

**The Union Hospital of  
Cecil County, Inc.**

Financial Statements

June 30, 2011 and 2010



# **The Union Hospital of Cecil County, Inc.**

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June 30, 2011 and 2010

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## Independent Auditors' Report

Board of Directors  
The Union Hospital of Cecil County, Inc.

We have audited the accompanying balance sheet of The Union Hospital of Cecil County, Inc. (a Maryland not-for-profit corporation) (the "Hospital") as of June 30, 2011 and 2010, and the related statements of operations, 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 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 financial statements referred to above present fairly, in all material respects, the financial position of The Union Hospital of Cecil County, Inc. as of June 30, 2011 and 2010, and the results of its operations, changes in net assets, and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*ParenteBeard LLC*

Philadelphia, Pennsylvania  
October 5, 2011

**The Union Hospital of Cecil County, Inc.**

Balance Sheet

June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>		<u>2011</u>	<u>2010</u>
<b>Assets</b>			<b>Liabilities and Net Assets</b>		
<b>Current Assets</b>			<b>Current Liabilities</b>		
Cash and cash equivalents	\$ 6,711,325	\$ 3,632,787	Accounts payable and accrued expenses	\$ 6,696,676	\$ 6,097,580
Investments	48,134,088	45,357,593	Accrued salaries and benefits	4,955,957	4,524,652
Accounts receivable, patients (net of estimated allowances for doubtful accounts of \$9,530,000 in 2011 and \$8,452,000 in 2010)	15,631,343	16,659,476	Third-party advances	2,460,368	1,834,657
Current portion of notes receivable, related party	583,013	568,633	Current portion of long-term debt and capital lease obligations	<u>1,562,678</u>	<u>2,216,359</u>
Other receivables	608,232	213,296	Total current liabilities	15,675,679	14,673,248
Inventories of supplies	1,990,589	1,686,189			
Prepaid expenses	<u>1,797,805</u>	<u>1,314,477</u>	<b>Long-Term Debt and Capital Lease Obligations, Net</b>	71,261,519	82,676,519
Total current assets	75,456,395	69,432,451	<b>Estimated Medical Malpractice Claims Liability</b>	<u>519,814</u>	<u>500,000</u>
<b>Assets Held in Trust</b>	5,968,719	8,081,744	Total liabilities	<u>87,457,012</u>	<u>97,849,767</u>
<b>Property and Equipment, Net</b>	80,022,285	84,954,723			
<b>Due From Affiliates, Net</b>	2,451,270	4,431,144	<b>Net Assets</b>		
<b>Notes Receivable, Related Party</b>	1,158,970	1,741,983	Unrestricted	83,217,623	75,819,074
<b>Other Assets, Net</b>	1,757,928	1,285,660	Temporarily restricted	<u>852,799</u>	<u>1,112,680</u>
<b>Interest in Net Assets of Affiliate</b>	4,711,867	4,853,816	Total net assets	84,070,422	76,931,754
Total assets	<u>\$ 171,527,434</u>	<u>\$ 174,781,521</u>	Total liabilities and net assets	<u>\$ 171,527,434</u>	<u>\$ 174,781,521</u>

See notes to financial statements

# The Union Hospital of Cecil County, Inc.

## Statement of Operations

Years Ended June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
<b>Unrestricted Revenues, Gains, and Other Support</b>		
Net patient service revenues	\$ 137,791,566	\$ 127,636,339
Other operating revenues	2,051,719	1,980,982
Net assets released from restrictions for use in operations	<u>308,776</u>	<u>1,010,539</u>
Total unrestricted revenues, gains, and other support	<u>140,152,061</u>	<u>130,627,860</u>
<b>Expenses</b>		
Salaries and employee benefits	63,312,190	61,358,579
Supplies and other expenses	27,394,709	26,521,864
Purchased services	22,550,989	21,710,056
Provision for doubtful accounts	9,542,426	10,819,843
Depreciation and amortization	8,715,464	8,349,876
Interest	<u>4,074,222</u>	<u>3,949,057</u>
Total expenses	<u>135,590,000</u>	<u>132,709,275</u>
Operating income (loss)	<u>4,562,061</u>	<u>(2,081,415)</u>
<b>Nonoperating Income</b>		
Investment income	6,327,810	5,264,718
Other, net	<u>121,351</u>	<u>15,773</u>
Total nonoperating income	<u>6,449,161</u>	<u>5,280,491</u>
Revenues in excess of expenses	11,011,222	3,199,076
<b>Change in Unrestricted Net Assets of The Union Hospital of Cecil County Foundation, Inc. and Subsidiary</b>		
	130,757	219,671
<b>Transfers to Affiliates</b>	(4,089,347)	(2,642,957)
<b>Net Assets Released From Restriction for Purchase of Property and Equipment</b>	<u>345,917</u>	<u>50,113</u>
Increase in unrestricted net assets	<u>\$ 7,398,549</u>	<u>\$ 825,903</u>

See notes to financial statements

## The Union Hospital of Cecil County, Inc.

### Statement of Changes in Net Assets Years Ended June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
<b>Unrestricted Net Assets</b>		
Revenues in excess of expenses	\$ 11,011,222	\$ 3,199,076
Change in unrestricted net assets of the Union Hospital of Cecil County Foundation, Inc. and Subsidiary	130,757	219,671
Transfer to affiliates	(4,089,347)	(2,642,957)
Net assets released from restriction for purchase of property and equipment	<u>345,917</u>	<u>50,113</u>
Increase in unrestricted net assets	<u>7,398,549</u>	<u>825,903</u>
<b>Temporarily Restricted Net Assets</b>		
Other changes in beneficial interest in net assets of The Union Hospital of Cecil County Foundation, Inc. and Subsidiary	-	(500)
Contributions, net of event expenses of \$388,000 and \$360,000 in 2011 and 2010, respectively	383,978	300,032
Change in provision for uncollectible pledges	10,834	(52,574)
Net assets released from restriction	<u>(654,693)</u>	<u>(1,060,652)</u>
Decrease in temporarily restricted net assets	<u>(259,881)</u>	<u>(813,694)</u>
Increase in net assets	7,138,668	12,209
<b>Net Assets, Beginning</b>	<u>76,931,754</u>	<u>76,919,545</u>
<b>Net Assets, Ending</b>	<u><u>\$ 84,070,422</u></u>	<u><u>\$ 76,931,754</u></u>

See notes to financial statements

**The Union Hospital of Cecil County, Inc.**

## Statement of Cash Flows

Years Ended June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
<b>Cash Flows from Operating Activities</b>		
Increase in net assets	\$ 7,138,668	\$ 12,209
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation	8,715,464	8,349,876
(Gain) loss on disposal of assets	(203,398)	165,122
Provision for doubtful accounts	9,542,426	10,819,843
Amortization of bond premium and deferred financing costs	213,233	41,264
Transfers to affiliates	4,089,347	2,642,957
Net realized and unrealized gains and losses on trading securities	(5,296,411)	(4,121,224)
Changes in assets and liabilities:		
Accounts receivable, patient	(8,514,293)	(10,956,103)
Other receivables, inventories, and prepaid expenses	(1,182,664)	308,631
Due to/from affiliates	1,979,874	2,639,221
Other assets, net	(638,582)	975
Accounts payable and accrued expenses	599,096	(488,060)
Accrued salaries and benefits	431,305	397,262
Third-party advances	625,711	454,353
Estimated medical malpractice claims liability	19,814	-
Net cash provided by operating activities	<u>17,519,590</u>	<u>10,266,326</u>
<b>Cash Flows from Investing Activities</b>		
Purchases of property and equipment	(4,002,681)	(13,888,078)
Proceeds received from sale of property and equipment	423,053	34,136
Decrease (increase) in investments, net	2,519,916	(1,196,117)
Decrease in assets held in trust	2,113,025	134,767
Change in beneficial interest in net assets of The Union Hospital of Cecil County Foundation, Inc. and Subsidiary	141,949	510,943
Decrease in note receivable, affiliate	568,633	554,608
Net cash flows provided by (used in) investing activities	<u>1,763,895</u>	<u>(13,849,741)</u>
<b>Cash Flows from Financing Activities</b>		
Transfers to affiliates	(4,089,347)	(2,642,957)
Proceeds from debt issuance	3,740,759	10,093,688
Payment of long-term debt and capital lease obligations	(15,856,359)	(3,457,348)
Increase in deferred financing costs	-	(153,330)
Net cash (used in) provided by financing activities	<u>(16,204,947)</u>	<u>3,840,053</u>
Net increase in cash and cash equivalents	<u>3,078,538</u>	<u>256,638</u>
<b>Cash and Cash Equivalents, Beginning</b>	<u>3,632,787</u>	<u>3,376,149</u>
<b>Cash and Cash Equivalents, Ending</b>	<u>\$ 6,711,325</u>	<u>\$ 3,632,787</u>
<b>Supplemental Disclosure of Cash Flow Information</b>		
Cash paid for interest	<u>\$ 4,451,805</u>	<u>\$ 3,986,072</u>
<b>Noncash Investing and Financing Activity</b>		
Obligations incurred for purchase of property and equipment	<u>\$ -</u>	<u>\$ 1,726,845</u>

See notes to financial statements

# **The Union Hospital of Cecil County, Inc.**

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Notes to Financial Statements  
June 30, 2011 and 2010

## **1. Organizational Structure and Nature of Operations**

The Union Hospital of Cecil County, Inc. (the "Hospital") is a Maryland not-for-profit corporation and is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code. The Hospital operates a general community hospital in Elkton, Maryland, which serves residents from Cecil County and the surrounding area.

Affinity Health Alliance, Inc. (the "Health System") is a nonstock, not-for-profit corporation and the sole corporate member of the Hospital. The Health System is also the sole corporate member or sole stockholder of other related healthcare organizations, one of which is a for-profit corporation.

### **Subsequent Events**

The Hospital evaluated subsequent events for recognition or disclosure through October 5, 2011 the date the financial statements were issued.

## **2. Summary of Significant Accounting Policies**

### **Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of 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.

### **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 their exempt income under Section 501(a) of the Internal Revenue Code.

The Hospital accounts for uncertainty in income taxes by prescribing a recognition threshold of more-likely-than-not to be sustained upon examination by the appropriate taxing authority. Measurement of the tax uncertainty occurs if the recognition threshold has been met. There were no tax uncertainties that met the recognition threshold in 2011 and 2010.

The Hospital's policy is to recognize interest related to unrecognized tax benefits in interest expense and penalties in operating expenses.

The Hospital's federal Exempt Organization Business Income Tax Returns for years ended 2010, 2009, and 2008 remain subject to examination by the Internal Revenue Service.

### **Cash and Cash Equivalents**

Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturities of three months or less at date of purchase, excluding investments and assets held in trust.

# **The Union Hospital of Cecil County, Inc.**

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Notes to Financial Statements  
June 30, 2011 and 2010

## **Accounts Receivable, Patients**

Accounts receivable, patients are reported at net realizable value. Accounts are written off when they are determined to be uncollectible based upon management's assessment of individual accounts. The allowance for doubtful accounts is estimated based upon a periodic review of the accounts receivable aging, payor classifications and application of historical write-off percentages.

## **Other Receivables**

Other receivables are reported at net realizable value. Accounts are written off when they are determined to be uncollectible based upon management's assessment of individual accounts. No allowance for doubtful collections was recorded because management believes realization losses on other receivables will be immaterial.

## **Inventories of Supplies**

Inventories, which consist primarily of medical supplies and drugs, are recorded at the lower of cost (using the weighted average method) or market.

## **Investments and Investment Risk**

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value. Mutual funds are valued at quoted market prices, which represent the net asset value of shares held. Cash and cash equivalents are carried at cost which approximates fair value. Managed hedge funds represent ownership in limited partnerships that invest in hedge funds and private equity capital funds. Investments in these funds representing less than 3% ownership are recorded at cost. Investments representing greater than 3% ownership are accounted for under the equity method. Investment income or loss (including realized gains and losses on investments, interest and dividends and unrealized gains and losses on trading securities) is included in the determination of revenues in excess of expenses unless the income or loss is restricted by donor or law.

The Hospital's investments are comprised of a variety of financial instruments and are managed by investment advisors. The fair values reported in the balance sheet are subject to various risks including changes in the equity markets, the interest rate environment, and general economic conditions. Due to the level of risk associated with certain investment securities and the level of uncertainties related to changes in the fair value of investment securities, it is reasonably possible that the amounts reported in the accompanying financial statements could change materially in the near term.

## **Assets Held in Trust**

Assets held in trust are comprised of assets held by a bond trustee under trust indentures in conjunction with the issuance of the Series 1998, 2002, 2005 and 2009 Revenue Bonds, which are to be held by a trustee. They include the debt service reserve fund and the construction fund.

# **The Union Hospital of Cecil County, Inc.**

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Notes to Financial Statements  
June 30, 2011 and 2010

## **Property and Equipment**

Property and equipment acquisitions are recorded at cost. Donated property and equipment are recorded at fair market value at the date of receipt. Depreciation is computed using the straight-line method based on estimated useful lives.

Equipment under capital lease obligations is amortized on the straight-line method over the shorter period of the lease term or the estimated useful life of the improvements and equipment. Such amortization is included in depreciation and amortization in the consolidated financial statements.

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

## **Interest in Net Assets of Affiliate**

Generally accepted accounting principles establish standards for transactions in which a donor makes a contribution by transferring assets to a not-for-profit recipient organization that agrees to use those assets on behalf of or transfer them to a beneficiary entity. Under certain circumstances, a beneficiary organization is required to recognize its rights to assets held by a recipient organization as an asset on the balance sheet, and changes in value of that asset as a change in net assets in the period of change. The Hospital is the beneficiary of the net assets of an unconsolidated affiliate, The Union Hospital of Cecil County Foundation, Inc. and Subsidiary, (the "Foundation"), that requires reporting under generally accepted accounting principles in the fiscal 2011 and 2010 financial statements. The interest in the net assets of the Foundation recorded as of June 30, 2011 and 2010 was \$4,711,867 and \$4,853,816, respectively.

## **Temporarily Restricted Net Assets**

Temporarily restricted net assets for various capital and other Hospital related expenditures are those whose use by the Hospital has been limited by donors to a specific time period or purpose. Restricted net assets of \$654,693 and \$1,060,652 were released from restriction during 2011 and 2010, respectively, in accordance with donor restrictions.

## **Long-Term Debt and Amortization**

Long-term debt is shown net of original bond issue premium. This premium is being amortized on a straight-line basis (which approximates the effective interest method) over the term of the Revenue Bonds. Deferred financing costs associated with the Revenue Bond issuance and a term loan are included in other assets, net and are being amortized on a straight-line basis over the terms of the respective debt. Deferred financing costs were \$926,070 and \$1,092,384 at June 30, 2011 and 2010, respectively.

# **The Union Hospital of Cecil County, Inc.**

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Notes to Financial Statements  
June 30, 2011 and 2010

## **Donor-Restricted Gifts**

Unconditional 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 as 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. Donor-restricted contributions whose restrictions are met within the same year as received are reported as additions to unrestricted net assets in the accompanying financial statements.

## **Estimated Malpractice Claims Liability**

The provision for estimated medical malpractice claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported.

## **Revenues in Excess of Expenses**

The statement of operations includes the determination of revenues in excess of expenses. Changes in unrestricted net assets which are excluded from the determination of revenues in excess of expenses, consistent with industry practice, include permanent transfers of assets to and from subsidiaries for other than goods and services, changes in unrestricted net assets of affiliate and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purpose of acquiring such long-lived assets).

## **Net Patient Service Revenues and Allowances**

Patient service revenues are recorded at established rates on the accrual basis in the period during which the service is provided. Allowances to give recognition to third-party arrangements and charity care are also accounted for on the accrual basis. Revenues received under certain reimbursement agreements are subject to audit and retroactive adjustments by third-party payors. Provision for estimated retroactive adjustments under these agreements are recorded as required. There were no such adjustments in 2011 and 2010.

A substantial portion of the Hospital's revenue is from patient services reimbursed by the Medicare and Medicaid programs and by Blue Cross plans. For Medicare and Medicaid patients, payments for services are based upon the Hospital's standard billing rates less a six percent discount. In addition, Blue Cross and other payors are eligible for discounts of two percent based on advances made to the Hospital or one percent of the payment of services within 30 days from the date billed. The differences between the payments (the reimbursable amount) and the standard billing rates have been recorded as contractual allowances in arriving at net patient service revenues in the accompanying statement of operations.

# **The Union Hospital of Cecil County, Inc.**

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Notes to Financial Statements  
June 30, 2011 and 2010

## **Uncompensated Care**

The Hospital provides care to patients who meet certain criteria under its uncompensated care programs; the services are offered and/or provided at a reduced cost based on demonstrated inability to pay or at amounts less than its established rates. Records are maintained to estimate the level of patient service revenue forgone. Uncompensated care includes charity care, amounts in excess of allowable day limits for Medicaid patients, lack of medical necessity for Medicare and other patients, and bad debt write-offs.

The amount of uncompensated care, recorded at established rates, provided during fiscal years 2011 and 2010 was approximately \$16,030,000 and \$16,063,000, respectively.

## **New Accounting Pronouncements**

### **Charity Care**

The Hospital will be required to adopt amended guidance related to health care entities which requires that direct and indirect costs be used as the measurement for charity care disclosure purposes. The guidance was also amended to require disclosure of the method used to identify or determine such costs. The amended guidance is effective for fiscal years beginning after December 15, 2010. Adoption of the amended guidance will revise disclosure in the notes to the Hospital's financial statements but will not impact amounts reported in the primary financial statements.

### **Insurance Claims**

The Hospital will be required to adopt amended guidance which clarifies that health care entities may not net insurance recoveries against a related claim liability. In addition, the amount of the claim liability should be determined without consideration of insurance recoveries and estimated insurance recoveries, if any, should be measured and presented separately within the balance sheet. The amended guidance is effective for fiscal years beginning after December 15, 2010. The Hospital has not completed the process of evaluating the impact, if any, of this amended guidance on its financial statements.

### **Provision for Doubtful Accounts**

The Hospital will be required to adopt amended guidance related to health care entities which requires a change in reporting the provision for bad debts associated with net patient service revenues. As a result of this guidance, the provision, which is currently reported as an operating expense in the Hospital's statement of operations, will be reported as a deduction from patient service revenues, net of contractual allowances and discounts. The guidance also enhances required disclosures regarding the policies for recognizing net patient service revenues and assessing bad debts. In addition, the guidance requires disclosure of net patient service revenues and qualitative and quantitative information about changes in the allowance for doubtful accounts, both by major payor sources. The amended guidance is effective for fiscal years ending after December 15, 2012. Adoption of the amended guidance will require retrospective restatement of the statement of operations and prospective financial statement disclosures.

# The Union Hospital of Cecil County, Inc.

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Notes to Financial Statements  
June 30, 2011 and 2010

### 3. Regulatory Environment

The healthcare industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Recently, governmental activity has increased with respect to investigations and allegations concerning possible violations and fraud and abuse statutes and regulations by healthcare providers. Violations of these laws and regulations could result in expulsion from government healthcare programs, together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Management believes that the Hospital is in compliance with fraud and abuse as well as other applicable government laws and regulations. While no regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time. Also, future changes in federal and state reimbursement funding mechanisms and related government budgeting constraints could have an adverse effect on the Hospital.

In 1983, Congress approved a Medicare prospective payment plan for most inpatient services as part of the Social Security Amendment Act of 1983. Hospitals in Maryland are currently exempt from these federal reimbursement regulations under a special waiver. The waiver currently in effect is subject to renewal based upon criteria defined in the federal law. Under these payment arrangements with Medicare, a retroactive adjustment could occur if certain performance standards are not attained by all hospitals on a statewide basis. The impact, if any, of any retroactive adjustment of the Medicare prospective payment system, should hospitals in Maryland become subject to such system, on future operations of the Hospital has not been determined.

The Hospital's rate structure is subject to review and approval by the Maryland Health Services Cost Review Commission ("HSCRC"). During 2011, the Hospital adopted the Total Patient Revenue Reimbursement System ("TPR"). The Hospital's patient revenue is 100% fixed regardless of increases and decreases in volumes and changes in case mix. The system is in effect for a three year period ending June 30, 2013. The Hospital received an incentive of \$7 million spread over the three year period. The 2011 financial statements reflect \$2 million of this incentive. The 2010 financial statements reflect the Charge per Case methodology (CPC) which reimbursed the Hospital based on its actual volumes and changes in case mix.

In July 2008, the Maryland General Assembly expanded Medicaid eligibility to provide coverage for a portion of Maryland's uninsured. The legislation requires the HSCRC to implement a uniform assessment on hospital rates to reflect the aggregate reduction in hospital uncompensated care from the expansion in Medicaid coverage provided the assessment does not exceed the actual averted uncompensated care. During 2010 and 2011, the assessment was 1.76% and 2.4%, respectively, which is reflected in the Hospital's deductions from revenue in the financial statements. The Hospital has not experienced the reduction in uncompensated care to justify the assessment made in 2010 and recorded a receivable of \$382,500 in the 2011 financial statements.

# The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2011 and 2010

## 4. Investments and Assets Held In Trust

Investments and assets held in trust consist of the following as of June 30:

	<u>2011</u>	<u>2010</u>
Investments:		
Cash and cash equivalents	\$ 1,111,804	\$ 2,759,699
Mutual funds:		
Small Cap	1,641,479	1,263,126
Mid Cap	1,693,077	1,389,171
Large Cap	2,142,910	4,742,805
Money Market	1,761,751	908,951
Fixed income funds	20,717,842	17,973,054
International real estate	2,022,665	1,727,831
International equities	3,691,956	3,042,914
Managed hedge funds	5,437,374	4,687,374
U.S. government obligations	781,871	100,029
Corporate Bonds	579,747	600,221
Common stocks	6,551,612	6,162,418
	<u>\$ 48,134,088</u>	<u>\$ 45,357,593</u>
Assets held in trust:		
Cash and cash equivalents	\$ 1,178,199	\$ 3,000,210
U.S. government obligations	4,790,520	5,081,534
	<u>\$ 5,968,719</u>	<u>\$ 8,081,744</u>

Investment income and realized and unrealized gains and losses for investments, assets held in trust, and cash and cash equivalents are comprised of the following for the years ended June 30:

	<u>2011</u>	<u>2010</u>
Investment income (loss):		
Interest and dividend income, net	\$ 1,031,399	\$ 1,143,494
Realized losses, net	(174,989)	(1,290,892)
Changes in unrealized gains and losses on trading securities	5,471,400	5,412,116
	<u>\$ 6,327,810</u>	<u>\$ 5,264,718</u>

# The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2011 and 2010

## 5. Fair Value Measurements

The Hospital measured its investments and assets held in trust on a recurring basis in accordance with accounting principles generally accepted in the United States of America.

Fair value is defined as the price that would be received to sell an asset or the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. The framework that the authoritative guidance establishes for measuring fair value includes a hierarchy used to classify the inputs used in measuring fair value. The hierarchy prioritizes the inputs used in determining valuations into three levels. The level in the fair value hierarchy within which the fair value measurement falls is determined based on the lowest level input that is significant to the fair value measurement.

The levels of the fair value hierarchy are as follows:

Level 1 - Fair value is based on unadjusted quoted prices in active markets that are accessible to the Hospital for identical assets. These generally provide the most reliable evidence and are used to measure fair value whenever available.

Level 2 - Fair value is based on significant inputs, other than Level 1 inputs, that are observable either directly or indirectly for substantially the full term of the asset through corroboration with observable market data. Level 2 inputs include quoted market prices in active markets for similar assets, quoted market prices in markets that are not active for identical or similar assets, and other observable inputs.

Level 3 - Fair value would be based on significant unobservable inputs. Examples of valuation methodologies that would result in Level 3 classification include option pricing models, discounted cash flows, and other similar techniques.

These items were measured with the following inputs at June 30, 2011:

	<b>Quoted Prices in Active Markets (Level 1)</b>	<b>Other Observable Inputs (Level 2)</b>
Cash and cash equivalents	\$ 2,290,003	\$
Mutual funds:		
Small Cap	1,641,479	
Mid Cap	1,693,077	
Large Cap	2,142,910	
Money Market	1,761,751	
Fixed income funds	20,717,842	
International real estate	2,022,665	
International equities	3,691,956	
Common stocks	6,551,612	
U.S. government obligations		5,572,391
Corporate bonds		579,747
	<u>\$ 42,513,295</u>	<u>\$ 6,152,138</u>

# The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2011 and 2010

These items were measured with the following inputs at June 30, 2010:

	<b>Quoted Prices in Active Markets (Level 1)</b>	<b>Other Observable Inputs (Level 2)</b>
Cash and cash equivalents	\$ 5,759,909	\$ -
Mutual funds:		
Small Cap	1,263,126	-
Mid Cap	1,389,171	-
Large Cap	4,742,805	-
Money Market	908,951	-
Fixed income funds	17,973,054	-
International real estate	1,727,831	-
International equities	3,042,917	-
Common stocks	6,162,418	-
U.S. government obligations	-	5,181,563
Corporate bonds	-	600,221
	<hr/>	<hr/>
Total	<u>\$ 42,970,182</u>	<u>\$ 5,781,784</u>

The Hospital does not hold any investments or assets held under trust that are considered Level 3 in the fair value hierarchy.

Investments also include \$5,437,374 and \$4,687,374 of alternative investments at June 30, 2011 and 2010, respectively. These are excluded from the fair value hierarchy because they are recorded at cost.

## Fair Value of Financial Instruments

The carrying amounts and estimated fair values of the Hospital's financial instruments at June 30, 2011 and 2010 are as follows:

	<b>2011</b>		<b>2010</b>	
	<b>Carrying Amount</b>	<b>Fair Value</b>	<b>Carrying Amount</b>	<b>Fair Value</b>
Cash and cash equivalents	\$ 6,711,325	\$ 6,711,325	\$ 3,632,787	\$ 3,632,787
Investments	48,134,088	48,529,888	45,357,593	45,623,324
Assets held under trust	5,968,719	5,968,719	8,081,744	8,081,744
Third-party advances	2,640,368	2,640,368	1,834,657	1,834,657
Long-term debt, excluding capital leases	71,161,427	71,675,817	84,892,878	74,450,916

## The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2011 and 2010

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in methodologies used at June 30, 2011.

Cash and cash equivalents approximate fair value because of the short maturity of those financial instruments.

Money market fund and mutual fund securities: Valued at the net asset value ("NAV") of shares held by the plan at year end.

Common stock: Valued at closing price reported on the active market on which the individual securities are traded.

US government obligations and corporate bonds: Based on quoted market prices, if available, or estimated using quoted market prices of similar securities.

Third-party advances approximate fair value because these amounts represent cash advances from third-party payors and because of their current maturities.

Long-term debt, excluding capital leases, fair value is calculated based on quoted market prices, if available, or estimated using quoted market prices of similar securities.

It is generally not practical to estimate the fair value of related party transactions since terms could not be duplicated in the market, and related parties can revise terms, making assumptions supporting fair values potentially unreliable. Therefore, these balances are not included in the fair value hierarchy above.

### 6. Property and Equipment and Accumulated Depreciation and Amortization

Property and equipment consisted of the following as of June 30:

	<u>2011</u>	<u>2010</u>
Land and improvements	\$ 2,525,321	\$ 2,523,873
Buildings and improvements	69,795,667	69,866,899
Fixed equipment	38,240,668	37,690,994
Major movable equipment	45,755,997	43,810,166
Construction in progress	61,410	149,634
Total	156,379,063	154,041,566
Less accumulated depreciation and amortization	<u>76,356,778</u>	<u>69,086,843</u>
Property and equipment, net	<u>\$ 80,022,285</u>	<u>\$ 84,954,723</u>

Included above is leased equipment at a cost of \$2,687,399 and \$2,743,560 with accumulated amortization of \$1,320,054 and \$733,417 as of June 30, 2011 and 2010, respectively.

Net assets were released from donor restrictions during 2011 and 2010 in the amount of \$345,917 and \$50,113, respectively, for certain equipment purchased during the year by the Hospital.

# The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2011 and 2010

During 2011 and 2010 equipment was disposed resulting in a gain (loss) on disposal of assets of \$154,782 and (\$165,122), respectively. The gain (loss) is recorded in other operating revenue on the statement of operations.

## 7. Long-Term Debt

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

	<u>2011</u>	<u>2010</u>
Maryland Health and Higher Educational Facilities Authority ("MHHEFA") Series 2005 Revenue Bonds	\$ 33,675,000	\$ 33,675,000
MHHEFA Series 2002 Revenue Bonds	20,575,000	21,075,000
Town of Elkton, Maryland Series 2000 Revenue Bonds (held by the Peoples Bank of Elkton)	3,076,981	3,324,100
EDRB Series 2009 Revenue Bonds	13,834,447	10,093,687
Capital lease obligations (Note 8)	1,192,154	1,836,395
MHHEFA Series 1998 Revenue Bonds (repaid in 2011)	-	14,465,000
Total	<u>72,353,582</u>	<u>84,469,182</u>
Unamortized original bond issue premium	470,615	423,696
Less current portion	<u>(1,562,678)</u>	<u>(2,216,359)</u>
Long-term debt and capital lease obligations, net	<u>\$ 71,261,519</u>	<u>\$ 82,676,519</u>

During the fiscal year 2010, the Hospital entered into Economic Development Revenue Bond, Series 2009 ("EDRB Series 2009 Bonds") in the maximum principal amount of \$16,000,000 pursuant to the terms of a Loan and Financing Agreement dated as of December 1, 2009 with The Columbia Bank, Peoples Bank of Elkton Division. The EDRB Series 2009 Bonds bear interest at 3.95% and are payable in varying amounts each year through November 30, 2016. The EDRB Series 2009 Bonds are collateralized by a security interest in all receipts of the Hospital. The Loan and Financing Agreement pertaining to the EDRB Series 2009 Bonds contains covenants, with respect to the maintenance of a specific coverage ratio, debt service ratio, and certain other matters for which the Hospital is in compliance. Not all of the funds available were drawn down, therefore, the balance on the loan at June 30, 2011 was \$13,834,447.

On July 14, 2005, the Hospital completed a MHHEFA revenue bond issue in the amount of \$33,675,000, net of an original issue premium of \$631,592. The MHHEFA Series 2005 Revenue Bonds (the "2005 Revenue Bonds") bear interest at rates varying from 4.50 percent to 5.00 percent and are payable in differing amounts through July 1, 2040. The 2005 Revenue Bonds are collateralized by a security interest in all receipts of the Hospital. The Master Loan Agreement pertaining to the 2005 Revenue Bonds contains covenants with respect to the maintenance of specific debt service coverage ratios and certain other matters for which the Hospital is in compliance. The debt is shown net of unamortized bond issue premium of \$523,385 and \$541,405 as of June 30, 2011 and 2010, respectively.

## The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2011 and 2010

In November 2002, the Hospital participated in a MHHEFA revenue bond issuance in the amount of \$24,000,000, net of an original bond issue discount of \$73,881. The MHHEFA Series 2002 Revenue Bonds (the "2002 Revenue Bonds") bear interest at rates varying from 3.0 to 5.625 percent and are payable in differing amounts each year through July 1, 2032. The 2002 Revenue Bonds are collateralized by a security interest in all receipts of the Hospital. The Master Loan Agreement pertaining to the 2002 Revenue Bonds contains covenants with respect to the maintenance of a specific coverage ratio, debt service ratio, and certain other matters for which the Hospital is in compliance. This debt is shown net of unamortized bond issue discount of \$52,743 and \$55,206 as of June 30, 2011 and 2010, respectively.

In June 2000, the Town of Elkton, Maryland issued a \$5,100,000 Revenue Bond (the "2000 Revenue Bonds") for the purpose of funding Hospital renovations and capital equipment expenditures. The 2000 Revenue Bonds were purchased by the Peoples Bank of Elkton, with the proceeds being loaned by the Town of Elkton to the Hospital, which assumed full responsibility for payments on the bonds. The 2000 Revenue Bonds bear interest at 3.95% and are payable in varying amounts each year through July 2020. The 2000 Revenue Bonds are collateralized by a security interest in all receipts of the Hospital. The Master Loan Agreement pertaining to the 2000 Revenue Bonds contains covenants, with respect to the maintenance of a specific coverage ratio, debt service ratio, and certain other matters that the Hospital is in compliance with.

The Hospital incurred \$153,330, \$337,459, \$62,000, and \$391,030, respectively, of legal, financing, and administrative fees in connection with the issuance of the EDRB Series 2009 Bonds, 2005 Revenue Bonds, 2000 Revenue Bonds, and 2002 Revenue Bonds. These costs have been included in other assets in the accompanying balance sheet.

Amortization expense related to bond premiums, discounts, and deferred financing costs totaled \$213,233 and \$41,264 for the years ended June 30, 2011 and 2010, respectively, and has been included in interest expense in the accompanying statement of operations.

Scheduled repayments of long-term debt, exclusive of capital lease obligations discussed in Note 8, are as follows:

Years ending June 30:	
2012	\$ 940,331
2013	1,147,289
2014	1,196,513
2015	1,251,711
2016	1,312,923
Thereafter	<u>65,312,661</u>
Total	<u>\$ 71,161,428</u>

## The Union Hospital of Cecil County, Inc.

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Notes to Financial Statements  
June 30, 2011 and 2010

### 8. Capital Lease Obligations

The Hospital has various capital lease agreements for medical equipment, which expire through 2014. Future minimum lease payments under these agreements are as follows:

Years ending June 30:		
2012	\$	661,361
2013		421,629
2014		<u>163,771</u>
Total minimum lease payments		1,246,761
Less amount representing interest		<u>(54,607)</u>
Total		1,192,154
Less current portion, principal		<u>(623,875)</u>
Long term portion, principal	\$	<u><u>568,279</u></u>

### 9. Pension Plan

Effective January 1, 1999, the Hospital set up a 403(b) defined contribution plan (the "403(b) plan") which includes a matching provision, for employees of the Health System, the Hospital and the Foundation. The Hospital has used the 403(b) plan as its primary retirement plan as of January 1, 2000. The 403(b) plan expenses may include a discretionary employer contribution for employees who work at least 1,000 hours in a calendar year and a 50% employer match contribution up to 1.5% of gross wages for those employees who choose to make voluntary contributions. Pension expense related to the 403(b) plan was \$413,479 and \$302,057 for the years ended June 30, 2011 and 2010, respectively, and is included in salaries and employee benefits in the accompanying statement of operations.

There were no discretionary contributions into the 403(b) plan in 2011 and 2010.

Prior to January 1, 2000, the Hospital offered a defined contribution retirement plan (the "Plan") that covered substantially all employees. Effective January 1, 2000, the Plan became frozen with no loss of accrued savings.

# The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2011 and 2010

## 10. Concentration of Credit Risk

The Hospital grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of gross revenues from patients and third-party payors was as follows for the years ended June 30:

	<u>2011</u>	<u>2010</u>
Medicare	40 %	37 %
Medicaid	4	4
Blue Cross/Blue Shield	18	20
Health maintenance organizations	22	22
Self-pay patients	6	7
Other third-party payors	<u>10</u>	<u>10</u>
Total	<u>100 %</u>	<u>100 %</u>

The Hospital maintains its cash and cash equivalents with several financial institutions. Cash and cash equivalents on deposit with any one financial institution are insured up to \$250,000.

## 11. Functional Expenses

The Hospital provides health care services to residents within its geographic location. Expenses related to providing these services are approximately as follows for the years ended June 30:

	<u>2011</u>	<u>2010</u>
Healthcare services	\$ 95,428,065	\$ 93,138,000
Support services	<u>40,161,935</u>	<u>39,572,000</u>
Total	<u>\$ 135,590,000</u>	<u>\$ 132,710,000</u>

## 12. Commitments and Contingencies

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

The healthcare industry is subject to numerous laws and regulations of federal, state and local governments. Compliance with these laws and regulations is subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time. Government activity continues to increase with respect to investigations and allegations concerning possible violations by healthcare providers of fraud and abuse statutes and regulations, which could result in the imposition of significant fines and penalties as well as significant repayments for patient services previously billed. Management is not aware of any material incidents or noncompliance that have not been provided for in the accompanying consolidated financial statements; however, the possible future financial effects of this matter on the Hospital, if any, are not presently determinable.

# The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2011 and 2010

The Hospital has entered into operating lease agreements for Hospital equipment, which expire on various dates through the year 2014. Total rental expense for the years ended June 30, 2011 and 2010 for all operating leases were \$658,068 and \$582,084, respectively. Future minimum lease payments under all operating leases are as follows:

Years ending June 30:	
2012	\$ 414,085
2013	228,526
2014	228,526
2015	228,526
Thereafter	<u>205,473</u>
Total	<u>\$ 1,305,136</u>

### 13. Medical Malpractice Claims Coverage

For the period October 17, 2003 through December 31, 2004, the Hospital maintained its malpractice insurance coverage with the Zurich Insurance Company under a claims-made policy.

As of January 1, 2005, when existing policies expired, the Hospital elected to obtain its professional and general liability insurance from Freestate Healthcare Insurance Company, Ltd., a Cayman Islands company ("Freestate"). Freestate was incorporated as of January 1, 2005 as a chartered captive insurance company for eight nonprofit hospitals in the State of Maryland, including the Hospital. Each of the hospitals has contributed an equal amount of \$15,000 as capital to Freestate in return for a one-eighth share interest in Freestate. Freestate is governed by a Board of Directors selected by the shareholders. The policy has no stated deductible.

Freestate's primary insurance is under the terms of a claims-made insurance policy and has limits of liability of \$1 million per claim and no aggregate limit per policy year. Freestate's excess liability coverage insures against losses in excess of the above primary coverage reported during the period of policy coverage. This excess liability insurance policy has an individual occurrence limit of \$10 million and an annual aggregate limit of \$10 million. Prior acts of coverage for newly employed physicians will not be provided without prior approval of Freestate's Board of Directors. Each hospital's annual premium will be established through a retrospective rating process, with initial premiums based on actuarial estimates. Initial premiums will be charged at the 75% confidence level and retrospective premium assessments will be capped at an amount equal to the expected losses for the policy period at an 85% confidence level, in each case as determined by an independent actuary.

The Hospital's liability for the estimated future payments of its unasserted medical malpractice claims was approximately \$520,000 and \$500,000 at June 30, 2011 and 2010, respectively.

The Hospital believes that it has adequate insurance coverages for all asserted claims and has no knowledge of unasserted claims which would exceed insurance coverages.

The Hospital would claim charitable immunity for claims exceeding coverage limits. Legal expenses associated with covered claims are also covered and included under policy limits.

# The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2011 and 2010

## 14. Related Party Transactions

The Union Hospital of Cecil County Health Services, Inc. (“Health Services”), a related healthcare organization, constructed a medical professional building (“MPB”) on the Hospital’s campus. The Hospital has loaned funds to Health Services in order to finance the original MPB construction and subsequent improvements. Interest is not charged on these balances and there are no fixed repayment terms. The amounts due from affiliated organizations (“Affiliates”) as listed below, are valued at management’s estimate of net realizable value, however, because of inherent uncertainties in the Affiliates’ operating results, it is at least reasonably possible that the estimates used may change within the near term. The Hospital has a net receivable of \$2,444,371 and \$3,304,850 from Health Services as of June 30, 2011 and 2010, respectively, which is to be repaid via proceeds from the accounts receivable amount due from the University of Maryland. The Hospital transferred \$2,384,875 and \$2,000,000 of net receivables due from Health Services in 2011 and 2010, respectively, to an investment in net assets of Health Services. In addition, the Hospital transferred \$642,957 to Triangle Health Alliance during 2010 for operational purposes. Receivables (payables) from other affiliates within the Hospital as of June 30, 2011 and 2010 is shown below:

	<u>2011</u>	<u>2010</u>
Affinity Health Alliance, Inc. (Parent)	\$ (236,756)	\$ (335,573)
Health Services	2,444,371	3,304,850
Union Hospital of Cecil County Foundation, Inc.	242,974	462,749
Triangle Health Alliance, Inc.	-	642,958
Cecil County Breeders’ Fair, Inc.	681	601
Open MRI	-	355,559
Total	<u>\$ 2,451,270</u>	<u>\$ 4,431,144</u>

The Hospital pays a management fee to the Parent for administrative, finance, and human resources services. The management fee was calculated as 2% of the Hospital’s net operating revenues (including the provision for doubtful accounts) for fiscal years 2011 and 2010. Fees of \$3,108,574 and \$2,931,867 are included in purchased services in the accompanying statement of operations for the years ended June 30, 2011 and 2010, respectively.

The Hospital and Ventures entered into a loan agreement and promissory note on February 1, 2009, whereby the Hospital loaned \$2,900,000 to Ventures to purchase Open MRI and Imaging Center of Elkton, LLC. The loan bears interest at 2.5% and requires Ventures to make monthly payments to the Hospital in the amount of \$51,659. The loan will be fully repaid in May of 2014.

During 2011 and 2010, the Hospital transferred net assets to affiliates of approximately \$4,089,347 and \$2,642,957, respectively. These amounts were transferred to Health Services, Triangle and Open MRI.