



**Consolidated Financial Statements,  
Supplementary Information, and Report of  
Independent Certified Public Accountants**

**Meritus Medical Center, Inc.**

**June 30, 2014 and 2013**

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## Report of Independent Certified Public Accountants

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We have audited the accompanying consolidated financial statements of Meritus Medical Center, Inc. (“Meritus”), which comprise the consolidated balance sheets as of June 30, 2014 and 2013, and the related consolidated statements of operations and change in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management’s responsibility for the financial statements

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

Auditor’s responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 consolidated financial statements.

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

**Draft**  
TENTATIVE AND PRELIMINARY

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Meritus Medical Center, Inc. as of June 30, 2014 and 2013, and the results of its operations and changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Supplementary Information

The accompanying consolidating balance sheet as of June 30, 2014 and consolidating statement of operations and changes in net assets for the years then ended is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such supplementary information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures. These additional procedures included comparing and reconciling the information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the supplementary information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

*Grant Thornton LLP*

Baltimore, Maryland  
October 7, 2014

## **CONSOLIDATED FINANCIAL STATEMENTS**

**Meritus Medical Center, Inc.**  
**CONSOLIDATED BALANCE SHEETS**

**June 30,**

ASSETS	2014	2013
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 23,028,552	\$ 18,808,563
Restricted cash	3,334,609	2,747,487
Short-term investments	13,546,738	10,259,473
Current portion of assets whose use is limited	10,269,752	11,648,408
Accounts receivable, net	60,374,652	63,030,783
Supplies	7,140,311	9,165,678
Prepaid and other current assets	<u>7,837,111</u>	<u>6,969,973</u>
Total current assets	125,531,725	122,630,365
 <b>EQUITY INVESTMENTS IN AFFILIATES</b>	 22,296,346	 22,551,905
 <b>ASSETS WHOSE USE IS LIMITED</b>		
Board designated funds	119,276,606	94,196,257
Supplemental retirement benefit investments	4,502,797	4,094,548
Temporarily and permanently restricted donor funds	<u>1,165,290</u>	<u>1,159,895</u>
	124,944,693	99,450,700
Assets held by trustee under bond indenture agreement	18,431,372	18,346,435
Funds designated for insurance purposes	<u>11,122,821</u>	<u>9,460,701</u>
	154,498,886	127,257,836
 <b>PROPERTY, PLANT AND EQUIPMENT, net</b>	 254,417,012	 269,270,634
 <b>PLEDGES RECEIVABLE, net</b>	 904,833	 2,862,307
 <b>DEFERRED FINANCING COSTS, net</b>	 2,390,299	 2,515,084
 <b>OTHER ASSETS</b>	 <u>2,149,163</u>	 <u>2,971,783</u>
Total assets	<u>\$562,188,264</u>	<u>\$550,059,914</u>

*The accompanying notes are an integral part of these financial statements.*

<b>LIABILITIES AND NET ASSETS</b>	<u>2014</u>	<u>2013</u>
<b>CURRENT LIABILITIES</b>		
Accounts payable and accrued expenses	\$ 13,966,990	\$ 13,761,319
Accrued salaries, wages and withholdings	8,785,577	8,138,663
Accrued compensation benefit	11,286,870	12,092,642
Advances from third-party payors	6,741,663	7,510,014
Accrued interest payable	7,267,031	7,642,631
Current portion of long-term debt	<u>4,802,704</u>	<u>6,444,712</u>
Total current liabilities	52,850,835	55,589,981
<b>LONG-TERM DEBT</b> , net of current portion	250,014,108	254,747,107
<b>ACCRUED RETIREMENT BENEFITS</b>	5,006,646	4,480,453
<b>OTHER LONG-TERM LIABILITIES</b>	<u>7,184,860</u>	<u>6,733,140</u>
Total liabilities	315,056,449	321,550,681
<b>NET ASSETS</b>		
Unrestricted		
Meritus	240,478,231	220,287,217
Non-controlling interest	<u>532,145</u>	<u>901,526</u>
Total unrestricted net assets	241,010,376	221,188,743
Temporarily restricted	5,092,821	6,291,872
Permanently restricted	<u>1,028,618</u>	<u>1,028,618</u>
Total net assets	247,131,815	228,509,233
Total liabilities and net assets	<u>\$562,188,264</u>	<u>\$550,059,914</u>

# Meritus Medical Center, Inc.

## CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS

Years ended June 30,

	2014	2013
<b>Unrestricted revenue, gains and other support</b>		
Net patient service revenue	\$361,575,439	\$370,863,385
Less provision for bad debts	<u>(14,554,244)</u>	<u>(14,416,252)</u>
Net patient service revenue less provision for bad debts	347,021,195	356,447,133
Other revenue	10,415,853	13,001,011
Equity earnings in affiliates	1,692,686	2,911,678
Net assets released from restriction used for operations	<u>1,309,061</u>	<u>2,174,772</u>
	360,438,795	374,534,594
<b>Expenses</b>		
Salaries and wages	142,181,627	145,051,579
Employee benefits	39,280,455	38,101,662
Professional fees	11,196,748	8,862,757
Supplies and other	129,462,523	131,933,187
Interest	14,435,032	14,959,202
Depreciation and amortization	<u>21,876,123</u>	<u>24,171,012</u>
	358,432,508	363,079,399
Operating income before other items	2,006,287	11,455,195
<b>Other items</b>		
Pension settlement costs	<u>-</u>	<u>(11,291,050)</u>
	-	(11,291,050)
Operating income	2,006,287	164,145
<b>Non-operating gains (losses), net</b>		
Investment returns, net	15,736,822	10,380,915
Other, net	(48,605)	(2,596,927)
Income tax benefit	<u>1,497,360</u>	<u>1,116,333</u>
Excess of revenue over expenses	19,191,864	9,064,466
<b>Deficiency in revenue over expenses attributable to non-controlling interest</b>	<u>369,381</u>	<u>128,065</u>
Excess of revenue over expenses attributable to Meritus	19,561,245	9,192,531

*The accompanying notes are an integral part of these financial statements.*

	<u>2014</u>	<u>2013</u>
<b>Other changes in unrestricted net assets</b>		
Change in retirement benefit obligation	-	11,291,050
Change in non-controlling interests	(369,381)	(1,708,065)
Net assets released from restriction for property, plant, and equipment	<u>629,769</u>	<u>1,722,373</u>
Increase in unrestricted net assets	19,821,633	20,497,889
<b>Temporarily restricted net assets</b>		
Contributions	739,679	959,301
Net assets released from restriction for property, plant, and equipment	(629,769)	(1,722,373)
Net assets released from restrictions for operations	<u>(1,308,961)</u>	<u>(2,174,772)</u>
Decrease in temporarily restricted net assets	<u>(1,199,051)</u>	<u>(2,937,844)</u>
INCREASE IN NET ASSETS	18,622,582	17,560,045
<b>Net assets</b>		
Beginning of year	<u>228,509,233</u>	<u>210,949,188</u>
End of year	<u>\$247,131,815</u>	<u>\$228,509,233</u>

# Meritus Medical Center, Inc.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended June 30,

	2014	2013
<b>Cash flows from operating activities</b>		
Increase in net assets	\$ 18,622,582	\$17,560,045
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	21,876,123	24,171,012
Provision for bad debts	14,554,244	14,416,252
Change in retirement benefit obligation	-	(11,291,050)
Change in non-controlling interest	369,381	1,708,065
Net realized and unrealized gains on investments	(12,617,505)	(7,632,673)
Loss on disposal of assets	(17,628)	(673,041)
Equity earnings in affiliates	(1,692,686)	(2,911,678)
Changes in assets and liabilities		
Accounts receivable	(11,898,113)	(26,337,141)
Supplies, prepaid, and other current assets	1,158,229	(761,038)
Other assets	2,780,094	292,391
Accounts payable, accrued expenses and long-term liabilities	1,141,312	(2,075,838)
Accrued salaries, wages and withholdings	646,914	3,178,738
Accrued compensation benefit	(805,772)	6,632,664
Advances from third-party payors	(768,351)	(110,616)
Interest payable	(375,600)	(121,388)
Accrued retirement benefits	(526,193)	269,759
Net cash provided by operating activities	32,447,031	16,314,463
<b>Cash flows from investing activities</b>		
Purchase of property, plant and equipment	(8,508,707)	(9,638,965)
Proceeds from the disposal of assets	1,628,620	3,110,516
Purchase of restricted cash, short-term investments, and assets whose use is limited	(147,918,420)	(38,547,804)
Sale of restricted cash, short-term investments, and assets whose use is limited	130,799,144	23,689,907
Equity distributions from affiliates, net	2,317,626	4,531,871
Net cash used in investing activities	(21,681,737)	(16,854,475)

*The accompanying notes are an integral part of these financial statements.*

	<u>2014</u>	<u>2013</u>
<b>Cash flows from financing activities</b>		
Payments on long-term debt	<u>(6,595,525)</u>	<u>(7,905,368)</u>
Net cash used in financing activities	<u>(6,595,525)</u>	<u>(7,905,368)</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	4,219,989	(8,445,380)
<b>Cash and cash equivalents</b>		
Beginning of year	<u>18,808,563</u>	<u>27,253,943</u>
End of year	<u>\$ 23,028,552</u>	<u>\$18,808,563</u>
<b><u>Supplemental disclosure of cash flow information:</u></b>		
Cash paid for income taxes	\$ -	\$ 928,028
Cash paid for interest	14,810,632	15,080,590
<b><u>Supplemental disclosure of non-cash investing and financing activities:</u></b>		
Assets acquired under capital leases	\$ 50,220	\$ -
Decrease in accrual for the purchase of property, plant and equipment	-	(183,885)

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2014 and 2013

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### 1. DESCRIPTION OF ORGANIZATION

#### Organization

Until January 31, 2013, Meritus Health, Inc. was the parent corporation of the Meritus Medical Center, Inc., Meritus Enterprises, the Meritus Medical Center Endowment Fund, Inc., the Meritus Healthcare Foundation, Inc., and the Meritus Insurance Company, Ltd.

Effective February 1, 2013, Meritus Health, Inc. completed a corporate reorganization. The goal of the reorganization was to facilitate an improved governance structure. The Meritus Medical Center Endowment Development Company, Inc., the Meritus Medical Center Endowment Fund and Meritus Health, Inc. all merged into Meritus Medical Center, Inc. The surviving organization, Meritus Medical Center, Inc. (“Hospital”) is the parent corporation of the Meritus Healthcare Foundation, Inc. (“Foundation”), the Meritus Insurance Company, Ltd. (“MIC”) and Meritus Holdings, LLC (“Holdings”), which owns Meritus Enterprises (“MEI”). These entities are collectively referred to as “Meritus”.

The Hospital is a not-for-profit acute care hospital located in Hagerstown, Maryland and serves the residents of western Maryland, southern Pennsylvania, and the panhandle of West Virginia. The Hospital currently offers acute general hospital inpatient services including adult medical/surgical care, obstetrics and newborn care, including a family birthing center, cardiac catheterizations, comprehensive inpatient rehabilitation, radiology and diagnostic services, inpatient and outpatient mental health services, a regional Level III Trauma Center, an intensive care unit, a progressive care unit, a coronary care unit, and a pediatric unit. The Hospital also manages gifts, donations or bequests given for the benefit of Meritus and acquires real estate properties for rental to medical provider entities and development opportunities.

The Foundation is a not-for-profit corporation whose purpose is to raise philanthropic support for the capital and endowment campaigns of the Hospital. The Foundation also raises money for the Hospital’s medical programs, healthcare objectives, scientific research, educational programs, and related community activities. Resources for the Foundation’s activities are primarily provided by donors.

MIC is a Cayman Island captive insurance company, wholly-owned by the Hospital that provides primary limits of insurance to Meritus for professional liability, employed physicians professional liability, comprehensive general liability, deductible, and stop loss coverage for health insurance.

Holdings is a tax-exempt entity that operates a laboratory, urgent care centers, and other health services. The Hospital is the sole member of Holdings.

MEI is a for-profit corporation that operates retail pharmacies, physician practices, and other health services. During the year ended June 30, 2014, MEI disposed of the retail pharmacies. In addition, MEI holds a 60% interest in Robinwood Surgery Center which provides ambulatory surgery services and a 50% interest in Diagnostic Imaging Services which provides outpatient imaging services.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

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### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Hospital, Holdings, MEI, the Foundation, and MIC. MEI owns a 60% interest in Robinwood Surgery Center, LLC, at June 30, 2014 and 2013, which is included in the consolidated financial statements with the related non-controlling interest reported as a component of net assets. All material inter-company balances and transactions have been eliminated in consolidation.

#### Use of Estimates

The preparation of consolidated financial statements, in conformity with accounting principles generally accepted in the United States of America, 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Accordingly, actual results could differ from those estimates. The most significant management estimates and assumptions related to the determination of allowance for doubtful accounts and contractual allowances for patient accounts receivable, tax accruals, useful lives of property, plant and equipment, self-insured reserves, including professional and general liabilities and the reported fair values of certain assets and liabilities.

#### Fair Value Measurements

Meritus measures fair value as the price that would be received to sell an asset or paid to transfer a liability (the exit price) in an orderly transaction between market participants at the measurement date. The accounting guidance outlines a valuation framework and creates a fair value hierarchy in order to increase the consistency and comparability of fair value measurements and the related disclosures. The fair value hierarchy is broken down into three levels based on the source of inputs as follows:

- Level I** - Quoted prices are available in active markets for identical assets or liabilities as of the report date. A quoted price for an identical asset or liability in an active market provides the most reliable fair value measurement because it is directly observable to the market.
- Level II** - Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the report date. The nature of these securities include investments for which quoted prices are available but traded less frequently and investments that are fair valued using other securities, the parameters of which can be directly observed.
- Level III** - Securities that have little to no pricing observability as of the report date. These securities are measured using management's best estimate of fair value, where the inputs into the determination of fair value are not observable and require significant management judgment or estimation.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

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### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

#### **Fair Value Measurements - continued**

Financial instruments consist of cash equivalents, patient accounts receivable, investments, excluding those accounted for by the equity method, accounts payable and accrued expenses and long-term debt. The carrying amounts reported in the consolidated balance sheets for cash equivalents, patient accounts receivable, and accounts payable and accrued expenses approximate fair value. Management's estimates of other financial instruments are described elsewhere in the notes to the consolidated financial statements.

#### **Patient Accounts Receivable/Allowance for Doubtful Accounts**

Patient accounts receivable result from the healthcare services provided by Meritus. Meritus provides an allowance for doubtful accounts for estimated losses resulting from the unwillingness or inability of patients or third-party payors to make payments for services. The allowance is determined by analyzing specific accounts and historical data and trends. Patient accounts receivable are charged off against the allowance for doubtful accounts when management determines that recovery is unlikely and Meritus ceases collection efforts. Losses have been consistent with management's expectations.

#### **Cash and Cash Equivalents**

Cash and cash equivalents consist of short-term, highly liquid investments that are readily convertible to cash and have original maturities of three months or less. Cash and cash equivalents are carried at cost which approximates fair value.

#### **Assets Whose Use is Limited**

Assets whose use is limited include assets set aside by the Board of Directors for specific purposes, for supplemental retirement benefit investments, to fulfill donor purposes, assets held by trustees under bond indenture agreement, and funds designated for insurance purposes. Amounts required to meet current liabilities are shown as current assets in the consolidated balance sheets.

#### **Investments and Investment Income**

Investments in equity securities (i.e., investments that have readily determinable fair values and are not accounted for by the equity method) and all investments in debt securities are reported at fair value on the consolidated balance sheets, under the fair value option.

Investment income, which includes interest and dividends, on proceeds of borrowings that are held by a trustee are reported as other revenue. Other investment income, which includes interest, dividends and realized and unrealized gains and losses on assets limited as to use by Board of Directors and funds designated for insurance purposes are recorded as non-operating gains (losses), net, unless the income or loss is restricted by donor or law.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

#### Investments and Investment Income - continued

Meritus' investments are managed by investment managers. Investment securities, in general, are exposed to various risks, such as interest rate, credit and overall market volatility. Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such change could materially affect the amounts reported in the consolidated financial statements.

#### Supplies

Supplies for the Hospital are carried at the lower of cost or market on a weighted average basis.

Supplies for Holdings and MEI are valued at the lower of cost or market, with the cost being recorded on the first-in, first-out method.

Major classes of supplies as of June 30, are as follows:

	<u>2014</u>	<u>2013</u>
<b>Hospital:</b>		
Surgical and medical supplies	\$5,009,480	\$4,351,832
Other supplies	<u>881,403</u>	<u>855,238</u>
	5,890,883	5,207,070
<b>Holdings and MEI:</b>		
Durable medical equipment	403,379	470,604
Surgical and medical supplies	414,652	507,531
Pharmacy and home care infusion	-	2,257,508
Medical laboratory	<u>431,398</u>	<u>722,962</u>
	<u>1,249,429</u>	<u>3,958,605</u>
	<u>\$7,140,312</u>	<u>\$9,165,675</u>

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

#### Property, Plant and Equipment

Property, plant and equipment acquisitions are recorded at cost. Those assets acquired by gift are carried at amounts established as fair value at the time of acquisition. Depreciation is provided over the estimated useful life of each class of depreciable assets and is computed using the straight-line method. Equipment under capital lease is amortized by the straight-line method over the shorter of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the consolidated financial statements. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. No interest was capitalized during the years ended June 30, 2014 and 2013. Durable medical equipment held for resale is included in supplies. The remainder of durable medical equipment is rented to patients and is included in property, plant and equipment. Assets are retired or disposed of at book value and related gains or losses are recorded for assets sold. Useful lives range as follows:

Land improvements	5 - 25 years
Buildings	10 - 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 unless explicit donor stipulations specify how the donated assets must be used. When applicable, 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-lived assets must be maintained, expirations of donor restrictions, occur when the donated or acquired long-lived assets are placed into service.

Meritus continually evaluates whether events and circumstances have occurred that indicate the remaining estimated useful life of long-lived assets is appropriate, or whether the remaining balance may not be recoverable. When factors indicate that long-lived assets should be evaluated for possible impairment, Meritus uses an estimate of the related undiscounted operating income over the remaining life of the long-lived asset in measuring whether the long-lived asset is recoverable. The impairment loss on these assets is measured as the excess of the carrying amount of the asset over its fair value. Fair value is based upon market prices, where available, or discounted cash flows. Management believes that no revision to the remaining useful lives or write-down of long-lived assets is required at June 30, 2014.

#### Deferred Financing Costs

Financing costs incurred in issuing debt have been capitalized and are being amortized over the life of the debt using the interest method.

#### Advertising Costs

Advertising costs for the years ended June 30, 2014 and 2013 were \$1,254,536 and \$1,073,028, respectively, and are recorded within supplies and other expenses.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

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### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

#### Compensated Absences

Meritus records a liability for amounts due to employees for future absences which are attributable to services performed in the current and prior periods. This liability is included in accrued salaries, wages and withholdings on the consolidated balance sheets.

#### Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by Meritus have been limited by donors to a specific time period or purpose. When donor restrictions expire, that is, when a time restriction ends or a purpose restriction is accomplished, temporarily restricted net assets are reclassified into unrestricted net assets and reported as net assets released from restrictions.

Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions if for operating purposes and as other changes in unrestricted net assets if for capital purposes in the consolidated statements of operations and changes in net assets. Permanently restricted net assets have been restricted by donors to be maintained by Meritus in perpetuity.

#### Excess of Revenue over Expenses

The consolidated statements of operations include the excess of revenue over expenses. Changes in unrestricted net assets that are excluded from the excess of revenues over expenses, consistent with industry practice, include net assets released from restrictions for property, plant and equipment, the change in retirement benefit obligation and change in non-controlling interest.

#### Net Patient Service Revenue

For services provided at the Hospital campus, all payors are required to pay the Maryland Health Services Cost Review Commission ("HSCRC") approved rates. The major third-party payors, as recognized by the HSCRC, are allowed discounts of up to 6% on approved rates. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered.

The Hospital's charges are subject to review and approval by the HSCRC. The Hospital management has filed the required forms with the HSCRC and believes the Hospital to be in compliance with HSCRC requirements. The total rate of reimbursement for services to patients under the Medicare and Medicaid programs is based on an arrangement between the Centers for Medicare and Medicaid Service and the HSCRC. Management believes that this program will remain in effect at least through June 30, 2015. The Hospital has an agreement with the HSCRC under a rate regulation concept called Total Patient Revenue ("TPR") which was renewed until June 30, 2016. TPR is a revenue constraint methodology which provides for inflation, bad debt, payor differential and adjustments for population growth, but excludes case mix and volume changes. For the years ended June 30, 2014 and 2013, the regulated revenue cap was \$304,582,766 and \$299,989,323 respectively. For the year ending June 30, 2015, the regulated revenue cap is \$309,246,715.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

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### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

#### Net Patient Service Revenue - continued

Services not located on the Hospital campus are not regulated by the HSCRC. Medicare and Medicaid pay the revenues associated with these services based upon established fee schedules. Commercial payors pay at negotiated rates for these services.

Net patient service revenue is reported as estimated net realizable amounts from patients, third-party payors, and others for services rendered and include estimated retroactive revenue adjustments due to future audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, and investigations.

Net revenues from the Medicare and Medicaid programs collectively constitute approximately 48% of Meritus' net patient service revenue for the years ended June 30, 2014 and 2013. Laws and regulations governing the HSCRC, Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Meritus believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. While no such regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action.

Accounts receivable are reduced by an allowance for doubtful accounts. Meritus' allowance for doubtful accounts totaled \$9,337,133 and \$7,267,702 at June 30, 2014 and 2013, respectively. In evaluating the collectibility of accounts receivable, Meritus analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. Management reviews data about these major payor sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts. For receivables associated with services provided to patients who have third-party coverage, Meritus analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts, if necessary (for example, for expected uncollectible deductibles and copayments 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, Meritus records a significant provision for bad debts on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. For the year ended June 30, 2014, there was a positive change in estimate related to certain self-pay patient receivables that are on structured payment plans, which provided an increase to net patient service revenue less provision for bad debts of approximately \$875,000. The difference between the billed rates and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts. Meritus has not experienced significant changes in write-off trends and has not changed its charity care policy for the year ended June 30, 2014.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

#### Net Patient Service Revenue - continued

Patient service revenue as a percentage for the year ended June 30, 2014 and 2013, net of contractual allowances and discounts (but before the provision for bad debts), recognized in the period from these major payor sources based on primary insurance designation, is as follows:

	<u>Third-Party Payors</u>	<u>Self-Pay</u>	<u>Total all Payors</u>
<b>2014:</b>			
Patient service revenue, net of contractual allowances and discounts	\$ <u>93</u> %	\$ <u>7</u> %	\$ <u>100</u> %
<b>2013:</b>			
Patient service revenue, net of contractual allowances and discounts	\$ <u>91</u> %	\$ <u>9</u> %	\$ <u>100</u> %

Deductibles and copayments under third-party payment programs within the third-party payor amount above are the patients' responsibility and Meritus considers these amounts in its determination of the provision for bad debts based on collection experience.

#### Charity Care

Meritus provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Meritus does not pursue collection on amounts deemed to qualify as charity. Meritus also estimates that the direct and indirect cost of services and supplies furnished to patients eligible for charity care using a ratio of cost to gross charges based on internal data is \$18,893,415 and \$19,582,829 for the years ended June 30, 2014 and 2013, respectively.

Meritus' patient acceptance policy is based upon its mission statement and its charitable purposes. This policy results in Meritus' assumption of higher-than-normal credit risk from its patients. To the extent that Meritus realizes additional losses resulting from such higher credit risks and clients are not identified or do not meet Meritus' defined charity care policy, such additional losses are included in the provision for bad debt.

Meritus also sponsors certain other charitable programs, which provide substantial benefit to the broader community. Such programs include services to needy and elderly populations that require special support, as well as health and education for the general community welfare. In addition, all other uncollectable amounts resulting from the patients' inability to pay are recorded as a reduction to net patient service, consistent with Meritus' policy.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

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### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

#### Other Revenue

Other revenue is comprised of rental income, gains and losses on disposal of assets, incentive payments related to the implementation and meaningful use of certified electronic health records and other miscellaneous items.

The American Recovery and Reinvestment Act of 2009 provides for Medicare and Medicaid incentive payments for eligible hospitals and professionals that implement and achieve meaningful use of certified electronic health record (“EHR”) technology. For Medicare and Medicaid EHR incentive payments Meritus utilizes a grant accounting model to recognize these revenues. Under this accounting policy, EHR incentive payments were recognized as revenues when attestation that the EHR meaningful use criteria for the required period of time was demonstrated. Accordingly, Meritus recognized \$2,040,210 and \$1,063,113 of EHR revenues for the years ended June 30, 2014 and 2013. These amounts are included in other revenue in the consolidated statements of operations and changes in net assets. Meritus’ attestation of compliance with the meaningful use criteria is subject to audit by the federal government or its designee. Additionally, Medicare EHR incentive payments received are subject to retrospective adjustment upon final settlement of the applicable cost report from which payments were calculated.

#### Income Taxes

The Internal Revenue Service has ruled that the Hospital, and the Foundation qualify under Section 501(c)(3) of the Internal Revenue Code and are, therefore, not subject to tax under present income tax regulations.

Holdings is considered a disregarded entity for tax purposes and is reported through the Hospital.

MEI accounts for income taxes through the current recognition of deferred tax liabilities and assets for the expected future tax consequences of temporary differences between tax bases and financial reporting bases of other assets and liabilities.

At present, no income, profit or capital gain taxes are levied in the Cayman Islands and accordingly, no provision for taxation has been made for MIC. In the event that such taxes are levied, MIC has been granted an exemption until September 9, 2023 for any such taxes that might be introduced. MIC intends to conduct its affairs so as not to be liable for taxes in any other jurisdiction.

Meritus follows the accounting guidance for uncertainties in income tax positions, which requires that a tax position be recognized or derecognized based on a “more likely than not” threshold. This applies to positions taken or expected to be taken in a tax return. Meritus does not believe its consolidated financial statements include any material uncertain tax positions. As of June 30, 2014, the Meritus tax years ended June 30, 2011 through June 30, 2014 for federal tax jurisdiction remain open to examination.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

#### Concentration of Credit Risk

Meritus invests its excess cash, investments, and assets in financial institutions which are federally insured under the Federal Deposit Insurance Act ("FDIA"). Deposits in certain accounts exceed federally insured deposit limits. Meritus has experienced no losses on its deposits.

Meritus grants credit without collateral to the patients it serves who primarily live in the tri-state area. The majority of these patients have either insurance through Blue Cross, another insurance company or a health maintenance organization, or qualify for the Maryland Medical Assistance or the Centers for Medicare and Medicaid Services ("CMS") programs.

At June 30, Meritus' patient accounts receivable were made up of the following:

	<u>2014</u>	<u>2013</u>
Health maintenance organizations	4%	2%
Medical assistance HMO	20%	14%
Medicare	26%	27%
Commercial insurance and other	22%	23%
Blue Cross/Blue Shield	13%	15%
Self-pay	<u>15%</u>	<u>19%</u>
	<u>100%</u>	<u>100%</u>

#### 457(b) Deferred Compensation Plan

The Hospital is party to a 457(b) deferred compensation plan intended to provide retirement benefits to certain eligible employees. Assets are deposited with the plan managers, pursuant to this agreement, such that the value of the assets determined by the fair value approximately equals the related accrued deferred compensation liability. The funds are placed into a range of investment strategies from conservative to aggressive. The liability associated with this plan is included in accrued retirement benefits on the consolidated balance sheets.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 3. INVESTMENTS AND INVESTMENT INCOME

Investments at June 30 consisted of the following:

	2014	2013
<b>Short-Term Investments:</b>		
Fixed income	\$ <u>13,546,738</u>	\$ <u>10,259,473</u>
<b>Asset whose use is limited:</b>		
Cash and cash equivalents	\$ 3,223,154	\$ 1,284,750
Fixed income	46,113,177	39,303,969
Common stock	72,623,671	55,845,158
Cash surrender value of life insurance	<u>2,984,691</u>	<u>3,016,823</u>
	<u>\$124,944,693</u>	<u>\$99,450,700</u>
<b>Assets held by trustee under debt agreement:</b>		
U.S. government securities	\$ <u>28,701,124</u>	\$ <u>29,044,843</u>
<b>Funds designated for insurance:</b>		
Fixed income	\$ <u>11,122,821</u>	\$ <u>9,460,701</u>

Meritus had restricted cash of \$3,334,609 and \$2,747,487 as of June 30, 2014 and 2013, respectively, for unemployment insurance collateral and workers' compensation collateral, in compliance with the self-insurance requirement under the regulations of the State of Maryland Employment Security Administration and Workers' Compensation Administration.

Investment returns, net of investments included in the consolidated statements of operations and changes in net assets are comprised of the following for the years ended June 30:

	2014	2013
<b>Investment returns, net:</b>		
Interest and dividends, net of investment fees of \$309,001 and \$221,088 in 2014 and 2013, respectively	\$ 3,119,317	\$ 2,748,241
Net realized gains on investments	2,527,373	2,013,469
Change in unrealized gains and losses on investments	<u>10,090,132</u>	<u>5,619,205</u>
	<u>\$15,736,822</u>	<u>\$10,380,915</u>

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 4. FAIR VALUE MEASUREMENTS

The following table presents Meritus' assets measured at fair value on a recurring basis using the market approach, as of June 30:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b>2014:</b>				
Cash and cash equivalents	\$ 19,972,594	\$ -	\$ -	\$ 19,972,594
Restricted cash	3,334,609	-	-	3,334,609
Short-term investments:		-	-	
Fixed income	13,546,738	-	-	13,546,738
Assets whose use is limited:				
Cash and cash equivalents	6,557,764	-	-	6,557,764
Fixed income	53,642,912	3,593,086	-	57,235,998
Common stock	72,623,671	-	-	72,623,671
Cash surrender value of life insurance	-	2,984,691	-	2,984,691
U.S. government securities	-	<u>28,701,124</u>	-	<u>28,701,124</u>
<b>Total assets</b>	<b><u>\$169,678,288</u></b>	<b><u>\$35,278,901</u></b>	<b><u>\$ -</u></b>	<b><u>\$204,957,189</u></b>
<b>2013:</b>				
Cash and cash equivalents	\$ 18,808,563	\$ -	\$ -	\$ 18,808,563
Restricted cash	2,747,487	-	-	2,747,487
Short-term investments	10,259,473	-	-	10,259,473
Assets whose use is limited	<u>105,001,595</u>	<u>33,904,649</u>	-	<u>138,906,244</u>
<b>Total assets</b>	<b><u>\$136,817,118</u></b>	<b><u>\$33,904,649</u></b>	<b><u>\$ -</u></b>	<b><u>\$170,721,767</u></b>

Meritus does not have any Level 3 financial instruments as of June 30, 2014 and 2013.

Investments are valued using a market approach as follows:

Cash and cash equivalents - Cash and cash equivalents are classified as Level 1 inputs and represent short-term, highly liquid investments that are readily convertible to cash and have original maturities of three months or less.

Common stock - Common stock are Level 1 inputs and consist of stock of U.S. companies and are valued based upon unadjusted quoted prices in the market.

Fixed income - Valued at the closing price reported in the active market in which the bond is traded.

Cash surrender value of life insurance - Cash surrender value of life insurance represents the face value of the contract discounted at a specified rate of interest according to the insured's life expectancy.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 4. FAIR VALUE MEASUREMENTS - Continued

U.S. government securities - Government obligations are classified as Level 2 inputs and represent bonds issued by the government and are valued based upon unadjusted quoted prices in a non-active market.

### 5. ACCOUNTS RECEIVABLE

Accounts receivable at June 30 consist of the following:

	2014	2013
Patient accounts receivable	\$ 73,605,713	\$73,236,076
Less:		
Contractual allowance	(10,816,631)	(7,873,344)
Allowance for doubtful accounts	<u>(9,337,133)</u>	<u>(7,267,702)</u>
	53,451,949	58,095,030
Other receivables	<u>6,922,703</u>	<u>4,935,753</u>
	<u>\$ 60,374,652</u>	<u>\$63,030,783</u>

Pledges receivable at June 30 consist of the following:

	2014	2013
Capital campaign	\$2,673,949	\$4,799,317
Other	<u>2,473,641</u>	<u>1,125,426</u>
Total unconditional promises to give	<u>\$5,147,590</u>	<u>\$5,924,743</u>
Receivable in less than one year	\$3,740,065	2,423,117
Receivable in one to five years	1,313,268	2,843,601
Receivable in more than five years	<u>94,257</u>	<u>658,026</u>
Total unconditional promises to give	5,147,590	5,924,744
Less:		
Discounts to net present value	(192,983)	(449,019)
Allowance for uncollectible promises	<u>(692,970)</u>	<u>(653,932)</u>
Net unconditional promises to give	<u>\$4,261,637</u>	<u>\$4,821,793</u>

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 5. ACCOUNTS RECEIVABLE - Continued

	<u>2014</u>	<u>2013</u>
Pledges receivable, current portion included in other receivables	\$3,356,804	\$1,959,486
Pledges receivable, net of current portion	<u>904,833</u>	<u>2,862,307</u>
	<u>\$4,261,637</u>	<u>\$4,821,793</u>

Discount rates utilized were derived utilizing the unsecured borrowing rate and ranged from 3.98% to 5.52%.

### 6. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment at June 30 is comprised of the following:

	<u>2014</u>	<u>2013</u>
Land	\$ 25,755,594	\$ 25,667,355
Buildings, and improvements	206,079,978	204,587,148
Equipment	<u>190,781,808</u>	<u>185,792,343</u>
	422,617,380	416,046,846
Less accumulated depreciation and amortization	<u>(168,301,998)</u>	<u>(147,400,204)</u>
	254,315,382	268,646,642
Construction in progress	<u>101,630</u>	<u>623,992</u>
	<u>\$ 254,417,012</u>	<u>\$ 269,270,634</u>

Total depreciation and amortization expense for property, plant and equipment for the years ended June 30, 2014 and 2013 was \$21,694,019 and \$23,795,988, respectively.

### 7. EQUITY INVESTMENTS IN AFFILIATES

The following investments, recorded under the equity method of accounting, are included in the consolidated balance sheets.

The Hospital holds a 20% equity interest in Maryland Care, Inc. Maryland Care, Inc. is a managed care organization ("MCO") that was established to serve Maryland's Medicaid population as a result of the State's requirement for Medicaid patients to be a member of an MCO.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 7. EQUITY INVESTMENTS IN AFFILIATES - Continued

The Hospital holds a 50% equity interest in Tri-State Health Partners. Tri-State Health Partners is a physician hospital organization (“PHO”) established to organize, assemble and facilitate the provision of cost effective healthcare services.

MEI has a 50% interest in Diagnostic Imaging, which provides radiology imaging services, and has a 33.33% interest in Western Maryland Supply, LLC, which provides durable medical equipment for rental or purchase. During the year ended June 30, 2013, RSC sold its 50% share in Endoscopy Real Estate for \$384,000 resulting in a gain of \$422,309. GI Real Estate provides rental property to a group of healthcare practitioners and is 50% owned by MEI.

Summary financial information as of June 30, 2014 and 2013 and for the years then ended appears below for the significant equity investments:

	Hospital Maryland Care, Inc.		Hospital Tri-State Health Partners	
	2014	2013	2014	2013
Assets	\$283,277,561	\$190,761,317	\$2,804,577	\$2,943,756
Liabilities	<u>200,799,676</u>	<u>118,154,824</u>	<u>39,010</u>	<u>120,909</u>
Equity	<u>\$ 82,477,885</u>	<u>\$ 72,606,493</u>	<u>\$2,765,567</u>	<u>\$2,822,847</u>
Net (loss) income	<u>\$ (460,631)</u>	<u>\$ 2,007,880</u>	<u>\$ (213,900)</u>	<u>\$ (300,910)</u>
	MEI Diagnostic Imaging Services, LLC		MEI General Surgery Real Estate, LLC	
	2014	2013	2014	2013
Assets	\$ 10,559,194	\$ 9,879,708	\$ 566,334	\$ 571,285
Liabilities	<u>3,560,322</u>	<u>3,113,840</u>	<u>457,424</u>	<u>479,301</u>
Equity	<u>\$ 6,998,872</u>	<u>\$ 6,765,868</u>	<u>\$ 108,910</u>	<u>\$ 91,984</u>
Net income	<u>\$ 2,632,875</u>	<u>\$ 3,131,721</u>	<u>\$ 16,925</u>	<u>\$ 14,302</u>

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 7. EQUITY INVESTMENTS IN AFFILIATES - Continued

	MEI GI Real Estate		MEI - Western Maryland Medical Supply, LLC	
	2014	2013	2014	2013
Assets	\$ 527,769	\$ 545,139	\$ 953,172	\$1,301,660
Liabilities	<u>239,377</u>	<u>300,562</u>	<u>833,090</u>	<u>1,200,403</u>
Equity	<u>\$ 288,392</u>	<u>\$ 244,577</u>	<u>\$ 120,082</u>	<u>\$ 101,257</u>
Net income (loss)	<u>\$ 53,815</u>	<u>\$ 43,794</u>	<u>\$ 18,833</u>	<u>\$ (77,117)</u>

### 8. LONG-TERM DEBT

Long-term debt at June 30 consists of the following:

	2014	2013
<b>MHHEFA Revenue Bonds:</b>		
Series 2008 4.00% - 6.00% serial bonds, net of original issue discounts \$1,214,539 and \$1,273,796, respectively	\$252,712,036	\$256,309,718
2001 Taxable Note B to Bank of America	-	537,947
City of Hagerstown note	121,826	140,748
2011 Bank of America Note - 2.04% interest rate	-	386,667
Mortgages and equipment loans with banks, with interest rates ranging from 2.3% to 7.75%	1,021,847	1,792,014
Capital lease obligations, with interest rates ranging from 2.9% to 5.0%	<u>961,103</u>	<u>2,024,725</u>
	254,816,812	261,191,819
Less current portion of long-term debt	<u>(4,802,704)</u>	<u>(6,444,712)</u>
	<u>\$250,014,108</u>	<u>\$254,747,107</u>

Meritus uses current market prices in determining the fair value of its Revenue Bonds. The carrying value of other long-term debt approximates fair value. The fair value of total long-term debt, excluding capital lease obligations, was approximately \$263,802,000 and \$270,967,000 at June 30, 2014 and 2013, respectively.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 8. LONG-TERM DEBT - Continued

In February 2008, Meritus issued Maryland Health and Higher Educational Facilities Authority (“MHHEFA”) Revenue Bonds Washington County Hospital Issue Series 2008 for the construction of a replacement hospital, funding of the debt service reserve and capitalized interest funds, and to refinance various previously outstanding debts. The Series 2008 Bonds are due in annual principal installments through January 2043. Interest is due semi-annually in January and July.

The long-term debt related to the Series 2008 Bonds is reflected in the consolidated financial statements net of the unamortized original issue bond discounts. The original issue bond discounts are being amortized over the life of the debt and are included in amortization expense in the consolidated statements of operations and changes in net assets.

All bonds are collateralized by a first lien and claims on all receipts of Meritus, except restricted donations and contributions. In connection with the Series 2008 Bonds, MHHEFA has a security interest in existing facilities of Meritus. All bonds require the Hospital to maintain certain financial ratios and stipulated insurance coverage as defined. Meritus was in compliance with these covenants at June 30, 2014 and 2013.

The 2001 Taxable Note B to Bank of America was issued for the construction of the Robinwood Medical Center III. The taxable portion of the debt required monthly principal payments of \$82,701 through February 1, 2014 with remaining principal due at that time. The interest was calculated and payable monthly based upon the outstanding principal balance at the time. The variable interest rates was 1.19% as of June 30, 2013. The bond note has been paid-in full as of June 30, 2014.

Scheduled principal repayments on long-term debt including payments on capital lease obligations are as follows for the next five years as of June 30:

	Long-term Debt	Capital Lease Obligations
2015	\$ 4,101,051	\$722,823
2016	4,184,101	259,911
2017	4,237,654	5,648
2018	4,444,015	-
2019	4,660,407	-
Thereafter	<u>233,443,021</u>	<u>-</u>
	<u>\$255,070,249</u>	988,381
Less amount representing interest		<u>(27,279)</u>
		<u>\$961,103</u>

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 8. LONG-TERM DEBT - Continued

The Hospital maintains a line of credit with a financial institution which is automatically renewed annually in the amount of \$1,000,000, bearing interest on the drawn portion at the bank's prime interest rate. The line was not in use at June 30, 2014 and 2013.

MEI maintains a line of credit with a financial institution which is automatically renewed annually in the amount of \$500,000, bearing interest on the drawn portion at the bank's prime interest rate plus 2%. The line was not in use at June 30, 2014 and 2013.

### 9. INCOME TAXES

MEI and its subsidiaries file a consolidated federal return and separate state returns. The income tax benefit (expense) for the years ended June 30, consists of:

	<u>2014</u>	<u>2013</u>
<b>Current:</b>		
Federal	\$1,191,661	\$1,212,298
State	<u>389,169</u>	<u>273,284</u>
	1,580,830	1,485,582
<b>Deferred:</b>		
Federal	(71,903)	(332,424)
State	<u>(11,567)</u>	<u>(36,746)</u>
	<u>(83,470)</u>	<u>(369,170)</u>
	<u>\$1,497,360</u>	<u>\$1,116,412</u>

On July 1, 2011, MEI completed a structural realignment to include the formation of Holdings. The realignment included the conversion of taxable subsidiaries of MEI resulting in a net federal and state conversion tax of \$4,000,000. The above conversion tax was repeated for both book and tax for the years ended June 30, 2014 and 2013

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 9. INCOME TAXES - Continued

The significant components of the deferred tax assets and deferred tax liabilities, which are included in prepaid and other current assets and other assets at June 30, are as follows:

	<u>2014</u>	<u>2013</u>
<b>Deferred tax asset:</b>		
Accrued vacation	\$ 504,897	\$ 650,109
Deferred compensation	1,379,792	1,264,490
Allowance for bad debts	437,229	222,888
Captive insurance premiums	-	17,775
Other	<u>183,241</u>	<u>247,100</u>
	2,505,159	2,402,362
<b>Deferred tax liabilities:</b>		
Fixed assets and intangible assets	(1,301,325)	(1,191,089)
Captive insurance premiums	(48,760)	-
Partnership basis	<u>(45,872)</u>	<u>(18,604)</u>
	<u>(1,395,957)</u>	<u>(1,209,693)</u>
	<u>\$ 1,109,202</u>	<u>\$ 1,192,669</u>

### 10. POST RETIREMENT BENEFIT PLANS

#### Defined Contribution Plans

Meritus has a 401(k) Savings Plan. The plan is available to all Meritus employees. Meritus matches employee contributions for an amount up to 6% of each employee's base salary, subject to limitations. During 2014, the plan was amended as a safe harbor 401(k) plan.

Amounts charged to expense for the years ended June 30, 2014 and 2013 were \$5,691,638 and \$5,933,171, respectively.

The Hospital has frozen a 403(b) plan. Effective July 1, 2011, the plan was frozen to future contributions.

The Hospital and MEI each maintain an employee funded supplemental non-qualified retirement plan for certain employees. The plan requires the benefits be paid upon termination, retirement or death. The related liability is \$4,502,797 and \$4,094,548 at June 30, 2014 and 2013, respectively. Management has designated investments for the intended purpose of funding the liability when payable. Amounts charged to expense for the years ended June 30, 2014 and 2013 were \$0 and \$29,321, respectively.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 10. POST RETIREMENT BENEFIT PLANS - Continued

#### Defined Contribution Plans - continued

Meritus maintained a cash balance pension plan ("Plan") that was terminated for all participants effective June 30, 2011 and was fully liquidated as of January 31, 2013. The Plan covered substantially all current Hospital employees and maintained the balance for MEI employees previously employed by the Hospital. Benefits under the plan were generally based on the participant's age, years of service and compensation levels. Annual contributions were made to the plan in accordance with the Employee Retirement Income Security Act of 1974 ("ERISA") regulations. Employees were fully vested after three years of service.

The change in benefit obligation, plan assets, and funded status of the Plan for the year ended June 30, 2013 is shown below:

	<u>2013</u>
<b>Change in benefit obligation:</b>	
Benefit obligation at beginning of year	\$ 43,103,556
Interest cost	427,799
Actuarial gain	(86,261)
Benefits paid	<u>(43,445,094)</u>
Benefit obligation at end of year	\$ <u>          -</u>
<b>Change in plan assets:</b>	
Fair value of plan assets at beginning of year	\$ 39,794,100
Actual return on plan assets	(33,208)
Contributions	3,684,202
Benefits paid	<u>(43,445,094)</u>
Fair value of plan assets at end of year	\$ <u>          -</u>
Net amount recognized - accrued compensation benefit	\$ <u>          -</u>

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 10. POST RETIREMENT BENEFIT PLANS - Continued

#### Defined Contribution Plans - continued

The accumulated benefit obligation is \$0 at June 30, 2013.

	<u>2013</u>
<b>Net periodic benefit cost</b>	
Interest cost	\$ 427,799
Expected return on plan assets	(29,041)
Prior service cost	12,203
Actuarial loss	<u>(36,215)</u>
	374,746
Settlement loss	<u>11,291,050</u>
	11,665,796
<b>Change in amounts recognized in unrestricted net assets</b>	<u>(11,291,050)</u>
	<u>\$ 374,746</u>

#### Assumptions

	<u>2013</u>
<b>Weighted-average assumptions used to determine net periodic benefit cost for the years ended June 30:</b>	
Discount rate	3.430%
Expected return on plan assets	0.80%
Rate of compensation increase	N/A

### 11. INSURANCE COVERAGE

Meritus has a wholly-owned insurance captive, MIC, to provide primary limits of insurance of \$1,000,000 per occurrence/\$3,000,000 aggregate for professional and general liability. The professional liability coverage is provided on a claims-made basis. In addition, MIC purchased reinsurance from an A rated reinsurer in the amount of \$15,000,000 to cover any potential liabilities above the \$1,000,000/\$3,000,000 primary limits, which were covered by MIC. The self-insured liabilities determined by an actuary for professional and general are discounted at 4%, and are included in other long-term liabilities in the consolidated balance sheets.

In addition, MIC provides stop loss health insurance coverage to Meritus for the medical expenses of its employees. Coverage is for expenses in excess of the deductible amount of 300,000 per individual. MIC purchased reinsurance for amounts in excess of \$600,000 per individual to fully reinsure this exposure. The reimbursement maximum under this reimbursement is \$400,000 per individual with no lifetime maximum per individual.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 11. INSURANCE COVERAGE - Continued

Consistent with most companies with similar insurance operations, the liability for losses is ultimately based on management's reasonable expectations of future events. It is reasonably possible that the expectations associated with these amounts could change in the near term (i.e., within one year) and that the effect of such changes could be material to the consolidated financial statements.

	2014	2013
Reserves for losses and loss adjustment expenses at beginning of year	\$ 5,545,046	\$ 5,734,653
Less reinsurance recoverable on unpaid claims	<u>(1,075,976)</u>	<u>(1,229,261)</u>
Net provision for losses and loss adjustment expenses at beginning of year	4,469,070	4,505,392
Incurred related to:		
Current fiscal year	1,635,601	1,293,856
Prior fiscal years - change in estimates	<u>(607,520)</u>	<u>(251,755)</u>
Total losses and loss adjustment expenses incurred, net of reinsurance recoverable	1,028,081	1,042,101
Paid related to:		
Current fiscal year	(69,332)	(5,184)
Prior fiscal years	<u>(992,919)</u>	<u>(1,073,239)</u>
Total losses and loss adjustment expenses paid, net of reinsurance recoverable	<u>(1,062,251)</u>	<u>(1,078,423)</u>
Net provision for losses and loss adjustment expenses at end of year	4,434,900	4,469,070
Add reinsurance recoverable on unpaid claims	<u>942,639</u>	<u>1,075,976</u>
Reserves for losses and loss adjustment expenses at end of year	<u>\$ 5,377,539</u>	<u>\$ 5,545,046</u>

### 12. COMMITMENTS AND CONTINGENCIES

#### Operating Lease Obligations

Meritus leases equipment under non-cancelable lease arrangements. In addition, Meritus leases office space in several locations under operating leases. Some of the leases provide for renewal options. Rent expense under all operating leases was \$5,031,558 and \$5,491,473 for the years ended June 30, 2014 and 2013, respectively.

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

### 12. COMMITMENTS AND CONTINGENCIES - Continued

Future minimum lease payments under these non-cancelable operating leases as of June 30 are as follows:

2015	\$3,762,295
2016	2,560,964
2017	1,464,310
2018	954,853
2019	747,265

#### Litigation

Meritus is 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 a material adverse effect on Meritus' financial position or results of operations.

### 13. TEMPORARILY AND PERMANENTLY RESTRICTED NET ASSETS

Temporarily and permanently restricted net assets at June 30 are restricted for the following purposes:

	<u>2014</u>	<u>2013</u>
Temporarily restricted for financial support of patients and hospital programs	\$2,081,136	\$1,656,395
Capital campaign	<u>3,011,685</u>	<u>4,635,477</u>
	<u>\$5,092,821</u>	<u>\$6,291,872</u>
Permanently restricted investments are to be held in perpetuity, the income of which is expendable to support charity care and health care education	<u>\$1,028,618</u>	<u>\$1,028,618</u>

# Meritus Medical Center, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

June 30, 2014 and 2013

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### 14. FUNCTIONAL EXPENSES

Meritus provides general healthcare services to residents within its geographic location. Expenses related to providing these services for the years ended June 30 are as follows:

	<u>2014</u>	<u>2013</u>
Health care services	\$336,942,301	\$341,402,901
Fundraising	674,382	719,503
Administration	<u>20,815,825</u>	<u>20,956,995</u>
	<u>\$358,432,508</u>	<u>\$363,079,399</u>

### 15. SUBSEQUENT EVENTS

Meritus evaluated subsequent events through October 7, 2014, the date these consolidated financial statements were available to be issued. All material matters are disclosed in the footnotes to the consolidated financial statements.

## **SUPPLEMENTARY INFORMATION**

# Meritus Medical Center, Inc.

## CONSOLIDATING BALANCE SHEET

June 30, 2014

ASSETS	Meritus Medical Center	Meritus Holdings Consolidated	Meritus Insurance Company	Meritus Healthcare Foundation	Consolidating Total	Consolidating Entries	Consolidated Total
<b>CURRENT ASSETS</b>							
Cash and cash equivalents	\$ 15,118,502	\$ 7,418,690	\$ 311,797	\$ 179,563	\$ 23,028,552	\$ -	\$ 23,028,552
Restricted cash	3,334,609	-	-	-	3,334,609	-	3,334,609
Investments, short term	13,546,738	-	-	-	13,546,738	-	13,546,738
Current portion of assets held by trustee	9,319,752	-	950,000	-	10,269,752	-	10,269,752
Accounts receivable, net	66,143,454	17,566,572	52,225	3,463,682	87,225,933	(6,697,517)	80,528,416
Allowance for uncollectibles	(9,904,525)	(10,249,239)	-	-	(20,153,764)	-	(20,153,764)
Net patient accounts receivable	56,238,929	7,317,333	52,225	3,463,682	67,072,169	(6,697,517)	60,374,652
Supplies	5,890,883	1,249,428	-	-	7,140,311	-	7,140,311
Prepaid and other current assets	5,738,060	4,884,563	261,900	(112,812)	10,771,711	(2,934,600)	7,837,111
Total current assets	109,187,474	20,870,014	1,575,922	3,530,433	135,163,842	(9,632,117)	125,531,725
<b>EQUITY INVESTMENTS IN AFFILIATES</b>	42,023,558	3,624,567	-	-	45,648,125	(23,351,779)	22,296,346
<b>ASSETS LIMITED AS TO USE</b>							
Board designated investments	112,314,063	-	-	6,962,543	119,276,606	-	119,276,606
Supplemental retirement benefit invest	1,499,986	3,002,811	-	-	4,502,797	-	4,502,797
Temp & perm restricted donor funds	1,165,290	-	-	-	1,165,290	-	1,165,290
Total assets limited as to use	114,979,339	3,002,811	-	6,962,543	124,944,693	-	124,944,693
Trusteed assets	18,431,372	-	-	-	18,431,372	-	18,431,372
Funds designated for insurance purposes	-	-	11,122,821	-	11,122,821	-	11,122,821
Total assets limited as to use	133,410,711	3,002,811	11,122,821	6,962,543	154,498,886	-	154,498,886
<b>PROPERTY, PLANT AND EQUIPMENT, NET</b>	245,897,181	8,508,396	-	11,435	254,417,012	-	254,417,012
<b>PLEDGES RECEIVABLE, NET</b>	-	-	-	904,833	904,833	-	904,833
<b>DEFERRED FINANCING, NET</b>	2,390,299	-	-	-	2,390,299	-	2,390,299
<b>OTHER ASSETS</b>	6,951,601	1,494,666	942,640	-	9,388,907	(7,239,744)	2,149,163
Total assets	\$ <u>539,860,824</u>	\$ <u>37,500,454</u>	\$ <u>13,641,383</u>	\$ <u>11,409,244</u>	\$ <u>602,411,905</u>	\$ <u>(40,223,641)</u>	\$ <u>562,188,264</u>

# Meritus Medical Center, Inc.

## CONSOLIDATING BALANCE SHEET - CONTINUED

June 30, 2014

	Meritus Medical Center	Meritus Holdings Consolidated	Meritus Insurance Company	Meritus Healthcare Foundation	Consolidating Total	Consolidating Entries	Consolidated Total
<b>CURRENT LIABILITIES</b>							
Accounts payable and accrued expenses	\$ 11,096,781	\$ 4,473,553	\$ 989,702	\$ 59,472	\$ 16,619,508	\$ (2,652,518)	\$ 13,966,990
Accrued salaries, wages and withholdings	7,449,744	1,335,833	-	-	8,785,577	-	8,785,577
Accrued compensation benefit	8,653,929	2,622,827	-	10,114	11,286,870	-	11,286,870
Advances from third party payors	6,592,612	149,052	-	-	6,741,664	-	6,741,663
Accrued interest payable	7,267,031	-	-	-	7,267,031	-	7,267,031
Current maturity of long-term debt	4,556,890	245,814	-	-	4,802,704	-	4,802,704
Total current liabilities	45,616,987	8,827,079	989,702	69,586	55,503,354	(2,652,518)	52,850,835
<b>LONG TERM DEBT, NET OF CURRENT PORTION</b>	249,564,968	449,140	-	-	250,014,108	-	250,014,108
<b>ACCRUED RETIREMENT BENEFITS</b>	1,499,986	3,506,660	-	-	5,006,646	-	5,006,646
<b>OTHER LONG TERM LIABILITIES</b>	-	1,395,958	12,380,620	-	13,776,578	(6,591,718)	7,184,860
Total liabilities	296,681,941	14,178,837	13,370,322	69,586	324,300,686	(9,244,236)	315,056,449
<b>STOCKHOLDER'S EQUITY</b>							
Common stock	-	700,000	120,000	-	820,000	(820,000)	-
Paid-in capital	-	1,150,080	-	-	1,150,080	(1,150,080)	-
Retained earnings	-	21,921,408	151,061	-	22,072,469	(22,072,469)	-
Total stockholders' equity	-	23,771,488	271,061	-	24,042,549	(24,042,549)	-
<b>NET ASSETS</b>							
Unrestricted:							
Meritus	233,992,306	(1,351,397)	-	3,787,436	236,428,345	4,049,886	240,478,231
Non-controlling interest	-	532,145	-	-	532,145	-	532,145
Total unrestricted net assets	233,992,306	(819,252)	-	3,787,436	236,960,490	4,049,886	241,010,376
Restricted net assets - temporary	8,157,959	369,381	-	7,552,222	16,079,562	(10,986,741)	5,092,821
Restricted net assets - permanent	1,028,618	-	-	-	1,028,618	-	1,028,618
Total net assets	243,178,883	(449,871)	-	11,339,658	254,068,670	(6,936,855)	247,131,815
Total liabilities and net assets	\$ 539,860,824	\$ 37,500,454	\$ 13,641,383	\$ 11,409,244	\$ 602,411,905	\$ (40,223,641)	\$ 562,188,264

# Meritus Medical Center, Inc.

## CONSOLIDATING STATEMENT OF OPERATIONS AND CHANGE IN NET ASSETS

Year end June 30, 2014

	Meritus Medical Center	Meritus Holdings Consolidated	Meritus Insurance Company	Meritus Healthcare Foundation	Consolidating Total	Consolidating Entries	Consolidated Total
<b>Unrestricted revenue, gains and other support</b>							
Net patient revenue	\$ 299,020,505	\$ 74,816,909	\$ -	\$ -	\$ 373,837,414	\$ (12,261,976)	\$ 361,575,439
Less (provisions) recoveries for bad debts	<u>(15,222,793)</u>	<u>668,549</u>	<u>-</u>	<u>-</u>	<u>(14,554,244)</u>	<u>-</u>	<u>(14,554,244)</u>
Net patient revenue less provisions for bad debts	283,797,712	75,485,458	-	-	359,283,170	(12,261,976)	347,021,195
Other revenue	12,880,060	1,351,949	1,425,359	389,517	16,046,885	(5,631,032)	10,415,853
Equity earnings in affiliates	(475,962)	1,473,732	-	-	997,770	694,916	1,692,686
Net assets released from restrictions for operations	<u>642,196</u>	<u>-</u>	<u>-</u>	<u>1,280,179</u>	<u>1,922,375</u>	<u>(613,314)</u>	<u>1,309,061</u>
	296,844,006	78,311,140	1,425,359	1,669,696	378,250,201	(17,811,405)	360,438,795
<b>Operating expenses</b>							
Salaries and wages	106,980,695	34,921,880	-	279,052	142,181,627	-	142,181,627
Benefits	32,236,471	8,288,930	-	104,854	40,630,255	(1,349,800)	39,280,455
Professional fees	11,196,748	-	-	-	11,196,748	-	11,196,748
Supplies and other	106,970,540	37,153,523	1,870,484	286,484	146,281,031	(16,818,509)	129,462,523
Interest	14,407,267	30,384	-	-	14,437,651	(2,619)	14,435,032
Depreciation and amortization	20,555,406	1,309,914	-	10,804	21,876,123	-	21,876,123
	<u>292,347,127</u>	<u>81,704,631</u>	<u>1,870,484</u>	<u>681,194</u>	<u>376,603,435</u>	<u>(18,170,928)</u>	<u>358,432,508</u>
Operating income	4,496,880	(3,393,491)	(445,125)	988,5020	1,646,766	359,523	2,006,287
<b>Non-operating gains (losses), net</b>							
Investment returns, net	13,433,011	544,735	445,125	1,313,951	15,736,822	-	15,736,822
Other, net	1,052,974	-	-	(1,464,897)	(411,923)	363,318	(48,605)
Income tax benefit	<u>-</u>	<u>1,497,360</u>	<u>-</u>	<u>-</u>	<u>1,497,360</u>	<u>-</u>	<u>1,497,360</u>
Excess of revenue over expenses	18,982,865	(1,351,396)	-	837,556	18,469,025	722,841	19,191,864
<b>Deficiency in revenue over expenses attributable to non-controlling interest</b>							
	<u>-</u>	<u>369,381</u>	<u>-</u>	<u>-</u>	<u>369,381</u>	<u>-</u>	<u>369,381</u>
Excess of revenue over expenses attributable to Meritus	18,982,865	(982,014)	-	837,556	18,838,406	722,841	19,561,245

## Meritus Medical Center, Inc.

### CONSOLIDATING STATEMENT OF OPERATIONS AND CHANGE IN NET ASSETS - CONTINUED

Year end June 30, 2014

	Meritus Medical Center	Meritus Holdings Consolidated	Meritus Insurance Company	Meritus Healthcare Foundation	Consolidating Total	Consolidating Entries	Consolidated Total
<b>Other changes in unrestricted net assets</b>							
Change in non-controlling interest	-	(369,381)	-	-	(369,381)	-	(369,381)
Net assets released from restriction for property, plant and equipment	<u>629,769</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>629,769</u>	<u>-</u>	<u>629,769</u>
Increase in unrestricted net assets	19,612,634	(1,351,395)	-	837,556	19,098,794	722,841	19,821,633
<b>Temporarily restricted net assets</b>							
Contributions	1,311,522	-	-	723,528	2,035,050	(1,295,371)	739,679
Net assets released from restriction for property, plant and equipment	(629,769)	-	-	-	(629,769)	-	(629,769)
Net assets held by MHF	4,390,378	-	-	-	4,390,378	(4,390,378)	-
Net assets released from restriction for operations	(642,096)	-	-	(1,280,179)	(1,922,275)	613,314	(1,308,961)
Increase (decrease) in temporary restricted net assets	<u>4,430,035</u>	<u>-</u>	<u>-</u>	<u>(556,650)</u>	<u>3,873,384</u>	<u>(5,072,436)</u>	<u>(1,199,051)</u>
INCREASE (DECREASE) IN NET ASSETS	24,042,669	(1,351,397)	-	280,905	22,972,177	(4,349,595)	18,622,582
<b>Net assets</b>							
Beginning of year	<u>219,136,214</u>	<u>24,673,014</u>	<u>271,061</u>	<u>11,058,753</u>	<u>255,139,042</u>	<u>(26,629,809)</u>	<u>228,509,233</u>
End of year	<u>\$ 243,178,883</u>	<u>\$ 23,321,617</u>	<u>\$ 271,061</u>	<u>\$ 11,339,658</u>	<u>\$ 278,111,219</u>	<u>\$ (30,979,404)</u>	<u>\$ 247,131,815</u>



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