HARFORD MEMORIAL HOSPITAL, INC. AND UPPER CHESAPEAKE MEDICAL CENTER, INC.

Combined Financial Statements and Combining Schedules

December 31, 2012 and 2011

(With Independent Auditors' Report Thereon)

HARFORD MEMORIAL HOSPITAL, INC. AND
UPPER CHESAPEAKE MEDICAL CENTER, INC.

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KPMG LLP
1 East Pratt Street
Baltimore, MD 21202-1128

Independent Auditors' Report

The Boards of Directors
Harford Memorial Hospital, Inc. and
Upper Chesapeake Medical Center, Inc.:

Report on the Financial Statements

We have audited the accompanying combined financial statements of Harford Memorial Hospital, Inc. and Upper Chesapeake Medical Center, Inc. (the Hospitals or the Obligated Group), which comprise the combined balance sheets as of December 31, 2012 and 2011, and the related combined statements of operations and changes in net assets, and cash flows for the years then ended, and the related notes to the combined financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these combined financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of combined financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these combined 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 combined financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the combined financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the combined financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the combined financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the combined financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the combined financial statements referred to above present fairly in all material respects, the financial position of Harford Memorial Hospital, Inc. and Upper Chesapeake Medical Center, Inc. as of December 31, 2012 and 2011, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

As discussed in note 1(w) to the combined financial statements, the Hospitals changed their presentation of provision for bad debts as a result of the adoption of Accounting Standards Update No. 2011-07, *Health Care Entities: Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and Allowance for Doubtful Accounts for Certain Health Care Entities.*

Supplemental Information

Our audit was conducted for the purpose of forming an opinion on the combined financial statements as a whole. The supplementary information included in Schedules 1 and 2 is presented for purposes of additional analysis and is not a required part of the combined financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the combined financial statements. The information has been subjected to the auditing procedures applied in the audit of the combined financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the combined financial statements or to the combined financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the combined financial statements as a whole.

KPMG LLP

April 26, 2013

HARFORD MEMORIAL HOSPITAL, INC. AND
UPPER CHESAPEAKE MEDICAL CENTER, INC.

Combined Balance Sheets

December 31, 2012 and 2011

(In thousands)

Assets		2012	2011
Current assets:			
Cash and cash equivalents	$	37,073	35,903
Current portion of assets held by trustee (notes 2, 7 and 13)		2,563	2,848
Current portion of board designated and other investments (note 2)		41,529	41,081
Patient accounts receivable, net of allowance and contractuals of $19,428 and $17,806 in 2012 and 2011, respectively (note 3)		40,626	38,378
Prepaid expenses and other current assets		12,497	11,148
Total current assets		134,288	129,358
Due from affiliates (note 12)		28,960	27,759
Assets held by trustee, less current portion (notes 2, 7 and 13)		4,044	4,069
Board designated and other investments, less current portion (note 2)		49,268	43,904
Property, plant, and equipment, net (note 4)		213,589	191,826
Economic interest in net assets of foundation		11,390	7,007
Other assets (note 5)		1,379	1,641
Total assets	$	442,918	405,564
Liabilities and Net Assets			
Current liabilities:			
Accounts payable	$	22,593	21,382
Accrued salaries, benefits, and other (notes 8 and 9)		26,446	25,994
Current portion of long-term debt (notes 7 and 13)		2,980	895
Advances from third-party payors		7,522	6,833
Total current liabilities		59,541	55,104
Due to affiliates (note 12)		1,456	—
Long-term debt, less current portion (notes 7 and 13)		186,499	172,898
Other long-term liabilities (notes 1, 7 and 9)		59,091	55,659
Pension liability (note 8)		9,703	10,200
Total liabilities		316,290	293,861
Unrestricted net assets		115,238	104,696
Temporarily restricted net assets		11,390	7,007
Total net assets		126,628	111,703
Total liabilities and net assets	$	442,918	405,564

See accompanying notes to combined financial statements.

HARFORD MEMORIAL HOSPITAL, INC. AND
UPPER CHESAPEAKE MEDICAL CENTER, INC.

Combined Statements of Operations and Changes in Net Assets

Years ended December 31, 2012 and 2011

(In thousands)

	2012	2011
Operating activities:		
Unrestricted revenues, gains, and other support:		
Patient service revenue (net of contractual allowances and discounts)	$ 341,730	319,551
Provision for bad debts	(21,191)	(23,124)
Net patient service revenue (notes 3, 9, and 11)	320,539	296,427
Other	10,960	5,319
Total unrestricted revenues, gains, and other support	331,499	301,746
Expenses (note 14):		
Salaries	121,786	113,255
Employee benefits (notes 8 and 9)	29,966	26,338
Supplies and other operating expenses	137,677	120,842
Depreciation and amortization (notes 4 and 5)	14,586	13,070
Interest and amortization (notes 5, and 7)	5,367	5,624
Total expenses	309,382	279,129
Operating income	22,117	22,617
Nonoperating income:		
Investment income (note 2)	5,751	19
Change in the fair value and settlement payments on derivative instruments (note 7)	(4,056)	(12,174)
Other	—	(241)
Nonoperating income (loss)	1,695	(12,396)
Excess of revenues over expenses	23,812	10,221
Other changes in unrestricted net assets:		
Contributions for purchases of property and equipment (note 12)	1,471	701
Pension – related changes other than net periodic pension cost (note 8)	(954)	(9,756)
Transfers to affiliates, net (note 12)	(13,787)	(7,515)
Increase (decrease) in unrestricted net assets	10,542	(6,349)
Changes in temporarily restricted net assets:		
Donor restricted gifts	4,383	7,007
Increase in temporarily restricted net assets	4,383	7,007
Net assets, beginning of year	111,703	111,045
Net assets, end of year	$ 126,628	111,703

See accompanying notes to combined financial statements.

HARFORD MEMORIAL HOSPITAL, INC. AND
UPPER CHESAPEAKE MEDICAL CENTER, INC.

Combined Statements of Cash Flows

Years ended December 31, 2012 and 2011

(In thousands)

	2012	2011
Cash flows from operating activities:		
Increase in net assets	$ 14,925	658
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	14,482	13,070
Amortization of deferred financing costs	104	174
Amortization of bond discount	31	36
Provision for bad debts	21,191	23,124
Realized and unrealized (gains) loss on securities	(5,097)	775
Loss on interest rate swaps	234	8,151
Contributions for purchases of property and equipment	(1,471)	(701)
Change in funded status of defined benefit plan	954	9,756
Loss on debt refinancing	—	133
Transfers to affiliates, net	13,787	7,515
Change in assets and liabilities:		
Increase in patient accounts receivable	(23,439)	(30,508)
Increase in prepaid expenses and other current assets	(1,349)	(1,377)
Decrease (increase) in amounts due from affiliates, net	255	(18,123)
Increase in economic interest in net assets of foundation	(4,383)	(7,007)
(Increase) decrease in accounts payable, accrued expenses, and advances from third-party payors	(562)	10,645
Decrease in pension liability	(1,451)	(3,398)
Increase in other long-term liabilities	3,198	9,747
Net cash provided by operating activities	31,409	22,670
Cash flows from investing activities:		
Property, plant, and equipment additions	(33,173)	(19,589)
Purchases/sales of assets held by trustee, board-designated, other investments, net	(405)	11,942
Net cash used in investing activities	(33,578)	(7,647)
Cash flows from financing activities:		
Proceeds of borrowings	18,340	122,438
Repayment of long-term debt	(2,685)	(123,961)
Payment of financing costs	—	(876)
Contributions for purchases of property and equipment	1,471	701
Transfers to affiliates, net	(13,787)	(9,807)
Net cash provided by (used in) financing activities	3,339	(11,505)
Net increase in cash and cash equivalents	1,170	3,518
Cash and cash equivalents, beginning of year	35,903	32,385
Cash and cash equivalents, end of year	$ 37,073	35,903
Supplemental information:		
Transfer of fixed assets from affiliate	$ —	2,292
Capital additions accrued but not paid	2,914	1,056

See accompanying notes to combined financial statements.

(1) Summary of Significant Accounting Policies

(a) Organization

Harford Memorial Hospital, Inc. and Upper Chesapeake Medical Center, Inc. (collectively, the Hospitals or the Obligated Group) are nonprofit, nonstock membership corporations formed under the laws of the State of Maryland, organized for charitable purposes and recognized by the Internal Revenue Service (IRS) as tax-exempt organizations under Section 501(c)(3) of the Internal Revenue Code. UCHS/UMMS Venture, LLC (the Venture) is the sole member of the Hospitals. The Venture members are the University of Maryland Medical System (UMMS) and Upper Chesapeake Health System, Inc. (UCHS). The Venture, a Maryland limited liability company, is organized to coordinate activities of healthcare facilities and other corporate bodies whose purposes include the provision of healthcare services or financial assistance to residents of Harford County, Maryland. The Venture is also the sole member or sole shareholder of the common stock of each of the following entities:

Harford Memorial Hospital, Inc. (HMH)
Upper Chesapeake Medical Center, Inc. (UCMC)
Upper Chesapeake Medical Services, Inc. (UCMS)
Upper Chesapeake Properties, Inc. (UCP)
Upper Chesapeake Health Foundation, Inc. (UCHF)
Upper Chesapeake Health Ventures, Inc. (UCHV)
Upper Chesapeake Residential Hospice House, Inc. (UCRHH)
Hospice of Harford County, LLC (HHC)
UC Land Development, LLC (UCLD)

On October 1, 2009, the Venture and UMMS executed an Affiliation Agreement (the Agreement) and an Amended and Restated Operating Agreement, which increased UMMS' ownership in the Venture to 34% in exchange for cash, which is designated primarily for use for clinical projects. The Agreement requires profits for each calendar year to be allocated according to ownership percentage.

The Agreement required UMMS to purchase an additional 15% interest in the Venture, which occurred on October 1, 2010. The purchase of the additional 15% interest was in exchange for cash. UMMS' total interest in the Venture is 49% as of December 31, 2012.

Under the terms of the Agreement, the Board of Directors consists of 17 seats, 15 controlled by UCHS and 2 controlled by UMMS.

The Agreement also provides that at some point in the future, UMMS may become the sole member of UCHS by contributing a stated amount of immediately available funds, which will be restricted for use related to capital expansion of health services for the residents of Harford County, Maryland and a final contribution of cash on or before December 31, 2018, which will also be restricted for use.

Under the Agreement, 4% cumulative distributions on the purchase price will be earned by UMMS, and will be payable within 120 days after the end of each fiscal year, commencing with the fiscal year ending December 31, 2017, if net cash is available for distribution as calculated under the Agreement. Such distributions will terminate at the time UMMS becomes the sole member of UCHS.

(b) Basis of Accounting

The combined financial statements are prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles (GAAP), and include the accounts of HMH and UCMC, which comprise the Obligated Group as defined in the Amended and Restated Master Loan Agreement described in note 7. In combination, all material intercompany balances and transactions have been eliminated.

(c) Cash and Cash Equivalents

Cash equivalents consist primarily of temporary investments with original maturities of three months or less.

(d) Assets Held by Trustee, Board-Designated, and Other Investments

The assets held by trustee, board-designated, and other investments are considered trading and are classified as current or noncurrent assets based on management's intention as to use. All debt and equity securities are reported at fair value principally based on quoted market prices on the combined balance sheets.

The Hospitals hold an investment in a fund which under GAAP is considered an alternative investment totaling $2,599 and $2,344 as of December 31, 2012 and 2011, respectively. The fund invests primarily in debt securities of emerging markets. This fund utilizes various types of debt and equity securities along with derivative instruments in its investment strategy. Alternative investments are recorded under the equity method of accounting.

Assets limited as to use include assets held by the trustee under an indenture agreement. Board designated investments are set aside by the Board of Directors to fund future capital improvements. The board retains control of these assets and may at their discretion use such assets for other corporate purposes.

Investments are exposed to certain risks, such as interest rate, credit, and overall market volatility. Due to the level of risk associated with certain investment securities, changes in the value of investment securities could occur in the near term, and these changes could materially differ from the amounts reported in the accompanying combined financial statements.

Investment income including unrealized gains and losses, realized gains and losses on investment sales, and interest and dividends is recorded on the accrual basis and is reported as nonoperating gains or losses in the excess of revenues over expenses in the accompanying combined statements of

operations and changes in net assets unless the income or loss is restricted by the donor or law. Investment income and net gains that are restricted by the donor are recorded as a component of changes in temporarily or permanently restricted net assets, in accordance with donor-imposed restrictions. Realized gains and losses are determined based on the specific security's original purchase price.

(e) Derivative Instruments and Hedging Activities

The Hospitals account for derivatives and hedging activities in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 815, *Derivatives and Hedging*, which requires entities to recognize all derivative instruments as either assets or liabilities in the combined balance sheet at their respective fair values.

The Hospitals formally assess, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. Changes in the fair value of a derivative that is highly effective and that is designated and qualifies as a cash flow hedge are recorded in other changes in net assets to the extent that the derivative is effective as a hedge, until earnings are affected by the variability in cash flows of the designated hedged item. The ineffective portion of the change in fair value of a derivative instrument that qualifies as a cash flow hedge is reported in excess of revenues over expenses.

The Hospitals discontinue hedge accounting prospectively when it is determined that the derivative is no longer effective in offsetting changes in the fair value or cash flows of the hedged item, the derivative expires or is sold, terminated, exercised, or management determines that designation of the derivative as a hedging instrument is no longer appropriate.

In all situations in which hedge accounting is discontinued and the derivative is retained, the Hospitals continue to carry the derivative at its fair value on the combined balance sheet and recognize any subsequent changes in its fair value in excess of revenues over expenses.

(f) Patient Accounts Receivable

Patient accounts receivable are stated at estimated net realizable amounts from patients, third-party payors, and other insurers for services provided.

The Hospitals grant credit to patients, substantially all of whom are local residents. The Hospitals generally do not require collateral or other security in extending credit; however, they routinely obtain assignment of (or are otherwise entitled to receive) patients' benefits receivable under their health insurance programs, plans, or policies.

(Dollars in thousands)

(g) Inventories

Inventories consisting primarily of drugs and medical/surgical supplies are stated at lower of cost or market and are included in prepaid expenses and other current assets on the combined balance sheets. Cost is determined principally using the first-in, first-out method.

(h) Property, Plant, and Equipment

Property, plant, and equipment are recorded at cost or, if donated, at their fair market value on the date of receipt. Depreciation is taken on a straight-line basis over the estimated useful lives of the depreciable assets. The estimated useful lives of the assets are as follows:

Land improvements	3 – 20 years
Buildings	20 – 40 years
Equipment	5 – 20 years

Gifts of long-lived assets such as land, buildings, or equipment are reported as other changes in unrestricted net assets and are excluded from the excess of revenues over expenses, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other 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.

Gains and losses on disposal or sale of long-lived assets are recorded as a component of operating income in the combined statement of operations and changes in net assets.

The Hospitals' policy is to capitalize interest cost incurred on debt during the construction of major projects exceeding one year.

The Hospitals entered into an agreement during 2007 to lease space in Medical Office Building II (MOB II), which opened during 2008 and is on the campus of UCMC. A nonaffiliated entity developed, owns and operates the MOB II. The Hospitals determined that due to certain structural elements installed by the Hospitals during construction of the space being leased, the Hospitals are required to be treated, for accounting purposes, as the "owner" of the MOB II in accordance with FASB ASC Subtopic 840-40, *Leases – Sale-Leaseback Transactions*. The asset and financing obligation will be reflected on the Hospitals' combined balance sheets until completion of the lease term, when they will be removed from the Hospitals' combined financial statements. At December 31, 2012, the recorded amount for the asset is $11,166 and the related liability is $11,711, which are included in buildings and other long-term liabilities, respectively.

(Dollars in thousands)

The future minimum payments under the financing obligation for the initial lease term (10 years) are as follows:

2013	$	941
2014		969
2015		998
2016		1,028
2017		1,059
Thereafter		720
Total future minimum financing obligation payments		5,715
Less interest		3,406
Present value of future minimum financing obligation payments	$	2,309

(i) Economic Interest in Net Assets of Foundation

The Hospitals account for the activities of the Upper Chesapeake Health Foundation (the Foundation) in accordance with ASC Topic 958 *Not-for-Profit Entities*. For fiscal years ending December 31, 2012 and 2011 the Hospitals recognized an economic interest in the net assets of the Foundation, a financially interrelated organization, as these fundraising activities were designated for use by the Hospitals.

(j) Deferred Financing Costs

Deferred financing costs, which are classified as other assets, are being amortized on the effective-interest method over the term of the related debt or letters of credit, and are included in interest and amortization.

(k) Bond Discount

The bond discount, which is classified as a reduction of long-term debt, is being amortized on the effective-interest method over the term of the related debt and is included in interest and amortization.

(l) Malpractice Claims

Costs of malpractice claims, which are subject to deductible provisions of the Hospitals' insurance programs are accrued when incidents occur that give rise to the claims if it can be determined that a liability is probable and the amount can be reasonably estimated (note 9).

(m) Temporarily Restricted Net Assets and Donor-Restricted Gifts

Temporarily restricted net assets are those whose use by the Hospitals has been limited by donors to a specific time period or purpose. Unconditional promises to give cash and other assets to the Hospitals are reported at fair value at the date the promise is received. Donor-restricted gifts whose restrictions are met within the same year as received are reported as unrestricted gifts in the accompanying combined statements of operations and changes in net assets. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received.

(n) Net Patient Service Revenue and Other

Patient service revenue of the Hospitals is recorded at rates established by the State of Maryland Health Services Cost Review Commission (HSCRC) and, accordingly, reflects actual charges to patients based on rates in effect during the period in which the services are rendered. The Hospitals have charge per episode (CPE) agreements with the HSCRC, which are renewed annually. These CPE agreements establish a prospectively approved average charge per inpatient episode (defined as hospital admissions plus births less thirty day re-admissions) and an estimated case mix index. These approved CPE targets are adjusted during the rate year for actual changes in case mix. The CPE agreements allow the Hospitals to adjust approved unit rates, within certain limits, to achieve the average CPE target for each rate year ending June 30.

Outpatient service revenue is recorded using the established HSCRC unit rates for hospital based outpatient services.

Contractual adjustments, which represent the difference between amounts billed as patient service revenue and amounts paid by third-party payors, are accrued in the period in which the related services are rendered.

The Health Information Technology for Economic and Clinical Health (HITECH) Act that was enacted as part of the American Recovery and Reinvestment Act of 2009 was signed into law in February 2009. In the context of the HITECH Act, certain healthcare entities must implement a certified Electronic Health Record (EHR) in an effort to promote the adoption and "meaningful use" of health information technology (HIT). Understanding the strategic importance of an EHR system, the Hospitals invested in a certified EHR system prior to the HITECH Act. The HITECH Act includes significant monetary incentives meant to encourage the adoption of an EHR system. During 2012, the Hospitals recognized incentive payments totaling approximately $5,400 which are included in other operating revenue in the combined statements of operations and changes in net assets.

(o) Charity Care

The Hospitals provide care to patients who meet certain criteria under their charity care policy without charge or at amounts less than their established rates. Because the facilities do not pursue the collection of amounts determined to qualify as charity care, those amounts are not reported as revenue.

(p) Nonoperating Income

Other activities that are largely unrelated to the Hospitals' primary mission are recorded as nonoperating income, which includes investment income and change in the fair value and settlement payments on derivative instruments.

(q) Impairment of Long-Lived Assets

Management regularly evaluates whether events or changes in circumstances have occurred that could indicate impairment in the value of long-lived assets. If there is an indication that the carrying amount of an asset is not recoverable, the Hospitals estimate the projected undiscounted cash flows, excluding interest, to determine if an impairment loss should be recognized. The amount of impairment loss is determined by comparing the historical carrying value of the asset to its estimated fair value. Estimated fair value is determined through an evaluation of recent and projected financial performance using standard industry valuation techniques.

In addition to consideration of impairment upon the events or changes in circumstances described above, management regularly evaluates the remaining lives of its long-lived assets. If estimates are changed, the carrying value of affected assets is allocated over the remaining lives.

In estimating the future cash flows for determining whether an asset is impaired and if expected future cash flows used in measuring assets are impaired, the Hospitals group the assets at the lowest level for which there are identifiable cash flows independent of other groups of assets. If such assets are impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. Based on management's evaluation, no long-lived assets were identified as impaired for the years ended December 31, 2012 and 2011.

(r) Excess of Revenues over Expenses

The combined statements of operations and changes in net assets include excess of revenues over expenses. Changes in unrestricted net assets, which are excluded from excess of revenues over expenses, consistent with industry practice, include contributions of long-lived assets (including assets acquired using contributions, which by donor restriction were to be used for the purposes of acquiring such assets), equity contributions, changes in funded status of defined benefit plan, and transfers to or from affiliates.

(s) Use of Estimates

The preparation of the combined financial statements in conformity with GAAP 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 combined financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(t) Income Taxes

The Hospitals have been recognized by the IRS as tax-exempt pursuant to Section 501(c)(3) of the Internal Revenue Code.

The Hospitals account for tax provisions in accordance with FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, included in ASC Subtopic 740-10, *Income Taxes – Overall*, which clarifies the accounting for uncertainty in tax provisions. FIN 48 requires that the Hospitals recognize the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs.

(u) Employee Pension Plan

UCHS sponsors a defined benefit pension plan. The plan is actuarially evaluated and involves various assumptions, which are elements of expense and liability measurement. Key assumptions include the discount rate and the expected rate of return on plan assets, retirement, mortality, and turnover. UCHS evaluates these assumptions annually and modifies them as appropriate. UCHS froze the defined benefit pension plan as of December 31, 2005.

The Hospitals account for the defined benefit pension plan in accordance with ASC Subtopic 715-20, *Compensation – Retirement Benefits – Defined Benefit Plans – General (ASC Topic 715)*, which requires the recognition of the overfunded or underfunded status of a defined benefit pension plan as an asset or liability in the combined balance sheet and to recognize any changes in that funded status through unrestricted net assets. Additionally, ASC Topic 715 requires the measurement date for plan assets and liabilities to coincide with the employer's year-end and to disclose in the notes to the combined financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation.

(v) Fair Value Measurements

The Hospitals utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible. The Hospitals determine fair value based on assumptions that market participants would use in pricing an asset or liability in the principal or most advantageous market. When considering market participant assumptions in fair value measurements, the following fair value hierarchy distinguishes between observable and unobservable inputs, which are categorized in one of the following levels:

- Level 1 Inputs: Unadjusted quoted prices in active markets for identical assets or liabilities accessible to the reporting entity at the measurement date.

(Dollars in thousands)

- Level 2 Inputs: Other than quoted prices included in Level 1 inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.
- Level 3 Inputs: Unobservable inputs for the asset or liability used to measure fair value to the extent that observable inputs are not available, thereby allowing for situation in which there is little, if any, market activity for the asset or liability at measurement date.

(w) New Accounting Pronouncements

In July 2011, the FASB issued ASU 2011-07, *Health Care Entities (Topic 954), Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*, which requires a healthcare entity to change the presentation of their statement of operations by reclassifying the provision for bad debts associated with patient service revenue from an operating expense to a deduction from patient service revenue (net of contractual allowance and discounts). This presentation only applies to the extent an entity does not assess collectability of revenue at the time services are rendered. Additionally, enhanced disclosures about an entity's policies for recognizing or assessing bad debts, as well as qualitative and quantitative information about changes in the allowance for doubtful accounts are required. The adoption of ASU 2011-07 was effective for the Hospitals beginning January 1, 2012. See note 11 for related disclosure information.

(2) Assets Held by Trustee, Board Designated, and Other Investments

Assets held by trustee, board designated, and other investments include the following at December 31:

		2012	2011
Board-designated and other investments	$	88,198	82,641
Alternative investments		2,599	2,344
Funds held by the trustee		6,607	6,917
	$	97,404	91,902

(Continued)

(Dollars in thousands)

Board-designated and other investments carried at fair value or under the equity method of accounting in the case of alternative investments, consist of the following at December 31:

	2012		2011	
Cash and cash equivalents	$ 11,426	13%	$ 13,258	15%
Common/preferred stock and mutual funds	34,327	38	28,905	34
Mortgage-backed and asset-backed securities	9,465	10	13,506	16
Corporate bonds and U.S. government obligations	32,980	36	26,972	32
Alternative investments	2,599	3	2,344	3
	$ 90,797	100%	$ 84,985	100%

As described in note 7, funds held by the trustee as of December 31, 2012 and 2011 are limited as to use under the Amended and Restated Master Loan Agreement. Funds held by the trustee, which consist of cash and U.S. government agency obligations, are stated at fair value and include the following funds at December 31:

	2012	2011
Debt service funds	$ 2,563	2,848
Debt service reserve funds	4,044	4,069
Total funds held by the trustee	$ 6,607	6,917

The debt service fund has been established to secure the payment of principal and interest due on the Series 2008C Revenue Bonds (note 7). The debt service reserve fund has been established to provide for future deficiencies, if any, in various bond repayment terms established by the Amended and Restated Master Loan Agreement. If the balance in the debt service reserve funds falls below the minimum requirement as a result of investment losses or withdrawals relating to deficiencies in other specified funds, the Hospitals will be required to make equal monthly payments to the trustee to restore the amount on deposit therein to the minimum required amount within a 24-month period. No requirement to make such payments existed at December 31, 2012 or 2011.

(Continued)

(Dollars in thousands)

Investment income related to unrestricted investments is comprised of the following for the years ended December 31:

		2012	2011
Interest and dividends	$	654	794
Gain on sale of investments and board-designated investments, net		2,215	3,377
Unrealized gain (loss) on investments and board-designated investments, net		2,903	(4,234)
Unrealized (loss) gain on trustee-held funds		(21)	82
Total investment return	$	5,751	19

(3) Patient Accounts Receivable

The Hospitals had receivables from third-party payors and others, net of contractual allowances, as follows at December 31:

		2012	2011
Medicare	$	16,625	14,319
Medicaid		1,818	4,071
Commercial insurance and HMOs		26,136	23,222
Blue Cross		5,850	5,761
Self-pay and others		9,625	8,811
		60,054	56,184
Less allowance for estimated uncollectibles and contractuals		19,428	17,806
Patient accounts receivable, net	$	40,626	38,378

Patient service revenue, by payor class, consisted of the following for the years ended December 31:

	2012	2011
Medicare	41%	41%
Medicaid	1	2
Commercial insurance and HMOs	38	37
Blue Cross	15	15
Self-pay and others	5	5
	100%	100%

(Continued)

(Dollars in thousands)

(4) Property, Plant, and Equipment

Property, plant, and equipment are summarized as follows at December 31:

	2012	2011
Land	$ 17,767	17,767
Land improvements	8,312	4,687
Buildings	183,318	181,863
Equipment	134,569	125,373
Leasehold improvements	1,938	1,935
	345,904	331,625
Less accumulated depreciation	161,499	147,191
	184,405	184,434
Construction in process	29,184	7,392
	$ 213,589	191,826

Depreciation expense for the years ended December 31, 2012 and 2011 was $14,308 and $12,929, respectively.

(5) Other Assets

Other assets consist of the following at December 31:

	2012	2011
Deferred financing costs, net	$ 1,155	1,259
Bed licenses acquired	171	277
Other intangible assets	53	105
	$ 1,379	1,641

As of December 31, 2010, costs incurred with the issuance of the Series 2008C bonds, approximately $690 net of amortization, were deferred and are being amortized over the term of the related debt or letters of credit. During 2011, in connection with the refinancing discussed in note 7, $133 was written off and new financing costs of $876 were incurred relating to Series 2011 A, B and C. Further, the Hospitals incurred amortization expense of $104 and $174 for the years ended December 31, 2012 and 2011, respectively, which is included in the depreciation and amortization line item on the combined statement of operations and changes in net assets.

The costs of the bed licenses acquired associated with the purchase of Fallston General Hospital (FGH) in the amount of $2,999 was capitalized and is being amortized over its estimated useful life of 28 years.

(Continued)

(Dollars in thousands)

These bed licenses were transferred to UCMC when FGH closed in 2000. Accumulated amortization amounted to $2,828 and $2,722 at December 31, 2012 and 2011, respectively, and is included in the depreciation and amortization line item on the combined statements of operations and changes in net assets.

Other intangible assets associated with the acquisition of Surgery Pavilion in the amount of $520 were recorded and are being amortized over their estimated useful life of 10 years. Accumulated amortization amounted to $467 and $415 at December 31, 2012 and 2011, respectively, and is included in depreciation and amortization on the combined statements of operations and changes in net assets.

(6) Line of Credit

The Hospitals had an unsecured discretionary line of credit agreement, which expires in May 2013, with a bank that permitted the Hospitals to borrow up to $7,500 at LIBOR plus 125 basis points. There was no outstanding balance at December 31, 2012 and 2011.

(7) Long-Term Debt

Long-term debt consists of the following at December 31:

	2012	2011
Hospital revenue bonds:		
Series 2008 C (due January 1, 2038)	$ 52,470	53,365
Series 2011A (due January 1, 2043)	50,000	50,000
Series 2011B (due January 1, 2040)	58,330	59,225
Series 2011C (due January 1, 2040)	58,330	59,225
	219,130	221,815
Less amounts not drawn on Series 2011A	29,102	47,442
	190,028	174,373
Less bond discount	549	580
	189,479	173,793
Less current portion	2,980	895
	$ 186,499	172,898

The Series 2008C bonds are fixed rate term bonds obtained pursuant to the Amended and Restated Master Loan Agreement dated August 1, 2008 (the Master Loan Agreement) through the Maryland Health and Higher Educational Facilities Authority (the Authority or MHHEFA), which bear interest at 5.8% at December 31, 2012 and 2011. The Series 2008C Bonds were issued at a discount of $706. Accumulated amortization amounted to $157 and $126 at December 31, 2012 and 2011, respectively. The loan principal is payable annually on January 1 and the loan interest is payable to a trustee semiannually.

(Continued)

(Dollars in thousands)

The Series 2008C bonds are subject to mandatory annual sinking fund requirements. The 2013 sinking fund installment amount is $940. Sinking fund payments vary in increasing amounts from $940 to $3,750, with the final installment of $3,750 due in 2038.

On October 1, 2011, the Obligated Group entered into a Financing Agreement with MHHEFA and a lender for up to $50,000 of tax exempt Revenue Bonds, Series 2011A. The bonds are designated to support a capital project on the campus of UCMC, and bond proceeds are drawn upon as construction progresses. There was $20,898 and $2,558 drawn on the Series 2011A bonds as of December 31, 2012 and 2011, respectively. The Series 2011A bonds bear interest at 3.67% through October 31, 2021, and thereafter at LIBOR plus an applicable spread which is based on prevailing bond rates for similarly rated bonds. Principal payments on the Series 2011A bonds are due in annual installments on January 1 ranging from $935 in 2014 to $2,695 in 2043.

On December 1, 2011, MHHEFA issued $59,225 of tax exempt Revenue Bonds, Series 2011B on behalf of the Obligated Group. Bond proceeds were loaned to the Obligated Group pursuant to a First Supplemental Indenture of Trust and Supplemental Loan Agreement. The Series 2011B bonds bear interest at LIBOR plus 1.15%, subject to prevailing rates on bond spreads. The bond proceeds were used to refund the Series 2008B and a portion of the Series 2008A. Principal payments on the Series 2011B bonds are due in monthly installments ranging from $85 in 2013 to $430 in 2040. The Series 2011B bonds are subject to refinancing at the option of the bank in 2021.

On December 1, 2011, MHHEFA issued $59,225 of tax exempt Revenue Bonds, Series 2011C on behalf of the Obligated Group. Bond proceeds were loaned to the Obligated Group pursuant to a First Supplemental Indenture of Trust and Supplemental Loan Agreement. The Series 2011C bonds bear interest at LIBOR plus 0.95%, subject to prevailing rates on bond spreads. The bond proceeds were used to refund the Series 2008A. Principal payments on the Series 2011C bonds are due in monthly installments ranging from $85 in 2013 to $405 in 2040. The Series 2011C bonds are subject to refinancing at the option of the bank in 2017.

Annual principal maturities of long-term liabilities including sinking fund payments at December 31, 2012 are as follows:

2013	$	2,980
2014		4,040
2015		4,210
2016		4,390
2017		4,585
Thereafter		198,925
	$	219,130

The Hospitals are jointly and severally liable under the Master Loan Agreement. Pursuant to the Master Loan Agreement, the Hospitals are required to maintain certain funds on deposit with the trustee as described in note 2. As security for the performance of its obligations under the Master Loan Agreement, the Obligated Group has granted the Authority a security interest in its revenues.

The Obligated Group is also subject to certain qualitative and quantitative financial covenants as defined in the Master Loan Agreement and in the First Supplemental Indenture of Trust and Supplemental Loan Agreements, as long as the bonds are outstanding. The Obligated Group is in compliance with the debt covenants as of December 31, 2012.

Interest payments were $4,829 and $4,821 for the years ended December 31, 2012 and 2011, respectively.

The Hospitals use interest rate swaps as a part of its risk management strategy to manage exposure to fluctuations in interest rates and to manage the overall cost of its debt. The interest rate swaps are not used for speculative purposes and are measured at fair value in the combined balance sheet. The fair value of the interest rate swap agreements is the estimated amount that the Hospitals would receive or pay to terminate the swap agreements at the reporting date, taking into account current interest rates and the current creditworthiness of the swap counterparties. The swap agreements are valued based on readily observable market parameters for all substantial terms of the contracts and are therefore categorized as Level 2 securities. The fair market value of the swap agreements is included in other long-term liabilities in the accompanying combined balance sheet.

A derivative instrument (interest rate swap) was entered into in conjunction with the 2007 Series Bond issuance, with a notional amount of $116,150 at December 31, 2012 at a fixed rate of 3.915% and a floating rate of 67% of one-month LIBOR. The purpose of the swap is to convert variable rate debt to fixed rate debt. The unrealized loss of $(1,411) and $(10,265) is included in nonoperating income for the years ended December 31, 2012 and 2011, respectively. The fair value of the interest rate swap was approximately $(32,710) and $(31,299) at December 31, 2012 and 2011, respectively, and is included in other long-term liabilities.

A derivative instrument (basis swap) was entered into in 2006 with a notional amount of $92,540 at December 31, 2012. The unrealized gain of $1,177 and $2,114 is included in nonoperating income for the years ended December 31, 2012 and 2011, respectively. The fair value of the basis swap was approximately $80 and $(1,097) at December 31, 2012 and 2011, respectively, and is included in other long-term liabilities.

Settlement payments for the years ended December 31, 2012 and 2011 of $(3,822) and $(4,023), respectively, are included in the change in the fair value and settlement payments on derivative instruments.

(Dollars in thousands)

(8) Employee Benefit Plans

Defined Contribution Plan

UCHS sponsors a defined contribution benefit plan, which allows employees to contribute amounts tax-deferred up to certain limits allowable under IRS guidelines. The Hospitals are required to match up to 100% of employee contributions up to 4% of employee salaries, based on years of service. The Hospitals are also required to make a contribution of 1% of each employee's salary for all employees who work more than 1,000 hours annually. Additional contributions are required to be made by the Hospitals for employees aged 50 and older, who have completed 10 years of service. Employees vest in amounts contributed by the Hospitals ratably over a five-year period.

For the years ended December 31, 2012 and 2011, the Hospitals' expenses related to the defined contribution plan were approximately $4,244 and $3,301, respectively, and are included in the employee benefits line item on the combined statements of operations and changes in net assets.

Defined Benefit Plan

The Hospitals participate in a noncontributory defined benefit pension plan (the Plan), administered by UCHS, which covers substantially all employees of HMH, UCMC, UCHF, UCHS and UCSJHC who have completed six months of employment and attained the age of twenty and a half years. UCHS and certain of its subsidiaries make annual contributions to the Plan equal to the minimum funding requirement pursuant to ERISA regulations. UCHS is the plan sponsor and elected to freeze the defined benefit plan on December 31, 2005.

The following tables set forth the changes in the projected benefit obligation, the changes in Plan assets, the Plan's funded status, and amounts recognized in the combined financial statements at December 31:

		2012	2011
Projected benefit obligation, at beginning of year	$	63,132	55,567
Actual benefit payments		(1,931)	(1,774)
Loss due to differences between actual and assumed experience		7,072	6,041
Interest cost		3,266	3,298
Projected benefit obligation, at end of year		71,539	63,132
Fair value of plan assets, at beginning of year		52,932	51,725
Contributions		4,199	4,485
Actual benefit payments		(1,931)	(1,774)
Return on plan assets		6,636	(1,504)
Fair value of plan assets, at end of year		61,836	52,932
Funded status	$	(9,703)	(10,200)

(Continued)

(Dollars in thousands)

		2012	2011
Amounts recognized in unrestricted net assets:			
Net actuarial loss	$	(31,949)	(30,986)
Prior service cost		(23)	(32)
Accumulated amount in net assets	$	(31,972)	(31,018)

The estimated amounts that will be amortized from unrestricted net assets into net periodic pension cost in fiscal year ending December 31, 2013 are as follows:

Net actuarial loss	$	3,542
Prior service cost		8
	$	3,550

		2012	2011
Components of net periodic pension costs:			
Interest cost	$	3,266	3,298
Expected return on plan assets		(4,051)	(4,457)
Loss		3,524	2,238
Net amortization and deferral		8	8
Net periodic pension cost	$	2,747	1,087

Assumptions used to determine benefit obligations as of December 31, 2012 and 2011 were as follows: discount rate of 4.48% and 5.27% in 2012 and 2011, respectively, and expected long-term rate of return on assets of 7.50% and 8.50% in 2012 and 2011, respectively. Salary increases are not applicable to 2012 and 2011 because the Plan was frozen on December 31, 2005.

Assumptions used to determine net costs for 2012 and 2011 were as follows: discount rate of 5.27% and 6.05% in 2012 and 2011, respectively, and expected long-term rate of return on assets of 7.50% and 8.50% in 2012 and 2011, respectively.

The overall long-term rate of return was developed by estimating the expected long-term real return for each asset class within the portfolio, computing an average weighted real rate of return for the portfolio as a whole, reflecting both the Plan's expected asset class allocation and the correlations between the various asset classes and adding that expected real rate of return to the expected long-term rate of inflation. The expected long-term rate of return reflects an expected real rate of return and an underlying inflation component per year.

(Dollars in thousands)

The investment objective of the Plan is to produce a rate of return as determined by the Plan actuary. The Plan is diversified into equities, fixed income obligations, and cash and cash equivalents, so as to provide a reasonable assurance that no single security or class of securities will have a disproportionate impact on the Plan's rate of return. Equity securities are targeted at 55% with a range from 40% to 70%. Fixed income obligations and cash equivalents are targeted at 30% with a range from 10% to 50%. Periodic rebalancing takes place to maintain the desired allocation. Management may change these allocations at its discretion, although such changes are likely to occur infrequently.

The Plan's asset allocation at December 31, by asset category, is as follows:

	2012	2011
Asset category:		
Cash and equivalents	4%	7%
Common/preferred stock and mutual funds	57	52
Government bonds	9	11
Corporate bonds	30	30
Total	100%	100%

The following tables present the Plan's assets measured at fair value at December 31, 2012 and 2011:

	2012			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash and cash equivalents	$ 2,540	—	—	2,540
Common/preferred stock	21,780	—	—	21,780
Equity mutual funds and exchange traded funds	13,460	—	—	13,460
U.S. agency mortgage-backed and asset-backed securities	232	—	—	232
Corporate bonds	18,320	—	—	18,320
U.S. government obligations	5,008	—	—	5,008
Municipal bonds	496	—	—	496
Total assets	$ 61,836	—	—	61,836

(Continued)

(Dollars in thousands)

	2011			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets:				
Cash and cash equivalents	$ 3,975	—	—	3,975
Common/preferred stock	17,558	—	—	17,558
Equity mutual funds and exchange traded funds	9,839	—	—	9,839
U.S. agency mortgage-backed and asset-backed securities	4,074	—	—	4,074
Corporate bonds	15,693	—	—	15,693
U.S. government obligations	1,237	—	—	1,237
Municipal bonds	556	—	—	556
Total assets	$ 52,932	—	—	52,932

Equity and debt securities and fixed income obligations are measured using quoted market prices at the reporting date multiplied by the quantity held. Mortgage and asset-backed securities are measured using quoted market prices at the reporting date multiplied by the quantity held.

The Hospitals expect to contribute $4,000 to the Plan in 2013.

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

	Expected benefit payments
Fiscal years:	
2013	$ 2,519
2014	2,741
2015	2,998
2016	3,240
2017	3,444
2018 – 2022	19,933

(Continued)

(9) Certain Significant Risks and Uncertainties

(a) Regulation and Reimbursement

The Hospitals provide general acute healthcare services. The Hospitals and other healthcare providers in Maryland are subject to certain inherent risks, including the following:

- Dependence on revenues derived from reimbursement by the federal Medicare and state Medicaid programs
- Regulation of hospital rates by the HSCRC
- Government regulation, government budgetary constraints, and proposed legislative and regulatory changes
- Lawsuits alleging malpractice and related claims

Such inherent risks require the use of certain management estimates in the preparation of the Hospitals' combined financial statements and it is reasonably possible that a change in such estimates may occur.

The Medicare and state Medicaid reimbursement programs represent a substantial portion of the Hospitals' revenues and the Hospitals' operations are subject to a variety of other federal, state, and local regulatory requirements. Failure to maintain required regulatory approvals and licenses and/or changes in such regulatory requirements could have a significant adverse effect on the Hospitals. Changes in federal and state reimbursement funding mechanisms and related government budgetary constraints could have a significant adverse effect on the Hospitals.

The healthcare industry is also subject to numerous laws and regulations from federal, state and local governments, and the government has aggressively increased enforcement of Medicare and Medicaid anti-fraud and abuse laws. The Hospitals' compliance with these laws and regulations is subject to periodic governmental review, which could result in enforcement actions unknown or unasserted at this time. Noncompliance with such laws and regulations could result in repayments of amounts improperly reimbursed, substantial monetary fines, civil and criminal penalties, and exclusion from Medicare and Medicaid programs.

The federal government and many states have aggressively increased enforcement under Medicare and Medicaid anti-fraud and abuse laws and physician self referral laws (STARK law and regulation). Recent federal initiatives have prompted a national review of federally funded healthcare programs. In addition, the federal government and many states have implemented programs to audit and recover potential overpayments to providers from the Medicare and Medicaid programs. The Hospitals receive requests from the recovery audit contractors and have implemented a response program as well as a compliance program to monitor conformance with applicable laws and regulations, but the possibility of future government review and enforcement action exists.

As a result of recently enacted and pending federal healthcare reform legislation, substantial changes are anticipated in the United States healthcare system. Such legislation includes numerous provisions affecting the delivery of healthcare services, the financing of healthcare costs, reimbursement to healthcare providers and the legal obligations of health insurers, providers and employers. These provisions are currently slated to take effect at specified times over the next decade. This federal healthcare reform legislation did not affect the 2012 or 2011 combined financial statements.

(b) Malpractice

Claims alleging malpractice have been asserted against the Hospitals and are currently in various stages of litigation. Additional claims may be asserted arising from services provided to patients through December 31, 2012.

On October 1, 2005, the Hospitals entered into an insurance agreement whereby the malpractice claims are being administered through a captive insurance company (Upper Chesapeake Insurance Company LTD or the Captive) domiciled in the Cayman Islands, which is wholly owned by UCHS. The Captive is managed by Kane, a management company based in the Cayman Islands. The Hospitals incurred premiums for claims-made insurance policies of $3,997 and $3,379 for the years ended December 31, 2012 and 2011, respectively. Retention limits on which the Captive assumes the risk of loss are based on an annual occurrence basis of $1,000 per occurrence and $6,000 in the aggregate.

The Hospitals have accrued $2,922 and $2,505 at December 31, 2012 and 2011, respectively, for claims that are incurred but not reported. These balances are recorded in accrued salaries, benefits and other in the accompanying combined balance sheet.

As discussed in note 1(w), the Hospitals recorded an additional accrual for medical malpractice claims which resulted in an additional liability and related intercompany receivable of $15,186 and $11,428 at December 31, 2012 and 2011, respectively.

In the opinion of management, based upon information provided by its advisors, estimated malpractice costs accrued at December 31, 2012 and 2011 are adequate to provide for potential losses resulting from pending or threatened litigation or for losses incurred but not reported claims.

(c) Welfare Benefit Plan

The Hospitals participate in a welfare benefit plan established by UCHS effective January 1, 1998. The purpose of this plan is to provide eligible employees and their dependents with coverage for hospital and medical expenses on a self-insured basis, subject to risk retention limits, and to provide dental and vision benefits pursuant to specified insurance policies and contracts. An estimate for incurred-but-not-reported health insurance claims of $1,719 and $1,403 has been accrued and recorded in accrued salaries, benefits, and other in the accompanying combined balance sheets at December 31, 2012 and 2011, respectively.

(d) Workers' Compensation

The Hospitals participate in a self-insured plan for workers' compensation claims. Stop-loss coverage has been purchased through a commercial insurer for claims in excess of $500. Accrued claims of $2,913 and $3,046 include estimates for incidents incurred but not reported and are included in accrued salaries, benefits, and other in the accompanying combined balance sheets at December 31, 2012 and 2011, respectively. The Hospitals maintain a surety bond in the amount of $4,200 and a letter of credit in the amount of $1,680 to secure payments on the outstanding workers' compensation claims as required by the State of Maryland Workers' Compensation Commission.

(e) Unemployment

The Hospitals maintain a letter of credit in the amount of $1,255 for the purpose of securing unemployment benefit payments as required by the State of Maryland.

(f) Litigation

From time to time, the Hospitals are involved in litigation and regulatory investigations arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on the Hospitals' future financial position or results of operations.

(g) Asset Retirement Obligation

The Hospitals have recorded an Asset Retirement Obligation (ARO) for asbestos removal. The liability is recognized at its net present value with a corresponding increase to the carrying amount of the long-lived asset to which the ARO relates. The estimated asbestos removal costs are $1,212 and $1,303 as of December 31, 2012 and 2011, respectively, and are included in other long-term liabilities. During 2012, there were payments made of $109 related to asbestos removal, along with annual accretion of $17.

(10) Leases

The Hospitals have several operating lease agreements for office space, computer and medical equipment, office machines and vehicles. Total rent expense recorded by the Hospitals under these leases was approximately $3,828 and $4,619 for the years ended December 31, 2012 and 2011, respectively.

(Continued)

(Dollars in thousands)

Future rental payments under noncancelable operating leases with durations in excess of one year are as follows:

2013	$	3,560
2014		2,483
2015		1,440
2016		375
2017		43
	$	7,901

(11) Charity Care, Bad Debt and Other Deductions from Revenue

The Hospitals provide care to patients regardless of their ability to pay. In identifying charity care, the Hospitals assess the patient's ability to pay, utilizing generally recognized poverty income levels for the community, and identify certain cases where incurred charges are considered to be beyond the patient's ability to pay. The Hospitals maintain records to identify and monitor the level of charity care they provide. These records reflect the amount of charges forgone under their charity care policy and amounted to approximately $7,829 and $7,214 for the years ended December 31, 2012 and 2011, respectively. The total direct and indirect costs to provide the care amounted to approximately $5,835 and $5,331 for the years ended December 31, 2012 and 2011, respectively.

In addition to the direct charity care noted above, all patients covered by the Medicare and Medicaid and other third-party payors programs are accepted. These programs reimburse the Hospitals at less than the established charges for services provided to recipients. During 2012, the state instituted a charge based on the amount of revenue covered by hospitals for Medicaid Services rendered (Medicaid Assessment). The difference between the charges for these services and the related reimbursement amounts for these and other third-party payors are as follows for the years ended December 31:

		2012	**2011**
Medicare	$	25,826	20,806
Medicaid		436	606
Other third-party payors		6,365	4,711
	$	32,627	26,123

The Hospitals also provide free services to the community through their "Healthlink" program. The "Healthlink" program provides health information, wellness programs, health screenings, and educational programs.

Patient accounts receivable are reduced by an allowance for bad debts. In evaluating the collectability of accounts receivable, the Hospitals analyze historical collections and write-offs and identify trends for each of its major payor sources of revenue to estimate the appropriate allowance for bad debts and provision for

(Dollars in thousands)

bad debts. Management regularly reviews data about these major payor sources of revenue in evaluating the sufficiency of the allowance for bad debts. For receivables associated with services provided to patients who have third-party coverage, the Hospitals analyze contractually due amounts and provide an allowance for bad debts, allowance for contractual adjustments, provision for bad debts, and contractual adjustments on accounts for which the third-party payor has not yet paid or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely. For receivables associated with self-pay patients or with balances remaining after the third-party coverage has already paid, the Hospitals record a significant provision for bad debts in the period of service on the basis of its historical collections, which indicates that many patients are unwilling to pay the portion of their bill for which they are financially responsible. The difference between the discounted rates and the amounts collected after all reasonable collection efforts have been exhausted is charged off against the allowance for bad debts.

		2012	2011
Beginning allowance and contractuals	$	(17,806)	(11,381)
Plus provision for bad debt		(21,191)	(23,124)
Less bad debt write-offs and contractuals		19,569	16,699
Ending allowance and contractuals	$	(19,428)	(17,806)

The change in the allowance for bad debts during 2012 is attributable to increased patient volumes in 2012, and trends experienced in the collection of the related patient receivables.

(12) Related-Party Transactions

UCHS provides management, promotion, and other support services to the Hospitals. Fees relating to such services are allocated to these entities based on management's estimate of UCHS resources consumed at each entity. Such services were allocated 84.0% and 88.5% to the Hospitals in 2012 and 2011, respectively. Fees to UCHS included in other operating expenses were $11,624 and $10,823 in 2012 and 2011, respectively.

UCMS provides physician and other support services to the Hospitals. Fees to UCMS included in operating expenses were $3,447 and $3,535 for the years ended December 31, 2012 and 2011, respectively. The Obligated Group transferred $13,511 and $10,024 during 2012 and 2011, respectively, to UCMS, representing an equity contribution. The Hospitals have entered into an agreement with a bank whereby the Hospitals are the guarantor for an unsecured discretionary line of credit agreement between the bank and UCMS. The line of credit agreement permits UCMS to borrow up to $3,500. The amount outstanding under this agreement was $1,200 as of December 31, 2012 and 2011, respectively.

UCHF contributed $552 and $701 to the Hospitals for capital improvements and equipment purchases for the years ended December 31, 2012 and 2011, respectively. These amounts are presented as contributions for purchases of property and equipment in the combined financial statements.

(Continued)

(Dollars in thousands)

On December 31, 2011, UCP, which supports the provision of healthcare services at HMH, contributed property with a book value of $2,292 to the Obligated Group.

The Obligated Group recognizes its rights to assets held by recipient organizations, which accept cash or other financial assets from a donor and agree to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both, to the Obligated Group. In 2011 UCF embarked on the campaign for the Cancer Center at Upper Chesapeake Health. The contributions will be used for the benefit of the Cancer Center which will be on the campus of UCMC. As such, the Obligated Group recorded an economic interest in the net assets of UCF of $11,390 and $7,007 for the years ended December 31, 2012 and 2011, respectively. The donor restricted gifts are included as an increase in temporarily restricted net assets in the combined statement of operations and changes in net assets.

Net amounts receivable from (payable to) affiliates at December 31 are summarized as follows:

		2012	2011
UCHS and subsidiary	$	19,983	3,951
UCLD		—	3,341
UCMS		5,630	6,465
Captive		309	11,684
UCRHH		324	366
UCP		1	64
UCHV		(1,456)	339
UCF		2,713	1,549
	$	27,504	27,759

(13) Fair Value Measurements

(a) Fair Value of Financial Instruments

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

(Continued)

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

Cash and cash equivalents, accounts receivable, due from affiliates, other assets, accounts payable, advances from third-party payors, due to affiliates, and accrued expenses: The carrying amounts, at face value or cost plus accrued interest, approximate fair value because of the short maturity of these instruments.

Board-designated and other investments: Equity and debt securities classified as trading and fixed income obligations are measured using quoted market prices at the reporting date multiplied by the quantity held. Mortgage and asset-backed securities are measured using quoted market prices at the reporting date multiplied by the quantity held.

Derivative instruments: The fair value of derivative instruments is determined using pricing models developed based on the LIBOR swap rate and other observable market data. The value was determined after considering the potential impact of collateralization and netting agreements, adjusted to reflect nonperformance risk of both the counterparty and the Obligated Group.

(b) Long-Term Debt

The Series 2008C and Series 2011A, B and C bonds bear interest at variable rate and fixed rates and, at December 31, 2012, had a fair value of $195,877. The fair value of the outstanding debt at December 31, 2011 was $178,676.

The fair value of the Hospitals' long-term debt is measured using quoted offered-side prices when quoted market prices are available. If quoted market prices are not available, the fair value is determined by discounting the future cash flows of each instrument at rates that reflect, among other things, market interest rates and the Hospitals' credit standing. In determining an appropriate spread to reflect its credit standing, the Hospitals consider credit default swap spreads, bond yields of other long-term debt offered by the Hospitals, and interest rates currently offered to the Hospitals for similar debt instruments of comparable maturities by the Hospitals' bankers as well as other banks that regularly compete to provide financing to the Hospitals.

(Dollars in thousands)

(c) Fair Value Hierarchy

The following tables present assets and liabilities that are measured at fair value on a recurring basis at December 31, 2012 and 2011:

	2012			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets:				
Cash and cash equivalents	$ 11,499	—	—	11,499
Common/preferred stock	17,422	—	—	17,422
Equity mutual funds and exchange traded funds	19,082	—	—	19,082
U.S. agency mortgage-backed and asset-backed securities	13,544	—	—	13,544
Corporate bonds	27,231	—	—	27,231
U.S. government obligations	4,924	—	—	4,924
Municipal bonds	1,103	—	—	1,103
Total assets	$ 94,805	—	—	94,805
Liabilities:				
Derivative instruments	$ —	32,630	—	32,630

	2011			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets:				
Cash and cash equivalents	$ 13,258	—	—	13,258
Common/preferred stock	14,495	—	—	14,495
Equity mutual funds and exchange traded funds	14,410	—	—	14,410
U.S. agency mortgage-backed and asset-backed securities	13,506	—	—	13,506
Corporate bonds	22,243	1,203	—	23,446
U.S. government obligations	9,807	—	—	9,807
Municipal bonds	636	—	—	636
Total assets	$ 88,355	1,203	—	89,558
Liabilities:				
Derivative instruments	$ —	32,396	—	32,396

(Continued)

(Dollars in thousands)

The Hospitals' accounting policy is to recognize transfers between levels of the fair value hierarchy on the date of the event or change in circumstances that caused the transfer. There were no significant transfers into or out of Level 1 or Level 2 for the year ended December 31, 2012.

(14) Functional Expenses

The Hospitals provide general healthcare services to residents within their geographic locations. Expenses related to providing these services, based on management's estimates of expense allocations, are as follows for the years ended December 31:

		2012	2011
Healthcare services	$	253,196	229,503
General and administrative		56,186	49,626
	$	309,382	279,129

(15) Subsequent Events

The Hospitals evaluated all events and transactions that occurred after December 31, 2012 and through April 26, 2013. The Hospitals did not have any material recognizable subsequent events during this period.

Schedule 1

HARFORD MEMORIAL HOSPITAL, INC. AND
UPPER CHESAPEAKE MEDICAL CENTER, INC.

Combining Balance Sheet Information

December 31, 2012

(In thousands)

Assets		Upper Chesapeake Medical Center, Inc.	Harford Memorial Hospital, Inc.	Eliminations		Combined
Current assets:						
Cash and cash equivalents	$	18,588	18,485	—		37,073
Current portion of assets held by trustee		2,153	410	—		2,563
Board-designated and other investments		41,529	—	—		41,529
Patient accounts receivable, net		27,904	12,722	—		40,626
Prepaid expenses and other current assets		8,600	3,897	—		12,497
Total current assets		98,774	35,514	—		134,288
Due from affiliates		62,105	4,405	(37,550)	(a)	28,960
Assets held by trustee, less current portion		3,397	647	—		4,044
Board designated and other investments, less current portion		—	49,268	—		49,268
Property, plant, and equipment, net		176,482	37,107	—		213,589
Economic interest in net assets of foundation		11,390	—	—		11,390
Other assets		1,263	116	—		1,379
Total assets	$	353,411	127,057	(37,550)		442,918
Liabilities and Net Assets						
Current liabilities:						
Accounts payable	$	13,204	9,389	—		22,593
Accrued salaries, benefits and other		17,378	9,068	—		26,446
Current portion of long-term debt		2,489	491	—		2,980
Advances from third-party payors		5,794	1,728	—		7,522
Total current liabilities		38,865	20,676	—		59,541
Due to affiliates		1,456	37,550	(37,550)	(a)	1,456
Long-term debt, less current portion		160,030	26,469	—		186,499
Other long-term liabilities		53,817	5,274	—		59,091
Pension liability		6,792	2,911	—		9,703
Total liabilities		260,960	92,880	(37,550)		316,290
Unrestricted net assets		81,061	34,177	—		115,238
Temporarily restricted net assets		11,390	—	—		11,390
Total net assets		92,451	34,177	—		126,628
Total liabilities and net assets	$	353,411	127,057	(37,550)		442,918

Combining eliminations:
(a) Eliminate intercompany receivables and payables.

See accompanying independent auditors' report.

Schedule 2

HARFORD MEMORIAL HOSPITAL, INC. AND UPPER CHESAPEAKE MEDICAL CENTER, INC.

Combining Statement of Operations Information

Year ended December 31, 2012

(In thousands)

	Upper Chesapeake Medical Center, Inc.	Harford Memorial Hospital, Inc.	Combined
Operating activities:			
Unrestricted revenues, gains, and other support:			
Patient service revenue (net of contractual allowances and discounts)	$ 249,533	92,197	341,730
Provision for bad debts	(12,082)	(9,109)	(21,191)
Net patient service revenue	237,451	83,088	320,539
Other	7,548	3,412	10,960
Total unrestricted revenues, gains, and other support	244,999	86,500	331,499
Expenses:			
Salaries	84,042	37,744	121,786
Employee benefits	20,657	9,309	29,966
Supplies and other operating expenses	106,627	31,050	137,677
Depreciation and amortization	10,567	4,019	14,586
Interest and amortization	3,959	1,408	5,367
Total expenses	225,852	83,530	309,382
Operating income	19,147	2,970	22,117
Nonoperating income:			
Investment income	454	5,297	5,751
Change in the fair value and settlement payments on derivative instruments	(4,056)	—	(4,056)
Nonoperating income (loss)	(3,602)	5,297	1,695
Excess of revenues over expenses	15,545	8,267	23,812
Other changes in unrestricted net assets:			
Contributions for purchases of property and equipment	377	1,094	1,471
Pension – related changes other than net periodic pension cost	(668)	(286)	(954)
Transfers (to) from affiliates, net	(13,916)	129	(13,787)
Increase in unrestricted net assets	1,338	9,204	10,542
Changes in temporarily restricted net assets:			
Donor restricted gifts	4,383	—	4,383
Increase in temporarily restricted net assets	4,383	—	4,383
Net assets, beginning of year	86,732	24,971	111,703
Net assets, end of year	$ 92,453	34,175	126,628

See accompanying independent auditors' report.