

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

Financial Statements

June 30, 2012 and 2011



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

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June 30, 2012 and 2011

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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, 2012 and 2011, 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, 2012 and 2011, 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 26, 2012

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

Balance Sheet

June 30, 2012 and 2011

	<u>2012</u>	<u>2011</u>		<u>2012</u>	<u>2011</u>
<b>Assets</b>			<b>Liabilities and Net Assets</b>		
<b>Current Assets</b>			<b>Current Liabilities</b>		
Cash and cash equivalents	\$ 9,312,226	\$ 6,711,325	Accounts payable and accrued expenses	\$ 6,034,264	\$ 6,696,676
Assets held in trust	13,259,541	-	Accrued salaries and benefits	5,380,992	4,955,957
Investments	48,006,909	48,134,088	Third-party advances	2,634,757	2,460,368
Accounts receivable, patients (net of estimated allowances for doubtful accounts of \$11,568,000 in 2012 and \$9,530,000 in 2011)	17,317,770	15,631,343	Current portion of long-term debt and capital lease obligations	<u>11,029,422</u>	<u>1,562,678</u>
Current portion of notes receivable, related party	597,756	583,013	Total current liabilities	25,079,435	15,675,679
Other receivables	980,790	608,232			
Inventories of supplies	1,805,445	1,990,589	<b>Long-Term Debt and Capital Lease Obligations, Net</b>	71,386,224	71,261,519
Prepaid expenses	<u>1,619,387</u>	<u>1,797,805</u>			
Total current assets	92,899,824	75,456,395	<b>Estimated Medical Malpractice Claims Liability</b>	<u>4,384,563</u>	<u>519,814</u>
<b>Assets Held in Trust</b>	1,766,816	5,968,719	Total liabilities	<u>100,850,222</u>	<u>87,457,012</u>
<b>Property and Equipment, Net</b>	79,944,732	80,022,285			
<b>Due From Affiliates, Net</b>	160,934	2,451,270	<b>Net Assets</b>		
<b>Notes Receivable, Related Party</b>	561,214	1,158,970	Unrestricted	84,203,884	83,217,623
<b>Other Assets, Net</b>	5,731,598	1,757,928	Temporarily restricted	<u>847,719</u>	<u>852,799</u>
<b>Interest in Net Assets of Affiliate</b>	4,836,707	4,711,867	Total net assets	85,051,603	84,070,422
Total assets	<u>\$ 185,901,825</u>	<u>\$ 171,527,434</u>	Total liabilities and net asset	<u>\$ 185,901,825</u>	<u>\$ 171,527,434</u>

See notes to financial statements

# The Union Hospital of Cecil County, Inc

## Statement of Operations

Years Ended June 30, 2012 and 2011

	<u>2012</u>	<u>2011</u>
<b>Unrestricted Revenues, Gains, and Other Support</b>		
Net patient service revenues	\$ 146,197,438	\$ 137,791,566
Other operating revenues	2,128,082	2,051,719
Net assets released from restrictions for use in operations	<u>105,278</u>	<u>308,776</u>
Total unrestricted revenues, gains, and other support	<u>148,430,798</u>	<u>140,152,061</u>
<b>Expenses</b>		
Salaries and employee benefits	69,543,149	63,312,189
Supplies and other expenses	28,070,437	27,396,953
Purchased services	24,783,012	22,550,114
Provision for doubtful accounts	8,987,151	9,542,426
Depreciation and amortization	8,666,397	8,715,464
Interest	<u>3,467,752</u>	<u>4,072,854</u>
Total expenses	<u>143,517,898</u>	<u>135,590,000</u>
Operating income	<u>4,912,900</u>	<u>4,562,061</u>
<b>Nonoperating Income (Loss)</b>		
Investment (loss) income	(590,196)	6,327,810
Other, net	<u>(66,319)</u>	<u>121,351</u>
Total nonoperating (loss) income	<u>(656,515)</u>	<u>6,449,161</u>
Revenues in excess of expenses	4,256,385	11,011,222
<b>Change in Interest in Net Assets of Affiliate</b>	100,175	130,757
<b>Transfers to Affiliates</b>	(3,652,832)	(4,089,347)
<b>Net Assets Released From Restriction for Purchase of Property and Equipment</b>	<u>282,533</u>	<u>345,917</u>
Increase in unrestricted net assets	<u>\$ 986,261</u>	<u>\$ 7,398,549</u>

See notes to financial statements

## The Union Hospital of Cecil County, Inc.

Statement of Changes in Net Assets  
Years Ended June 30, 2012 and 2011

	<u>2012</u>	<u>2011</u>
<b>Unrestricted Net Assets</b>		
Revenues in excess of expenses	\$ 4,256,385	\$ 11,011,222
Changes in interest in net assets of affiliate	100,175	130,757
Transfer to affiliates	(3,652,832)	(4,089,347)
Net assets released from restriction for purchase of property and equipment	<u>282,533</u>	<u>345,917</u>
Increase in unrestricted net assets	<u>986,261</u>	<u>7,398,549</u>
<b>Temporarily Restricted Net Assets</b>		
Contributions, net of event expenses of \$398,000 and \$388,000 in 2012 and 2011, respectively	417,678	383,978
Change in provision for uncollectible pledges	(34,947)	10,834
Net assets released from restriction	<u>(387,811)</u>	<u>(654,693)</u>
Decrease in temporarily restricted net assets	<u>(5,080)</u>	<u>(259,881)</u>
Increase in net assets	981,181	7,138,668
<b>Net Assets, Beginning</b>	<u>84,070,422</u>	<u>76,931,754</u>
<b>Net Assets, Ending</b>	<u><u>\$ 85,051,603</u></u>	<u><u>\$ 84,070,422</u></u>

See notes to financial statements

# The Union Hospital of Cecil County, Inc.

## Statement of Cash Flows

Years Ended June 30, 2012 and 2011

	<u>2012</u>	<u>2011</u>
<b>Cash Flows from Operating Activities:</b>		
Increase in net assets	\$ 981,181	\$ 7,138,668
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	8,666,397	8,715,464
Loss on disposal of assets	-	(203,398)
Loss on refinancing of long-term debt	166,522	-
Provision for doubtful accounts	8,987,151	9,542,426
Amortization of bond premium and deferred financing costs	23,266	213,233
Transfers to affiliates	3,652,832	4,089,347
Net realized and unrealized gains and losses on investments	1,841,226	(5,296,411)
Changes in assets and liabilities:		
Accounts receivable, patient	(10,673,578)	(8,514,293)
Other receivables, inventories, and prepaid expenses	(8,996)	(1,182,664)
Due to/from affiliates	2,290,336	1,979,874
Other assets, net	(3,722,308)	(638,582)
Accounts payable and accrued expenses	(662,412)	599,096
Accrued salaries and benefits	425,035	431,305
Third-party advances	174,389	625,711
Estimated medical malpractice claims liability	3,864,749	19,814
	<u>16,005,790</u>	<u>17,519,590</u>
Net cash provided by operating activities		
<b>Cash Flows from Investing Activities:</b>		
Purchases of property and equipment	(8,588,844)	(4,002,681)
Proceeds received from sale of property and equipment	-	423,053
(Increase) decrease in investments, net	(1,714,047)	2,519,916
(Increase) decrease in assets held in trust	(9,057,638)	2,113,025
Change in beneficial interest in net assets of The Union Hospital of Cecil County Foundation, Inc. and Subsidiary	(124,840)	141,949
Decrease in note receivable, affiliate	583,013	568,633
	<u>(18,902,356)</u>	<u>1,763,895</u>
Net cash flows (used in) provided by investing activities		
<b>Cash Flows from Financing Activities:</b>		
Transfers to affiliates	(3,652,832)	(4,089,347)
Proceeds from debt issuance	29,827,890	3,740,759
Payment of debt issuance costs	(444,573)	-
Payment of long-term debt and capital lease obligations	(20,233,018)	(15,856,359)
	<u>5,497,467</u>	<u>(16,204,947)</u>
Net cash provided by (used in) financing activities		
Net increase in cash and cash equivalents	2,600,901	3,078,538
<b>Cash and Cash Equivalents, Beginning</b>	<u>6,711,325</u>	<u>3,632,787</u>
<b>Cash and Cash Equivalents, Ending</b>	<u>\$ 9,312,226</u>	<u>\$ 6,711,325</u>
<b>Supplemental Disclosure of Cash Flow Information</b>		
Cash paid for interest	<u>\$ 3,516,812</u>	<u>\$ 3,875,001</u>

See notes to financial statements

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

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Notes to Financial Statements  
June 30, 2012 and 2011

## **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 26, 2012, 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 2012 and 2011.

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 after 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, 2012 and 2011

### **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 2002 and 2005 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, 2012 and 2011

## **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 accounting principles generally accepted in the United States of America in the 2012 and 2011 financial statements. The interest in the net assets of the Foundation recorded as of June 30, 2012 and 2011 was \$4,836,707 and \$4,711,867, 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 \$387,811 and \$654,693 were released from restriction during 2012 and 2011, 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 \$1,165,271 and \$926,070 at June 30, 2012 and 2011, respectively.

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

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Notes to Financial Statements  
June 30, 2012 and 2011

## **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, including costs associated with litigating or settling claims. Anticipated insurance recoveries associated with reported claims are reported separately in the Hospital's balance sheet at net realizable value.

## **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 2012 and 2011.

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, 2012 and 2011

## **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 assessments due to expansion and state budget cuts to the program, lack of medical necessity for Medicare and other patients, and bad debt write-offs.

The amount of uncompensated care, based on estimated costs incurred, provided during fiscal years 2012 and 2011 was approximately \$12,714,000 and \$12,745,000, respectively.

## **Recent Accounting Pronouncements**

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.

## **Reclassification**

Certain 2011 amounts have been reclassified to conform to 2012 presentation.

### **3. New Accounting Pronouncements**

#### **Charity Care**

In August 2010, the Financial Accounting Standards Board ("FASB") issued amended disclosure guidance relating to the measurement of charity care provided. The guidance requires that direct and indirect costs be used as the basis of measurement for charity care disclosure purposes. The guidance also requires disclosure of the method used to identify or determine such costs. The adoption of the amended guidance revised the disclosure in the notes to the Hospital's financial statements, but did not impact amounts reported in the primary financial statements.

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

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Notes to Financial Statements  
June 30, 2012 and 2011

## **Insurance Claims**

In August 2010, the FASB issued Accounting Standards Update 2010-24, Presentation of Insurance Claims and Related Insurance Recoveries which amended guidance relating to the presentation of insurance claims and related insurance recoveries. The guidance 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 adoption of the amended guidance resulted in presenting insurance recoveries and related liabilities on a gross basis in the Hospital's balance sheet and did not impact net assets.

## **4. 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 2012 and 2011 financial statements reflect approximately \$1.5 million and \$1.9 million, respectively, of this incentive.

# The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2012 and 2011

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 2012 and 2011, the assessment was 2.71% and 1.76%, respectively, which is reflected in the Hospital's deductions from revenue in the financial statements.

## 5. Investments and Assets Held In Trust

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

	<u>2012</u>	<u>2011</u>
Investments:		
Cash and cash equivalents	\$ 1,195,825	\$ 105,896
Certificates of deposit	501,989	1,005,908
U.S. government obligations	487,779	226,723
Corporate bonds	591,658	579,747
Municipal bonds	1,102,939	555,148
Mutual funds:		
Fixed income funds	12,611,151	13,392,091
Large cap	8,998,629	-
International equities	7,959,174	4,054,238
Other	4,411,754	16,225,351
Exchange-traded products	4,708,637	6,551,612
Managed hedge funds	5,437,374	5,437,374
	<u>\$ 48,006,909</u>	<u>\$ 48,134,088</u>
Assets held in trust:		
Cash and cash equivalents	\$ 3,249,214	\$ 1,178,199
U.S. government obligations	11,777,143	4,790,520
	<u>15,026,357</u>	<u>5,968,719</u>
Less current portion	13,259,541	-
	<u>\$ 1,766,816</u>	<u>\$ 5,968,719</u>
Noncurrent assets held in trust		

# The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2012 and 2011

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>2012</u>	<u>2011</u>
Investment income (loss):		
Interest and dividend income, net	\$ 1,251,030	\$ 1,031,399
Realized losses, net	(2,394,122)	(174,989)
Changes in unrealized gains and losses on investments	<u>552,896</u>	<u>5,471,400</u>
 Total	 <u>\$ (590,196)</u>	 <u>\$ 6,327,810</u>

## 6. 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.

## The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2012 and 2011

These items were measured with the following inputs at June 30, 2012:

	<b>Quoted Prices in Active Markets (Level 1)</b>	<b>Other Observable Inputs (Level 2)</b>	<b>Total</b>
Cash and cash equivalents	\$ 4,445,039	\$ -	\$ 4,445,039
Certificates of deposit	-	501,989	501,989
Mutual funds:			
Fixed income	12,611,151	-	12,611,151
Large cap	8,998,629	-	8,998,629
International equities	7,959,174	-	7,959,174
Other	4,411,754	-	4,411,754
Exchange-traded products	4,708,637	-	4,708,637
Municipal bonds	-	1,102,939	1,102,939
U.S. government obligations	12,264,922	-	12,264,922
Corporate bonds	-	591,658	591,658
<b>Total</b>	<b>\$ 55,399,306</b>	<b>\$ 2,196,586</b>	<b>\$ 57,595,892</b>

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>	<b>Total</b>
Cash and cash equivalents	\$ 1,284,095	\$ -	\$ 1,284,095
Certificates of deposit	-	1,005,908	1,005,908
Mutual funds:			
Fixed income	13,392,091	-	13,392,091
International equities	4,054,238	-	4,054,238
Other	16,225,351	-	16,225,351
Exchange-traded products	6,551,612	-	6,551,612
Municipal bonds	-	555,148	555,148
U.S. government obligations	5,017,243	-	5,017,243
Corporate bonds	-	579,747	579,747
<b>Total</b>	<b>\$ 46,524,630</b>	<b>\$ 2,140,803</b>	<b>\$ 48,665,433</b>

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 of alternative investments at June 30, 2012 and 2011. These are excluded from the fair value hierarchy because they are recorded at cost.

# The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2012 and 2011

## Fair Value of Financial Instruments

The carrying amounts and estimated fair values of the Hospital's financial instruments at June 30, 2012 and 2011 are as follows:

	2012		2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	\$ 9,312,226	\$ 9,312,226	\$ 6,711,325	\$ 6,711,325
Investments	48,006,909	48,056,771	48,134,088	48,529,888
Assets held under trust	15,026,357	15,026,357	5,968,719	5,968,719
Third-party advances	2,634,757	2,634,757	2,640,368	2,640,368
Long-term debt, excluding capital leases	81,392,336	82,262,312	71,161,427	71,675,817

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, 2012.

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

Mutual funds and exchange-traded products: Valued at the net asset value ("NAV") of shares held by the Hospital at year end.

Managed hedge funds: Valued based on the NAV of shares held at year end calculated in consideration with the fair value of the underlying securities.

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

Certificates of deposit, municipal bonds, U.S. 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.

## The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2012 and 2011

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

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

	<u>2012</u>	<u>2011</u>
Land and improvements	\$ 2,532,539	\$ 2,525,321
Buildings and improvements	70,341,786	69,795,667
Fixed equipment	38,645,516	38,240,668
Major movable equipment	49,727,198	45,755,997
Construction in progress	3,540,439	61,410
Total	164,787,478	156,379,063
Less accumulated depreciation and amortization	<u>84,842,746</u>	<u>76,356,778</u>
Property and equipment, net	<u>\$ 79,944,732</u>	<u>\$ 80,022,285</u>

Included above is leased equipment at a cost of \$2,524,654 and \$2,687,399 with accumulated amortization of \$1,778,898 and \$1,320,054 as of June 30, 2012 and 2011, respectively.

### 8. Long-Term Debt

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

	<u>2012</u>	<u>2011</u>
Maryland Health and Higher Educational Facilities Authority ("MHHEFA") Series 2005 Revenue Bonds	\$ 33,675,000	\$ 33,675,000
MHHEFA Series 2002 Revenue Bonds	20,055,000	20,575,000
Town of Elkton, Maryland Series 2012 Revenue Bonds (held by SunTrust Bank)	27,662,336	-
Capital lease obligations (Note 9)	568,280	1,192,154
Debt repaid in 2012	-	16,911,428
Total	81,960,616	72,353,582
Unamortized original bond issue premium	455,030	470,615
Less current portion	<u>(11,029,422)</u>	<u>(1,562,678)</u>
Long-term debt and capital lease obligations, net	<u>\$ 71,386,224</u>	<u>\$ 71,261,519</u>

## The Union Hospital of Cecil County, Inc.

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### Notes to Financial Statements

June 30, 2012 and 2011

On May 18, 2012, the Town of Elkton, Maryland ("Elkton") issued \$27,662,336 in Economic Development Refunding Revenue Bonds ("EDRRB"), Series 2012 ("Series 2012 Bonds"). Also on May 18, 2012, the Hospital entered into a Loan and Financing Agreement with Elkton (the "Agreement") to borrow the proceeds from the Series 2012 Bonds in a series of notes as follows:

- \$10,000,000 from the EDRRB, Series 2012A Bonds to partially refund the Economic Development Revenue Bond, Series 2009, and pay costs of issuance. The note bears interest at 2.25% and is payable in monthly installments of \$44,477 through December 2036.
- \$5,842,234 from the EDRRB, Series 2012B-1 Bonds to refund the remaining portion of the Economic Development Revenue Bond, Series 2009, and pay costs of issuance. This note bears interest at 2.25% and is payable in monthly installments of \$25,995 through December 2036.
- \$2,820,102 from the EDRRB, Series 2012B-2 Bonds to refund Elkton's 2000 Revenue Bonds and pay costs of issuance. This note bears interest at 1.87% and is payable in monthly installments of \$31,708 through June 2020.
- \$9,000,000 from the EDRRB, Series 2012C Bonds to partially refund the MHHEFA Series 2002 Revenue Bonds and pay costs of issuance. This note bears interest at 2.25% and provides interest-only installments until July 2022, at which time \$92,268 in monthly installments through June 2031. On July 2, 2012, the proceeds from this note were used to partially refund the MHHEFA Series 2002 Revenue Bonds.

The Agreement contains covenants with respect to the maintenance of specific debt service coverage ratios and days cash on hand and other matters for which the Hospital is in compliance.

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 \$505,312 and \$523,385 as of June 30, 2012 and 2011, respectively.

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 \$50,282 and \$52,743 as of June 30, 2012 and 2011, respectively.

# The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2012 and 2011

On July 18, 2012, the Hospital participated in a MHHEFA revenue bond issuance in the amount of \$13,931,000. The MHHEFA Series 2012 Revenue Bonds (the "2012 Revenue Bonds") were issued to refund the remaining portion of the 2002 Revenue Bonds, finance certain capital projects and increase the debt service reserve fund for the 2005 Revenue Bonds. The 2012 Revenue Bonds bear interest at 2.75% and are payable in monthly annual installments through June 2022.

Amortization expense related to bond premiums, discounts, and deferred financing costs totaled \$23,266 and \$213,233 for the years ended June 30, 2012 and 2011, 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 9, are as follows:

Years ending June 30:	
2013	\$ 10,622,308
2014	1,740,398
2015	1,783,535
2016	1,826,799
2017	1,873,085
Thereafter	<u>63,546,211</u>
Total	<u>\$ 81,392,336</u>

## 9. 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:	
2013	\$ 421,629
2014	<u>163,771</u>
Total minimum lease payments	585,400
Less amount representing interest	<u>(17,120)</u>
Total	568,280
Less current portion, principal	<u>(407,114)</u>
Long term portion, principal	<u>\$ 161,166</u>

# The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2012 and 2011

## 10. 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 \$508,299 and \$413,479 for the years ended June 30, 2012 and 2011, 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 2012 and 2011.

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.

## 11. 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>2012</u>	<u>2011</u>
Medicare	41 %	40 %
Medicaid	22	22
Blue Cross/Blue Shield	18	18
Health maintenance organizations	4	4
Self-pay patients	5	6
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 exceed FDIC coverage from time to time.

## The Union Hospital of Cecil County, Inc.

Notes to Financial Statements  
June 30, 2012 and 2011

### 12. 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>2012</u>	<u>2011</u>
Healthcare services	\$ 102,310,000	\$ 95,428,000
Support services	<u>41,208,000</u>	<u>40,162,000</u>
Total	<u>\$ 143,518,000</u>	<u>\$ 135,590,000</u>

### 13. 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 Hospital has entered into operating lease agreements for Hospital equipment. Total rental expense for the years ended June 30, 2012 and 2011 for all operating leases were \$764,053 and \$687,891, respectively. Future minimum lease payments under all operating leases are as follows:

Years ending June 30:	
2013	\$ 360,178
2014	360,178
2015	360,178
2016	<u>248,799</u>
Total	<u>\$ 1,329,333</u>

# The Union Hospital of Cecil County, Inc.

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Notes to Financial Statements  
June 30, 2012 and 2011

## 14. 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 total amount reported medical malpractice claims liability is \$4,384,563 at June 30, 2012 and \$519,814 at June 30, 2011. As discussed in Note 3, the Hospital adopted new accounting guidance in 2012 related to the presentation of insurance claims and related insurance recoveries. As a result, the Hospital has recorded a receivable, and related claim liability, for anticipated insurance recoveries of \$3,739,749 at June 30, 2012. The estimated insurance recoveries receivable is included in other assets in the balance sheet.

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, 2012 and 2011

### 15. Related Party Transactions

The Hospital periodically receives or advances funds for working capital purposes. Interest is not charged and there are no fixed repayment terms on these transactions. Receivables (payables) from other affiliates within the Hospital as of June 30, 2012 and 2011 is shown below:

	<u>2012</u>	<u>2011</u>
Health System	\$ (80,622)	\$ (236,756)
Union Hospital of Cecil County Health Services, Inc.	-	2,444,371
Union Hospital of Cecil County Foundation, Inc.	295,237	242,974
Cecil County Breeders' Fair, Inc.	<u>(53,681)</u>	<u>681</u>
Total	<u>\$ 160,934</u>	<u>\$ 2,451,270</u>

The Hospital pays a management fee to the Health System 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 2012 and 2011. Fees of \$1,658,826 and \$3,108,574 are included in purchased services in the accompanying statement of operations for the years ended June 30, 2012 and 2011, respectively.

The Hospital and The Union Hospital of Cecil County Ventures, Inc. ("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 2012 and 2011, the Hospital transferred net assets to affiliates of approximately \$3,652,832 and \$4,089,347, respectively.