Salaries, wages and other compensation	15	350,781	41,768		392,564
Due to third party payors		39,820			39,820
Professional liability risks		3,307	45,624		48,931
Other accrued liabilities	2,103	139,730	7,049		148,882
Long-term debt due within one year	7,000	101	1,686		8,787
	9,118	725,357	112,722		847,197
Long-term debt	1,606,483	384	4,021		1,610,888
Intercompany		2,286,488	312,489	(2,598,977)	

Professional liability risks		114,380	121,916		236,296
Deferred tax liabilities		33,222		(12,685)	20,537
Deferred credits and other liabilities		145,799	65,310		211,109
Noncontrolling interests-redeemable					
Commitments and contingencies					
Equity:					
Stockholders equity	1,335,575	268,773	36,463	(305,236)	1,335,575
Noncontrolling interests-nonredeemable			36,225		36,225
	1,335,575	268,773	72,688	(305,236)	1,371,800
	$ 2,951,176	$ 3,574,403	$ 689,146	$ (2,916,898)	$ 4,297,827

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Balance Sheet (Continued)

	As of December 31, 2011				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
ASSETS					
Current assets:					
Cash and cash equivalents	$	$ 21,825	$ 19,736	$	$ 41,561
Cash restricted		5,551			5,551
Insurance subsidiary investments			70,425		70,425
Accounts receivable, net		908,100	86,600		994,700
Inventories		28,220	2,840		31,060
Deferred tax assets		17,785			17,785
Income taxes		39,184	329		39,513
Other		30,489	2,198		32,687
		1,051,154	182,128		1,233,282
Property and equipment, net		1,007,187	51,854		1,059,041
Goodwill		815,787	268,868		1,084,655
Intangible assets, net		420,468	26,739		447,207
Assets held for sale		5,612			5,612
Insurance subsidiary investments			110,227		110,227
Investment in subsidiaries	266,817			(266,817)	
Intercompany	2,503,209			(2,503,209)	
Deferred tax assets			12,387	(12,387)	
Other	52,623	92,231	53,615		198,469
	$ 2,822,649	$ 3,392,439	$ 705,818	$ (2,782,413)	$ 4,138,493
LIABILITIES AND EQUITY					
Current liabilities:					
Accounts payable	$ 102	$ 196,326	$ 20,373	$	$ 216,801
Salaries, wages and other compensation	43	371,022	36,428		407,493
Due to third party payors		37,306			37,306
Professional liability risks		3,582	42,428		46,010
Other accrued liabilities		121,959	8,734		130,693
Long-term debt due within one year	7,000	96	3,524		10,620
	7,145	730,291	111,487		848,923

Long-term debt	1,526,583	460	4,839		1,531,882
Intercompany		2,169,985	333,224	(2,503,209)	
Professional liability risks		108,853	108,864		217,717
Deferred tax liabilities		30,342		(12,387)	17,955
Deferred credits and other liabilities		130,466	61,305		191,771
Noncontrolling interests-redeemable			9,704		9,704
Commitments and contingencies					
Equity:					
Stockholders equity	1,288,921	222,042	44,775	(266,817)	1,288,921
Noncontrolling interests-nonredeemable			31,620		31,620
	1,288,921	222,042	76,395	(266,817)	1,320,541
	$ 2,822,649	$ 3,392,439	$ 705,818	$ (2,782,413)	$ 4,138,493

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Cash Flows

	Three months ended September 30, 2012				
(In thousands)	**Parent company/ issuer**	**Guarantor subsidiaries**	**Non-guarantor subsidiaries**	**Consolidating and eliminating adjustments**	**Consolidated**
Net cash provided by operating activities	$ 917	$ 126,936	$ 13,636	$	$ 141,489
Cash flows from investing activities:					
Routine capital expenditures		(24,140)	(1,799)		(25,939)
Development capital expenditures		(13,702)	(1,475)		(15,177)
Acquisitions		(71,440)			(71,440)
Purchase of insurance subsidiary investments			(9,692)		(9,692)
Sale of insurance subsidiary investments			8,063		8,063
Net change in insurance subsidiary cash and cash equivalents			(685)		(685)
Change in other investments		1,003			1,003
Other		(25)			(25)
Net cash used in investing activities		(108,304)	(5,588)		(113,892)
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit	364,600				364,600
Repayment of borrowings under revolving credit	(390,400)				(390,400)
Repayment of other long-term debt	(1,750)	(24)	(891)		(2,665)
Payment of deferred financing costs	(288)				(288)
Purchase of noncontrolling interests			(715)		(715)
Change in intercompany accounts	26,921	(22,054)	(4,867)		
Net cash used in financing activities	(917)	(22,078)	(6,473)		(29,468)
Change in cash and cash equivalents		(3,446)	1,575		(1,871)
Cash and cash equivalents at beginning of period		30,773	6,793		37,566
Cash and cash equivalents at end of period	$	$ 27,327	$ 8,368	$	$ 35,695

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Cash Flows (Continued)

	Three months ended September 30, 2011				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Net cash provided by operating activities	$ 1,029	$ 58,112	$ 7,377	$	$ 66,518
Cash flows from investing activities:					
Routine capital expenditures		(35,140)	(1,455)		(36,595)
Development capital expenditures		(44,152)			(44,152)
Acquisitions, net of cash acquired		(50,928)			(50,928)
Purchase of insurance subsidiary investments			(8,867)		(8,867)
Sale of insurance subsidiary investments			10,398		10,398
Net change in insurance subsidiary cash and cash equivalents			(826)		(826)
Other		(663)			(663)
Net cash used in investing activities		(130,883)	(750)		(131,633)
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit	533,200				533,200
Repayment of borrowings under revolving credit	(474,700)				(474,700)
Repayment of other long-term debt		(1,542)	(1,003)		(2,545)
Payment of deferred financing costs	(1,855)				(1,855)
Purchase of noncontrolling interests			(7,292)		(7,292)
Change in intercompany accounts	(57,677)	48,084	9,593		
Other	3				3
Net cash provided by (used in) financing activities	(1,029)	46,542	1,298		46,811
Change in cash and cash equivalents		(26,229)	7,925		(18,304)
Cash and cash equivalents at beginning of period		35,196	17,203		52,399
Cash and cash equivalents at end of period	$	$ 8,967	$ 25,128	$	$ 34,095

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Cash Flows (Continued)

	Nine months ended September 30, 2012				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Net cash provided by operating activities	$ 7,892	$ 163,839	$ 19,356	$	$ 191,087
Cash flows from investing activities:					
Routine capital expenditures		(71,211)	(5,593)		(76,804)
Development capital expenditures		(34,734)	(3,441)		(38,175)
Acquisitions		(139,308)			(139,308)
Sale of assets		1,110			1,110
Purchase of insurance subsidiary investments			(30,890)		(30,890)
Sale of insurance subsidiary investments			30,073		30,073
Net change in insurance subsidiary cash and cash equivalents			(15,171)		(15,171)
Change in other investments		1,454			1,454
Capital contribution to insurance subsidiary		(8,600)		8,600	
Other		(1,029)			(1,029)
Net cash used in investing activities		(252,318)	(25,022)	8,600	(268,740)
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit	1,329,300				1,329,300
Repayment of borrowings under revolving credit	(1,244,900)				(1,244,900)
Repayment of other long-term debt	(5,250)	(70)	(2,656)		(7,976)
Payment of deferred financing costs	(601)				(601)
Contribution made by noncontrolling interest			200		200
Distribution made to noncontrolling interests			(3,521)		(3,521)
Purchase of noncontrolling interests			(715)		(715)
Change in intercompany accounts	(86,441)	94,051	(7,610)		
Capital contribution to insurance subsidiary			8,600	(8,600)	
Net cash provided by (used in) financing activities	(7,892)	93,981	(5,702)	(8,600)	71,787
Change in cash and cash equivalents		5,502	(11,368)		(5,866)
Cash and cash equivalents at beginning of period		21,825	19,736		41,561
Cash and cash equivalents at end of period	$	$ 27,327	$ 8,368	$	$ 35,695

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Cash Flows (Continued)

	Nine months ended September 30, 2011				
(In thousands)	**Parent company/ issuer**	**Guarantor subsidiaries**	**Non-guarantor subsidiaries**	**Consolidating and eliminating adjustments**	**Consolidated**
Net cash provided by (used in) operating activities	$ (38,301)	$ 143,202	$ 16,405	$ (3,500)	$ 117,806
Cash flows from investing activities:					
Routine capital expenditures		(93,734)	(1,529)		(95,263)
Development capital expenditures		(69,570)			(69,570)
Acquisitions, net of cash acquired		(741,079)	30,172		(710,907)
Sale of assets		1,714			1,714
Purchase of insurance subsidiary investments			(25,904)		(25,904)
Sale of insurance subsidiary investments			37,587		37,587
Net change in insurance subsidiary cash and cash equivalents					