



MEDSTAR HEALTH, INC.

Consolidated Financial Statements
and Supplementary Schedules

June 30, 2010 and 2009

(With Independent Auditors' Report Thereon)

MEDSTAR HEALTH, INC.

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

Independent Auditors' Report

The Board of Directors
MedStar Health, Inc.:

We have audited the accompanying consolidated balance sheets of MedStar Health, Inc. and subsidiaries (the Corporation) as of June 30, 2010 and 2009 and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of MedStar Health, Inc. and subsidiaries as of June 30, 2010 and 2009, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The consolidating information included in Schedules 1 and 2 is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. Such information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic consolidated financial statements taken as a whole.

KPMG LLP

October 4, 2010

MEDSTAR HEALTH, INC.

Consolidated Balance Sheets

June 30, 2010 and 2009

(Dollars in millions)

Assets	2010	2009
Current assets:		
Cash and cash equivalents	\$ 509.6	560.7
Investments	16.8	13.9
Assets whose use is limited or restricted	40.8	33.6
Receivables:		
From patient services (less allowances for uncollectible accounts of \$211.0 in 2010 and \$175.0 in 2009)	438.1	363.3
Other	64.6	63.4
	<u>502.7</u>	<u>426.7</u>
Inventories	50.4	48.2
Prepays and other current assets	40.9	37.7
	<u>1,161.2</u>	<u>1,120.8</u>
Total current assets		
Investments	509.2	372.4
Assets whose use is limited or restricted	358.0	374.6
Property and equipment, net	1,023.4	898.4
Interest in net assets of foundation	41.1	36.1
Other assets	119.6	112.1
	<u>119.6</u>	<u>112.1</u>
Total assets	<u>\$ 3,212.5</u>	<u>2,914.4</u>

MEDSTAR HEALTH, INC.

Consolidated Balance Sheets

June 30, 2010 and 2009

(Dollars in millions)

Liabilities and Net Assets	2010	2009
Current liabilities:		
Accounts payable and accrued expenses	\$ 284.2	262.2
Accrued salaries, benefits, and payroll taxes	204.6	193.4
Amounts due to third-party payors, net	42.0	39.5
Current portion of long-term debt	265.8	27.5
Current portion of self insurance liabilities	56.3	54.6
Other current liabilities	81.9	72.4
Total current liabilities	<u>934.8</u>	<u>649.6</u>
Long-term debt, net of current portion	795.8	1,051.2
Self insurance liabilities, net of current portion	190.9	160.0
Pension liabilities	401.3	300.1
Other long-term liabilities, net of current portion	134.8	106.6
Total liabilities	<u>2,457.6</u>	<u>2,267.5</u>
Net assets:		
Unrestricted	643.9	543.3
Temporarily restricted	74.0	69.0
Permanently restricted	37.0	34.6
Total net assets	<u>754.9</u>	<u>646.9</u>
Total liabilities and net assets	<u>\$ 3,212.5</u>	<u>2,914.4</u>

See accompanying notes to consolidated financial statements.

MEDSTAR HEALTH, INC.

Consolidated Statements of Operations and Changes in Net Assets

Years ended June 30, 2010 and 2009

(Dollars in millions)

	<u>2010</u>	<u>2009</u>
Operating revenues:		
Net patient service revenue:		
Hospital inpatient services	\$ 2,176.6	2,168.5
Hospital outpatient services	1,100.8	966.7
Physician services	175.5	161.5
Other patient service revenue	<u>114.4</u>	<u>111.6</u>
Total net patient service revenue	3,567.3	3,408.3
Premium revenue	102.0	91.7
Other operating revenue	<u>186.1</u>	<u>178.0</u>
Net operating revenues	<u>3,855.4</u>	<u>3,678.0</u>
Operating expenses:		
Personnel	1,988.7	1,906.6
Supplies	619.9	591.4
Purchased services	461.1	428.9
Other operating	354.7	325.9
Provision for bad debts	182.5	186.5
Restructuring costs	—	7.9
Interest expense	39.0	39.3
Depreciation and amortization	<u>146.5</u>	<u>131.7</u>
Total operating expenses	<u>3,792.4</u>	<u>3,618.2</u>
Earnings from operations	63.0	59.8
Nonoperating gains (losses):		
Investment income	21.3	15.5
Net realized gains (losses) on investments	0.7	(55.2)
Unrealized loss on derivative instruments	(4.1)	(5.9)
Unrealized gains (losses) on trading investments	60.9	(69.7)
Income tax provision	(1.9)	(0.4)
Equity interest in net earnings of affiliates and other	<u>2.1</u>	<u>1.4</u>
Total nonoperating gains (losses)	<u>79.0</u>	<u>(114.3)</u>
Excess (deficiency) of revenue over expenses	<u>\$ 142.0</u>	<u>(54.5)</u>

MEDSTAR HEALTH, INC.

Consolidated Statements of Operations and Changes in Net Assets

Years ended June 30, 2010 and 2009

(Dollars in millions)

	2010	2009
Unrestricted net assets:		
Excess (deficiency) of revenue over expenses	\$ 142.0	(54.5)
Addition of St. Mary's net assets	72.2	—
Change in funded status of defined benefit plans	(121.3)	(130.9)
Change in unrealized gains (losses) on investments	0.1	(0.2)
Net assets released from restrictions used for purchase of property and equipment	7.6	3.6
	<u>100.6</u>	<u>(182.0)</u>
Increase (decrease) in unrestricted net assets		
Temporarily restricted net assets:		
Addition of St. Mary's net assets	3.8	—
Contributions	8.5	9.4
Realized net gains (losses) on restricted investments	2.1	(3.8)
Change in unrealized gains (losses) on restricted investments	4.9	(8.3)
Net assets released from restrictions	(14.3)	(9.8)
	<u>5.0</u>	<u>(12.5)</u>
Increase (decrease) in temporarily restricted net assets		
Permanently restricted net assets:		
Addition of St. Mary's net assets	0.1	—
Contributions	2.0	1.2
Realized net gains (losses) on marketable restricted investments	0.1	(0.2)
Change in unrealized gains (losses) on restricted investments	0.2	(0.3)
	<u>2.4</u>	<u>0.7</u>
Increase in permanently restricted net assets		
Increase (decrease) in net assets	<u>108.0</u>	<u>(193.8)</u>
Net assets, beginning of year	<u>646.9</u>	<u>840.7</u>
Net assets, end of year	<u>\$ 754.9</u>	<u>646.9</u>

See accompanying notes to consolidated financial statements.

MEDSTAR HEALTH, INC.
Consolidated Statements of Cash Flows
Years ended June 30, 2010 and 2009
(Dollars in millions)

	2010	2009
Cash flows from operating activities:		
Change in net assets	\$ 108.0	(193.8)
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Net assets of St. Mary's Hospital	(76.1)	—
Depreciation and amortization	146.5	131.7
Amortization of bond financing costs and bond premiums and other	0.3	0.2
Loss on sale of property and equipment	0.3	0.3
Change in funded status of defined benefit plans	121.3	130.9
Realized net (gains) losses on marketable investments	(2.9)	59.2
Change in unrealized (gains) losses of marketable investments	(66.1)	78.5
Unrealized loss on derivative instruments	4.1	5.9
Net settlement payment on derivative instrument	4.4	3.5
Deferred income tax provision	1.4	0.2
Provision for bad debts	182.5	186.5
Temporarily and permanently restricted contributions	(10.5)	(10.6)
Changes in operating assets and liabilities:		
Receivables	(244.0)	(175.1)
Inventories and other assets	(5.8)	17.3
Accounts payable and accrued expenses	27.5	67.1
Amounts due to third-party payors	(1.8)	(3.4)
Other liabilities	40.4	43.5
Net cash provided by operations	229.5	341.9
Cash flows from investing activities:		
Cash from acquisition of St. Mary's Hospital	20.9	—
(Purchases) sales of investments and assets whose use is limited or restricted, net	(47.6)	40.8
Net settlement payment on derivative instrument	(4.4)	(3.5)
Purchases of property and equipment	(203.6)	(204.5)
Net cash used in investing activities	(234.7)	(167.2)
Cash flows from financing activities:		
Proceeds from long-term borrowings	—	111.6
Repayment of long-term borrowings	(56.4)	(11.0)
Temporarily and permanently restricted contributions	10.5	10.6
Net cash (used in) provided by financing activities	(45.9)	111.2
(Decrease) increase in cash and cash equivalents	(51.1)	285.9
Cash and cash equivalents at beginning of year	560.7	274.8
Cash and cash equivalents at end of year	\$ 509.6	560.7
Supplemental disclosure of cash flow information:		
Interest paid	\$ 43.8	37.6
Noncash investing and financing activities:		
Accounts payable for fixed asset purchases	\$ 7.4	16.5

See accompanying notes to consolidated financial statements.

MEDSTAR HEALTH, INC.

Notes to Consolidated Financial Statements

June 30, 2010 and 2009

(Dollars in millions)

(1) Description of Organization and Summary of Significant Accounting Policies

(a) Organization

MedStar Health, Inc. (the Corporation) is a tax exempt, Maryland membership corporation which, through its controlled entities and other affiliates, provides and manages healthcare services in the region encompassing Maryland, Washington D.C. and Northern Virginia. The Corporation became operational on June 30, 1998 by the transfer of the membership interests of Helix Health, Inc. (Helix – a not-for-profit Maryland Corporation) and Medlantic Healthcare Group, Inc. (Medlantic – a not-for-profit Delaware Corporation) in exchange for the guarantee of the debt of both Helix and Medlantic by the Corporation. The principal tax exempt and taxable entities of the Corporation are:

Tax Exempt

- The Good Samaritan Hospital of Maryland, Inc.
- The Union Memorial Hospital
- Franklin Square Hospital Center, Inc.
- Harbor Hospital, Inc.
- Bay Development Corporation
- Church Home and Hospital of the City of Baltimore, Inc.
- Washington Hospital Center Corporation
- National Rehabilitation Hospital, Inc.
- MedStar-Georgetown Medical Center, Inc.
- MedStar Health Research Institute, Inc.
- MedStar Health Visiting Nurse Association, Inc.
- MGH Health Services, Inc.
- Center for Ambulatory Surgery, Inc.
- St. Mary's Hospital of St. Mary's County, Inc. and Subsidiaries

Taxable

- Parkway Ventures, Inc.
- MedStar Enterprises, Inc.
- MedStar Physician Partners, Inc.
- Greenspring Financial Insurance, LTD.
- St. Mary's Health Alliance

MEDSTAR HEALTH, INC.

Notes to Consolidated Financial Statements

June 30, 2010 and 2009

(Dollars in millions)

(b) Changes in Organizational Structure

On September 30, 2009, the Corporation and St. Mary's Hospital of St. Mary's County, Inc. and Subsidiaries (St. Mary's Hospital) closed on an affiliation transaction that substituted the Corporation as sole member of St. Mary's Hospital. St. Mary's Hospital includes a 103-bed acute care hospital located in Leonardtown, Maryland, in St. Mary's County.

The Corporation's affiliation with St. Mary's Hospital was accounted for as an "as-if pooling of interests" in accordance with U.S. generally accepted accounting principles. Accordingly, the assets and liabilities of St. Mary's Hospital and its subsidiaries were recorded at their carrying values. The financial position and results of operations of St. Mary's Hospital are included in the accompanying consolidated financial statements for the period beginning on or after July 1, 2009. The Corporation's net assets increased by \$76.1 on July 1, 2009 due to the affiliation. The financial results for the fiscal year ended June 30, 2009 have not been restated to reflect the affiliation of St. Mary's Hospital.

Summarized unaudited consolidated financial information for St. Mary's Hospital as of July 1, 2009 and summarized financial information the year ended June 30, 2010 is as follows:

	July 1, 2009
Current assets	\$ 42.5
Noncurrent assets	97.7
Total assets	<u>\$ 140.2</u>
Current liabilities	\$ 22.5
Noncurrent liabilities	41.6
Net assets	<u>76.1</u>
Total liabilities and net assets	<u>\$ 140.2</u>
	Year ended
	June 30, 2010
Net operating revenue	\$ 117.9
Total operating expenses	<u>113.6</u>
Earnings from operations	4.3
Total nonoperating losses, net	<u>(1.4)</u>
Excess of revenue over expenses	<u>\$ 2.9</u>

MEDSTAR HEALTH, INC.

Notes to Consolidated Financial Statements

June 30, 2010 and 2009

(Dollars in millions)

(c) Basis of Presentation

The consolidated financial statements are prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles. All majority owned and direct member entities are consolidated. All entities where the Corporation exercises significant influence but for which it does not have control are accounted for under the equity method. All other entities are accounted for under the cost method. All significant intercompany accounts and transactions have been eliminated.

(d) Use of Estimates

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

(e) Cash Equivalents

All highly liquid investments with a maturity date of three months or less when purchased are considered to be cash equivalents.

(f) Investments and Assets whose use is Limited or Restricted

The Corporation's investment portfolio is considered trading and is 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 consolidated balance sheets.

The Corporation has investments in alternative investments, primarily hedge funds of funds totaling \$91.3 and \$41.1 at June 30, 2010 and 2009, respectively. These funds utilize various types of debt and equity securities and derivative instruments in their investment strategies. Alternative investments are recorded under the equity method.

Investments in unconsolidated affiliates are accounted for under the cost or equity method of accounting, as appropriate and are included in other assets in the consolidated balance sheets. The Corporation utilizes the equity method of accounting for its investments in entities over which it exercises significant influence. The Corporation's equity income or loss is recognized in nonoperating gains (losses). The fair value of the HBCS Capital Certificate was estimated to approximate cost, since the Certificate is not traded, has no specific maturity, and is noninterest bearing (see note 5).

Investments limited as to use or restricted include assets held by trustees under bond indenture, self-insurance trust arrangements, assets restricted by donor, and assets designated by the Board of Directors for future capital improvements and other purposes over which it retains control and may, at its discretion, use for other purposes. Amounts from these funds required to meet current liabilities have been classified in the consolidated balance sheets as current assets. Purchases and sales of securities are recorded on a trade-date basis.

MEDSTAR HEALTH, INC.

Notes to Consolidated Financial Statements

June 30, 2010 and 2009

(Dollars in millions)

Investment income (interest and dividends) including realized gains and losses on investment sales are reported as nonoperating gains or losses in the excess of revenues over expenses in the accompanying consolidated statements of operations and changes in net assets unless the income or loss is restricted by the donor or law. Investment income on funds held in trust for self-insurance purposes is included in other operating revenue. Investment income and net gains (losses) 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 or adjusted cost if the investment was previously determined to be other-than-temporarily impaired. Unrealized gains and losses are included in nonoperating gains (losses) within the excess of revenue over expenses.

(g) Inventories

Inventories, which primarily consist of medical supplies and pharmaceuticals at many of the operating entities, are stated at the lower of cost or market, with cost being determined primarily under the average cost or first-in, first-out methods.

(h) Property and Equipment

Property and equipment acquisitions are recorded at cost and are depreciated or amortized over the estimated useful lives of the assets. Estimated useful lives range from three to forty years. Amortization of assets held under capital leases are computed using the shorter of the lease term or the estimated useful life of the leased asset and is included in depreciation and amortization expense. The Corporation periodically evaluates the recoverability of property and equipment based upon projected undiscounted cash flows and operating income for each business. 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. Interest expense capitalized totaled \$7.0 and \$7.1 for 2010 and 2009, respectively, which was offset by investment earnings of \$1.2 and \$4.6, respectively. Depreciation is computed on a straight-line basis. Major classes and estimated useful lives of property and equipment are as follows:

Leasehold improvements	Lease term
Buildings and improvements	10 – 40 years
Equipment	3 – 20 years

Gifts of long-lived assets such as land, buildings, or equipment are reported as unrestricted support, 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.

MEDSTAR HEALTH, INC.

Notes to Consolidated Financial Statements

June 30, 2010 and 2009

(Dollars in millions)

(i) Interest in Net Assets of Foundation

The Corporation 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 Corporation. Changes in the Corporation's economic interests in these financially interrelated organizations are recognized in the consolidated statements of operations and changes in net assets as a component of changes in temporarily restricted net assets.

(j) Internal-Use Software

The Corporation capitalizes the direct costs, including internal personnel costs, associated with the implementation of new information systems for internal use. The Corporation capitalized \$1.6 and \$5.8 during the years ended June 30, 2010 and 2009, respectively. Capitalized amounts are amortized over the estimated lives of the software, generally three to five years.

(k) Financing Costs

Financing costs incurred in issuing bonds have been capitalized and included in other assets. These costs are being amortized over the estimated duration of the related debt using the effective interest method. Accumulated amortization totaled \$3.9 and \$3.3 at June 30, 2010 and 2009, respectively.

(l) Estimated Professional Liability Costs

The provision for estimated self-insured professional liability claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported. These estimates are based on actuarial analysis of historical trends, claims asserted and reported incidents.

(m) Leases

Lease arrangements, including assets under construction, are capitalized when such leases convey substantially all the risks and benefits incidental to ownership. Capital leases are amortized over either the lease term or the life of the related assets, depending upon available purchase options and lease renewal features. Amortization related to capital leases is included in the statements of operations within depreciation and amortization expense.

(n) Derivatives

The Corporation utilizes derivative financial instruments to manage its interest rate risks associated with tax-exempt debt. The Corporation does not hold or issue derivative financial instruments for trading purposes. The derivative instruments are recorded on the balance sheet at their respective fair values. The Corporation's current derivative investments do not qualify for hedge accounting; therefore, the changes in fair value have been recognized in the accompanying consolidated statements of operations and changes in net assets as mark-to-market adjustments. The fair market value of the derivative instruments are included in other long-term liabilities in the accompanying consolidated balance sheets.

MEDSTAR HEALTH, INC.

Notes to Consolidated Financial Statements

June 30, 2010 and 2009

(Dollars in millions)

(o) Net Patient Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments due to future audits, reviews and investigations. The differences between the estimated and actual amounts are recorded as part of net patient service revenue in future periods as the amounts become known, or as years are no longer subject to audit, review or investigation. Payment arrangements include prospectively determined rates per discharge, fee-for-service, discounted charges, and per diem payments. Hospital inpatient services, hospital outpatient services, the physician component of physician/managed care networks, and other patient services consists of revenue, which is recognized when the services are rendered based on billable charges. Other patient service revenue primarily consists of home care, long-term care and other nonhospital patient services.

Premium revenue consists of amounts received from the State of Maryland by the Corporation's managed care organization for providing medical services to subscribing participants, regardless of services actually performed. The managed care organization provides services primarily to enrolled Medicaid beneficiaries. This revenue is recognized ratably over the contractual period for the provision of services. Medical expenses of the managed care organization include a provision for incurred but unreported claims.

(p) Charity Care

The Corporation provides care to patients who meet certain criteria under its charity care policies without charge or at amounts less than established rates. Because the Corporation does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue.

(q) Grants

Federal grants are accounted for as either an exchange transaction or as a contribution based on terms and conditions of the grant. If the grant is accounted for as an exchange transaction, revenue is recognized as other operating revenue when earned. If the grant is accounted for as a contribution, the revenues are recognized as either other operating revenue, or as temporarily restricted contributions depending on the restrictions within the grant.

(r) Contributions

Unconditional promises to give cash and other assets to the Corporation are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statement of operations as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying financial statements.

MEDSTAR HEALTH, INC.

Notes to Consolidated Financial Statements

June 30, 2010 and 2009

(Dollars in millions)

(s) *Income Taxes*

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date. Any changes to the valuation allowance on the deferred tax asset are reflected in the year of the change. The Corporation accounts for uncertain tax positions in accordance with the FASB Accounting Standards Codification (ASC) Topic 740, *Income Taxes*.

(t) *Excess of Revenue over Expenses*

The consolidated statements of operations and changes in net assets includes a performance indicator, which is the excess of revenue over expenses. Changes in unrestricted net assets that are excluded from excess of revenue over expenses, include unrealized gains and losses on investments classified as other-than-trading securities, contributions of long-lived assets (including assets acquired using contributions that by donor restriction were to be used for the purpose of acquiring such assets), certain changes in accounting principle and defined benefit obligations in excess of recognized pension cost, among others.

(u) *Temporarily and Permanently Restricted Net Assets*

Temporarily restricted net assets are those whose use by the Corporation or individual operating units has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the Corporation or individual operating units in perpetuity.

(v) *Fair Value of Financial Instruments*

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

Cash and cash equivalents, receivables, other current assets, other assets, current liabilities and long-term liabilities: The carrying amount reported in the consolidated balance sheets for each of these assets and liabilities approximates their fair value.

The fair value of investments, assets whose use is limited or restricted and the interest rate swap is discussed in note 3. The fair value of long term debt is discussed in note 7.

(w) *Reclassifications*

Certain prior year amounts have been reclassified to conform with current period presentation, the effect of which is not material.

MEDSTAR HEALTH, INC.

Notes to Consolidated Financial Statements

June 30, 2010 and 2009

(Dollars in millions)

(x) *New Accounting Pronouncements*

In June 2009, the FASB issued guidance that eliminates the hierarchy of authoritative accounting and reporting guidance on nongovernmental GAAP and replaces it with a single authoritative source, the FASB Accounting Standards Codification (ASC). The ASC affects the way in which users refer to GAAP and perform accounting research, but does not change GAAP. This guidance is effective for reporting periods ending after September 15, 2009. The Corporation adopted the provisions of this guidance as of September 30, 2009. The adoption did not have an impact on the Corporation's financial position or results of operations.

In December 2008, the FASB issued guidance related to *Employers' Disclosures about Postretirement Benefit Plan Assets* which amended previously issued guidance. The purpose of the guidance is to enhance disclosures and provide users' with information regarding the types of assets and associated risks in an employer's defined benefit pension or other postretirement plan and events in the economy and markets that could have a significant effect on the value of plan assets. The disclosures about plan assets required shall be provided for fiscal years ending after December 15, 2009. The Corporation adopted this disclosure requirement for the year ended June 30, 2010.

In April 2009, the FASB issued guidance related to *Not-for-Profit Entities: Mergers and Acquisitions Including an amendment of FASB Statement No. 142*. This guidance establishes principles and requirements for how a not-for-profit entity determines whether a combination is a merger or an acquisition and amends previously issued guidance related to *Intangibles - Goodwill and Other*, to make it fully applicable to not-for-profit entities. The guidance is effective for mergers for which the merger date is on or after the beginning of an initial reporting period beginning on or after December 15, 2009; therefore, effective for the Corporation on January 1, 2010. The guidance is effective for acquisitions for which the acquisition date is on or after the beginning of the first *annual* reporting period beginning on or after December 15, 2009; therefore, effective for the Corporation on July 1, 2010. It may not be applied to mergers or acquisitions before those dates.

In September 2009, the FASB issued Accounting Standards Update (ASU) 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value Per Share (or Its Equivalent)*. The guidance amends ASC Topic 820 and permits, as a practical expedient, fair value of investments within its scope to be estimated using net asset value or its equivalent determined as of the reporting entity's measurement date. Net asset value, in many instances, may not equal fair value that would be calculated pursuant to ASC Topic 820.

In January 2010, the FASB issued ASU 2010-06, *Improving Disclosures about Fair Value Measurements*. ASU 010-06 amends ASC Topic 820, *Fair Value Measurements and Disclosures*, to require a number of additional disclosures regarding fair value measurements. Effective fiscal year 2010, ASU 2010-06 requires disclosure of the amounts of significant transfers between Level I and Level II investments and the reasons for such transfers, the reasons for any transfers in or out of Level III investments and disclosure of the policy for determining when transfers among levels are recognized. ASU 2010-06 also clarified that disclosures should be provided for each class of assets and liabilities and clarified the requirement to disclose information about the valuation techniques and inputs used in estimating Level II and Level III measurements. Effective in fiscal year 2011,

MEDSTAR HEALTH, INC.

Notes to Consolidated Financial Statements

June 30, 2010 and 2009

(Dollars in millions)

ASU 2010-06 also requires that information in the reconciliation of recurring Level III measurements about purchases, sales, issuances and settlements be provided on a gross basis. The adoption of ASU 2010-06 only required additional disclosures and did not have an impact on the consolidated financial statements. As the Corporation does not have significant transfers between Levels, or any Level III measurements, no additional disclosures were necessary.

In August 2010, the FASB issued ASU No. 2010-23, *Health Care Entities (Topic 954): Measuring Charity Care for Disclosure*. ASU 2010-23 is intended to reduce the diversity in practice regarding the measurement basis used in the disclosure of charity care. ASU 2010-23 requires that cost be used as the measurement basis for charity care disclosure purposes and that cost be identified as the direct and indirect cost of providing the charity care, and requires disclosure of the method used to identify or determine such costs. This ASU is effective for the Corporation on July 1, 2011. The Corporation is currently evaluating the impact on its disclosures from the adoption of this pronouncement.

(2) Investments and Assets Whose Use Is Limited or Restricted

Investments and assets whose use is limited or restricted as of June 30, 2010 and 2009, at fair value or under the equity method of accounting in the case of alternative investments, consist of the following:

	<u>2010</u>	<u>2009</u>
Collateralized guaranteed investment contract and cash	\$ 120.0	133.6
Fixed income securities and funds	377.3	347.4
Equity securities	336.2	264.0
Alternative investments	91.3	41.1
Other	—	8.4
	<u>924.8</u>	<u>794.5</u>
Total investments and assets whose use is limited or restricted	924.8	794.5
Less short-term investments and assets whose use is limited or restricted	<u>(57.6)</u>	<u>(47.5)</u>
Long-term investments and assets whose use is limited or restricted	<u>\$ 867.2</u>	<u>747.0</u>

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Assets whose use is limited or restricted as of June 30, 2010 and 2009, included in the table above, consist of the following:

	<u>2010</u>	<u>2009</u>
Funds held by trustees	\$ 31.1	78.9
Self-insurance funds	145.1	121.4
Funds restricted by donors for specific purposes and endowment	58.1	52.7
Funds designated by Board and Management	164.5	150.0
HBCS Capital Certificate	—	5.2
	<u>398.8</u>	<u>408.2</u>
Less assets required for current obligations	<u>(40.8)</u>	<u>(33.6)</u>
	<u>\$ 358.0</u>	<u>374.6</u>

Investment income and realized and unrealized gains and losses for assets whose use is limited, cash equivalents and investments are comprised of the following for the years ending June 30, 2010 and 2009:

	<u>2010</u>	<u>2009</u>
Other operating revenue:		
Investment income	\$ 2.4	(1.1)
Nonoperating gains (losses):		
Interest income and dividends	21.3	15.5
Net realized gains (losses) on sale of investments	0.7	(55.2)
Unrealized gains (losses) on trading investments	60.9	(69.7)
	<u>82.9</u>	<u>(109.4)</u>
Other changes in net assets:		
Changes in unrealized gains (losses) on other-than-trading investments	0.1	(0.2)
Realized net gains (losses) on temporarily and permanently restricted net assets	2.2	(4.0)
Changes in unrealized gains (losses) on temporarily and permanently restricted net assets	5.1	(8.6)
Total investment return	<u>\$ 92.7</u>	<u>(123.3)</u>

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(3) Fair Value of Financial Instruments

The Corporation adopted ASC Topic 820, *Fair Value Measurements and Disclosures* on July 1, 2008. The guidance provides for the following:

- Defines fair value as the price 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, and establishes a framework for measuring fair value;
- Establishes a three-level hierarchy for fair value measurement;
- Requires consideration of the Corporations' nonperformance risk when valuing liabilities; and
- Expands disclosures about instruments measured at fair value.

The three-level valuation hierarchy for fair value measurements is based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Corporations' market assumptions. The three level valuation hierarchy is defined as follows:

- Level 1 – Quoted prices for identical instruments in active markets;
- Level 2 – Quoted prices for similar instruments in active markets; quoted prices for identical or similar investments in markets that are not active; and model derived valuations whose significant inputs are observable; and
- Level 3 – Instruments whose significant inputs are unobservable.

The Corporation has incorporated an Investment Policy Statement (IPS) into the investment program. The IPS, which has been formally adopted by the Corporation's Board of Directors, contains numerous standards designed to ensure adequate diversification by asset class and geography. The IPS also limits all investments by manager and position size, and limits fixed income position size based on credit ratings, which serves to further mitigate the risks associated with the investment program. At June 30, 2010 and 2009, management believes that all investments were being managed in a manner consistent with the IPS.

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The table below presents the Corporation's investable assets and liabilities as of June 30, 2010, aggregated by the three level valuation hierarchy:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets:				
Cash and cash equivalents	\$ 629.6	—	—	629.6
U.S. treasury bonds	53.0	—	—	53.0
U.S. agency mortgage backed securities	101.5	—	—	101.5
Corporate bonds	—	58.9	—	58.9
Fixed income mutual funds	1.1	121.2	—	122.3
All other fixed income securities	—	41.6	—	41.6
Equity mutual funds & ETF's	3.4	148.3	—	151.7
Common stocks	184.5	—	—	184.5
Total assets	\$ 973.1	370.0	—	1,343.1
Liabilities:				
Interest rate swap	\$ —	18.1	—	18.1
Total liabilities	\$ —	18.1	—	18.1

The table below presents the Corporation's investable assets and liabilities as of June 30, 2009, aggregated by the three level valuation hierarchy:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets:				
Cash and cash equivalents	\$ 649.6	52.7	—	702.3
U.S. treasury bonds	20.8	—	—	20.8
U.S. agency mortgage backed securities	53.2	—	—	53.2
Corporate bonds	—	81.9	—	81.9
Fixed income mutual funds	0.6	125.0	—	125.6
All other fixed income securities	9.7	51.3	—	61.0
Equity mutual funds & ETF's	77.5	32.0	—	109.5
Common stocks	153.3	—	—	153.3
Total assets	\$ 964.7	342.9	—	1,307.6
Liabilities:				
Interest rate swap	\$ —	14.0	—	14.0
Total liabilities	\$ —	14.0	—	14.0

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(4) Property and Equipment

Property and equipment as of June 30, 2010 and 2009 is as follows:

	<u>2010</u>	<u>2009</u>
Land	\$ 51.7	38.6
Buildings and improvements	1,042.6	916.7
Equipment	1,351.7	1,254.2
Equipment under capital leases	1.5	2.3
	<u>2,447.5</u>	<u>2,211.8</u>
Less accumulated depreciation and amortization	<u>(1,594.4)</u>	<u>(1,480.8)</u>
	853.1	731.0
Construction-in-progress	<u>170.3</u>	<u>167.4</u>
	<u>\$ 1,023.4</u>	<u>898.4</u>

Construction-in-progress includes a variety of ongoing capital projects at the Corporation as of June 30, 2010 and 2009. In connection with the Franklin Square Hospital project (see note 7), the Corporation has unspent commitments of \$23.5 and \$43.2 as of June 30, 2010 and 2009, respectively. Also, in connection with the MGH project (see note 7), the Corporation had unspent commitments of \$1.5 and \$17.5 as of June 30, 2010 and 2009, respectively.

Depreciation and amortization expense related to property and equipment amounted to \$146.4 and \$131.6 for the years ended June 30, 2010 and 2009, respectively.

(5) Sale of Receivables

The Corporation was party to an agreement with Hospital Billing and Collection Service, Ltd., (HBCS), in which the Corporation sold certain eligible patient service receivables, with recourse, to HBCS and in return HBCS was required to provide collection services. Pursuant to the agreement, the Corporation was required to repurchase uncollected accounts after 180 days and the Corporation purchased a noninterest bearing Capital Certificate owned by HBCS. Also, HBCS withheld a portion of the selling price of receivables in exchange for a noninterest-bearing subordinated demand note. Effective February 2009, the Corporation entered into a repurchase agreement with HBCS whereby the Corporation would pay \$26.3 to repurchase all receivables sold to HBCS and the capital certificate and note would be canceled. Through June 30, 2009, the Corporation had repurchased \$21.9 of these receivables. The repurchase of the remaining \$4.4 of these receivables was completed in July 2009. At that time, the Capital Certificate and related note were canceled.

As of June 30, 2009, receivables sold and outstanding, net of repurchased accounts, were \$13.1 and reserves of \$3.1 were established for the uncollectible portion of the anticipated repurchases. The Capital Certificate of \$5.2 at June 30, 2009 is classified as assets whose use is limited in the consolidated balance sheets and the demand note of \$3.5 was classified as other receivables in the consolidated balance sheets.

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(6) Other Assets

Other assets as of June 30, 2010 and 2009 consist of the following:

	<u>2010</u>	<u>2009</u>
Deferred financing costs, net	\$ 13.8	13.6
Investments in unconsolidated entities	16.1	11.9
Reinsurance receivables	28.5	27.6
Goodwill, net	7.2	6.2
Deferred tax asset	21.1	22.5
Other assets	32.9	30.3
	<u>\$ 119.6</u>	<u>112.1</u>

The Corporation has investments in other healthcare related organizations that are accounted for under the equity method that total \$16.1 and \$11.9 at June 30, 2010 and 2009, respectively. Under the equity method, original investments are recorded at cost and adjusted by the Corporation's share of the undistributed earnings or losses of these organizations. The related ownership interest in these organizations ranges from 10% to 50%. The Corporation's share of earnings in these organizations was \$3.9 and \$3.1 for the years ended June 30, 2010 and 2009, respectively. Certain other nonconsolidated entities are recorded under the cost method.

Goodwill represents the excess of the cost to acquire businesses over the estimated fair market value of the net tangible and identifiable intangible assets acquired. Goodwill, net of accumulated amortization, of \$4.7 is related to for-profit subsidiaries. The remaining goodwill, net of accumulated amortization, of \$2.5 are associated with not-for-profit entities and are amortized using the straight-line method over lives ranging from 10 to 15 years. Accumulated amortization at June 30, 2010 and 2009 was \$4.1 and \$4.0, respectively. Amortization recognized in 2010 and 2009 totaled \$0.1. The Corporation annually evaluates the realizability of goodwill based upon an earnings multiple factor and operating income for each business having a significant goodwill balance. No impairment was recognized in 2010 or 2009.

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(7) Debt

At June 30, 2010 and 2009, the Corporation's outstanding borrowings include the following:

	2010	2009
Maryland Health and Higher Educational Facilities		
Authority Revenue Bonds:		
4.25% – 5.75% Serial bonds (Series 2004, due 2009 – 2025)	\$ 37.1	40.5
5.375% Term bonds (Series 2004, due 2024)	49.7	49.7
5.50% Term bonds (Series 2004, due 2033)	80.1	80.1
4.25% – 5.25% Serial bonds (Series 1998A, due 2009 – 2013)	12.8	16.7
4.75% – 5.25% Term bonds (Series 1998A, due 2019, 2029, and 2039)	146.2	146.2
4.00% – 5.25% Serial bonds (Series 1998B, due 2007 – 2008 and 2014 – 2016)	14.8	14.8
4.75% – 5.25% Term bonds (Series 1998B, due 2029 and 2039)	88.5	88.5
4.75% – 5.25% Term bonds (Series 2007, due 2042 and 2046)	145.0	145.0
Plus unamortized net premium	6.0	6.1
	580.2	587.6
District of Columbia Hospital Revenue Bonds:		
Multimodal Revenue bonds:		
0.14% – 0.30% at June 30, 2010 Serial bonds (Series 1998A due 2008-2039) (and 0.18% – 0.28% at June 30, 2009)	137.0	139.4
2.75% – 5.00% Serial bonds (Series 1998B, due 2008 – 2020)	14.7	15.9
5.00% Term bonds (Series 1998B, due 2029 and 2039)	54.1	54.1
2.75% – 5.00% Serial bonds (Series 1998C, due 2008 – 2020)	14.8	15.9
5.00% – 5.50% Term bonds (Series 1998C, due 2029 and 2039)	54.1	54.1
Less unamortized net discount	(1.0)	(0.9)
	273.7	278.5

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	<u>2010</u>	<u>2009</u>
Maryland Health and Higher Educational Facilities Authority Revenue Bonds St. Mary's Hospital: Series 2009 variable rate (rates ranging between 0.12% – 0.35%, due 2010 – 2039)	\$ 15.8	—
County Commissioners of St. Mary's County General Obligation Hospital Bonds of 2002: (rates ranging between 4.25% – 5.125%, due 2005 – 2022)	16.0	—
St. Mary's Hospital notes payable and other	5.1	—
Other:		
Notes payable to financial institutions or State Agencies under mortgages (floating rates ranging between 0.5% – 8.2%) and other	15.8	17.6
Line of credit due June 2011 (0.03% – 0.92% at June 30, 2010 and 0.03% – 0.89% at June 30, 2009)	<u>155.0</u>	<u>195.0</u>
	<u>207.7</u>	<u>212.6</u>
Total debt	1,061.6	1,078.7
Less current portion of long-term debt	<u>(265.8)</u>	<u>(27.5)</u>
Long-term debt, net	<u>\$ 795.8</u>	<u>1,051.2</u>

Scheduled maturities on borrowings, for the next five fiscal years and thereafter are as follows:

2011	\$ 265.8
2012	17.4
2013	17.7
2014	18.2
2015	17.6
Thereafter	<u>719.9</u>
Total	<u>\$ 1,056.6</u>

The fair value of outstanding tax exempt publicly traded bonds is estimated to be \$888.4 and \$810.4 as of June 30, 2010 and 2009, respectively. The fair value of other long-term debt approximates its carrying value.

In December 1998, the Maryland Health and Higher Education Facilities Authority (MHHEFA) and the District of Columbia (District) issued bonds (Series 1998 Bonds) on behalf of the Corporation. Bond proceeds of approximately \$588.6 were loaned to the Corporation under separate loan agreements with MHHEFA and the District upon execution of obligations pursuant to the Master Trust Indenture. The District of Columbia (District) issued \$300.0 of Multimodal Revenue Bonds, including \$150.0 Series

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1998A (\$15.6 repaid through August 2010), \$75.0 Series 1998B (\$7.4 repaid through August 2010), and \$75.0 Series 1998C (\$7.3 repaid through August 2010).

The Series 1998A bonds were converted to Variable Rate Demand Obligations backed by bank letters of credit in May 2008 and the municipal bond insurance policy was terminated. Of the Series 1998A bonds remaining outstanding in August 2010, approximately \$44.8 trade in a daily mode backed by a letter of credit issued by Wells Fargo Bank, N.A. (formerly Wachovia Bank, National Association) and remarketed by J.P. Morgan Securities Inc. The letter of credit has a term of three years expiring May 2011. The remaining \$89.6 trade in a weekly mode backed by two letters of credit each in the amount of approximately \$44.8 issued by Bank of America, N.A. and remarketed by Citigroup Global Markets Inc. The term of one letter of credit is three years expiring May 2011 and the term of the second letter of credit is five years expiring May 2013. Management is currently evaluating proposals for renewing or replacing these letters of credit. In the event of a failed remarketing, the bonds would be tendered to the bank and repaid over a five-year period, beginning at the time of the failed remarketing under each of the letters of credit. No portion of the bonds have been put at June 30, 2010 and 2009, respectively. The \$67.6 Series 1998B and \$67.7 Series 1998C bonds were converted to a fixed rate in May 2008 and remain insured by Assured Guaranty, Ltd. (Assured)(formerly Financial Security Assurance, Inc.). The reimbursement obligation with respect to the letters of credit are evidenced and secured by obligations issued by the Corporation under the Master Trust Indenture.

MHHEFA issued \$283.5 of Revenue Bonds, including the \$166.6 Series 1998A (\$11.6 repaid through August 2010) and \$116.9 Series 1998B (\$13.6 repaid through August 2010). All Series 1998 MHHEFA bonds were issued at fixed rates. Principal and interest under the Series 1998 MHHEFA bonds are insured under municipal insurance policies with Assured and Ambac.

Related to the District borrowings, the Corporation entered into an interest rate swap with Wells Fargo Bank, N.A. in a notional amount totaling \$150.0 (reduced to \$119.7 at August 2010). The swap agreement expires in fiscal year 2027. The interest rate swap is part of a comprehensive and long-term capital structure strategy. The purpose of the swap is to mitigate the effect of potential interest rate volatility and minimize the variability of the Corporation's average cost of capital. Under the terms of the swap, the Corporation pays a fixed rate and receives a variable rate. Collateral is only required to be posted under the swap in the event that the Corporation's credit ratings are downgraded by two rating agencies below the BBB level. To date, no collateral postings have been required. At June 30, 2010 and 2009, the variable interest rate under these agreements was 0.23% and 0.21%, respectively. The fixed rate was 3.69% as of June 30, 2010 and June 30, 2009. The variable rates are capped at 14.0%. The fair value of the interest rate swap at June 30, 2010 and June 30, 2009 was \$18.1 and \$14.0, respectively, and is included in other long-term liabilities. The change in fair value of the swap is reported in nonoperating gains (losses) in the statements of operations and changes in net assets.

In February 2004, MHHEFA issued \$170.3 in bonds (Series 2004 Bonds) on behalf of the Corporation. The proceeds of the Series 2004 Bonds were loaned to the Corporation pursuant to a loan agreement with MHHEFA upon execution of an obligation pursuant to the Master Trust Indenture. The Series 2004 Bonds were issued as \$40.5 serial bonds maturing 2009 through 2025 (\$7.0 repaid through August 2010), \$49.7 term bonds maturing 2024 and \$80.1 term bonds maturing 2033. Such Bonds were issued at fixed rates.

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Series 2004 Bonds maturing on or after August 2015 are subject to redemption or purchase at the option of the Corporation prior to maturity beginning in 2014.

In January 2007, MHHEFA issued \$145.0 in bonds (Series 2007 Bonds) on behalf of the Corporation. The Series 2007 Bonds were issued at a net premium of \$3.6, resulting in total proceeds of \$148.6. The proceeds of the Series 2007 Bonds were loaned to the Corporation pursuant to a loan agreement with MHHEFA upon execution of an obligation pursuant to the Master Trust Indenture. The proceeds from the offering, in conjunction with an equity contribution from the Corporation, have been used at Franklin Square Hospital to fund the construction of a seven-story patient tower, expanded parking, a new power plant, renovation of certain contiguous areas to the patient tower, site design, and to fund capitalized interest and transaction costs for the project. The Series 2007 Bonds were issued as \$56.0 term bonds maturing 2042 and \$89.0 term bonds maturing 2046. Such Bonds were issued at fixed rates. Series 2007 Bonds maturing on or after May 2042 are subject to redemption or purchase at the option of the Corporation prior to maturity beginning in 2016.

The Corporation, which is currently the sole member of an “obligated group” as defined in the Master Trust Indenture, is bound by the provisions of the Master Trust Indenture for payment of any outstanding obligations under existing loan agreements. All of the hospitals except Montgomery General Hospital, St. Mary’s Hospital, and certain other affiliates (the guarantors) of the Corporation are parties to a guaranty agreement pursuant to which they jointly and severally guaranty the payment and performance of the obligations under the Master Trust Indenture. The obligations of the guarantors under the Guaranty Agreement are collateralized by deeds of trust granted by the hospitals. Under the Master Trust Indenture and the deeds of trust, as collateral for the payments due thereunder, the Corporation and certain hospital affiliates, have granted a security interest in their revenues subject to permitted encumbrances.

Under the Master Trust Indenture, the Corporation is required to maintain, among other covenants, a maximum annual debt service coverage ratio of not less than 1.10 to 1.0. Under the loan agreements relating to the Series 1998 Bonds, the Corporation is required to maintain a historical debt service coverage ratio of not less than 2.0 to 1.0 and to maintain at least 65 days cash on hand. In the event the Corporation does not meet either of these requirements, it is required to fund a trustee-held debt service reserve fund securing the Series 1998 Bonds. The amount to be deposited shall equal the lesser of: 10% of the principal amount of such outstanding bonds, or the largest annual debt service with respect to such bonds in any future year, or 125% of the average annual debt service of future years. At June 30, 2010 and 2009, there were no funds required to be held in the debt service reserve fund for the Series 1998 Bonds.

The Corporation maintains a \$195.0 revolving credit agreement provided by a group of banks that expires in June 2011. The facility is evidenced by an obligation issued under the Master Trust Indenture. The outstanding balance on the facility was \$155.0 at June 30, 2010, and \$195.0 at June 30, 2009. Management is currently evaluating proposals for renewing or replacing this revolving credit agreement. Of the outstanding balance, \$45.0 was being held in operating cash at June 30, 2010 and \$103.7 was being held in operating cash at June 30, 2009, in order to maximize the Corporation’s liquidity. Proceeds were also utilized in fiscal 2008 and 2009 to retire Montgomery General Hospital’s tax-exempt debt and interest rate hedge, and to fund a portion of a project on Montgomery General Hospital’s campus.

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In addition, the Corporation maintains a \$30.0 letter of credit facility, provided by a single lender, which is also evidenced by an obligation issued under the Master Trust Indenture. This facility is principally used to securitize certain regulatory obligations under various insurance programs. This facility, which has terms and conditions similar to the revolving credit agreement, expires in June 2011. Management is currently evaluating proposals for renewing or replacing this letter of credit facility. However, the standby letters of credit issued under the facility can be canceled at the bank's option each year. At June 30, 2010 and 2009, standby letters of credit issued pursuant to the facility were \$17.0 and \$15.4, respectively. However, no amounts have been drawn by the beneficiaries under the standby letters of credit.

On September 30, 2009, St. Mary's Hospital joined the Corporation. St. Mary's Hospital had certain debt outstanding at the time of the affiliation, including 2002 St. Mary's County General Obligation bonds with an outstanding balance of \$15.2 at August 2010 and Series 2009 MHHEFA bonds with an outstanding balance of \$15.8 at August 2010. The bonds are secured by a mortgage on the real property of St. Mary's Hospital and a pledge of St. Mary's Hospital's revenues. Under terms of the financing documents, St. Mary's Hospital is required to maintain days cash on hand of 75 days in fiscal 2010 and 85 days thereafter, and to maintain a historical debt service coverage ratio in excess of 1.10. St. Mary's Hospital is also subject to certain additional covenants and tests on an ongoing basis.

(8) Retirement Plans

The Corporation has two qualified defined benefit pension plans (MedStar Health, Inc. Pension Equity Plan (PEP) and MedStar Health, Inc. Cash Balance Retirement Plan (CBRP)) covering substantially all full-time employees hired before 2005, and an supplemental executive pension plan (SEPP) for certain executive management employees. The CBRP also covers substantially all employees of MGH, who were formerly covered under a separate plan that was merged into the CBRP during the year. St. Mary's Hospital also has a defined benefit plan that substantially covers all employees of St. Mary's Hospital which is reflected in the June 30, 2010 information below.

Benefits under the plans are substantially based on years of service and the employees' career earnings. The Corporation contributes to the plans based on actuarially determined amounts necessary to provide assets sufficient to meet benefits to be paid to plan participants and to meet the minimum funding requirements of the Employee Retirement Income Security Act of 1974, as amended by the Pension Protection Act of 2006, and Internal Revenue Service regulations. Effective July 1, 2000, employees of the Transferred Businesses (see note 18) became participants in one of the Corporation's pension plans and are reflected in the pension information provided below.

The Corporation's investment policies are established by the MedStar Health, Inc. Investment Committee, comprised of members of the board of directors, other community leaders, and management. Among its responsibilities, the Investment Committee is charged with establishing and reviewing asset allocation strategies, monitoring investment manager performance, and making decisions to retain and terminate investment managers. Assets of each of the Corporation's pension plans are managed in a similar fashion by the same group of investment managers. The Corporation has incorporated an Investment Policy Statement (IPS) into the investment program. The IPS, which has been formally adopted by the Corporation's Board of Directors, contains numerous standards designed to ensure adequate diversification by asset class and geography. The IPS also limits all investments by manager and position size, and limits

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fixed income position size based on credit ratings, which serves to further mitigate the risks associated with the investment program. At June 30, 2010 and 2009, management believes that all investments were being managed in a manner consistent with the IPS.

The Investment Committee has adopted certain target ranges for various asset classes within the pension portfolio. At June 30, 2010, these targets permitted the investment of up to 70% of the portfolio in publicly traded equities, up to 50% in fixed income securities, up to 10% in hedge funds, up to 5% in private equity, and up to 5% in cash. Actual asset allocations fluctuate depending upon gains and losses within asset classes over periods of time, the timing of plan contributions and distributions, and rebalancing decisions. Due to these fluctuations, actual asset allocations could exceed these levels over certain periods in time.

The following table illustrates the actual allocations at June 30:

	Actual allocation June 30, 2010	Actual allocation June 30, 2009
Publicly traded equities – domestic	39%	39%
Publicly traded equities – international	8	8
Fixed income securities	35	38
Hedge funds	9	6
Private equities	3	3
Cash	6	6
Total	<u>100%</u>	<u>100%</u>

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The table below presents the Corporation's pension plan's investable assets as of June 30, 2010 aggregated by the three level valuation hierarchy:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Assets:				
Cash and cash equivalents	\$ 50.6	—	—	50.6
U.S. treasury bonds	36.1	—	—	36.1
U.S. agency mortgage backed securities	30.5	—	—	30.5
Corporate bonds	—	22.5	—	22.5
Fixed income mutual funds	0.4	81.1	—	81.5
All other fixed income securities	—	19.0	—	19.0
Equity mutual funds and ETF's	65.8	40.1	—	105.9
Common stocks	168.3	—	—	168.3
Private equity	—	—	14.2	14.2
Hedge funds	—	—	52.7	52.7
Total assets	<u>\$ 351.7</u>	<u>162.7</u>	<u>66.9</u>	<u>581.3</u>

Changes to the fair values based on the Level 3 inputs, are summarized as follows:

	<u>Private equity</u>	<u>Hedge funds</u>	<u>Total</u>
Balance as of June 30, 2009	\$ 11.6	26.5	38.1
Additions:			
Contributions/purchases	0.9	41.6	42.5
Disbursements:			
Withdrawals/sales	(0.7)	(18.0)	(18.7)
Net change in value	<u>2.4</u>	<u>2.6</u>	<u>5.0</u>
Balance as of June 30, 2010	<u>\$ 14.2</u>	<u>52.7</u>	<u>66.9</u>

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The following summarizes redemption terms for the hedge fund-of-funds vehicles held as of June 30, 2010:

	Fund 1	Fund 2	Fund 3	Fund 4	Fund 5
Redemption timing:					
Redemption frequency	Quarterly	Monthly	Quarterly	Quarterly	Quarterly
Required notice	90 days	90 days	70 days	90 days	65 days
Audit reserve:					
Percentage held back for audit reserve	10%	10%	10%	10%	10%
Gates:					
Potential gate holdback	—	9	—	—	—
Potential gate release timeframe	—	2011	—	—	—

Investments in hedge fund-of-funds are typically carried at estimated fair value. Fair value is based on the Net Asset Value (NAV) of the shares in each investment company or partnership. Such investment companies or partnerships mark-to-market or mark-to-fair value the underlying assets and liabilities in accordance with GAAP. Realized and unrealized gains and losses of the investment companies and partnerships are included in their respective operations in the current year. Changes in unrealized gains or losses on investments, including those for which partial liquidations were effected in the course of the year, are calculated as the difference between the NAV of the investment at year-end less the NAV of the investment at the beginning of the year, as adjusted for contributions and redemptions made during the year and certain lock-up provisions. Generally, no dividends or other distributions are paid.

The following summarizes the status of contributions to the private equity fund-of-funds vehicles held as of June 30, 2010:

	Total commitment	Percentage of commitment contributed	Percentage of commitment remaining
Fund 1	\$ 9.0	77.5%	22.5%
Fund 2	8.5	81.1	18.9
Fund 3	8.5	38.5	61.5
Total	\$ <u>26.0</u>		

Investments in limited partnership interests are carried at fair value as determined by the General Partner in the absence of readily ascertainable market values. The fair value of limited partnership interests is generally based on fair value capital balances reported by the underlying partnerships, subject to management review and adjustment. Security values of companies traded on exchanges, or quoted on NASDAQ, are based upon the last reported sales price on the valuation date. Security values of companies traded over the counter, but not quoted on NASDAQ, and securities for which no sale occurred on the valuation date are based upon the last quoted bid price. The value of any security for which a market

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quotation is not readily available may be its cost, provided however, that the General Partner adjusts such cost value to reflect any bona fide third party transactions in such a security between knowledgeable investors, of which the General Partner has knowledge. In the absence of any such third party transactions, the General Partner may use other information to develop a good faith determination of value. Examples include, but are not limited to, discounted cash flow models, absolute value models, and price multiple models. Inputs for these models may include, but are not limited to, financial statement information, discount rates, and salvage value assumptions.

The valuation of both marketable and nonmarketable securities may include discounts to reflect a lack of liquidity or extraordinary risks, which may be associated with the investment. Determination of fair value is performed on a quarterly basis by the General Partner. Because of the inherent uncertainty of valuation, the determined values may differ significantly from the values that would have been used had a ready market for those investments existed.

The Corporation has established a long-term investment return target of 8.5% for PEP and CBRP. These assumptions are based on historical returns achieved in the investment portfolios over the last ten years and represent the return that can reasonably be expected to be generated on a similarly structured portfolio in the future.

The Corporation recognizes the funded status of defined benefit pension plans in the balance sheet and the recognition in unrestricted net assets of unrecognized gains or losses, prior service costs or credits and transition assets or obligations. The funded status is measured as the difference between the fair value of the plan's assets and the projected benefit obligation of the plan. The Corporation also adopted the measurement provisions of the guidance on July 1, 2008, which changed the plans' measurement date to June 30. The change resulted in a reduction to net assets of approximately \$1.4.

As previously discussed, the Corporation merged the MGH plan into the CBRP effective December 31, 2008, which resulted in a curtailment and a remeasurement of MGH assets and obligations at that date. This remeasurement resulted in a reduction to net assets of \$2.7, partially offset by an increase in net assets of \$0.7 from recognition of the curtailment.

In addition, in April 2009, the Corporation announced a freeze to benefit accruals in the CBRP and PEP, except for certain union-represented employees covered by the CBRP. The freeze was effective December 31, 2009. Effective January 1, 2010, affected associates earn all future benefits through the Corporation's defined contribution retirement savings plan. The freeze constitutes a curtailment and as such, the Corporation remeasured the plans' assets and projected benefit obligations at April 30, 2009. The remeasurement resulted in a reduction to net assets of approximately \$142.0, partially offset by an increase in net assets of \$31.0 from recognition of the curtailment. This decrease is largely attributable to the effect of the recent investment market performance on the funded status of these plans.

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The following are deferred pension costs which have not yet been recognized in periodic pension expense but instead are accrued in unrestricted net assets, as of June 30, 2010 and 2009. Unrecognized actuarial losses represent unexpected changes in the projected benefit obligation and plan assets over time, primarily due to changes in assumed discount rates and investment experience. Unrecognized prior service cost is the impact of changes in plan benefits applied retrospectively to employee service previously rendered. Deferred pension costs are amortized into annual pension expense over the average remaining assumed service period for active employees.

	Amounts in unrestricted net assets to be recognized during the next fiscal year	Amounts recognized in unrestricted net assets at June 30, 2010	Amounts recognized in unrestricted net assets at June 30, 2009
Net prior service cost	\$ 0.5	4.1	4.8
Net actuarial loss	18.8	446.8	321.6
Total	\$ 19.3	450.9	326.4

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The following table sets forth the plans' funded status and amounts recognized in the accompanying consolidated financial statements as of June 30, 2010 and 2009:

	<u>2010</u>	<u>2009</u>
Change in benefit obligation:		
Benefit obligation at beginning of year	\$ 765.1	742.0
Addition of St. Mary's Hospital benefit plan	21.8	—
Effect of measurement date change	—	(15.7)
	<u>786.9</u>	<u>726.3</u>
Adjusted benefit obligation at beginning of year	786.9	726.3
Service cost	18.7	32.6
Interest cost	54.2	50.6
Participants contributions	3.6	5.3
Plan amendments	—	1.6
Actuarial loss	145.1	9.4
Benefits paid	(23.5)	(28.0)
Curtailments	(2.4)	(31.7)
Settlements and other	—	(1.0)
	<u>982.6</u>	<u>765.1</u>
Benefit obligation at end of year	982.6	765.1
Change in plan assets:		
Plan assets at fair value at beginning of year	465.0	582.5
Contributions after measurement date	—	5.0
Effect of measurement date change	—	(17.1)
Addition of St. Mary's Hospital benefit plan assets	18.9	—
	<u>483.9</u>	<u>570.4</u>
Adjusted plan assets at fair value at beginning of year	483.9	570.4
Actual return on plan assets	59.0	(105.3)
Company contributions	58.3	23.6
Plan participants' contributions	3.6	5.3
Benefits paid	(23.5)	(28.0)
Settlements and other	—	(1.0)
	<u>581.3</u>	<u>465.0</u>
Plan assets at fair value at end of year	581.3	465.0
Funded status/net amount recognized	\$ <u>(401.3)</u>	<u>(300.1)</u>

The amounts recognized in the consolidated financial statements consist of the following at June 30:

	<u>2010</u>	<u>2009</u>
Pension liabilities	\$ 401.3	300.1
Accumulated benefit obligation at the measurement date	968.6	749.8

Expected contributions for the defined benefit plans are \$57.9 for the year ended June 30, 2011.

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Expected fiscal year benefit payments for all plans is as follows:

2011	\$	31.0
2012		46.1
2013		49.4
2014		53.9
2015		54.6
2016 – 2018		318.9
Total	\$	<u>553.9</u>

Net periodic pension expense for the years ended June 30, 2010 and 2009 is as follows:

	<u>2010</u>	<u>2009</u>
Service cost – benefits earned during the year	\$ 18.7	32.6
Interest cost on projected benefit obligation	54.2	50.6
Return on plan assets	(49.9)	(52.9)
Net amortization and deferral	0.4	1.3
Recognized actuarial loss	11.7	6.6
Net periodic pension expense	\$ <u>35.1</u>	<u>38.2</u>

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The assumptions used in determining net periodic pension expense and accrued pension costs shown above are as follows:

	<u>2010</u>	<u>2009</u>
Discount rates for obligations at year end:		
MedStar Health, Inc. Pension Equity Plan	5.95%	7.20%
MedStar Health, Inc. Cash Balance Retirement Plan	5.75	6.95
MedStar Health, Inc. Supplemental Executive Pension Plan	5.20	6.45
St. Mary's Hospital Pension Plan	5.40	N/A
Rate of compensation increase for obligations at year end:		
MedStar Health, Inc. Pension Equity Plan	4.00%	4.00%
MedStar Health, Inc. Cash Balance Retirement Plan	4.00	4.00
MedStar Health, Inc. Supplemental Executive Pension Plan	3.50	3.50
St. Mary's Hospital Pension Plan	4.00	N/A
Discount rates for pension cost:		
MedStar Health, Inc. Pension Equity Plan – July 1 – April 30	N/A	7.40%
MedStar Health, Inc. Pension Equity Plan – May 1 – June 30	N/A	7.65
MedStar Health, Inc. Pension Equity Plan – July 1 – June 30	7.20%	N/A
MedStar Health, Inc. Cash Balance Retirement Plan – July 1 – April 30	N/A	6.95
MedStar Health, Inc. Cash Balance Retirement Plan – May 1 – June 30	N/A	7.05
MedStar Health, Inc. Cash Balance Retirement Plan – July 1 – June 30	6.95	N/A

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	<u>2010</u>	<u>2009</u>
MedStar Health, Inc. Supplemental Executive Pension Plan – July 1 – April 30	N/A	7.10
MedStar Health, Inc. Supplemental Executive Pension Plan – May 1 – June 30	N/A	7.40
MedStar Health, Inc. Supplemental Executive Pension Plan – July 1 – June 30	6.45	N/A
MGH Health Services Pension Plan – July 1 – December 31, 2008	N/A	6.25
St. Mary’s Hospital Pension Plan – July 1 – June 30, 2010	6.25	N/A
Expected long-term rate of return on plan assets – PEP and CBRP	8.50%	8.50%
Expected long-term rate of return on plan assets – MGH – July 1 – December 31	N/A	7.75
Expected long-term rate of return on plan assets – St. Mary’s Hospital	8.00	N/A
Rate of compensation increase for pension cost:		
MedStar Health, Inc. Pension Equity Plan – July 1 – April 30	N/A	5.00%
MedStar Health, Inc. Pension Equity Plan – May 1 – June 30	N/A	4.00
MedStar Health, Inc. Pension Equity Plan – July 1 – June 30	4.00%	N/A
MedStar Health, Inc. Cash Balance Retirement Plan – July 1 – April 30	N/A	5.00
MedStar Health, Inc. Cash Balance Retirement Plan – May 1 – June 30	N/A	4.00
MedStar Health, Inc. Cash Balance Retirement Plan – July 1 – June 30	4.00	N/A
MedStar Health, Inc. Supplemental Executive Pension Plan	3.50	3.50
MGH Health Services Pension Plan	N/A	3.50
St. Mary’s Hospital Pension Plan	4.00	N/A

The Corporation also has various contributory, tax deferred annuity and savings plans with participation available to certain employees. The Corporation matches employee contributions up to 2.5% of compensation in certain plans. The Corporation contributed approximately \$19.4 and \$17.2 during the years ended June 30, 2010 and 2009, respectively. The Corporation approved the temporary suspension of the 2-3% fixed tenure-based contribution to the 403(b) plan for calendar year 2010.

In addition, the Corporation has various deferred compensation plans for certain employees. The Corporation contributed \$0.1 to such plans for the years ended June 30, 2010 and 2009, respectively.

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(9) Business and Credit Concentrations

The Corporation provides healthcare services through its inpatient and outpatient care facilities located in the State of Maryland and the District of Columbia. The Corporation generally does not require collateral or other security in extending credit; however it routinely obtains assignment of (or is otherwise entitled to receive) patients' benefits receivable under their health insurance programs, plans or policies (e.g., Medicare, Medicaid, Blue Cross, Workers' Compensation, health maintenance organizations (HMOs) and commercial insurance policies).

A summary of net patient service revenue by major category of payor for the years ended June 30, 2010 and 2009 is as follows:

	<u>2010</u>	<u>2009</u>
Medicare	34%	34%
Medicaid	12	11
Carefirst Blue Cross Blue Shield	19	18
Other commercial and managed care payors	29	30
Self-pay	6	7
	<u>100%</u>	<u>100%</u>

A summary of net patient service receivables by major category of payor as of June 30, 2010 and 2009 is as follows:

	<u>2010</u>	<u>2009</u>
Medicare	24%	22%
Medicaid	12	10
Carefirst Blue Cross Blue Shield	16	14
Other commercial and managed care payors	34	39
Self-pay	14	15
	<u>100%</u>	<u>100%</u>

The Corporation's policy is to write-off all patient accounts that have been identified as uncollectible. An allowance for uncollectible accounts is recorded for accounts not yet written off which are expected to become uncollectible in future periods.

Under the Maryland Health Services Cost Review Commission (the Commission) rate methodology, amounts payable for services in 2010 and 2009 to Maryland hospital patients under the Medicare and Medicaid insurance programs are computed at 94% of regulated charges and hospital patients under the Blue Cross and approved health maintenance organization insurance programs are computed at 98% of regulated charges. Maryland accounts receivable from these third-party payors have been adjusted to reflect the difference between charges and the payable amounts.

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Certain Maryland-based hospital charges are subject to review and approval by the Maryland Health Services Cost Review Commission (HSCRC).

The HSCRC has jurisdiction over hospital reimbursement in Maryland by agreement with the Centers for Medicare and Medicaid Services (CMS). This agreement is based on a waiver from the Medicare Prospective Payment System reimbursement principles granted under Section 1814(b) of the Social Security Act. The waiver will continue as long as cumulative comparisons of cost per admission between Maryland and the nation continue to be favorable. Management believes that the waiver will remain in effect at least through June 30, 2011.

Effective July 1, 2000 through June 30, 2003 under a contract with the HSCRC and the Maryland Hospitals, a charge per case methodology was implemented to more effectively tie compliance standards to waiver performance. Under this methodology, actual charges per case are required to meet hospital specific targets established by the HSCRC, which are adjusted for changes in actual case-mix. The HSCRC and Maryland Hospitals completed a three year contract that expired on June 30, 2006. The contract has been renewed yearly and this methodology will continue through June 30, 2011.

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount. Management periodically reviews recorded amounts receivable from or payable to third party payors and may adjust these balances as new information becomes available. In addition, revenue received under certain third-party agreements is subject to audit. During 2010 and 2009, certain of the Corporation's prior year third party cost reports were audited and settled, or tentatively settled, by third party payors. Adjustments resulting from such audits and management reviews of unaudited years and open claims are reflected as adjustments to revenue in the year that the adjustment becomes known. The effect of these adjustments was to increase net patient service revenue by \$2.3 and \$7.1 during the years ended June 30, 2010 and 2009, respectively. Although certain other prior year cost reports submitted to third party payors remain subject to audit and retroactive adjustment, management does not expect any material adverse settlements.

Through its MedStar Family Choice, Inc. subsidiary, the Corporation enters into fee-for-service and capitation agreements with independent health professionals and organizations to provide covered services to eligible enrollees where such services cannot be provided by its employed physicians or controlled entities. Medical and clinical expenses from these agreements include claim payments, capitation payments, and estimates of outstanding claims liabilities for services provided prior to the balance sheet date. The estimates of outstanding claims liabilities (\$11.7 and \$10.3 at June 30, 2010 and 2009, respectively) are based on management's analysis of historical claims paid reports and as well as review of health services utilization during the period. Changes in these estimates are recorded in the period of change. Claims payments and capitation payments are expensed in the period services are provided to eligible enrollees.

MedStar Health Visiting Nurse Association (VNA) has resolved its investigation by the Office of Inspector General (OIG) of the Department of Health and Human Services related to its cost reports for the years 1998 through 2000. This investigation resulted in VNA entering into a corporate integrity agreement that is

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expected to end in 2010. The VNA sent its final report to the OIG in June 2010 and is awaiting its closure letter.

(10) Certain Significant Risks and Uncertainties

The Corporation provides general acute healthcare services in the State of Maryland and the District of Columbia. The Corporation and other healthcare providers 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 State of Maryland Health Services Cost Review Commission;
- Government regulation, government budgetary constraints and proposed legislative and regulatory changes, and;
- Lawsuits alleging malpractice or other claims.

Such inherent risks require the use of certain management estimates in the preparation of the Corporation's consolidated 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 Corporation's revenues and the Corporation's 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 Corporation.

Changes in federal and state reimbursement funding mechanisms and related government budgetary constraints could have a significant adverse effect on the Corporation.

The healthcare industry is 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 Corporation's compliance with these laws and regulations is subject to periodic governmental review, which could result in enforcement actions unknown or unasserted at this time. Management is aware of certain asserted and unasserted legal claims, none of which, in the opinion of management, is expected to result in losses in excess of insurance limits. Management has provided requested information to the government in conjunction with certain government investigations. In one matter, the Corporation has received a settlement demand in September 2010 and management is evaluating the settlement demand. The final outcomes of these government investigations cannot be determined at this time.

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. In September 2009, the Corporation was notified that the recovery audit contractors (RAC) would begin auditing company operations in 2010

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and the Corporation received its first request for records in the fourth quarter of fiscal year 2010. The Corporation has implemented 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 health care reform legislation, substantial changes are anticipated in the United States health care system. Such legislation includes numerous provisions affecting the delivery of health care services, the financing of health care costs, reimbursement to health care 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 health care reform legislation did not affect the 2010 or 2009 consolidated financial statements.

Nurses United of the National Capital Region represents the nurses at one of the Corporations hospitals in Washington, D.C. The union's contract expired in June 2010. Negotiations are on-going, and although the Corporation cannot determine the financial impact of these negotiations at this time, the Corporation is working with the union to reach an appropriate agreement.

(11) Self-Insurance Programs

The Corporation maintains self-insurance programs for professional and general liability risks, employee health and workers' compensation. Estimated liabilities have been recorded based on actuarial estimation of reported and incurred but not reported claims. The combined accrued liabilities for these programs as of June 30, 2010 and 2009 were as follows:

	<u>2010</u>	<u>2009</u>
Professional and general liability	\$ 205.2	177.5
Employee health	17.3	15.7
Workers' compensation	24.7	21.4
Total liabilities	<u>247.2</u>	<u>214.6</u>
Less current portion	<u>(56.3)</u>	<u>(54.6)</u>
	<u>\$ 190.9</u>	<u>160.0</u>

The Corporations' self insurance program for professional and general liability is responsible for the following exposures at June 30, 2010:

The first \$5.0 exposure for each claim with an inner aggregate of \$2.5 for July 1, 2009 – June 30, 2010. Commercial excess re-insurance has been purchased above this self-insured retention in multiple layers and in twin towers.

Each tower has six layers of excess re-insurance coverage. These six layers combine to provide up to \$100.0 per claim and \$100.0 in the annual aggregate for professional liability and general liability exposure. The Corporation maintains reinsurance contracts with various highly rated commercial insurance companies.

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The professional and general liabilities at June 30, 2010 and 2009 have been discounted at a rate of 3.75% and 4.5%, respectively. The workers' compensation liabilities at June 30, 2010 and 2009 have been discounted at a rate of 3.5%.

Assets available to fund these liabilities are held in separate accounts (see note 2). Contributions required to fund professional and general liability, employee health benefits and workers' compensation programs are determined by the plans' administrators based on appropriate actuarial assumptions. The professional and general liability programs are administered through an offshore wholly owned captive insurance company, Greenspring Financial Insurance Limited (GFIL) domiciled in Grand Cayman Island.

Effective March 1, 2010, MGH transitioned from its previous professional liability coverage under Freestate Healthcare Insurance Company, Ltd., (Freestate) to coverage under GFIL. Prior to becoming insured under GFIL, MGH purchased coverage from Freestate, a group captive insurance company formed by several Maryland hospitals that is also domiciled in the Cayman Islands. Through this program, MGH maintained professional liability insurance coverage of \$1.0 per occurrence with a \$3.0 aggregate limit. To supplement this liability insurance for the period January 1, 2008 through December 31, 2008, MGH maintained an umbrella policy with coverage of \$20.0 per claim and \$20.0 in the annual aggregate. Effective January 1, 2009, MGH renewed its umbrella coverage but reduced the limits to \$10.0 per claim and \$10.0 in the annual aggregate. In addition, also effective January 1, 2009, MGH was brought into the coverage provided to the Corporation under its commercial excess re-insurance program with coverage of \$100.0 per claim and \$100.0 in the annual aggregate.

St. Mary's Hospital maintains professional liability coverage with a commercial insurer. St. Mary's Hospital professional liability insurance coverage is on a claims made basis, with \$1.0 per incident coverage, up to a maximum of \$3.0 annually, contains a per incident deductible and includes prior acts coverage. St. Mary's Hospital also maintains an umbrella policy in the amount of \$5.0 and accrues for the estimated cost of uninsured asserted and unasserted malpractice claims when incidents occur.

The Corporation, in the normal course of business, is a party to a number of legal and regulatory proceedings. Management does not expect that the results of these proceedings will have a material adverse effect on the consolidated financial position or results of operations of the Corporation.

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(12) Temporarily and Permanently Restricted Net Assets

Temporarily and permanently restricted net assets as of June 30, 2010 and 2009 are available for the following purposes:

	<u>2010</u>	<u>2009</u>
Temporary restrictions:		
Interest in net assets of foundation	\$ 41.1	36.1
Other	32.9	32.9
	<u>\$ 74.0</u>	<u>69.0</u>
Permanent restrictions:		
Investments to be held in perpetuity, the income from which is available to support health care services	\$ 37.0	34.6

Temporarily restricted net assets are available for the purposes of purchasing property and equipment, providing health education, research and other healthcare services.

(13) Endowment Net Assets

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

(a) Interpretation of Relevant Law

The Corporation has interpreted the State Prudent Management of Institutional Funds Act (SPMIFA) as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, the Corporation classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the organization in a manner consistent with the standard of prudence prescribed by SPMIFA. In accordance with SPMIFA, the Corporation considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

- (1) The duration and preservation of the fund
- (2) The purposes of the Corporation and the donor-restricted endowment fund
- (3) General economic conditions

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- (4) The possible effect of inflation and deflation
- (5) The expected total return from income and the appreciation of investments
- (6) Other resources of the Corporation
- (7) The investment policies of the Corporation.

(b) Endowment net assets consist of the following at June 30, 2010

	Unrestricted	Temporarily restricted	Permanently restricted	Total
Donor-restricted endowment funds	\$ —	0.8	37.0	37.8
Total endowed net assets	\$ —	0.8	37.0	37.8

(c) Endowment net assets consist of the following at June 30, 2009

	Unrestricted	Temporarily restricted	Permanently restricted	Total
Donor-restricted endowment funds	\$ —	0.7	34.6	35.3
Total endowed net assets	\$ —	0.7	34.6	35.3

(d) Funds with Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or SPMIFA requires the Corporation to retain as a fund of perpetual duration. In accordance with GAAP, deficiencies of this nature that are reported in unrestricted net assets were \$2.4 and \$4.9 as of June 30, 2010 and 2009, respectively. These deficiencies resulted from unfavorable market fluctuations.

(e) Investment Strategies

The Corporation has adopted policies for corporate investments, including endowment assets, that seek to maximize risk-adjusted returns with preservation of principal. Endowment assets include those assets of donor-restricted funds that the Corporation must hold in perpetuity or for a donor-specified period(s). The endowment assets are invested in a manner that is intended to hold a mix of investment assets designed to meet the objectives of the account. The Corporation expects its

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endowment funds, over time, to provide an average rate of return that generates earnings to achieve the endowment purpose.

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

The Corporation monitors the endowment funds returns and appropriates average returns for use. In establishing this practice, the Corporation considered the long-term expected return on its endowment. This is consistent with the Corporation's objective to maintain the purchasing power of the endowment assets held in perpetuity or for a specified term as well as to provide additional real growth through new gifts and investment return.

(14) Income Taxes

The Corporation and the majority of its subsidiaries are not-for-profit corporations as defined in Section 501(c)(3) of the Internal Revenue Code and are exempt from federal income taxes under Section 501(a) of the Code. The Corporation's tax-exempt businesses generate nominal amounts of unrelated business income subject to income tax. For corporate income tax purposes, the Corporation has two consolidated groups of for-profit, taxable entities. The parent companies of these groups are Parkway Ventures, Inc. and MedStar Enterprises, Inc.

The Corporation's taxable subsidiaries have approximately \$266.1 of net operating loss (NOL) carryforwards as of June 30, 2010 and 2009, which expire in varying periods through 2030, available to offset future taxable income. This NOL carryforward represents \$101.1 of gross deferred tax assets. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. At June 30, 2010 and 2009, the Corporation decreased its net deferred tax asset by \$1.4 and \$0.2, respectively, which was recorded in nonoperating income. The remaining amount of the deferred tax asset considered realizable, \$23.9, could be reduced if estimates of future taxable income during the carry forward period are reduced. The current tax provisions for the years ended June 30, 2010 and 2009 were immaterial.

(15) Charity Care

In addition to charity care, the Corporation funds numerous programs designed to benefit the healthcare interests of the communities it serves, examples of which are: health education programs and services, health information and referral services, school-based clinics, public health screenings and home care. The costs associated with these programs are recorded in the appropriate operating expense categories. The Corporation provided \$74.5 and \$60.0 during the years ended June 30, 2010 and 2009, respectively, based on charges foregone (based on established rates).

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(16) Leases

The Corporation is obligated under various operating leases with initial terms of one year or more. Aggregate future minimum payments as of June 30, 2010 are as follows:

2011	\$	61.0
2012		32.8
2013		27.8
2014		22.3
2015		12.9
2016 and thereafter		<u>37.2</u>
Total minimum lease payments	\$	<u>194.0</u>

Certain leases include provisions allowing the minimum rental payments to be adjusted annually for increases in operating costs and, in some cases, real estate taxes attributable to leased property. Total rental expense for all operating leases amounted to approximately \$57.6 and \$57.1 during the years ended June 30, 2010 and 2009, respectively.

(17) Restructuring Costs

During fiscal year 2009, the Corporation restructured its technical service departments within Information Services and also implemented corporate reorganization initiatives. The Corporation incurred associated costs including severance, consulting and legal fees of \$7.9 during the year ended June 30, 2009.

(18) Commitments and Contingencies

In February 2000 and on June 30, 2000, the Corporation and the University signed certain definitive agreements whereby the Corporation would receive through purchase or capital lease substantially all of the assets (including working capital) owned by the University that constitutes the Georgetown University Hospital, the Community Practice Network, the Faculty Practice Group and certain office buildings and a parking lot on the campus (collectively referred to as the Transferred Businesses). These agreements became effective July 1, 2000 and transferred control of the identified physical plant and other real property assets of the Transferred Businesses to the Corporation for use as an academic medical center for a minimum of ninety-eight years. At the end of the one hundred and fifty year lease term (including a fifty-two year renewal), the University shall convey all leased assets, excluding the underlying land, to the Corporation for a nominal amount and enter into a rent-free ground lease for the Corporation's use. This transaction was accounted for under the purchase method of accounting effective July 1, 2000.

In recognition of the value of the transaction, the Corporation shall annually pay the University 50% of the amount by which the combined operating earnings before interest, taxes, depreciation and amortization (EBITDA), as defined in the asset purchase agreement, of certain entities of the Corporation in the Washington D.C. area (collectively referred to as the Washington Clinical Enterprises) exceeds \$60.0, subject to certain adjustments. These additional payments expire when cumulative payments reach \$70.0. The Corporation paid \$1.7 to the University through June 30, 2010.

MEDSTAR HEALTH, INC.

Notes to Consolidated Financial Statements

June 30, 2010 and 2009

(Dollars in millions)

The Corporation also entered into an Academic Affiliation and Operations Agreement (Affiliation Agreement) with the University. The purpose of this agreement is to make available to the University the facilities of the Transferred Businesses and provide the Corporation with a first-class University medical center. The University shall make payments to the Corporation determined by multiplying the University School of Medicine's total undergraduate tuition revenue by 36% for providing teaching services. Payments totaling \$0 and \$5.5 were received by the Corporation during the years ended June 30, 2010 and 2009, respectively. In addition, the Corporation recorded a receivable of \$10.2 and \$6.8, for payments not yet received, at June 30, 2010 and 2009, respectively. Tuition revenue totaled \$28.3 and \$34.2 during the years ended June 30, 2010 and 2009, respectively. In support of academic programs at the University, for each fiscal year following the termination of the additional payment terms in the asset purchase agreement described above, the Corporation shall pay to the University 17.5% of the operating EBITDA of the Washington Clinical Enterprises in excess of \$60.0, subject to certain adjustments. No amounts were due under this Affiliation Agreement at June 30, 2010.

The Corporation and the University also entered into a Research Agreement to sustain and advance a program of health-related University research at the Transferred Business facilities. Under this agreement the University is required to reimburse the Corporation for certain costs incurred by the Corporation in support of University sponsored research. Amounts reimbursed to the Corporation were \$2.9 and \$2.0 for 2010 and 2009, respectively.

Georgetown University Hospital and Georgetown University (the University) are parties to a fixed fee shared services agreement. Georgetown University provided to Georgetown University Hospital the following services: utilities, telephone/IT services, transportation services and library services. Expenses charged for such services were \$13.4 for 2010 and 2009, respectively.

The Washington Hospital Center (WHC) campus is subject to the lien of a Permitted Encumbrance in the amount of \$21.5 to the United States government. This encumbrance was created in the deed of the hospital property from the United States government to WHC in February 1960. There is no repayment date for this lien stated in the deed. Under enabling legislation, repayment could be required after a determination that the property is no longer required for hospital services or the property is disposed of, in which event all or a portion of the lien may be payable to the government. This lien is subordinated to the Deed of Trust on the WHC campus.

MEDSTAR HEALTH, INC.

Notes to Consolidated Financial Statements

June 30, 2010 and 2009

(Dollars in millions)

(19) Functional Expenses

The Corporation considers integrated health services, research and management and general to be its primary functional categories for purposes of expense classification. Management and general include information systems, general corporate management, advertising and marketing. Functional categories of expenses for the years ended June 30, 2010 and 2009 are as follows:

	<u>2010</u>	<u>2009</u>
Integrated health services	\$ 3,087.9	2,946.6
Management and general	662.5	623.8
Research	35.4	41.7
Fundraising	6.6	6.1
	<u>\$ 3,792.4</u>	<u>3,618.2</u>

(20) Subsequent Events

Management evaluated all events and transactions that occurred after June 30, 2010 and through October 4, 2010. The Corporation did not have any subsequent events that were required to be recognized or disclosed during this period.

SUPPLEMENTARY SCHEDULES

MEDSTAR HEALTH, INC.
 Consolidating Balance Sheet Information
 June 30, 2010
 (Dollars in millions)

Assets	Franklin Square	Good Samaritan	Harbor Hospital	Montgomery General	Union Memorial	Helix Resource Management	Medstar Family Choice	All Other MedStar Entities	Eliminations	Consolidated totals
Current assets:										
Cash and cash equivalents	\$ 0.8	—	—	47.2	—	—	29.4	432.2	—	509.6
Investments	—	—	—	—	—	—	0.1	16.7	—	16.8
Assets whose use is limited or restricted	—	—	—	—	—	—	—	40.8	—	40.8
Receivables:										
From patient services (less allowances for uncollectible accounts of \$211.0 in 2010)	46.6	32.3	18.0	13.8	45.5	0.5	1.1	284.4	(4.1)	438.1
Other	1.1	1.6	1.7	0.8	1.7	—	0.6	58.9	(1.8)	64.6
	47.7	33.9	19.7	14.6	47.2	0.5	1.7	343.3	(5.9)	502.7
Inventories	5.8	2.6	2.5	2.5	6.6	—	—	30.4	—	50.4
Prepays and other current assets	0.7	0.3	0.3	1.4	0.9	—	—	37.3	—	40.9
Total current assets	55.0	36.8	22.5	65.7	54.7	0.5	31.2	900.7	(5.9)	1,161.2
Investments	—	—	—	21.9	—	—	9.4	477.9	—	509.2
Assets whose use is limited or restricted	1.0	0.2	0.1	—	46.5	—	—	310.2	—	358.0
Property and equipment, net	221.8	81.4	35.1	77.9	107.5	—	0.1	499.6	—	1,023.4
Interest in net assets of foundation	—	41.1	—	—	—	—	—	—	—	41.1
Other assets	0.6	3.9	0.2	0.2	3.0	—	0.7	465.2	(354.2)	119.6
Total assets	\$ 278.4	163.4	57.9	165.7	211.7	0.5	41.4	2,653.6	(360.1)	3,212.5

MEDSTAR HEALTH, INC.
Consolidating Balance Sheet Information
June 30, 2010
(Dollars in millions)

Liabilities and Net Assets	Franklin Square	Good Samaritan	Harbor Hospital	Montgomery General	Union Memorial	Helix Resource Management	Medstar Family Choice	All Other MedStar Entities	Eliminations	Consolidated totals
Current liabilities:										
Accounts payable and accrued expenses	\$ 22.4	14.4	10.1	4.3	26.3	0.6	12.7	197.6	(4.2)	284.2
Accrued salaries, benefits, and payroll taxes	19.6	12.2	10.1	5.9	15.5	—	0.4	140.9	—	204.6
Amounts due to third-party payors, net	10.6	6.1	4.5	3.8	9.4	—	—	7.6	—	42.0
Intercompany payables	—	—	—	—	—	—	—	0.2	(0.2)	—
Current portion of long-term debt	—	—	—	—	0.5	—	—	265.3	—	265.8
Current portion of self insurance liabilities	0.9	0.6	0.3	0.8	0.3	—	—	53.4	—	56.3
Other current liabilities	6.9	4.8	5.2	—	7.3	—	10.6	48.6	(1.5)	81.9
Total current liabilities	<u>60.4</u>	<u>38.1</u>	<u>30.2</u>	<u>14.8</u>	<u>59.3</u>	<u>0.6</u>	<u>23.7</u>	<u>713.6</u>	<u>(5.9)</u>	<u>934.8</u>
Long-term debt, net of current portion	—	—	—	8.3	1.9	—	—	785.6	—	795.8
Self insurance liabilities, net of current portion	4.1	1.4	0.6	—	1.2	—	—	183.6	—	190.9
Pension liabilities	—	—	—	7.2	—	—	—	394.1	—	401.3
Other long-term liabilities, net of current portion	7.9	13.0	8.0	2.0	13.8	—	—	91.4	(1.3)	134.8
Total liabilities	<u>72.4</u>	<u>52.5</u>	<u>38.8</u>	<u>32.3</u>	<u>76.2</u>	<u>0.6</u>	<u>23.7</u>	<u>2,168.3</u>	<u>(7.2)</u>	<u>2,457.6</u>
Net assets:										
Common stock	—	—	—	—	—	0.1	—	10.4	(10.5)	—
Additional paid in capital	0.5	—	—	—	—	—	17.1	236.9	(254.5)	—
Unrestricted	205.1	69.7	19.0	130.1	107.2	(0.2)	0.6	200.3	(87.9)	643.9
Temporarily restricted	0.4	41.2	0.1	3.3	2.4	—	—	26.6	—	74.0
Permanently restricted	—	—	—	—	25.9	—	—	11.1	—	37.0
Total net assets (deficit)	<u>206.0</u>	<u>110.9</u>	<u>19.1</u>	<u>133.4</u>	<u>135.5</u>	<u>(0.1)</u>	<u>17.7</u>	<u>485.3</u>	<u>(352.9)</u>	<u>754.9</u>
Total liabilities and net assets	<u>\$ 278.4</u>	<u>163.4</u>	<u>57.9</u>	<u>165.7</u>	<u>211.7</u>	<u>0.5</u>	<u>41.4</u>	<u>2,653.6</u>	<u>(360.1)</u>	<u>3,212.5</u>

See accompanying independent auditors' report.

MEDSTAR HEALTH, INC.

Consolidating Statements of Operations and Summary Changes in Net Assets Information

Year ended June 30, 2010

(Dollars in millions)

	Franklin Square	Good Samaritan	Harbor Hospital	Montgomery General	Union Memorial	Helix Resource Management	Medstar Family Choice	All Other MedStar Entities	Eliminations	Consolidated totals
Operating revenues:										
Net patient service revenue:										
Hospital inpatient services	\$ 273.6	200.1	132.8	91.1	267.4	—	—	1,248.8	(37.2)	2,176.6
Hospital outpatient services	145.9	106.4	55.4	41.5	121.8	—	—	646.3	(16.5)	1,100.8
Physician services	—	—	—	—	—	3.6	—	171.9	—	175.5
Other patient service revenue	—	—	—	—	—	—	—	126.3	(11.9)	114.4
Total net patient service revenue	419.5	306.5	188.2	132.6	389.2	3.6	—	2,193.3	(65.6)	3,567.3
Premium revenue	—	—	—	—	—	—	105.0	0.6	(3.6)	102.0
Other operating revenue	7.6	6.2	10.3	2.1	14.4	—	—	341.3	(195.8)	186.1
Net operating revenues	427.1	312.7	198.5	134.7	403.6	3.6	105.0	2,535.2	(265.0)	3,855.4
Operating expenses:										
Personnel	203.5	147.5	97.1	64.6	181.3	—	3.8	1,291.0	(0.1)	1,988.7
Supplies	67.8	53.4	30.2	22.7	85.6	—	0.2	364.6	(4.6)	619.9
Purchased services	37.5	41.2	17.8	17.2	49.3	3.4	94.7	279.4	(79.4)	461.1
Other operating	55.2	37.0	28.6	13.0	44.7	—	4.3	352.8	(180.9)	354.7
Provision for bad debts	17.1	11.9	8.2	4.8	10.1	(0.1)	—	130.5	—	182.5
Interest expense	4.5	3.1	2.4	0.4	4.1	—	—	24.5	—	39.0
Depreciation and amortization	14.7	11.6	7.9	7.7	18.5	—	—	86.1	—	146.5
Total operating expenses	400.3	305.7	192.2	130.4	393.6	3.3	103.0	2,528.9	(265.0)	3,792.4
Earnings from operations	26.8	7.0	6.3	4.3	10.0	0.3	2.0	6.3	—	63.0
Nonoperating gains (losses):										
Investment income	0.2	—	0.1	0.4	0.7	—	0.1	19.8	—	21.3
Net realized gains (losses) on investments	—	—	—	0.3	0.1	—	(0.1)	0.4	—	0.7
Unrealized loss on derivative instrument	—	—	—	—	—	—	—	(4.1)	—	(4.1)
Unrealized gains on trading investments	0.1	—	—	2.1	3.8	—	—	54.9	—	60.9
Income tax provision	—	—	—	—	—	—	(0.6)	(1.3)	—	(1.9)
Equity interest in net earnings of affiliates and other	—	0.1	—	—	0.1	—	—	1.9	—	2.1
Excess of revenue over expenses	27.1	7.1	6.4	7.1	14.7	0.3	1.4	77.9	—	142.0
Addition of St. Mary's net assets	—	—	—	—	—	—	—	76.1	—	76.1
Change in funded status of defined benefit plans	—	—	—	—	—	—	—	(121.3)	—	(121.3)
Change in restricted investments and unrealized appreciation	—	5.5	—	—	0.2	—	—	1.7	—	7.4
Restricted contributions, net assets released from restrictions and other	2.4	(0.4)	—	1.3	0.4	—	—	0.1	—	3.8
Transfer from (to) parent, net	33.7	(4.8)	(11.8)	35.2	(23.1)	0.3	—	(29.5)	—	—
Total changes in net assets	\$ 63.2	7.4	(5.4)	43.6	(7.8)	0.6	1.4	5.0	—	108.0

See accompanying independent auditors' report.