

COHEN  
RUTHERFORD  
+ KNIGHT<sup>PC</sup>  
Certified Public Accountants



**Audited Consolidated Financial  
Statements**

**Calvert Health System, Inc. and  
Subsidiaries**

June 30, 2011 and 2010

**Calvert Health System, Inc. and Subsidiaries**  
Consolidated Financial Statements  
Years Ended June 30, 2011 and 2010

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## Report of Independent Auditors

Audit Committee of the Board of Directors of  
Calvert Health System, Inc.

We have audited the accompanying consolidated statements of financial position of Calvert Health System, Inc. and subsidiaries (the System) as of June 30, 2011 and 2010, and the related consolidated statements of operations and other changes in unrestricted net assets, changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Calvert Health System, Inc. and subsidiaries as of June 30, 2011 and 2010, and the consolidated results of their 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.

*Cohen, Rutherford + Knight, P.C.*

October 14, 2011  
Bethesda, Maryland

# Calvert Health System, Inc. and Subsidiaries

## Consolidated Statements of Financial Position

	June 30	
	2011	2010
<i>ASSETS</i>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 19,440,295	\$ 17,338,200
Short-term investments -- Note 3	53,831	5,820
Patient accounts receivable, net of allowance for uncollectible accounts of \$4,680,320 in 2011 and \$4,867,251 in 2010 -- Note 10	12,771,631	14,649,690
Inventories	2,322,829	2,387,293
Prepaid expenses and other assets	2,744,336	1,746,393
Assets limited as of use, current -- Note 3	2,296,749	2,340,540
<b>TOTAL CURRENT ASSETS</b>	39,629,671	38,467,936
<b>INVESTMENTS AND OTHER ASSETS</b>		
Investments -- Note 3	52,134,850	37,950,286
Investments in affiliated enterprises -- Note 2	4,142,448	3,748,871
Assets limited as of use -- Notes 3 and 13	6,960,831	6,446,402
Property and equipment, net -- Note 5	88,971,862	89,003,827
Other assets	637,666	714,900
<b>TOTAL ASSETS</b>	\$ 192,477,328	\$ 176,332,222
<i>LIABILITIES AND NET ASSETS</i>		
<b>CURRENT LIABILITIES</b>		
Accounts payable and accrued expenses	\$ 15,929,572	\$ 11,807,788
Current portion of long-term debt -- Note 6	850,000	815,000
Advances from third party payors	4,054,939	3,739,286
<b>TOTAL CURRENT LIABILITIES</b>	20,834,511	16,362,074
Long-term debt, less current portion -- Note 6	59,132,421	59,940,445
Accrued pension cost -- Note 7	4,646,563	8,107,723
Other long-term liabilities	4,929,327	3,849,515
<b>TOTAL LIABILITIES</b>	89,542,822	88,259,757
<b>NET ASSETS</b>		
Unrestricted - general	98,733,816	83,988,947
Unrestricted - board designated	2,766,352	2,445,747
Unrestricted - noncontrolling interest in subsidiary	423,142	371,524
Temporarily restricted -- Note 4	361,041	700,993
Permanently restricted -- Notes 4 and 16	650,155	565,254
<b>TOTAL NET ASSETS</b>	102,934,506	88,072,465
<b>TOTAL LIABILITIES AND NET ASSETS</b>	\$ 192,477,328	\$ 176,332,222

See the accompanying notes to the consolidated financial statements.

# Calvert Health System, Inc. and Subsidiaries

## Consolidated Statements of Operations and Other Changes in Unrestricted Net Assets

	Year Ended June 30	
	2011	2010
<b>REVENUE</b>		
Net patient service revenue -- Note 10	\$ 123,400,360	\$ 118,006,396
Rental revenue -- Note 12	2,565,188	2,546,713
Other operating revenue	4,339,588	2,973,727
<b>TOTAL OPERATING REVENUE</b>	<b>130,305,136</b>	<b>123,526,836</b>
<b>EXPENSES -- Note 11</b>		
Salaries and wages	54,431,445	50,881,579
Employee benefits -- Note 7	11,877,710	10,377,985
Supplies	23,034,631	23,219,850
Purchased services	5,938,675	5,571,012
Professional fees	4,139,381	3,568,936
Depreciation and amortization -- Note 5	8,404,619	8,689,465
Interest -- Note 6	3,037,543	3,075,994
Provision for uncollectible accounts	3,853,759	7,318,485
Other -- Note 12	14,531,251	13,950,458
<b>TOTAL OPERATING EXPENSES</b>	<b>129,249,014</b>	<b>126,653,764</b>
<b>INCOME (LOSS) FROM OPERATIONS</b>	<b>1,056,122</b>	<b>(3,126,928)</b>
<b>NONOPERATING GAINS</b>		
Investment income -- Note 3	362,957	(672,164)
Income from equity investments	471,052	384,303
<b>NONOPERATING GAINS (LOSSES), NET</b>	<b>834,009</b>	<b>(287,861)</b>
<b>EXCESS OF REVENUE OVER EXPENSES (EXPENSES OVER REVENUE)</b>	<b>1,890,131</b>	<b>(3,414,789)</b>
Net assets released from restrictions for capital acquisitions	448,846	256,496
Distributions to noncontrolling interest in subsidiary	(78,400)	(107,800)
Pension-related changes other than net periodic pension cost -- Note 7	3,431,020	(4,868,555)
Net unrealized gains on marketable investments -- Note 3	9,425,495	3,892,171
<b>INCREASE (DECREASE) IN UNRESTRICTED NET ASSETS</b>	<b>\$ 15,117,092</b>	<b>\$ (4,242,477)</b>

See the accompanying notes to consolidated financial statements.

## Calvert Health System, Inc. and Subsidiaries

### Consolidated Statements of Changes in Net Assets

	<u>Unrestricted</u>	<u>Noncontrolling Interest</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
<b>NET ASSETS, JUNE 30, 2009</b>	\$ 90,716,198	\$ 332,497	\$ 778,514	\$ 507,015	\$ 92,334,224
Excess of (expenses over revenue) revenue over expenses	(3,561,616)	146,827	0	0	(3,414,789)
Transfer of net assets	0	0	12,750	(12,750)	0
Contributions	0	0	865,637	0	865,637
Net assets released from restrictions for capital acquisitions	256,496	0	(256,496)	0	0
Net assets released from restrictions to fund operating programs	0	0	(699,412)	0	(699,412)
Distributions to noncontrolling interest in subsidiary	0	(107,800)	0	0	(107,800)
Investment income on restricted net assets -- Note 3	0	0	0	14,982	14,982
Pension-related changes other than net periodic pension cost -- Note 7	(4,868,555)	0	0	0	(4,868,555)
Net unrealized gains on marketable investments -- Note 3	3,892,171	0	0	56,007	3,948,178
<b>Increase (decrease) in net assets</b>	<u>(4,281,504)</u>	<u>39,027</u>	<u>(77,521)</u>	<u>58,239</u>	<u>(4,261,759)</u>
<b>NET ASSETS, JUNE 30, 2010</b>	\$ 86,434,694	\$ 371,524	\$ 700,993	\$ 565,254	\$ 88,072,465
Excess of revenue over expenses	1,760,113	130,018	0	0	1,890,131
Transfer of net assets	0	0	46,150	(46,150)	0
Contributions	0	0	606,812	50	606,862
Net assets released from restrictions for capital acquisitions	448,846	0	(448,846)	0	0
Net assets released from restrictions to fund operating programs	0	0	(544,068)	0	(544,068)
Distributions to noncontrolling interest in subsidiary	0	(78,400)	0	0	(78,400)
Investment income on restricted net assets -- Note 3	0	0	0	15,484	15,484
Pension-related changes other than net periodic pension cost -- Note 7	3,431,020	0	0	0	3,431,020
Net unrealized gains on marketable investments -- Note 3	9,425,495	0	0	115,517	9,541,012
<b>Increase (decrease) in net assets</b>	<u>15,065,474</u>	<u>51,618</u>	<u>(339,952)</u>	<u>84,901</u>	<u>14,862,041</u>
<b>NET ASSETS, JUNE 30, 2011</b>	<u>\$ 101,500,168</u>	<u>\$ 423,142</u>	<u>\$ 361,041</u>	<u>\$ 650,155</u>	<u>\$ 102,934,506</u>

See the accompanying notes to the consolidated financial statements.

## Calvert Health System, Inc. and Subsidiaries Consolidated Statements of Cash Flows

	2011	2010
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Increase (decrease) in net assets	\$ 14,862,041	\$ (4,261,759)
Adjustments to reconcile increase (decrease) in net assets to net cash and cash equivalents provided by operating activities:		
Provision for uncollectible accounts	3,853,759	7,318,485
Depreciation and amortization	8,404,619	8,689,465
Cash donations restricted for capital acquisition	(380,091)	(462,709)
Equity in earnings of affiliated enterprises	(471,052)	(384,303)
Investment income on restricted assets	(15,484)	(14,982)
Realized net (gains) losses on investments	(167,069)	933,885
Unrealized net gains on investments	(9,541,012)	(3,948,178)
Pension-related changes other than net periodic pension cost	(3,431,020)	4,868,555
Increase in patient accounts receivable	(1,990,424)	(7,824,485)
Decrease in inventories	64,464	217,431
(Increase) decrease in prepaid expenses and other assets	(2,215,389)	625,759
Increase in accounts payable, accrued expenses and other liabilities	5,529,083	599,286
<b>NET CASH AND CASH EQUIVALENTS PROVIDED BY OPERATING ACTIVITIES</b>	<b>14,502,425</b>	<b>6,356,450</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchases of investments	(9,505,164)	(17,828,880)
Sales of investments	5,875,716	16,728,555
Net increase in assets limited as to use	(89,699)	(44,257)
Purchases of property and equipment	(8,339,235)	(10,007,634)
<b>NET CASH AND CASH EQUIVALENTS USED IN INVESTING ACTIVITIES</b>	<b>(12,058,382)</b>	<b>(11,152,216)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Repayment of long-term debt	(815,000)	(780,000)
Total cash received restricted for capital acquisitions	380,091	462,709
Net distributions from investees	77,477	334,154
Investment income on restricted assets	15,484	14,982
<b>NET CASH AND CASH EQUIVALENTS (USED IN) PROVIDED BY FINANCING ACTIVITIES</b>	<b>(341,948)</b>	<b>31,845</b>
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>2,102,095</b>	<b>(4,763,921)</b>
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR</b>	<b>17,338,200</b>	<b>22,102,121</b>
<b>CASH AND CASH EQUIVALENTS AT END OF YEAR</b>	<b>\$ 19,440,295</b>	<b>\$ 17,338,200</b>

See accompanying notes to the consolidated financial statements.

# Calvert Health System, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements

### Note 1 - Organization and Summary of Significant Accounting Policies

#### *Organization*

Calvert Health System, Inc. and subsidiaries (the System), a Maryland corporation formed on January 1, 2000, is the sole member of Calvert Memorial Hospital of Calvert County (the Hospital), CMH Holding Company (Holding Co. I) and CMH II Holding Company (Holding Co. II).

The System and the Hospital are nonprofit, nonstock membership corporations formed under the laws of the State of Maryland, organized for charitable purposes and exempt from Federal income taxes under Section 501(c)(3) of the Internal Revenue Code (IRC).

Holding Co. I and Holding Co. II are nonprofit, nonstock membership corporations formed under the laws of the State of Maryland, organized for charitable purposes and exempt from Federal income taxes under Section 501(c)(2) of the IRC. Holding Co. I owns an interest in a medical office building on the Hospital's campus and a medical office building in Solomon's Island, Maryland. Holding Company II owns a medical office building on the Hospital's campus and owns a 100% interest in Calvert Medical Arts Center, LLC (CMAC) which owns the Calvert Medical Arts building on the Hospital's campus.

The Hospital has four wholly owned or controlled subsidiaries: Calvert Memorial Hospital Foundation, Inc. (the Foundation); Calvert Health Ventures (CHV); Calvert Physician Associates, LLC (CPA); and Calvert Community Health, Inc. (CCH). The Foundation is a non-profit corporation which holds and manages certain investment assets for the benefit of the Hospital. CHV is a for-profit corporation that owns and manages investments in certain health care related entities, including Calvert Medical Management, LLC (CMM), an imaging center, a physical therapy and sports rehabilitation center, and a medical office building in Dunkirk, Maryland. CPA is a limited liability company which employs physicians who provide health care services for the residents of Calvert County and the surrounding area. CMM is a medical service organization that supports CPA's operations and the Hospital's ambulatory electronic health record project. CCH is the Hospital's for-profit organization to establish managed care contracts. CCH is currently inactive.

CHV holds a 51% indirect interest in Calvert Physical Therapy and Sports Fitness Center (CPTSFC), a joint venture between CHV, Kubb Physical Therapy Partnership (Kubb) and NRH Ambulatory Services, Inc. (NRH). The Hospital's consolidated financial statements include CPTSFC as a consolidated subsidiary and reflect Kubb's and NRH's noncontrolling interests in CPTSFC's net assets and net income.

#### *Principles of Consolidation*

At June 30, 2011 and 2010, the System's consolidated financial statements include the accounts of the Hospital and its wholly owned or controlled subsidiaries, Holding Co. I and Holding Co. II. All material intercompany transactions are eliminated.



# Calvert Health System, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements - Continued

### Note 1 - Organization and Summary of Significant Accounting Policies - Continued

#### *Basis of Presentation*

The System classifies net assets, revenues, expenses, gains and losses, based on the existence or absence of donor-imposed restrictions; accordingly, net assets of the System and changes therein are classified and reported as follows:

*Unrestricted net assets* - Net assets that are not subject to donor-imposed stipulations.

*Temporarily restricted net assets* - Net assets subject to donor-imposed stipulations that may or will be met either by actions of the System and/or the passage of time.

*Permanently restricted net assets* - Net assets subject to donor-imposed stipulations that will be maintained permanently by the System. Generally, the donors of these assets permit the System to use all or part of the income earned on related investments for general or specific purposes.

Revenues are reported as increases in unrestricted net assets unless use of the related assets is limited by donor-imposed restrictions. Expenses are reported as decreases in unrestricted net assets. Gains and losses are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulation or by law. Contributions with no donor-imposed restrictions are recognized as revenues in the period received as increases in unrestricted net assets. Contributions with donor-imposed restrictions are reported as increases in temporarily or permanently restricted net assets unless such contributions are expended in the same fiscal year, in which case they are recorded as unrestricted contributions. Expirations of temporary restrictions on net assets (i.e., the donor-stipulated purpose has been fulfilled and/or the stipulated time period has elapsed) are reported as net assets released from restriction and reclassified between the applicable classes of net assets. In accordance with applicable accounting standards, assets that have been released to support the Hospital's operating programs are reported as a component of other operating revenue in the accompanying consolidated statements of operations; whereas assets that are released for the acquisition of property and equipment are reported as a direct increase to unrestricted net assets in the accompanying consolidated statements of changes in net assets.

Income and realized net gains/losses on investments are reported as:

- Increases in permanently restricted net assets if the terms of the gift or the System's interpretation of relevant state law require that they be added to the principal of a permanent endowment fund;
- Increases in temporarily restricted net assets if the terms of the gift impose restrictions on the use of the income;
- Increases in unrestricted net assets in all other cases.

# **Calvert Health System, Inc. and Subsidiaries**

## **Notes to the Consolidated Financial Statements - Continued**

### **Note 1 - Organization and Summary of Significant Accounting Policies - Continued**

#### *Use of Estimates*

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

#### *Cash and Cash Equivalents*

Cash and cash equivalents consist primarily of highly liquid, unrestricted, short-term investments in U.S. Treasury bills, commercial paper, and other interest bearing deposits with maturities of less than one year from the date of purchase. Primarily all of the System's cash and cash equivalents are maintained in one commercial bank, of which an aggregate maximum of \$250,000 is insured by the Federal Deposit Insurance Corporation (FDIC). The System's cash balance routinely exceeds the maximum amount insured by the FDIC.

#### *Investments*

Investments in debt and equity securities are recorded at fair value. Investment income, realized gains and losses and unrealized gains and losses on trading securities are reported in the consolidated statements of operations unless restricted by the donor, in which case they are reported as an addition to, or deduction from, the fund balance of the appropriate donor-restricted fund. In accordance with applicable accounting standards, unrealized gains and losses on securities classified as other than trading are reported as a direct charge to net assets in the accompanying consolidated statements of changes in net assets. The specific identification method is used to compute realized gains or losses on sales of investments. Other investments, when acquired by gift or bequest, are recorded at fair value at the date received and adjusted in future periods to reflect the fair market value of the assets. Approximately \$4,857,000 and \$2,391,000 of the investments balance at June 30, 2011 and 2010, respectively, has been designated to fund an executive severance and deferred compensation plan that has been established to provide benefits to the System's executive management team.

The System periodically evaluates whether any declines in the fair value of investments are other-than-temporary. This evaluation consists of a review of several factors, including but not limited to: length of time and extent that a security has been in an unrealized loss position; the existence of an event that would impair the issuer's future earnings potential; the near term prospects for recovery of the fair value of a security; and the intent and ability of the System to hold the security until the fair value recovers. Declines in fair value below cost that are deemed to be other-than-temporary result in realized losses with the market value becoming the new cost basis for the security.

# Calvert Health System, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements - Continued

### Note 1 - Organization and Summary of Significant Accounting Policies - Continued

#### *Investments in Affiliated Enterprises*

Investments in affiliated, non-controlled enterprises are accounted for using the equity method of accounting.

#### *Assets Limited as to Use*

Assets limited as to use primarily include assets held by trustees under indenture agreements and designated assets set aside by the Board of Trustees for future capital improvements, over which the Board retains control and may at its discretion subsequently use for other purposes. These assets are stated fair value. This balance also reflects the discounted net present value of pledges receivable reported by the Foundation (*see Notes 3 and 13*).

#### *Property and Equipment*

Property and equipment acquisitions are recorded at cost, except for donated items, which are recorded at fair value at the date of donation. Renovations, alterations, and improvements that increase the useful lives or the functionality of the related assets are capitalized and subsequently depreciated over the remaining useful life of each class of depreciable assets. Depreciation is provided on a straight-line basis over the estimated useful lives of the assets. Useful lives range from 20-40 years for buildings, 5-10 years for equipment and 10-20 years for leasehold improvements. Interest cost incurred on borrowed funds during the construction period of capital assets is capitalized as a component of the cost of acquiring those assets.

#### *Other Assets*

Other assets consist of deferred financing costs, long term prepaid rent, and long term other receivables. Gross deferred financing costs are amortized over the life of the related bonds and amounted to \$885,867 at June 30, 2011 and 2010. Accumulated amortization of such costs amounted to \$372,676 and \$339,257 at June 30, 2011 and 2010, respectively.

#### *Third Party Advances*

The Hospital receives advances from third party payers to provide working capital for services rendered to the beneficiaries of such services. These advances are subject to periodic adjustment, and are principally determined based on the timing difference between the provision of care and the anticipated payment date of the claim for service.

#### *Consolidated Statements of Operations*

For purposes of display, transactions deemed by management to be ongoing, major or central to the provision of health care services are reported as revenue and expenses. Peripheral or incidental transactions are reported as non-operating gains and losses.

# Calvert Health System, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements - Continued

### Note 1 - Organization and Summary of Significant Accounting Policies - Continued

#### *Excess of Revenue over Expenses*

The consolidated statements of operations and other changes in unrestricted net assets report excess of revenue over expenses. Changes in unrestricted net assets which are excluded from this performance indicator, consistent with industry practice, include unrealized gains and losses on investments other than trading securities, permanent transfers of assets to and from affiliates for other than goods and services, contributions of (and assets released from donor restrictions related to) long-lived assets.

#### *Net Patient Service Revenue and Patient Accounts Receivable*

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payers, and others for services rendered, after contractual adjustments. Patient accounts receivable include charges for amounts due from Medicare, Maryland Medical Assistance (Medicaid), Blue Cross, commercial insurers, and self-pay patients (*see Note 10*). Contractual adjustments represent the differences between amounts billed as patient service revenue and amounts allowed by third party payers, and are accrued on an estimated basis in the period in which the related services are rendered and adjusted in future periods as final settlements are determined. Contractual adjustments are included in the determination of net patient service revenue as reported in the accompanying consolidated statements of operations, whereas the provision for uncollectible self-pay amounts is reported as an operating expense. Rates charged are based primarily on rates established by the State of Maryland Health Services Cost Review Commission (HSCRC); accordingly, revenue reflects actual charges to patients based on rates in effect during the period in which the services are rendered (*see Notes 9 and 10*).

The Hospital grants credit without collateral to its patients, most of whom are local residents insured under third-party payer agreements (*see Note 10*). Accounts receivable are reported at their net realizable value from third-party payers, patients, residents and others for services rendered. Allowances are provided for third-party payers based on estimated reimbursement rates. Allowances are also provided for bad debts on an estimate of uncollectible accounts. Write-off of uncollectible accounts is determined on a case-by-case basis after a review of the circumstances surrounding individual patient accounts.

#### *Charity Care*

The System provides care to patients regardless of their ability to pay. In identifying charity care, the System assesses the patient's ability to pay, utilizing generally recognized poverty income levels for the community, and identifies certain cases where incurred charges are considered to be beyond the patient's ability to pay. Because the System does not pursue collection of amounts determined to qualify as charity care, such amounts are not reported as a component of net patient service revenue or patient accounts receivable (*see Note 10*).

## **Calvert Health System, Inc. and Subsidiaries**

### **Notes to the Consolidated Financial Statements - Continued**

#### **Note 1 - Organization and Summary of Significant Accounting Policies - Continued**

##### ***Charity Care - Continued***

The System maintains records to identify and monitor the level of charity care it provides. These records represent the amount of charges forgone under its charity care policy and amounted to approximately \$4,318,000 in 2011 and \$2,021,100 in 2010. The charity policy of the System provides free care to patients up to 200% of the federal poverty level and provides free care on a sliding scale up to 300% of the federal poverty level.

##### ***Other Operating Revenue***

Other operating revenue of the System includes cafeteria income, grant income, and revenue from instructional classes and other operating programs.

##### ***Tax-Exempt Status***

The System is exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code as a public charity. The System is entitled to rely on this determination as long as there are no substantial changes in its character, purposes, or methods of operation. Management has concluded that there have been no such changes and therefore the System's status as a public charity exempt from federal income taxation remains in effect.

The state in which the System operates also provides general exemption from state income taxation for organizations that are exempt from federal income taxation. However, the System is subject to both federal and state income taxation at corporate tax rates on its unrelated business income. Exemption from other state taxes, such as real and personal property taxes, is separately determined.

The System had no unrecognized tax benefits or such amounts were immaterial during the periods presented. For tax periods with respect to which no unrelated business income was recognized, no tax return was required. Tax periods for which no return is filed remain open for examination indefinitely. Although information returns were filed, no tax returns were filed during 2011 and 2010.

Management has also considered the impact of unrelated business activities and has concluded that the Hospital is not subject to unrelated business tax or any other taxes that could be imposed by the Internal Revenue Code or state taxing authorities. As such no provision is made for income taxes and no asset or liability has been recognized for deferred taxes.

##### ***Inventories***

Inventories consist primarily of drugs and medical supplies and are carried at the lower of cost or market, as determined principally by the first-in, first-out method.

## **Calvert Health System, Inc. and Subsidiaries**

### **Notes to the Consolidated Financial Statements - Continued**

#### **Note 1 - Organization and Summary of Significant Accounting Policies - Continued**

##### ***Subsequent Events***

Subsequent events have been evaluated by management through October 14, 2011, which is the date the financial statements were available to be issued.

##### ***Recent Changes in Accounting Standards***

In August 2010, the Financial Accounting Standards Board (FASB) amended the Accounting Standards Codification (ASC) for Health Care Entities to require that cost be used as the measurement basis for charity care disclosures and that cost be identified as the direct and indirect costs of providing the charity care. This amendment is effective for fiscal years beginning after December 15, 2010. Also, in August 2010, the FASB amended the ASC for Health Care Entities to clarify that a health care entity should not net insurance recoveries against a related claim liability. Additionally, the amount of the claim liability should be determined without considerations of insurance recoveries. This amendment is effective for fiscal years and interim periods within those years, beginning after December 15, 2010. In July 2011, the FASB amended the ASC for Health Care Entities to require certain health care entities to change the presentation of their statement of operations by reclassifying the provision for bad debts associated with patient service revenue from an operating expense to a deduction from patient service revenue (net of contractual allowances and discounts). Additionally, these entities are required to provide enhanced disclosure about their policies for recognizing revenue and assessing bade debts. This amendment is effective for fiscal years beginning after December 15, 2012. Management is currently evaluating the impact on the System's future financial statements of adoption of these changes in accounting.

##### **Reclassifications**

Certain prior year amounts have been reclassified to conform to the current year's presentation.

## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 2 - Investments in Affiliated Enterprises

A summary of investments in affiliated enterprises at June 30 follows:

	<u>2011</u>		<u>2010</u>	
	Investment	Income	Investment	Income
Calvert Medical Imaging Center	\$ 1,013,946	\$ (20,585)	\$ 1,059,530	\$ 176,936
NRH/CPT Regional Rehab, LLC	50,709	31,867	63,998	29,589
Chesapeake-Potomac Healthcare Alliance, LLC	2,888,815	426,623	2,462,192	187,470
Chesapeake Physical Medicine, LLC	4,798	(13,439)	18,237	(3,915)
Freestate Healthcare Insurance Company, LTD	20,452	113	20,339	0
Maryland eCare, LLC	(9,007)	(4,308)	(4,699)	522
Calvert Medical Office Building Limited Partnership	172,735	50,781	129,274	(6,299)
	<u>\$ 4,142,448</u>	<u>\$ 471,052</u>	<u>\$ 3,748,871</u>	<u>\$ 384,303</u>

An overview of these organizations is presented in this note. Because the Hospital's investment in Calvert Medical Imaging Center (CMIC) represents approximately 24% and 29% and the Hospital's investment in Chesapeake-Potomac Healthcare Alliance (the Alliance) represents approximately 70% and 68% of the reported investment balance in affiliates as of June 30, 2011 and 2010, respectively, summarized financial information for CMIC and the Alliance is also presented in this note.

#### Calvert Medical Imaging Center

Calvert Medical Imaging Center (CMIC) is a joint venture between CHV and American Radiology Services, Inc. which operates diagnostic imaging facilities. CHV maintains a 50% interest in CMIC.

Summarized unaudited financial information of CMIC as of and for the years ended June 30 is presented below:

	<u>2011</u>	<u>2010</u>
Total assets	<u>\$ 6,434,050</u>	<u>\$ 7,556,993</u>
Total liabilities	4,476,332	5,491,780
Partners' capital	<u>1,957,718</u>	<u>2,065,213</u>
Total liabilities and partners' capital	<u>\$ 6,434,050</u>	<u>\$ 7,556,993</u>
	<u>2011</u>	<u>2010</u>
Total revenue	\$ 5,627,447	\$ 6,521,874
Net income	12,676	346,933

## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 2 - Investments in Affiliated Enterprises - Continued

##### NRH/CPT Regional Rehab, LLC

CHV invested in NRH/CPT Regional Rehab, LLC (NRH/CPT) for the purpose of providing comprehensive and coordinated physical therapy and rehabilitation services in St. Mary's and Charles counties. CHV maintains a 15% interest in NRH/CPT.

##### Chesapeake-Potomac Healthcare Alliance, LLC

Chesapeake-Potomac Healthcare Alliance, LLC (the Alliance) is a joint venture in which the Hospital and two other hospitals have invested equally. It was created to provide certain healthcare services to the population of southern Maryland. The Alliance is a 60% owner of Chesapeake Potomac Regional Cancer Center, LLC (CPRCC), a limited liability company which owns and operates two outpatient radiation oncology centers. The other 40% of CPRCC is owned by Holy Cross Hospital of Silver Spring and Adventist Healthcare, Inc. The Alliance is also one of two members in Chesapeake-Potomac Home Health Agency, Inc., a Maryland non-stock corporation that was formed in 1995 for the purpose of providing home health care and other health care services to individuals in need of such services in Calvert, Charles and St. Mary's counties.

Summarized unaudited financial information of the Alliance as of and for the years ended June 30 is presented below:

	<u>2011</u>	<u>2010</u>
Total assets	<u>\$ 16,019,080</u>	<u>\$ 15,206,913</u>
Total liabilities	5,126,415	6,039,130
Members' equity	<u>10,892,665</u>	<u>9,167,783</u>
Total liabilities and members' equity	<u>\$ 16,019,080</u>	<u>\$ 15,206,913</u>
	<u>2011</u>	<u>2010</u>
Total revenue	\$ 13,421,334	\$ 12,043,126
Net income	1,279,870	916,295



## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 2 - Investments in Affiliated Enterprises - Continued

##### Chesapeake Physical Medicine, LLC

Chesapeake Physical Medicine, LLC is a joint venture of CHV and a group of medical professionals created to provide outpatient chiropractic services to the population of Calvert County. CHV maintains a 25% interest in this joint venture.

##### Freestate Healthcare Insurance Company, LTD

Freestate Healthcare Insurance Company, LTD is a captive insurance company formed in the Cayman Islands. It is owned by six Maryland hospitals. Freestate provides insurance coverage to its shareholders for professional liability and comprehensive general liability (*see Note 8*).

##### Maryland eCare, LLC

Maryland eCare, LLC is a joint venture formed by seven Maryland hospitals to provide remote monitoring technology with clinical decision support and physician/nursing services for their use in intensive care units and other clinical areas within their respective hospitals. The Hospital maintains a 7.8% interest in this joint venture.

##### Calvert Medical Office Building Limited Partnership

Holding Co. I has a 7.6% limited partnership interest in Calvert Medical Office Building Limited Partnership.

#### Note 3 - Investments

Unrestricted investments, stated at market value, which approximates fair value at June 30 include:

	<u>2011</u>	<u>2010</u>
Equity mutual funds	\$ 36,443,118	\$ 24,925,686
Fixed income mutual funds	10,468,782	9,314,246
Guaranteed investment account	2,112,593	0
Alternative investments	3,164,188	3,716,174
	<u>52,188,681</u>	<u>37,956,106</u>
Less short-term investments	53,831	5,820
Long-term investments	<u>\$ 52,134,850</u>	<u>\$ 37,950,286</u>

## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 3 – Investments - Continued

Assets limited as to use, stated at fair value, at June 30 include:

	2011	2010
Internally designated for capital acquisition and scholarships:		
Cash and cash equivalents	\$ 751,014	\$ 598,924
Net pledges receivable (see Note 13)	66,342	102,079
Equity mutual funds	2,416,447	2,010,991
	3,233,803	2,711,994
Held by trustee under indenture agreement:		
Cash and cash equivalents	2,418,952	2,419,668
U.S. Government issues	3,604,825	3,655,280
	\$ 9,257,580	\$ 8,786,942

Assets held by a trustee under indenture agreements consist of the following funds at June 30:

	2011	2010
Debt service fund	\$ 2,296,749	\$ 2,340,540
Debt service reserve fund	3,727,028	3,734,408
	\$ 6,023,777	\$ 6,074,948

The debt service fund is comprised of principal and interest funds held by a trustee in accordance with the Hospital's bond indentures. The debt service fund is classified as a current asset in the accompanying consolidated statements of financial position.

The System's investments include investments in limited partnerships and other alternative investments, which are made in accordance with the System's investment policies. The limited partnerships acquire, hold, invest, manage, dispose of, and otherwise deal in and with securities of all kinds and descriptions. Publicly traded securities are generally valued by reference to closing market prices on one or more national securities exchange or generally accepted pricing services selected by the fund managers of the limited partnership. Securities not valued by such pricing services will be valued upon bid quotations obtained from independent dealers in the securities. In the absence of any independent quotations, securities will be valued by the fund managers on the basis of data obtained from the best available sources. Investments in limited partnerships are accounted for under the equity method. The equity in earnings or losses from these investments is recorded as a component of investment income in the consolidated statement of operations. Although the various fund managers use their best judgment at estimating the fair value of the alternative investments, there are inherent limitations in any valuation technique. Therefore, the value is not necessarily indicative of the amount that could be realized in a current transaction. Future events will also affect the estimates of fair value, and the effect of such events on the estimates of the fair value could be material.

## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 3 - Investments - Continued

Investment income and gains for assets limited as to use, cash equivalents and other investments are comprised of the following for the years ended June 30:

	<u>2011</u>	<u>2010</u>
Income:		
Interest and dividend income	\$ 681,034	\$ 738,313
Realized losses	(302,593)	(1,395,495)
Total investment income	<u>\$ 378,441</u>	<u>\$ (657,182)</u>
Unrealized gains on investments	<u>\$ 9,541,012</u>	<u>\$ 3,948,178</u>

Current accounting standards define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date and establish a framework for measuring fair value, and establish a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date, as follows:

Level 1: Quoted prices in active markets for identical assets or liabilities.

Level 2: Observable input other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

## **Calvert Health System, Inc. and Subsidiaries**

### **Notes to the Consolidated Financial Statements - Continued**

#### **Note 3 - Investments – Continued**

The following discussion describes the valuation methodologies used for financial assets measured at fair value. The techniques utilized in estimating the fair values are affected by the assumptions used, including discount rates, and estimates of the amount and timing of future cash flows. Care should be exercised in deriving conclusions about System's business, its value, or financial position based on the fair value information of financial assets presented below.

Fair value estimates are made at a specific point in time, based on available market information and judgments about the financial asset, including estimates of the timing, amount of expected future cash flows, and the credit standing of the issuer. In some cases, the fair value estimates cannot be substantiated by comparison to independent markets. In addition, the disclosed fair value may not be realized in the immediate settlement of the financial asset. Furthermore, the disclosed fair values do not reflect any premium or discount that could result from offering for sale at one time an entire holding of a particular financial asset. Potential taxes and other expenses that would be incurred in an actual sale or settlement are not reflected in the amounts disclosed.

Fair values for System's fixed maturity securities are based on prices provided by its investment managers, who use a variety of pricing sources to determine market valuations. Each designate specific pricing services or indexes for each sector of the market based upon the provider's experience. System's fixed maturity securities portfolio is highly liquid, which allows for a high percentage of the portfolio to be priced through pricing services.

Fair values of equity securities have been determined by System from observable market quotations, when available. Private placement securities and other equity securities where a public quotation is not available are valued by using broker quotes.

The guaranteed deposit account is valued at contract value, (which include contributions made, adjusted for interest earned, withdrawals, and administrative expenses) which approximates fair value.

System's investments include investments in limited partnerships and other alternative investments, which are made in accordance with System's investment policies. The limited partnerships acquire, hold, invest, manage, dispose of, and otherwise deal in and with securities of all kinds and descriptions. Publicly traded securities are generally valued by reference to closing market prices on one or more national securities exchange or generally accepted pricing services selected by the fund managers of the limited partnership. Securities not valued by such pricing services will be valued upon bid quotations obtained from independent dealers in the securities.

## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 3 - Investments – Continued

The following table presents System's fair value hierarchy for assets measured at fair value on a recurring basis as of June 30, 2011 and 2010:

2011	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$ 3,169,966	\$ 0	\$ 0	\$ 3,169,966
Equity mutual funds				
Diversified emerging markets	3,157,430	0	0	3,157,430
Foreign large blend	3,033,426	0	0	3,033,426
Foreign large value	2,690,210	0	0	2,690,210
Foreign small/mid value	919,017	0	0	919,017
Healthcare	372,250	0	0	372,250
Industrials	312,900	0	0	312,900
Information Tech	1,470,043	0	0	1,470,043
Large growth	8,971,368	0	0	8,971,368
Large value	4,739,833	0	0	4,739,833
Large blend	858,442	0	0	858,442
Mid-cap value	350,906	0	0	350,906
Mid-cap growth	6,575,293	0	0	6,575,293
Small blend	2,728,107	0	0	2,728,107
World allocation	1,859,308	0	0	1,859,308
Moderate allocation	557,139	0	0	557,139
Other	263,893	0	0	263,893
Fixed income mutual funds				
Intermediate term	10,211,712	0	0	10,211,712
Short-term	257,070	0	0	257,070
Alternative investments	0	2,551,677	612,511	3,164,188
U.S. Government issues (Maturity 1-10 years)	3,604,825	0	0	3,604,825
Guaranteed investment account	0	2,112,593	0	2,112,593
	<u>\$ 56,103,138</u>	<u>\$ 4,664,270</u>	<u>\$ 612,511</u>	<u>\$ 61,379,919</u>
2010	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$ 3,018,582	\$ 0	\$ 0	\$ 3,018,582
Equity mutual funds	26,936,677	0	0	26,936,677
Fixed income mutual funds	9,314,256	0	0	9,314,256
Alternative investments	0	2,385,379	1,330,795	3,716,174
U.S. Government issues	3,655,280	0	0	3,655,280
	<u>\$ 42,924,795</u>	<u>\$ 2,385,379</u>	<u>\$ 1,330,795</u>	<u>\$ 46,640,969</u>

**Calvert Health System, Inc. and Subsidiaries**  
**Notes to the Consolidated Financial Statements - Continued**

**Note 3 - Investments – Continued**

The following table presents the activity during 2011 and 2010 for the Level 3 funds:

	<u>2011</u>	<u>2010</u>
Market value, beginning of year	\$ 1,330,795	\$ 3,712,741
Net realized gains (losses)	6,690	(786,768)
Disbursements	(742,016)	(2,634,685)
Unrealized gains	17,042	1,039,507
Market value, end of year	<u>\$ 612,511</u>	<u>\$ 1,330,795</u>

**Note 4 - Temporarily and Permanently Restricted Net Assets**

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

	<u>2011</u>	<u>2010</u>
Purchase of equipment	\$ 210,703	\$ 466,583
Health education	38,795	12,485
Health care services	111,543	221,925
	<u>\$ 361,041</u>	<u>\$ 700,993</u>

Permanently restricted net assets at June 30 are restricted to:

	<u>2011</u>	<u>2010</u>
Investments to be held in perpetuity, the income from which is expendable to support health education	<u>\$ 650,155</u>	<u>\$ 565,254</u>

**Calvert Health System, Inc. and Subsidiaries**  
**Notes to the Consolidated Financial Statements - Continued**

**Note 5 - Property and Equipment**

A summary of property and equipment at June 30 follows:

	<u>2011</u>	<u>2010</u>
Land improvements	\$ 2,486,177	\$ 2,440,120
Buildings	66,056,860	65,845,930
Building improvements	36,033,882	31,848,421
Fixed equipment	4,478,569	4,309,823
Movable equipment	51,620,776	46,908,126
	<u>160,676,264</u>	<u>151,352,420</u>
Less accumulated depreciation and amortization	78,515,525	70,176,361
	82,160,739	81,176,059
Land	5,658,386	5,658,386
Construction in progress	1,152,737	2,169,382
Property and equipment, net	<u>\$ 88,971,862</u>	<u>\$ 89,003,827</u>

Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. No interest was capitalized for the years ended June 30, 2011 and 2010.

Depreciation expense for the years ended June 30, 2011 and 2010 amounted to \$8,371,200 and \$8,654,895 respectively.

## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 6 - Long-Term Debt

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

	2011	2010
Maryland Health and Higher Educational Facilities Authority Revenue Bonds (1998 Revenue Bonds); maturing in varying amounts from July 1, 1999 to July 1, 2028; interest due semi-annually at rates ranging from 3.9% to 5.25%; (5.00% and 4.80% at June 30, 2011 and 2010, respectively).	\$ 21,140,000	\$ 21,855,000
Maryland Health and Higher Educational Facilities Authority Revenue Bonds (2004 Revenue Bonds); maturing in varying amounts from July 1, 2008 to July 1, 2039; interest due semi-annually at rates ranging from 3.5% to 5.5%; (4.0% at June 30, 2011 and 2010).	32,635,000	32,735,000
Maryland Bank & Trust Company term loan payable, commencing on November 21, 2008 interest due monthly at variable rates based on the LIBOR Rate (1.89% and 1.99% at June 30, 2011 and 2010, respectively); due September 2015.	7,000,000	7,000,000
	60,775,000	61,590,000
Less current portion	850,000	815,000
	59,925,000	60,775,000
Less amortized original issue discount	792,579	834,555
	\$ 59,132,421	\$ 59,940,445

#### Series 1998 Revenue Bonds

The 1998 Revenue Bonds were issued by the Maryland Health and Higher Educational Facilities Authority (the Authority) on June 11, 1998 for the purpose of financing and refinancing the costs of acquisition, construction, renovation and equipping of certain hospital facilities. The Obligated Group for the 1998 Revenue Bonds is composed of Calvert Memorial Hospital and Calvert Health System. As security for the performance of its obligations under the related Loan Agreement, the Obligated Group members have granted a security interest in its receipts, revenues, rental income and other moneys received by or on behalf of any Obligated Group member to the Authority. The Obligated Group is required to maintain certain deposits in the form of a debt service reserve fund with a trustee. Such deposits are included in assets limited as to use. The revenue bonds also place limits on the incurrence of additional borrowings. The required debt service coverage ratio is 1.10. Annual payments (ranging from \$870,000 in 2014 to \$1,640,000 in 2027) to a sinking fund relating to the revenue bonds will commence in 2014 with a final balance of \$1,720,000 on July 1, 2028. Series 1998 bonds maturing on or after July 1, 2009, are subject to redemption prior to maturity beginning on July 1, 2008, at the option of the Authority upon the direction of the Hospital. Management believes it is in compliance with all applicable covenants.



# Calvert Health System, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements - Continued

### Note 6 - Long-Term Debt - Continued

#### Series 2004 Revenue Bonds

The 2004 Revenue Bonds were issued by the Authority on July 8, 2004 for the purpose of financing the costs of acquisition, construction, renovation and equipping of certain hospital facilities. The Obligated Group for the 2004 Revenue Bonds is composed of Calvert Memorial Hospital and Calvert Health System. As security for the performance of its obligations under the related Loan Agreement, the Obligated Group members have granted a security interest in its receipts, revenues, rental income and other moneys received by or on behalf of any Obligated Group member to the Authority. The Obligated Group is required to maintain certain deposits in the form of a debt service reserve fund with a trustee. Such deposits are included in assets limited as to use. The revenue bonds also place limits on the incurrence of additional borrowings. The required debt service coverage ratio is 1.10. Annual payments (ranging from \$145,000 in 2019 to \$3,320,000 in 2038) to a sinking fund relating to the revenue bonds will commence in 2019 with a final balance of \$3,500,000 on July 1, 2039. Series 2004 bonds maturing on or after July 1, 2015 are subject to redemption prior to maturity beginning on July 1, 2014 at the option of the Authority upon the direction of the Hospital. Management believes it is in compliance with all applicable covenants.

#### Commercial loan

In November 2008, the System obtained a loan from a commercial bank for the purpose of financing a portion of the construction of the Calvert Medical Arts Center. Principal payments are payable in twenty-three consecutive monthly payments payable on the first day on each month beginning October 2013 (the conversion date). The System is required to make principal payments in the amount necessary to fully amortize the balance over a period of twenty-five years from the conversion date.

The System is required to pay the unpaid balance plus all accrued interest thereon, on September 1, 2015. Interest is required to be paid monthly. The interest rate is calculated using the LIBOR rate in effect from time to time, plus 1.65% per annum.

Principal payments due under all debt instruments as of June 30, 2011 are as follows:

2012	\$ 850,000
2013	895,000
2014	1,145,000
2015	1,265,000
2016	7,540,000
and thereafter	<u>49,080,000</u>
Total	<u>\$ 60,775,000</u>

Interest paid on indebtedness by the System was \$2,996,027 and \$3,033,269 in 2011 and 2010, respectively.

## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 7 - Employee Pension Plans

The Hospital has a defined contribution plan whereby contributions are made on an annual basis by participating employees and the Hospital. Substantially all employees are eligible to participate, subject to meeting the criteria specified by the plan. Participating employees are permitted to contribute up to 20% of their annual compensation, not to exceed a maximum threshold as set forth by the IRS on an annual basis. The Hospital provides a matching contribution not to exceed 2% of each employee's base annual compensation. Employees hired January 1, 2008 and later are only eligible to participate in the defined contribution plan. They receive an employer contribution of 2.5% of their annual W-2 wages. They may receive an additional employer matching contribution of up to 2% based upon the participant's own contribution.

Additionally, the Hospital has a qualified non-contributory defined benefit pension plan covering substantially all employees who were employed by the Hospital prior to January 1, 2008, as well as certain employees of the System who meet certain age and service requirements. Effective January 1, 2008, the Hospital instituted a "soft freeze" of the defined benefit plan. The plan was amended effective January 1, 1993 from a defined benefit plan, the benefits of which were calculated primarily upon age and employee compensation near retirement, to a cash balance defined benefit plan, which calculates benefits based upon age and years of service. The Hospital makes annual contributions to the plan based on the advice of consulting actuaries. Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future. The Hospital used a June 30 measurement date for its plan in 2011 and 2010.

The following table sets forth the changes in the projected benefit obligation at June 30:

	<b>2011</b>	<b>2010</b>
Benefit obligation at beginning of year	\$ 27,584,779	\$ 19,979,289
Service cost	975,488	797,824
Interest cost	1,550,875	1,373,393
Changes in assumptions	(394,971)	5,390,576
Actuarial loss (gain)	161,434	538,813
Benefits paid	(546,049)	(495,116)
Benefit obligation at end of year	\$ 29,331,556	\$ 27,584,779

The following table sets forth the changes in the plan assets at June 30:

	<b>2011</b>	<b>2010</b>
Fair value of plan assets at beginning of year	\$ 19,477,056	\$ 15,878,976
Actual return on plan assets	3,753,982	1,758,196
Employer contributions	2,000,004	2,335,000
Actual benefits paid	(546,049)	(495,116)
Fair value of plan assets at end of year	\$ 24,684,993	\$ 19,477,056

## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 7 - Employee Pension Plans – Continued

In accordance with current standards, the Hospital recognized the full extent of the underfunded (a liability) status of the plan, which is measured as the difference between the fair value of the Plan assets and the projected benefit obligation. As of June 30, 2011 and 2010, the plan's projected benefit obligation exceeded the fair value of the plan's assets by \$4,646,563 and \$8,107,723, respectively. The plan's accumulated benefit obligation was \$27,799,445 and \$26,225,218 as of June 30, 2011 and 2010, respectively.

Net periodic pension cost for the years ended June 30 include the following components:

	<b>2011</b>	<b>2010</b>
Service cost	\$ 975,488	\$ 797,824
Interest cost	1,550,875	1,373,393
Expected return on plan assets	(1,703,695)	(1,401,951)
Amortization of prior service cost	(29,633)	(29,633)
Recognized net actuarial loss	1,176,829	734,222
Net periodic benefit cost	\$ 1,969,864	\$ 1,473,855

The following table sets forth the weighted average assumptions used to determine benefit obligations as of June 30:

	<b>2011</b>	<b>2010</b>
Discount rate	5.66%	6.75%
Rate of compensation increase	3.00%	4.00%

The following table sets forth the weighted average assumptions used to determine net periodic benefit costs for the years ended June 30:

	<b>2011</b>	<b>2010</b>
Discount rate	5.66%	6.75%
Expected return on plan assets	8.50%	8.50%
Rate of compensation increase	3.00%	4.00%

Amounts recognized in unrestricted net assets as of June 30 consist of:

	<b>2011</b>	<b>2010</b>
Net loss	\$ 8,634,172	\$ 12,094,825
Prior service cost	(122,082)	(151,715)
Total	\$ 8,512,090	\$ 11,943,110

## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 7 - Employee Pension Plans – Continued

The investment of pension assets is guided by the pension investment policy. Pension assets are invested to ensure that the pension plan has the ability to pay all benefit and expense obligations when due, to maximize return within prudent levels of risk for pension assets and to maintain a funding cushion for unexpected developments. The target weighted-average asset allocation of pension investments is 60% equities and 40% debt securities and cash. Equity securities primarily include investments in large-cap and mid-cap companies. Fixed income securities primarily include corporate bonds. Mutual funds (fixed income and equity) are valued by observable market quotations. The guaranteed deposit account is valued at contract value, (which include contributions made, adjusted for interest earned, participant withdrawals, and administrative expenses) which approximates fair value.

The fair values of the Hospital's pension plan assets at June 30, 2011, by asset category are as follows:

	<u>Level 1</u>	<u>Level 2</u>	<u>Total</u>
Cash and cash equivalents	\$ 22,562	\$ 0	\$ 22,562
Equity mutual funds			
Mid-Cap Growth	1,604,984	0	1,604,984
Foreign Large Blend	2,126,293	0	2,126,293
Mid-Cap Value	1,557,674	0	1,557,674
Large Growth	3,149,883	0	3,149,883
Large Value	3,084,048	0	3,084,048
Large Blend	3,199,649	0	3,199,649
Fixed income mutual funds			
High Yield Bond	808,261	0	808,261
Intermediate-Term Bond	2,168,577	0	2,168,577
Inflation-Protected Bond	1,532,977	0	1,532,977
Short-term Bond	2,162,583	0	2,162,583
Guaranteed deposit account	0	3,267,503	3,267,503
	<u>\$ 21,417,490</u>	<u>\$ 3,267,503</u>	<u>\$ 24,684,993</u>

The fair values of the System's pension plan assets at June 30, 2010, by asset category are as follows:

	<u>Level 1</u>	<u>Level 2</u>	<u>Total</u>
Cash and cash equivalents	\$ 25,340	\$ 0	\$ 25,340
Equity mutual funds	11,088,979	0	11,088,979
Fixed income mutual funds	5,010,055	0	5,010,055
Guaranteed deposit account	0	3,352,682	3,352,682
	<u>\$ 16,124,374</u>	<u>\$ 3,352,682</u>	<u>\$ 19,477,056</u>

## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 7 - Employee Pension Plans – Continued

The Hospital expects to contribute \$2.1 million to its pension plan for fiscal year ending June 30, 2012. The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

2012	\$	793,714
2013		830,702
2014		887,050
2015		1,003,791
2016		1,116,319
2017-2021		7,961,554
Total expected benefit payments	\$	<u>12,593,130</u>

#### Note 8 - Malpractice Insurance

Prior to March 1, 2005, the Hospital maintained a professional liability insurance policy on a claims-made basis. Under this insurance policy, the Hospital was insured for individual claims up to \$1,000,000 with a total annual aggregate of \$3,000,000 with no deductible for claims made. The Hospital also had excess coverage of up to \$10,000,000 for individual claims and in the aggregate.

Effective March 1, 2005, the Hospital became a shareholder of the newly formed Freestate Healthcare Insurance Company, Ltd. (Freestate), a captive insurance company formed in the Cayman Islands. As of June 30, 2011, the Hospital maintains a 16.7% shareholder interest in Freestate. The Hospital decided to become a shareholder of Freestate when the Hospital's insurance company decided not to continue to write insurance policies for hospitals within the State of Maryland effective March 1, 2005. The Hospital believes that becoming a shareholder of a captive insurance company provides the best long-term solution to providing insurance coverage that is cost effective and predictable. Freestate provides insurance coverage on a claims-made basis to its owners and their affiliates for professional liability claims and comprehensive general liability of \$1,000,000 for each and every claim. Freestate has entered into reinsurance and excess policy agreements with independent insurance companies to limit its losses for professional liability and comprehensive general liability claims. The Hospital has \$10,000,000 of additional insurance in the aggregate through such reinsurance arrangements. Retrospective premium assessments and credits are calculated based on the aggregate experience of all named insureds under the policy. Each named insured's assessment or credit is based on the percentage of their actual exposure to the actual exposure of all named insureds. In management's opinion, the assets of Freestate are sufficient to meet its obligations as of June 30, 2011. If the financial condition of Freestate were to materially deteriorate in the future, and Freestate was unable to pay its claim obligations, the responsibility to pay those claims would return to the member hospitals.

## **Calvert Health System, Inc. and Subsidiaries**

### **Notes to the Consolidated Financial Statements - Continued**

#### **Note 8 - Malpractice Insurance -- Continued**

CPTSFC maintains a professional liability insurance policy on a claims-made basis. CPTSFC is insured for individual claims up to \$1,000,000 with a total annual aggregate of \$3,000,000 with no deductible.

The Hospital is involved in litigation arising in the ordinary course of business. Claims alleging malpractice have been asserted against the Hospital and are currently in various stages of litigation. Additional claims may be asserted against the Hospital arising from services provided through June 30, 2011. Management believes that no material loss will result from any pending or threatened litigation or from incidents incurred but not reported.

#### **Note 9 - Maryland Health Services Cost Review Commission**

Patient service revenue is recorded at rates established by the HSCRC. Effective July 1, 2010, the Hospital entered into a Total Patient Revenue (TPR) rate agreement with the HSCRC. Under the TPR system, the Hospital is provided a fixed revenue (CAP) amount under which it must operate each year. The CAP is adjusted annually for inflation, change in the Hospital's payer mix and uncompensated care, and change in population. Prior to July 1, 2010, the Hospital's inpatient charges were subject to an inpatient charge per case target (adjusted for case mix) and unit rates for outpatient centers. Annually, both the charge per case and outpatient rates were adjusted by the update formula, rate compliance and case mix.

## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 10 - Concentration of Credit and Business Risk

The System provides health care services to residents located primarily in Calvert, St. Mary's, southern Anne Arundel and Charles counties. The System generally does not require collateral or other security in extending credit; however, it routinely obtains assignment of (or is otherwise entitled to receive) patients' benefits receivable under their health insurance programs, plans or policies (e.g., Medicare, Medicaid, health maintenance organizations and commercial insurance policies).

At June 30, the Hospital had patient accounts receivable from third party payers and others as follows:

	2011		2010	
Medicare	\$ 4,461,914	22.2 %	\$ 5,303,636	22.3 %
Medicaid (including managed care)	1,991,390	9.9	2,887,198	12.2
Blue Cross	2,978,063	14.8	4,153,351	17.5
Commercial and other	1,918,713	9.6	2,492,378	10.5
HMO	3,974,377	19.8	4,327,599	18.2
Self-pay	4,748,193	23.7	4,574,990	19.3
	\$ 20,072,650	<u>100.0 %</u>	\$ 23,739,152	<u>100.0 %</u>
Less contractual adjustments	(2,620,699)		(4,222,211)	
	\$ 17,451,951		\$ 19,516,941	

Patient service revenue, by payer class, consisted of the following for the years ended June 30:

	2011		2010	
Medicare	\$ 54,804,369	35.0 %	\$ 50,291,550	35.1 %
Medicaid (including managed care)	19,274,589	12.3	16,337,606	11.4
Blue Cross	29,123,590	18.6	26,953,335	18.8
Commercial and other	8,967,344	5.7	7,806,116	5.4
HMO	36,658,755	23.5	35,071,842	24.4
Self-pay	7,569,962	4.9	7,016,633	4.9
	\$ 156,398,609	<u>100.0 %</u>	\$ 143,477,082	<u>100.0 %</u>
Less contractual adjustments	(28,680,253)		(23,449,547)	
Less charity care	(4,317,996)		(2,021,139)	
	\$ 123,400,360		\$ 118,006,396	

## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 11 - Functional Expenses

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

	<u>2011</u>	<u>2010</u>
Health care services	\$ 107,698,602	\$ 104,723,849
General and administrative	21,550,412	21,929,915
	<u>\$ 129,249,014</u>	<u>\$ 126,653,764</u>

#### Note 12 - Lease Obligations

The System is obligated under various operating leases for several office facilities and equipment leases. Total office rent and equipment lease expense was \$1,646,308 and \$1,467,679 for the years ended June 30, 2011 and 2010, respectively, and is reported as a component of other expenses in the accompanying consolidated statements of operations and other changes in unrestricted net assets. The future minimum lease payments expected to be made to non-affiliated parties under non-cancelable operating leases are as follows for the years ended June 30:

2012	\$ 1,172,738
2013	1,020,328
2014	544,142
2015	147,528
2016	60,487
	<u>\$ 2,945,223</u>

The System is the owner of four medical office buildings. Rents to be received in the future from affiliated enterprises and other tenants are as follows for the years ended June 30:

	<u>Affiliates</u>	<u>Other</u>	<u>Total</u>
2012	\$ 1,243,870	\$ 1,604,735	\$ 2,848,605
2013	1,126,359	1,385,374	2,511,733
2014	1,075,425	1,429,737	2,505,162
2015	298,706	186,923	485,629
2016	44,340	42,336	86,676
	<u>\$ 3,788,700</u>	<u>\$ 4,649,105</u>	<u>\$ 8,437,805</u>

Rental income totaling \$2,565,188 and \$2,546,713 has been recognized in the accompanying consolidated statements of operations and other changes in unrestricted net assets for the years ended June 30, 2011 and 2010, respectively.



## **Calvert Health System, Inc. and Subsidiaries**

### **Notes to the Consolidated Financial Statements - Continued**

#### **Note 13 - Pledges Receivable**

During 2004, the Hospital commenced a capital campaign. Contributions from the campaign are being used to fund major equipment purchases for various construction projects. At June 30, 2011 pledges receivable was \$86,200 less an allowance for uncollectible pledges of \$18,636 and a discount of \$1,222. The entire pledges receivable balance is reported as a non-current asset in the accompanying consolidated statements of financial position because it is temporarily restricted for the acquisition of property, plant, and equipment.

#### **Note 14 - Certain Risks and Uncertainties**

The Hospital's ability to maintain and/or increase future revenues could be adversely affected by: (1) proposed and/or future changes in the laws, rules, regulations, and policies relating to the definition, activities, and/or taxation of not-for-profit tax-exempt entities; (2) the enactment into law of all or any part of the current budget resolutions under consideration by Congress related to Medicare and Medicaid reimbursement methodology and/or further reductions in payments to hospitals and other health care providers; (3) the medical malpractice crisis which may force physicians on the medical staff to leave the practice of medicine in the State of Maryland; (4) limited supply of physicians nationally which may limit the Hospital's ability to meet the healthcare demands of the population within its primary and secondary service areas 5) the ultimate impact of the federal Patient Protection and Affordable Care Act and the Health Care Education Affordability Reconciliation Act of 2010.

The Joint Commission a non-governmental privately owned entity, provides accreditation status to hospitals and other health care organizations in the United States. Such accreditation is based upon a number of requirements such as undergoing periodic surveys conducted by Joint Commission personnel. Certain managed care payers require hospitals to have appropriate Joint Commission accreditation in order to participate in those programs. In addition, the Center for Medicare and Medicaid Services (CMS), the agency with oversight of the Medicare and Medicaid programs, provides "deemed status" for facilities having Joint Commission accreditation. By being Joint Commission accredited, facilities are "deemed" to be in compliance with the Medicare and Medicaid conditions of participation. Termination as a Medicare provider or exclusion from any or all of these programs/payers would have a materially negative impact on the future financial position, operating results and cash flows of the Hospital. In November 2008 the Hospital was surveyed Joint Commission and received a full three-year Joint Commission accreditation through December 2011.

## **Calvert Health System, Inc. and Subsidiaries**

### **Notes to the Consolidated Financial Statements - Continued**

#### **Note 14 - Certain Risks and Uncertainties – Continued**

During September 2008, certain large U.S. financial institutions failed, primarily as a result of holdings in troubled subprime loans or assets collateralized with such distressed loans. These institutional failures, and the negative economic conditions that contributed to these failures, generated substantial volatility in global financial markets and substantial uncertainty regarding access to capital and the continued viability of many other financial institutions. Despite the federal legislative initiatives to ameliorate these conditions, global credit markets remain volatile and the health of the global economy continues to be uncertain. These conditions create uncertainty regarding the future valuation of the System's invested funds and the resulting impact on the future financial position, results of operations and cash flows of the System could be material.

#### **Note 15 - Fair Value of Financial Instruments**

The carrying amounts reported in the consolidated statements of financial position for cash and cash equivalents, investments, patient accounts receivable, assets limited as of use, accounts payable and accrued expenses, and third party advances approximate the related fair values. The composition and related fair values of assets limited as to use and investments are disclosed in Note 3. The fair value of the System's outstanding long-term obligations as of June 30, 2011 and 2010 was approximately \$54,713,504 and \$54,583,267, respectively.

#### **Note 16 - Endowment**

Current accounting standards provide guidance on the net asset classification of donor-restricted endowment funds for a not-for-profit organization that is subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA) and additional disclosures about an organization's endowment funds. The State of Maryland has adopted UPMIFA. The adoption of UPMIFA had no impact on the accounting for the System's endowment.

The System's endowment consists of two donor-restricted funds. Net assets associated with the endowment fund are classified and reported based on the existence or absence of donor-imposed restrictions.

## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 16 – Endowment - Continued

The Board of Directors of the System has interpreted the Maryland State Prudent Management of Institutional Funds Act (SPMIFA) as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, the Hospital classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund.

In accordance with SPMIFA, the System considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

1. The duration and preservation of the fund
2. The purposes of the System and the donor-restricted endowment fund
3. General economic conditions
4. The possible effect of inflation and deflation
5. The expected total return from income and the appreciation of investments
6. Other resources of the System
7. The investment policies of the System

From time to time, the fair value of assets associated with the endowment fund may fall below the level that the donor or SPMIFA required the System to retain as a fund of perpetual duration. There were no such deficiencies as of June 30, 2011 or 2010.

The System has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding while seeking to maintain the purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that the organization must hold in perpetuity. Under this policy, as approved by the Board of Directors, the endowment assets are invested in a manner that is intended to produce results that exceed the price and yield results of the Lehman Intermediate Government/Corporate Bond index while assuming a moderate level of investment risk. The System expects its endowment funds, over time, to provide an average rate of return of approximately 8% percent annually. Actual returns in any given year may vary from this amount.

## Calvert Health System, Inc. and Subsidiaries

### Notes to the Consolidated Financial Statements - Continued

#### Note 16 – Endowment - Continued

To satisfy its long-term rate-of-return objectives, the System relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). The System targets a diversified asset allocation that places a greater emphasis on highly liquid investments such as money market accounts to achieve its long-term return objectives within prudent risk constraints.

The endowment's net asset composition as of June 30, 2011 and 2010 and the changes therein, all of which are reported as permanently restricted net assets, were as follows:

	Unrestricted	Temporarily Restricted	Permanently Restricted
Donor-restricted endowment	\$ 0	\$ 0	\$ 650,155
Changes in Endowment Net Assets for the Fiscal Year June 30, 2011			
	Unrestricted	Temporarily Restricted	Permanently Restricted
Endowment net assets, beginning of year	\$ 0	\$ 0	\$ 565,254
Investment return:			
Net appreciation (realized and unrealized)	0	46,150	84,851
Other changes:			
Contributions	0	0	50
Released from restriction	0	(46,150)	0
Endowment net assets, end of year	\$ 0	\$ 0	\$ 650,155
	Unrestricted	Temporarily Restricted	Permanently Restricted
Donor-restricted endowment	\$ 0	\$ 0	\$ 565,254
Changes in Endowment Net Assets for the Fiscal Year June 30, 2010			
	Unrestricted	Temporarily Restricted	Permanently Restricted
Endowment net assets, beginning of year	\$ 0	\$ 0	\$ 507,015
Investment return:			
Net appreciation (realized and unrealized)	0	12,750	58,239
Other changes:			
Released from restriction	0	(12,750)	0
Endowment net assets, end of year	\$ 0	\$ 0	\$ 565,254