



FINANCIAL STATEMENTS AND
OTHER FINANCIAL INFORMATION

Peninsula Regional Medical Center
Years Ended June 30, 2011 and 2010
With Reports of Independent Auditors

Ernst & Young LLP

 **ERNST & YOUNG**

Peninsula Regional Medical Center
Financial Statements and Other Financial Information
Years Ended June 30, 2011 and 2010

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Report of Independent Auditors

Board of Trustees
Peninsula Regional Medical Center

We have audited the accompanying balance sheets of Peninsula Regional Medical Center (the Hospital) as of June 30, 2011 and 2010, and the related statements of operations and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Hospital's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Hospital's internal control over financial reporting. Our audits included 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 Hospital'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, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Peninsula Regional Medical Center at June 30, 2011 and 2010, and the results of its operations and changes in its net assets and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

September 16, 2011

Peninsula Regional Medical Center

Balance Sheets
(In Thousands)

	June 30	
	2011	2010
Assets		
Current assets:		
Cash and cash equivalents	\$ 25,638	\$ 25,295
Short-term investments	5,836	5,522
Accounts receivable, less allowance for uncollectible accounts (2011 – \$7,072; 2010 – \$7,689)	35,572	35,482
Inventories and other	13,119	12,306
Total current assets	<u>80,165</u>	78,605
Long-term investments	136,117	100,227
Board-designated investments	16,420	13,475
Assets limited as to use:		
Debt service reserve fund	9,349	9,376
Donor-restricted fund	23,607	19,937
Self-insurance fund	14,459	12,494
	<u>47,415</u>	41,807
Property and equipment, net	206,154	212,665
Unamortized financing costs, net of accumulated amortization (2011 – \$471; 2010– \$373)	2,450	2,548
Other assets	3,687	1,782
Total assets	<u>\$ 492,408</u>	<u>\$ 451,109</u>

	June 30	
	2011	2010
Liabilities and net assets		
Current liabilities:		
Current portion of long-term debt	\$ 2,810	\$ 2,720
Current portion of accrued self-insured liabilities	1,895	695
Accounts payable and accrued liabilities	26,507	25,975
Advances from third-party payors	8,461	8,158
Total current liabilities	<u>39,673</u>	<u>37,548</u>
Long-term debt, net	131,566	134,675
Other liabilities	12,134	27,581
Total liabilities	<u>183,373</u>	<u>199,804</u>
Net assets:		
Unrestricted	286,635	231,374
Temporarily restricted	14,335	11,880
Permanently restricted	8,065	8,051
Total net assets	<u>309,035</u>	<u>251,305</u>
Total liabilities and net assets	<u><u>\$ 492,408</u></u>	<u><u>\$ 451,109</u></u>

See accompanying notes.

Peninsula Regional Medical Center

Statements of Operations and Changes in Net Assets

(In Thousands)

	Year Ended June 30	
	2011	2010
Unrestricted revenue and other support:		
Net patient service revenue	\$ 380,052	\$ 368,409
Other operating revenue	2,357	2,059
Total unrestricted revenue and other support	<u>382,409</u>	370,468
Operating expenses:		
Salaries and wages	138,742	137,107
Supplies and other expenses	146,120	144,028
Employee benefits	36,169	36,592
Depreciation	21,829	20,881
Bad debts	17,411	17,977
Interest	6,591	6,853
Total operating expenses	<u>366,862</u>	363,438
Income from operations	15,547	7,030
Nonoperating income:		
Nonoperating income	12,164	10,304
Basis swap income	3,128	1,753
	<u>15,292</u>	12,057
Excess of unrestricted revenue and other support over expenses	\$ 30,839	\$ 19,087

(continued)

Peninsula Regional Medical Center

Statements of Operations and Changes in Net Assets (continued)

(In Thousands)

	Year Ended June 30	
	2011	2010
Unrestricted net assets:		
Excess of unrestricted revenue and other support over expenses	\$ 30,839	\$ 19,087
Net assets released from restrictions	1,200	2,530
Unrealized gains on investments	13,006	4,433
Pension adjustment	10,216	(1,620)
Increase in unrestricted net assets	<u>55,261</u>	<u>24,430</u>
Temporarily restricted net assets:		
Capital campaign transfers from the Foundation	–	1
Change in equity interest in the Foundation	1,141	1,048
Donations	–	29
Net realized gains on investments	1,222	865
Unrealized gains on investments	1,613	541
Net assets released from restrictions	(1,521)	(2,942)
Increase (decrease) in temporarily restricted net assets	<u>2,455</u>	<u>(458)</u>
Permanently restricted net assets:		
Donations	5	12
Net realized gains on investments	4	3
Unrealized gain on investments	5	2
Increase in permanently restricted net assets	<u>14</u>	<u>17</u>
Increase in net assets	<u>57,730</u>	<u>23,989</u>
Net assets at beginning of year	<u>251,305</u>	<u>227,316</u>
Net assets at end of year	<u>\$ 309,035</u>	<u>\$ 251,305</u>

See accompanying notes.

Peninsula Regional Medical Center

Statements of Cash Flows (In Thousands)

	Year Ended June 30	
	2011	2010
Operating activities		
Change in net assets	\$ 57,730	\$ 23,989
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation of property and equipment	21,829	20,835
Amortization of original issue premium	(299)	(297)
Amortization of intangible assets	98	98
(Gain) loss on sale of property and equipment	(32)	65
Net unrealized gains on investments	(13,021)	(4,976)
Net realized gains on investments	(7,478)	(5,813)
Non-cash change in donor-restricted fund	(2,038)	1,297
Proceeds from restricted contributions and realized losses on restricted investments	1,226	867
Changes in operating assets and liabilities:		
Accounts receivable	(90)	1,630
Inventories and other assets	(2,718)	(1,594)
Accounts payable and accrued liabilities	532	(2,124)
Accrued self-insured and other liabilities	(14,247)	(2,793)
Advances from third-party payors	303	13
Net cash provided by operating activities	41,795	31,197
Investing activities		
Purchase of investments	(99,550)	(95,247)
Proceeds from sales of investments	79,990	94,696
Purchases of property and equipment	(15,286)	(17,727)
Change in assets limited as to use	(2,660)	(1,546)
Net cash used in investing activities	(37,506)	(19,824)
Financing activities		
Proceeds from restricted contributions and realized losses on restricted investments	(1,226)	(867)
Repayments of long-term debt	(2,720)	(2,625)
Net cash used in financing activities	(3,946)	(3,492)
Net increase in cash and cash equivalents	343	7,881
Cash and cash equivalents at beginning of year	25,295	17,414
Cash and cash equivalents at end of year	\$ 25,638	\$ 25,295

See accompanying notes.

Peninsula Regional Medical Center

Notes to Financial Statements (In Thousands)

June 30, 2011

1. Organization and Mission

Peninsula Regional Medical Center (the Hospital) is a not-for-profit, nonstock corporation founded in 1897 to serve the health care needs of its region. Primary service areas include the Maryland counties of Wicomico, Somerset and Worcester, south Delaware and the northern Eastern Shore of Virginia. The Hospital's mission is to improve the health care of the community by providing exceptional quality primary, secondary and selected tertiary health care services to patients in a competent and compassionate manner, designed to elicit a high degree of customer satisfaction. The Hospital provides services regardless of race, creed, sex, national origin, handicap or age.

The Hospital is a wholly owned subsidiary of Peninsula Regional Health System, Inc. (the Health System) which serves as the parent company to the Hospital, Peninsula Regional Medical Center Foundation, Inc. (the Foundation) and Peninsula Health Ventures, Inc. (Health Ventures). The Health System is a not-for-profit Maryland membership corporation established to manage the integrated delivery of health care services to the community. The Health System is the sole corporate member of the Hospital, the Foundation and Health Ventures. In its capacity as sole member of these entities, the Health System will appoint trustees, approve major expenditures and approve long-term borrowings.

2. Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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 amounts could differ from those estimates.

Reclassifications

Certain amounts from the prior year financial statements have been reclassified in order to conform to the current year presentation.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

2. Significant Accounting Policies (continued)

Fair Value of Financial Instruments

The carrying amounts of financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, and advances from third-party payors, approximate fair value given the short-term nature of these financial instruments.

Cash and Cash Equivalents

Cash and cash equivalents include surplus operating funds invested in money market funds and highly liquid corporate, U.S. government and agency obligations, all with maturities of less than three months when purchased.

Investments and Investment Income

Investments are carried at fair value. All such investments are considered available for sale and are classified as current or noncurrent assets based on management's intention as to use. Short-term investments represent investments with contractual maturities within one year and current investments in money market funds which have been designated for long-term investment purposes. Assets limited as to use by donor restriction are recorded at fair value at the date of donation and changes in fair value are recognized in the period in which the change occurs. Investment income from all unrestricted investments is reported as nonoperating income. Investment income on investments of restricted assets is added to or deducted from the appropriate restricted net assets when restricted as to use by the donor.

The value of securities sold is based on the specific identification method.

The Hospital periodically evaluates whether any declines in the fair value of investments are other-than-temporary. This evaluation consists of a review of several factors, including but not limited to: length of time and extent that a security has been in an unrealized loss position; the existence of an event that would impair the issuer's future earnings potential; the near-term prospects for recovery of the market value of a security; and the intent and ability of the Hospital to hold the security until the market value recovers. Realized gains or losses are included in nonoperating (expense) income in the accompanying statements of operations. Declines in fair value below cost that are deemed to be other-than-temporary would be recorded as realized losses within nonoperating (expense) income. Based on its evaluation, the Hospital has recorded no other-than-temporary impairments for the years ended June 30, 2011 and 2010.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

2. Significant Accounting Policies (continued)

Derivative Instruments

The Hospital entered into a forward-starting interest rate exchange agreement on August 9, 2005 with Morgan Stanley Capital Services Inc. (the Counterparty) to reduce the risk of changing interest rates with a notional amount of \$137,845. Under the agreement, the Hospital paid a fixed rate of approximately 3.5% and received a variable rate of 68% of three-month London Interbank Offered Rate (LIBOR). The Hospital unwound the agreement on January 24, 2006 and paid the Counterparty a termination payment of \$1,575 on February 9, 2006 from proceeds of the 2006 Bond issue. The termination payment of \$1,575 has been recognized as unamortized financing costs and is being amortized over the life of the 2006 Bond issue using the straight-line method, which approximates the effective interest method.

On January 26, 2006, the Hospital amended the August 9, 2005 agreement with the Counterparty and entered into an interest rate swap (the Basis Swap) on a notional amount of \$142,910 under which the Hospital will pay the Counterparty floating rate payments based upon the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index and will receive floating rate payments based upon 68% of three-month LIBOR, plus a fixed spread of 0.523%. Under Accounting Standards Codification (ASC) No. 815, *Derivatives and Hedging*, the Hospital has recognized its derivative instruments in the balance sheets at fair value. As these derivative instruments are not designated as hedges, the changes in fair value have been recognized in the accompanying statements of operations and changes in net assets as mark-to-market adjustments, included within basis swap income (loss).

The fair market value of the swap agreement is included in other liabilities or other assets in the accompanying balance sheets. The fair market value calculation includes a credit valuation adjustment (CVA) as required by ASC 820, *Fair Value Measurements and Disclosures*. At June 30, 2011, the valuation of the interest rate swap asset was increased by \$447 when applying the CVA. At June 30, 2010, the valuation of the interest rate swap agreement liability position was reduced by \$708 when applying the CVA. The change in the fair market value of the swap agreement is recorded in the performance indicator, as the swaps are not designated as an effective hedge.

Credit exposure associated with non-performance by the counterparty to the derivative instrument is generally limited to the uncollateralized fair value of the asset related to instruments recognized in the balance sheets.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

2. Significant Accounting Policies (continued)

The Hospital's derivative agreement does not contain any credit support provisions that require it to post collateral if there are declines in the derivative value or its credit rating.

At June 30, 2011, the value of this instrument was a \$357 asset position, recorded in other assets. At June 30, 2010, the value of this instrument was a \$2,075 liability position, recorded in other liabilities.

Accounts Receivable and Contractual Allowances

The Hospital provides services to patients in the Eastern Shore area of Maryland, Delaware and Virginia, the majority of whom are covered by third-party health insurance. The Hospital bills the insurer directly for services provided.

Insurance coverage and financial information is obtained from patients upon admission when available. The Hospital's policy is to perform in-house collection procedures for approximately 85 days. A determination is made at that time as to what additional collection efforts to pursue. A provision for uncollectible accounts is recorded for amounts not yet written off, which are expected to become uncollectible.

Discounts ranging from 2% to 6% of charges are given to Medicare, Medicaid and certain approved commercial health insurance and health maintenance organization programs for regulated services. Discounts in varying percentages are given for certain unregulated services. These major payors routinely review patient billings and deny payment for certain charges as medically unnecessary or as performed without appropriate preauthorization. Discounts and denials are recorded as reductions of net patient service revenue. Accounts receivable from these third-party payors have been adjusted to reflect the difference between charges and the estimated reimbursable amounts.

Approximately 33% and 36%, respectively, of accounts receivable were due from the Medicare program as of June 30, 2011 and 2010, respectively.

Laws and regulations governing Medicare and Medicaid programs are complex and subject to interpretation. The Hospital believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing that would have a material effect on the financial statements. Compliance

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

2. Significant Accounting Policies (continued)

with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties and exclusion from Medicare and Medicaid programs.

Inventories and Other Assets

Inventories and other primarily includes inventories of supplies and prepaid expenses. Inventories of supplies are carried at lower of cost or market, using the first-in, first-out method.

Other Assets

Other assets primarily include an investment in a limited partnership. This investment is accounted for under the equity method of accounting.

Assets Limited as to Use

Assets limited as to use primarily includes assets held by trustees under indenture agreements, assets held by trustees under irrevocable self-insurance trust agreements and assets whose use has been limited by the donor of the underlying funds. Assets limited as to use also includes the Hospital's beneficial interest in the Foundation's temporarily restricted net assets. Amounts required to meet current liabilities of the Hospital have been classified in the balance sheets as current assets.

Board-Designated Investments

Board-designated investments include assets set aside by the Board of Trustees for future capital improvements and expansion. The Board of Trustees retains control of these assets and may, at its discretion, subsequently use them for other purposes.

Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. 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.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

2. Significant Accounting Policies (continued)

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

Unamortized Financing Costs

Financing costs incurred in issuing the Maryland Health and Higher Educational Facilities Authority Project and Refunding Revenue Bonds have been capitalized and are being amortized using the straight-line method over the life of the bonds, which approximates the effective interest method. The amount amortized is recorded as an operating expense.

Estimated Self-Insurance Liabilities and Workers' Compensation

The provision for estimated professional liability claims, general liability claims and workers' compensation claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported.

Pension Benefits

Pension benefits are recorded in accordance with ASC No. 715, *Compensation – Retirement Benefits*, which requires the recognition of the funded status of pension plans within the accompanying balance sheets. As of June 30, 2011 and 2010, the funded status of the pension plan has been recorded within other long-term assets and other long-term liabilities, respectively.

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the Hospital has been limited by donors to a specific time period or purpose. Temporarily restricted net assets are to be used for capital purposes and other health care services.

Permanently restricted net assets have been restricted by donors to be maintained by the Hospital in perpetuity.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)

(In Thousands)

2. Significant Accounting Policies (continued)

Net Patient Service Revenue

Net patient service revenue is reported at the estimated realizable amounts from patients, third-party payors and others for services rendered. During 2011 and 2010, approximately 49% and 49% of net patient service revenue was received under the Medicare program, 13% and 14% from CareFirst Blue Cross Blue Shield, 30% and 29% from contracts with other third parties, and 8% and 8% from other sources, respectively.

The following table sets forth the detail of net patient service revenue:

	Year Ended June 30	
	2011	2010
Gross patient service revenue	\$ 457,035	\$ 426,582
Revenue deductions:		
Charity care	15,662	13,865
Contractual and other allowances	61,321	44,308
Net patient service revenue	<u>\$ 380,052</u>	<u>\$ 368,409</u>

Charity Care

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

Donor-Restricted Gifts

Unconditional promises to give cash and other assets to the Hospital 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 donations 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 the purpose of the restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statements of operations and changes in net assets 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.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)

(In Thousands)

2. Significant Accounting Policies (continued)

Nonoperating Income

Nonoperating income primarily includes investment income from short-term and long-term investments, board-designated investments and investments within assets limited as to use. In addition, investment income is also recorded for certain equity method investments that are included within other assets.

The components of nonoperating income are as follows:

	Year Ended June 30	
	2011	2010
Interest and dividend income	\$ 3,356	\$ 3,204
Realized gains, net	7,478	5,813
Income earned on equity method investments	1,316	1,202
Other	14	85
Total	<u>\$ 12,164</u>	<u>\$ 10,304</u>

Income Taxes

The Hospital is a not-for-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code and is exempt from federal income taxes on related income pursuant to Section 501(a) of the Code.

Performance Indicator

The performance indicator for the Hospital is excess of unrestricted revenue and other support over expenses, which includes all changes in unrestricted net assets except for changes in unrealized gains and losses on investments, pension adjustments in accordance with ASC No. 958-715 – *Not for Profit Entities – Compensation – Retirement Benefits* and net assets released from restrictions for property acquisitions.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

2. Significant Accounting Policies (continued)

Recent Accounting Pronouncements

In January 2010, the FASB issued ASC Accounting Standards Update (ASU) No. 2010-06 (ASU 2010-06), which clarifies certain existing fair value measurement disclosure requirements of ASC Topic 820 – *Fair Value Measurements and Disclosures* and also requires additional fair value measurement disclosures. Specifically, ASU 2010-06 clarifies that assets and liabilities must be leveled by major class of asset or liability, and provides guidance regarding the identification of such major classes. Additionally, disclosures are required about valuation techniques and the inputs to those techniques, for those assets or liabilities designated as Level 2 or Level 3 instruments. Disclosures regarding transfers between Level 1 and Level 2 assets and liabilities are required, as well as a deeper level of disaggregation of activity within existing rollforwards of the fair value of Level 3 assets and liabilities. The adoption of this guidance did not have a significant impact on the Hospital's financial statements for the year ended June 30, 2011.

In August 2010, the FASB issued ASU 2010-23 which provided guidance on measuring charity care for disclosure purposes. This guidance requires that cost be used as the measurement basis for charity care disclosure purposes and that cost be identified as the direct and indirect costs of providing charity care. Disclosure requirements include the method used to identify or determine such costs. This guidance is effective for the Hospital for the fiscal year ending June 30, 2012. The Hospital is currently evaluating the impact of this guidance.

In July 2011, the FASB issued ASU 2011-07 which provided guidance on the presentation and disclosure of patient service revenue, provisions for bad debts, and the allowance for doubtful accounts for certain health care entities. This guidance changes the presentation of the statement of operations by reclassifying the provision for bad debts associated with patient service revenue from an operating expense to a deduction from patient service revenue (net of contractual allowances and discounts). Additionally, the guidance requires enhanced disclosures about the policies for recognizing revenue and assessing bad debts, as well as qualitative and quantitative information about changes in the allowance for doubtful accounts. This guidance is effective for the Hospital for the fiscal year ending June 30, 2013. The Hospital is currently evaluating the impact of this guidance.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)

(In Thousands)

3. Property and Equipment

A summary of property and equipment follows:

	Estimated Useful Lives	June 30	
		2011	2010
Land	–	\$ 10,492	\$ 10,492
Land improvements	20	11,228	10,626
Buildings and improvements	15 – 40	190,880	188,294
Fixed equipment	20	30,270	30,270
Movable equipment	7 – 10	189,707	179,964
		<u>432,577</u>	419,646
Less accumulated depreciation		<u>(233,750)</u>	(213,078)
		198,827	206,568
Construction in progress		7,327	6,097
Property and equipment, net		<u>\$ 206,154</u>	<u>\$ 212,665</u>

As of June 30, 2011, the Hospital was committed to building and equipment purchases totaling approximately \$1,279.

4. Other Liabilities

The components of other liabilities are as follows:

	June 30	
	2011	2010
Long-term benefit obligation	\$ –	\$ 14,610
Self insurance obligations	11,695	10,087
Interest rate swap liability	–	2,075
Other	439	809
Total	<u>\$ 12,134</u>	<u>\$ 27,581</u>

Peninsula Regional Medical Center

Notes to Financial Statements (continued)

(In Thousands)

5. Long-Term Debt

Long-term debt consists of the following:

	June 30	
	2011	2010
Maryland Health and Higher Educational Facilities Authority Revenue Bonds Series 2006:		
Serial bonds with interest rates ranging from 3.50% to 5.00% and effective rates ranging from 3.49% to 4.67% due in various annual amounts on July 1 of each year from 2007 through 2021 and 2027	\$ 36,560	\$ 39,265
5.00% term bonds with effective rate of 4.44% due July 1, 2026	24,635	24,635
5.00% term bonds with effective rate of 4.63% due July 1, 2036	69,505	69,505
Property acquisition note:		
5.50% due March 1 of each year from 2007 to 2015	60	75
	130,760	133,480
Less:		
Current portion of Maryland Health and Higher Educational Facilities Authority Series 2006 serial bonds	2,795	2,705
Property acquisition note	15	15
	127,950	130,760
Original issue premium	3,616	3,915
Long-term debt, less current portion	\$ 131,566	\$ 134,675

On February 9, 2006, the Maryland Health and Higher Educational Facilities Authority (MHHEFA) authorized the issuance of \$142,910 aggregate principal amount of Revenue Bonds (Series 2006 Bonds) at a premium of \$5,333. The proceeds of the issue, after payment of financing costs, were used primarily (i) to finance and refinance a portion of the costs of construction, renovation, acquisition and equipping of the 2006 Project; (ii) to refund outstanding 1993 bonds; (iii) to pay a portion of the interest accruing on the Series 2006 Bonds for a period to extend to January 1, 2009; and (iv) to pay the Counterparty a termination payment of \$1,575 in connection with a forward starting interest rate exchange agreement entered into on August 9, 2005 and unwound on January 24, 2006.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

5. Long-Term Debt (continued)

Under the terms of the 2006 project and refunding revenue bonds, the Hospital is required to maintain certain deposits with a trustee. Such deposits are included within assets limited as to use. The revenue note indenture also places limits on the incurrence of additional borrowings and requires that the Hospital satisfy certain measures of financial performance as long as the notes are outstanding.

The Hospital is required to make semiannual payments to the trustee sufficient to meet the annual debt service requirements of the refunding bond issue for the succeeding year. Annual sinking fund installments for the term bonds range from \$3,690 on July 1, 2027 to \$8,820 at maturity. The premium on the Series 2006 Bonds is being amortized over the life of the bonds using the effective interest method.

As security for the debt service requirements of the Series 2006 Bonds, MHHEFA has a first lien and claim on all receipts of the Hospital. The terms of the indenture agreement restrict the Hospital's ability to create additional indebtedness and its use of the facilities, and require the Hospital to maintain stipulated insurance coverage and a rate structure in each year sufficient to meet certain rate covenant requirements.

On March 1, 2006, the Hospital entered into a promissory note for the acquisition of property in the amount of \$135 (\$60 outstanding at June 30, 2011). The interest rate is 5.50% with principal and interest due annually through 2015.

On October 30, 2001, Delmarva Surgery Center, LLC (the Company), a 51%-owned subsidiary of Health Ventures, entered into variable rate loan agreements with M&T Bank in the amount of \$4,500 (\$2,168 outstanding at June 30, 2011) with monthly payments in various amounts through May 2012 to build and equip an ambulatory surgery center. The Company has entered into interest rate swap agreements that effectively convert its variable rate debt to a fixed rate basis for the years ended June 30, 2011 and 2010. The unrealized gain or loss on the interest rate swap is not significant.

Health Ventures has guaranteed the loan limited to its pro rata interest. In addition, the Hospital has entered into an agreement with M&T Bank to guarantee Health Ventures' commitment for this loan.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

5. Long-Term Debt (continued)

Scheduled principal repayments on long-term debt for the years ending June 30 are as follows:

2012	\$ 2,810
2013	2,930
2014	3,055
2015	3,185
2016	3,330
2017 and thereafter	115,450
	<u>\$ 130,760</u>

Fair values of long-term debt are estimated using discounted cash flow analyses, based on current incremental borrowing rates for similar types of borrowing arrangements.

The fair market value of the Hospital's long-term debt outstanding as of June 30, 2011 and 2010 was \$130,631 and \$135,899, respectively.

Total interest paid for fiscal years 2011 and 2010 was \$6,544 and \$6,652, respectively.

6. Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes:

	June 30	
	2011	2010
Health care services:		
Capital purposes	\$ 10,310	\$ 8,095
Patient services	3,295	3,027
Educational purposes	730	758
	<u>\$ 14,335</u>	<u>\$ 11,880</u>

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

6. Temporarily and Permanently Restricted Net Assets (continued)

Permanently restricted net assets are restricted to:

	June 30	
	2011	2010
Investments to be held in perpetuity, the income from which is expendable to support health care services	<u>\$ 8,065</u>	<u>\$ 8,051</u>

The Foundation initiated a major fundraising campaign for capital funds during fiscal year 2005 to support the Hospital's capital plans that include expansion and modernization of facilities. The Foundation has raised approximately \$14,834 as of June 30, 2011, which includes net pledges receivable present valued at approximately \$2,515. There were two large donations that represent approximately 32% and 35%, respectively, of the net pledges receivable at year-end. The Foundation expects to receive payment on the majority of the pledges by 2014 and all payments by 2025.

Scheduled payments on pledges receivable for the years ending June 30 are as follows:

2012	\$ 1,336
2013 – 2016	1,070
2017 and thereafter	<u>730</u>
	3,136
Less:	
Impact of discounting of pledges receivable to net present value	(276)
Allowance for uncollectible pledges	<u>(345)</u>
Net pledges receivable, capital campaign	2,515
Other pledges receivable	<u>424</u>
Total pledges receivable	<u><u>\$ 2,939</u></u>

Peninsula Regional Medical Center

Notes to Financial Statements (continued)

(In Thousands)

7. Functional Expenses

The Hospital considers health care services and management and general to be its primary functional categories for purposes of expense classification. Depreciation and interest costs are included in health care services. The Hospital's operating expenses by functional classification are as follows:

	Year Ended June 30	
	2011	2010
Health care services	\$ 335,768	\$ 334,750
Management and general	31,094	28,688
	<u>\$ 366,862</u>	<u>\$ 363,438</u>

8. Estimated Self-Insured Liability Claims and Workers' Compensation

The Hospital is self-insured for professional liability claims up to an annual limit of \$2,000 per claim and \$8,000 in aggregate. The Hospital carries an excess liability insurance policy for claims above these limits. There are known claims and incidents that may result in the assertion of additional claims, as well as claims from unknown incidents that may be asserted arising from services provided to patients. The Hospital has employed independent actuaries to estimate the ultimate costs, if any, of the settlement of such claims. The accrued self-insured professional liability losses have been discounted at 4% and in management's opinion provide an adequate reserve for loss contingencies. As of June 30, 2011 and 2010, respectively, \$10,953 and \$8,326 have been reserved for professional liability loss contingencies.

The Hospital established a trust for the purpose of setting aside assets based on actuarial funding recommendations. Under the trust agreement, the trust assets can only be used for payment of malpractice losses, related expenses and the cost of administering the trust. The assets of the trust are reported in assets limited as to use; income from trust assets, administrative costs and the Hospital's annual estimate of malpractice losses are reported in the statements of operations and changes in net assets.

The Hospital is self-insured for general liability claims beginning March 1, 2004 up to an annual limit of \$1,000 per claim and \$3,000 in aggregate. The Hospital carries an excess liability insurance policy for claims above these limits.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

8. Estimated Self-Insured Liability Claims and Workers' Compensation (continued)

The Hospital is also self-insured for workers' compensation up to an annual limit of \$400 per occurrence. The Hospital carries an excess liability insurance policy for workers' compensation claims above this limit. As of June 30, 2011 and 2010, respectively, \$2,592 and \$2,410 have been reserved for workers' compensation loss contingencies.

9. Investments

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

Fair values of all investments, including short-term investments, long-term investments, board-designated investments, and assets limited to use are based on quoted market prices and/or prices obtained from a third party using other market data for the same or comparable instruments and transactions in establishing the prices. Assets limited as to use also include the beneficial interest in the Foundation's temporarily restricted net assets which primarily consist of pledges receivable. Certain long-term pledges receivable have been discounted.

Fair value of investments and certain assets limited as to use held by the Hospital is summarized as follows:

	June 30	
	2011	2010
Investments:		
Cash and cash equivalents	\$ 14,368	\$ 6,988
U.S. treasury securities	20,118	14,651
Corporate bonds	37,067	36,143
Equity securities	111,410	79,025
Government sponsored mortgage-backed securities	19,013	20,097
Other (including pledges receivable held at the Foundation)	4,169	4,127
Total	<u>\$ 206,145</u>	<u>\$ 161,031</u>

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

9. Investments (continued)

ASC No. 320, *Investments – Debt and Equity Securities*, provides guidance on the recognition and presentation of other-than-temporary impairments. In addition, additional disclosures are required related to other-than-temporary impairments. Under this revised guidance, if a debt security is in an unrealized loss position and the Hospital has the intent to sell the debt security, or it is more likely than not that the Hospital will have to sell the debt security before recovery of its amortized cost basis, the decline in value is deemed to be other-than-temporary and is recorded to other-than-temporary impairment losses recognized in the performance indicator in the statements of operations. For impaired debt securities that the Hospital does not intend to sell or it is more likely than not that the Hospital will not have to sell such securities, but the Hospital expects that it will not fully recover the amortized cost basis, the credit component of the other-than-temporary impairment is recognized in other-than-temporary impairment losses recognized in the performance indicator in the statements of operations and the non-credit component of the other-than-temporary impairment is recognized as a change in unrestricted net assets.

The credit component of an other-than-temporary impairment is determined by comparing the net present value of projected future cash flows with the amortized cost basis of the debt security. The net present value is calculated by discounting the best estimate of projected future cash flows at the effective interest rate implicit in the debt security at the date of acquisition. Cash flow estimates are driven by assumptions regarding probability of default, including changes in credit ratings, and estimates regarding timing and amount of recoveries associated with a default. Furthermore, unrealized losses entirely caused by non-credit-related factors related to debt securities for which the Hospital expects to fully recover the amortized cost basis continue to be recognized as an unrealized loss on investments within the changes in unrestricted net assets.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

9. Investments (continued)

The following table shows the gross unrealized losses and fair value of the Hospital's investments with unrealized losses that are not deemed to be other than temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2011 and 2010:

	Fair Value < 1 year	Unrealized Losses < 1 year	Fair Value > 1 year	Unrealized Losses > 1 year	Total Unrealized Losses
June 30, 2011					
Government sponsored mortgage-backed securities	\$ 10,647	\$ 111	\$ -	\$ -	\$ 111
Corporate debt securities	6,429	86	-	-	86
Equity securities	14,395	922	1,260	146	1,068
Total investments	<u>\$ 31,471</u>	<u>\$ 1,119</u>	<u>\$ 1,260</u>	<u>\$ 146</u>	<u>\$ 1,265</u>
June 30, 2010					
Government sponsored mortgage-backed securities	\$ 1,407	\$ 17	\$ -	\$ -	\$ 17
Corporate debt securities	2,608	134	-	-	134
Equity securities	30,773	2,884	233	18	2,902
Total investments	<u>\$ 34,788</u>	<u>\$ 3,035</u>	<u>\$ 233</u>	<u>\$ 18</u>	<u>\$ 3,053</u>

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

10. Fair Value Measurements

ASC No. 820, *Fair Value Measurements and Disclosures*, establishes a framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under ASC No. 820 are described below:

- Level 1 – Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Hospital has the ability to access.
- Level 2 – Inputs to the valuation methodology include:
 - Quoted prices for similar assets or liabilities in active markets;
 - Quoted prices for identical or similar assets or liabilities in inactive markets;
 - Inputs other than quoted prices that are observable for the asset or liability; and
 - Inputs that are derived principally from or corroborated by observable market data by correlation or other means.
- Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

10. Fair Value Measurements (continued)

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Hospital believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

The following table presents the Hospital's assets and liabilities measured at fair value, aggregated by level in the fair value hierarchy within which those measurements fall:

	Assets at Fair Value as of June 30, 2011			
	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents	\$ 14,368	\$ –	\$ –	\$ 14,368
U.S. treasury securities	20,118	–	–	20,118
Corporate debt securities	–	37,067	–	37,067
Mortgage-backed securities	–	19,013	–	19,013
Publicly traded equity securities	111,010	400	–	111,410
Other	873	357	2,939	4,169
Total assets	\$ 146,369	\$ 56,837	\$ 2,939	\$ 206,145

	Assets at Fair Value as of June 30, 2010			
	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents	\$ 6,988	\$ –	\$ –	\$ 6,988
U.S. treasury securities	14,651	–	–	14,651
Corporate debt securities	–	36,143	–	36,143
Mortgage-backed securities	–	20,097	–	20,097
Publicly traded equity securities	78,889	136	–	79,025
Other	940	–	3,187	4,127
Total assets	\$ 101,468	\$ 56,376	\$ 3,187	\$ 161,031
Liabilities				
Interest rate swap liabilities	\$ –	\$ (2,075)	\$ –	\$ (2,075)
Total liabilities	\$ –	\$ (2,075)	\$ –	\$ (2,075)

Peninsula Regional Medical Center

Notes to Financial Statements (continued)

(In Thousands)

10. Fair Value Measurements (continued)

The fair values of securities are determined by third-party service providers utilizing various methods dependent upon the specific type of investment. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Where significant inputs, including benchmark yields, broker-dealer quotes, issuer spreads, bids, offers, the LIBOR curve and measures of volatility, are used by these third-party dealers or independent pricing services to determine fair values, the securities are classified within Level 2.

Long-term pledges receivable, which are measured at fair value on a non-recurring basis, are discounted to net present value upon receipt using an appropriate risk-free discount rate based on the term of the receivable. Pledges receivable are recorded net of an allowance for uncollectible pledges. The following table provides a reconciliation of the beginning and ending balances of pledges receivable at fair value that used significant unobservable inputs (Level 3):

	Year Ended June 30	
	2011	2010
Pledges receivable		
Balance at July 1	\$ 3,187	\$ 4,483
New pledges	482	–
Collections on pledges	(667)	(1,591)
Write-off of pledges	(133)	(45)
Changes in reserves	70	340
Balance at June 30	\$ 2,939	\$ 3,187

11. Pension Plan

The Hospital has a cash balance-type defined benefit pension plan covering substantially all of its employees. The Plan benefits are based on years of service and the employees' compensation during the last five years of covered employment. The Hospital's funding policy is to make sufficient contributions to the Plan to comply with the minimum funding provisions of the Employee Retirement Income Security Act. Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future.

The Peninsula Regional Medical Center PensionPlus Plan (the Plan) provides annual allocations to a participant's hypothetical account. When a participant retires, the participant has the choice to receive a lump-sum distribution equal to the value of the hypothetical account or to receive an annuity based on the value of the hypothetical account.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) *(In Thousands)*

11. Pension Plan (continued)

Prior to January 1, 2009, the Plan provided three different allocations: (i) a service-related allocation, (ii) an age-related allocation and (iii) a matching allocation. Both the service-related allocation and the age-related allocation were determined by multiplying a participant's annual compensation by a certain percentage. The matching allocation operated to provide an annual allocation in the Plan based on the participant's contribution to the Hospital's 403(b) Plan.

The IRS issued new regulations that were effective as of January 1, 2009. The new regulations prohibited a pension plan from providing a matching allocation based on a participant's contributions to a different plan. The Plan provided a matching allocation based on a participant's contribution to a 403(b) Plan. In order to comply with the new tax law requirements, the Plan was amended effective as of December 31, 2008, to eliminate future matching allocations in the Plan. At the same time, the Hospital adopted a 403(b) plan effective as of January 1, 2009 and provided a replacement matching contribution in the 403(b) plan.

The assets of the Plan are available to pay the benefits of eligible employees of all participating entities. The Plan had a prepaid asset of \$2,016 and an unfunded liability of \$14,610 as of June 30, 2011 and 2010, respectively.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

11. Pension Plan (continued)

The following provides a reconciliation of the changes in fair value of the Plan's assets and projected benefit obligations, and the Plan's funded status:

	<u>2011</u>	<u>2010</u>
Accumulated benefit obligation	\$ 79,466	\$ 73,326
Projected benefit obligation, beginning of year	\$ 80,834	\$ 72,140
Service cost	3,825	3,450
Interest cost	4,444	4,397
Actuarial (gain) loss	(1,133)	3,947
Benefits paid	(2,739)	(3,100)
Projected benefit obligation, end of year	<u>85,231</u>	<u>80,834</u>
Fair value of plan assets, beginning of year	66,224	55,926
Actual gain on plan assets	12,762	5,398
Employer contributions	11,000	8,000
Benefits paid	(2,739)	(3,100)
Fair value of plan assets, end of year	<u>87,247</u>	<u>66,224</u>
Fair value of plan assets greater than/(less than) projected benefit obligation	2,016	(14,610)
Prepaid/(Accrued) pension cost recorded in the balance sheets	<u>\$ 2,016</u>	<u>\$ (14,610)</u>

Components of net periodic benefit cost are as follows:

	<u>Year Ended June 30</u>	
	<u>2011</u>	<u>2010</u>
Service cost	\$ 3,825	\$ 3,450
Interest cost	4,444	4,397
Expected return on plan assets	(6,214)	(5,543)
Amortization of prior service credit	(126)	(126)
Recognized net actuarial loss	2,661	2,598
Net periodic benefit cost	<u>\$ 4,590</u>	<u>\$ 4,776</u>

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

11. Pension Plan (continued)

Net amount recognized in unrestricted net assets that have not been recognized in net periodic benefit cost are as follows:

	<u>2011</u>	<u>2010</u>
Net actuarial loss	\$ 30,341	\$ 40,682
Prior service credit	(692)	(818)
Total recognized in unrestricted net assets	<u>\$ 29,649</u>	<u>\$ 39,864</u>

The estimated net actuarial loss and prior service credit for the Plan that will be amortized from unrestricted net assets into net periodic benefit cost over the next fiscal year are \$2,106 and \$(126), respectively.

Weighted average assumptions used to determine projected benefit obligations and net periodic benefit costs at June 30 were as follows:

Projected benefit obligation	<u>2011</u>	<u>2010</u>
Discount rate	6.00%	5.60%
Rates of increase in compensation levels	3.70	5.00
Net periodic benefit cost	<u>2011</u>	<u>2010</u>
Discount rate	5.60%	6.31%
Rates of increase in compensation levels	5.00	5.00
Expected long-term rate of return on assets	7.75	8.00

The defined benefit pension plan asset allocation as of the measurement date (June 30) and the target asset allocation, presented as a percentage of total plan assets, were as follows:

	<u>2011</u>	<u>2010</u>	Target Allocation
Debt securities	30%	36%	25% – 40%
Equity securities	65%	59	45% – 75%
Cash and cash equivalents	5%	5	1% – 10%
Total	<u>100%</u>	<u>100%</u>	

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

11. Pension Plan (continued)

The Hospital's defined benefit plan invests in a diversified mix of traditional asset classes. Investments in U.S. equity securities and fixed income securities are made to maximize long-term results while recognizing the need for adequate liquidity to meet ongoing benefit and administrative obligations. Risk tolerance of unexpected investment and actuarial outcomes is continually evaluated by understanding the pension plan's liability characteristics. This is performed through forecasting and assessing ranges of investment outcomes over short- and long-term horizons, and by assessing the Hospital's financial condition and its future potential obligations from both the pension and general operational requirements. Complementary investment styles, such as growth and value equity investing techniques, are utilized by the Hospital's investment advisors to further improve portfolio and operational risk characteristics. Equity investments, both active and passively managed, are used primarily to increase overall plan returns. Fixed income investments provide diversification benefits and liability hedging attributes that are desirable, especially in falling interest rate environments.

Asset allocations and investment performance are formally reviewed at regularly scheduled meetings of the Hospital's Financial Resources Committee.

The overall rate of expected return on assets assumption was based on historical returns, with adjustments made to reflect expectations of future returns. The extent to which the future expectations were recognized included the target rates of return for the future, which have not historically changed.

The fair value of the Hospital's pension plan assets as of June 30, 2011 and June 30, 2010, by asset category (see Note 10, *Fair Value Measurements*, for a description of the asset categories) are as follows:

June 30, 2011	Level 1	Level 2	Level 3	Total
Assets				
Investments at fair value:				
Cash and cash equivalents	\$ 864	\$ -	\$ -	\$ 864
U.S. Treasuries	5,396	-	-	5,396
United States government and agency obligations	-	4,792	-	4,792
Corporate debt securities	-	15,461	-	15,461
Money market funds	4,269	-	-	4,269
Publicly traded equity securities	55,929	182	-	56,111
Other	354	-	-	354
Total investments	<u>\$ 66,812</u>	<u>\$ 20,435</u>	<u>\$ -</u>	<u>\$ 87,247</u>

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

11. Pension Plan (continued)

June 30, 2010	Level 1	Level 2	Level 3	Total
Assets				
Investments at fair value:				
Cash and cash equivalents	\$ 349	\$ -	\$ -	\$ 349
United States government and agency obligations	5,223	3,560	-	8,783
Corporate debt securities	-	14,922	-	14,922
Money market funds	3,540	-	-	3,540
Publically traded equity securities	38,630	-	-	38,630
Total investments	<u>\$ 47,742</u>	<u>\$ 18,482</u>	<u>\$ -</u>	<u>\$ 66,224</u>

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

United States government and agency obligations: the fair value is determined by an active price for an identical security in an observable market.

Corporate debt securities: the fair value is estimated using quoted prices for similar assets in active markets or quoted prices for identical or similar assets in non-active markets (few transactions, limited information, non-current prices, and high variability over time).

Money market funds: the carrying value of these money market funds approximates fair value as the maturities are less than three months.

Publically traded equity securities: the fair value is determined by market quotes for an identical security in an observable market.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Hospital believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)

(In Thousands)

11. Pension Plan (continued)

Cash Flows

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid as follows for the years ending June 30:

2012	\$	7,449
2013		7,784
2014		8,015
2015		8,032
2016		7,907
2017 – 2021		37,781

The Hospital intends to make voluntary contributions to the defined benefit pension plan of \$4,500 through June 30, 2012. This funding level exceeds any regulatory requirements for 2011.

12. Commitments and Contingencies

Agreement in Principle with the Office of Inspector General

The Hospital received several subpoenas from the Office of Inspector General of the U.S. Department of Health and Human Services (“OIG”), requiring the production of certain documents related to claims for physician health care services provided by a former Medical Staff Member. These subpoenas were issued in connection with a civil investigation being conducted by the U.S. Attorney’s Office for the District of Maryland. In January 2011, the Hospital reached a tentative “Agreement in Principle”, which was ultimately approved by the U.S. Department of Justice, the OIG, the Office of Personnel Management (OPM), and the state of Maryland in August 2011, to resolve all remaining potential civil claims arising out of the Hospital’s medical services to patients of the physician. The Hospital reached this agreement without admitting liability in order to avoid the expense and uncertainty of litigation and to allow the Hospital to move forward. In this regard and consistent with the settlement, an amount of \$1.8 million was paid in June 2011 and recorded as an other expense in the accompanying 2011 statement of operations and changes in net assets. The settlement also includes a five year Corporate Integrity Agreement that will require the Hospital to establish and/or enhance various compliance processes and also have several independent peer review reports completed on an annual basis.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

12. Commitments and Contingencies (continued)

Other

The Hospital has been named as a defendant in various lawsuits arising from the performance of its normal activities. In the opinion of the Hospital's management, after discussion with legal counsel, the amount, if any, of the Hospital's ultimate liability under these lawsuits will not have a material adverse effect on the financial position of the Hospital.

A portion of the Hospital's revenues is received from health maintenance organizations and other managed care payors. Managed care payors generally use case management activities to control utilization. These payors also have the ability to select providers offering the most cost-effective care. Management does not believe that the organization has undue exposure to any one managed care payor.

The Hospital's revenues may be subject to adjustment as a result of examination by government agencies or contractors, and as a result of differing interpretation of government regulations, medical diagnosis, charge coding, medical necessity, or other contract terms. The resolution of these matters, if any, often is not finalized until subsequent to the period during which the services were rendered.

13. Maryland Health Services Cost Review Commission

Certain Hospital charges are subject to review and approval by the Maryland Health Services Cost Review Commission (the Commission). Hospital management has filed the required forms with the Commission and believes the Hospital to be in compliance with Commission requirements.

The current rate of reimbursement for principally all inpatient services and certain other services to patients under the Medicare and Medicaid programs is based on an agreement between the Centers for Medicare and Medicaid Services and the Commission. This agreement is based upon a waiver from Medicare prospective payment system reimbursement principles granted to the State of Maryland under Section 1814(b) of the Social Security Act and will continue as long as the rate of increase for costs per hospital inpatient admission in Maryland is below the national average. Management expects this agreement will remain in effect at least through June 30, 2012.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

13. Maryland Health Services Cost Review Commission (continued)

The Commission and the Hospital entered into an agreement that is based on a rate methodology for those hospital service centers that provide inpatient services. Under this methodology, a target average charge per case is established for the Hospital based on past actual charges and case mix indices. The actual average charge per case is compared with the target average charge per case, and to the extent that the actual average exceeds or is less than the target, the difference adjusted for applicable penalties will reduce or increase the approved target for future rate years. For the year ended June 30, 2011, the Hospital was in compliance with its average charge per case target.

The Commission's rate-setting methodology for hospital service centers that provide both inpatient and outpatient services or only outpatient services consists of establishing an acceptable unit rate for defined inpatient and outpatient service centers within the hospital. The actual average unit charge for each service center is compared to the approved rate monthly and annually. Overcharges and undercharges due to either patient volume or price variances, adjusted for penalties where applicable, are applied to decrease (in the case of overcharges) or increase (in the case of undercharges) future approved rates on an annual basis.

Under the Commission's rate methodology for certain outpatient services, a target average charge per visit was established for the Hospital based on past actual charges and case mix indices. The actual average charge per visit is compared with the target average charge per visit, and to the extent that the actual average exceeds or is less than the target, it will reduce or increase the approved rates for future years. Management believes that this methodology will not have a significant impact on the Hospital in future years.

The timing of the Commission's rate adjustments for the Hospital could result in an increase or reduction in rates due to the variances and penalties described above in a year subsequent to the year in which such items occur, and there is at least a possibility that the amounts may be material. The Hospital's policy is to record revenue based on actual charges for services to patients in the year in which the services are performed. The Hospital recognizes unbilled revenue for in-house patients.

14. Subsequent Events

The Hospital has evaluated subsequent events through September 16, 2011, the date the financial statements were issued.

Other Financial Information

Report of Independent Auditors on Other Financial Information

Board of Trustees
Peninsula Regional Medical Center

Our audit was conducted for the purpose of forming an opinion on the June 30, 2011 financial statements taken as a whole. The June 30, 2011 supplementary information is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has been subjected to the auditing procedures applied in our audit of the June 30, 2011 financial statements and, in our opinion, is fairly stated in all material respects in relation to the June 30, 2011 financial statements taken as a whole.

A handwritten signature in black ink that reads 'Ernst & Young LLP'.

September 16, 2011

Peninsula Regional Medical Center

Summary of Operations
(In Thousands)

	Year Ended June 30				
	2011	2010	2009	2008	2007
Gross patient revenue	\$ 457,035	\$ 426,582	\$ 418,478	\$ 399,948	\$ 361,938
Deductions from revenue	76,983	58,173	50,440	45,406	41,700
Net patient service revenue	380,052	368,409	368,038	354,542	320,238
Other operating revenue	2,357	2,059	1,976	1,080	1,362
	382,409	370,468	370,014	355,622	321,600
Operating expenses	366,862	363,438	357,978	327,422	300,046
Income from operations	15,547	7,030	12,036	28,200	21,554
Nonoperating income (expense):					
Nonoperating income (expense)	12,164	10,304	(14,533)	12,033	7,419
Basis swap income (loss)	3,128	1,753	(3,344)	(1,927)	3,944
	15,292	12,057	(17,877)	10,106	11,363
Excess (deficit) of unrestricted revenue and other support over expenses	\$ 30,839	\$ 19,087	\$ (5,841)	\$ 38,306	\$ 32,917

Peninsula Regional Medical Center

Gross Patient Revenue (In Thousands)

	Year Ended June 30	
	2011	2010
Total gross patient revenue:		
Routine care:		
Daily hospital care	\$ 115,624	\$ 101,875
Daily hospital care – nursery	6,550	5,231
Emergency services	21,364	25,340
Admissions charge	3,393	3,487
	146,931	135,933
Professional services:		
Pathology and clinical laboratory	32,298	31,748
Operating room	30,546	33,166
Pharmacy	50,150	49,468
Radiology:		
Diagnostic	4,738	5,181
Nuclear medicine	2,293	2,728
Special procedures	3,013	3,106
Ultrasound lab	3,077	3,204
C/T scanning and magnetic resonance imaging	7,596	8,434
Vascular lab	3,492	3,704
Radiation oncology	14,085	10,648
Medical oncology	6,232	6,194
Respiratory care and pulmonary function	9,811	8,958
Blood bank	1,959	2,015
Medical and surgical supplies	57,004	61,796
Delivery service	6,536	6,266
Anesthesiology	3,257	2,637
Electrocardiogram	429	468
Cardiac laboratory	12,652	13,383
Intravenous solutions	688	723
Lithotripsy	44	43
Physical, speech and occupational therapy	4,724	5,594
Neurological diagnostics	1,974	1,859
Cardiac rehabilitation	1,391	1,078
Family practice, clinic and diagnostic centers	17,650	14,863
Specialty practices	19,627	736
Transitional care	7,621	7,856
Recovery care	6,756	4,793
Observation service	461	–
	310,104	290,649
Gross patient revenue	\$ 457,035	\$ 426,582

Peninsula Regional Medical Center

Operating Expenses
(In Thousands)

	Year Ended June 30		Increase
	2011	2010	(Decrease)
Nursing services	\$ 94,459	\$ 94,606	\$ (147)
Buildings and grounds	14,545	14,240	305
Laboratory	13,844	13,599	245
Materials management	7,184	7,768	(584)
Administration	26,020	22,279	3,741
Food services	4,066	3,907	159
Financial affairs and information systems	17,571	17,637	(66)
Respiratory services	5,325	5,372	(47)
Pharmacy	32,924	31,089	1,835
Radiology	14,369	14,104	265
Radiation oncology	4,706	4,339	367
Medical oncology	6,338	6,567	(229)
Physician services	7,518	11,477	(3,959)
Electrocardiology, neurological diagnostic, cardiac catheterization laboratory, family practice, lithotripsy, diagnostic and breast care centers	35,971	32,724	3,247
Physical, speech and occupational therapy	3,101	2,915	186
Admitting and registration	2,318	2,225	93
Education and training	1,258	1,312	(54)
Transitional care	2,241	2,239	2
Employee benefits, child care (exclusive of FICA)	27,274	29,328	(2,054)
Bad debts	17,411	17,977	(566)
Depreciation	21,829	20,835	994
Interest	6,544	6,853	(309)
Amortization of financing costs and deferred charge for retirement of debt	46	46	—
	\$ 366,862	\$ 363,438	\$ 3,424

Peninsula Regional Medical Center

Analysis of Property and Equipment
(In Thousands)

	Assets			Allowances for Depreciation				Net Amount June 30, 2011	
	Balance July 1, 2010	Additions	Disposals	Balance June 30, 2011	Balance July 1, 2010	Provisions	Deductions		Balance June 30, 2011
Property used in operations:									
Land	\$ 10,492	–	–	\$ 10,492	\$ –	–	–	\$ –	\$ 10,492
Land improvements	10,626	602	–	11,228	4,470	541	–	5,011	6,217
Buildings	188,294	2,645	59	190,880	45,980	6,275	49	52,206	138,674
Fixed equipment	30,270	–	–	30,270	28,743	908	–	29,651	619
Movable equipment	179,964	10,874	1,131	189,707	133,885	14,105	1,108	146,882	42,825
	419,646	14,121	1,190	432,577	213,078	21,829	1,157	233,750	198,827
Property and costs related to construction in progress	6,097	1,230	–	7,327	–	–	–	–	7,327
	<u>\$ 425,743</u>	<u>\$ 15,351</u>	<u>\$ 1,190</u>	<u>\$ 439,904</u>	<u>\$ 213,078</u>	<u>\$ 21,829</u>	<u>\$ 1,157</u>	<u>\$ 233,750</u>	<u>\$ 206,154</u>

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