COHEN
RUTHERFORD
+ KNIGHT PC
Certified Public Accountants

Audited Consolidated Financial Statements and Other Financial Information

Mercy Health Services, Inc. and Subsidiaries

June 30, 2010

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Other Financial Information

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Report of Independent Auditors

The Board of Trustees
Mercy Health Services, Inc. and Subsidiaries
Baltimore, MD

We have audited the accompanying consolidated balance sheets of Mercy Health Services, Inc. and Subsidiaries as of June 30, 2010 and 2009, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of Mercy Health Services, Inc. and Subsidiaries' management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Greenleaf Insurance Company, Ltd., a wholly-owned subsidiary, which statements reflect total assets of $37,752,778 and $33,102,777 as of June 30, 2010 and 2009, respectively, and total revenues of $12,480,954 and $6,443,202 for the years ended June 30, 2010 and 2009, respectively. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Greenleaf Insurance Company, Ltd., is based solely on the report of the other auditors.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Mercy Health Services, Inc. and Subsidiaries as of June 30, 2010 and 2009, and the results of their operations, changes in their net assets, and their 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.

September 1, 2010

Mercy Health Services, Inc. and Subsidiaries
Consolidated Balance Sheets
(Dollars in thousands)

	June 30, 2010	June 30, 2009
ASSETS		
CURRENT ASSETS		
Cash, cash equivalents and short-term investments -- *Note A*	$ 75,434	$ 87,683
Current portion of funds held by trustee or authority -- *Note E*	6,257	6,229
Resident prepayments and security deposits	862	849
Patient accounts receivable, net -- *Note B*	38,389	39,877
Other amounts receivable, net	2,391	3,180
Current pledges receivable, net -- *Note C*	5,543	5,583
Other current assets	7,649	6,159
TOTAL CURRENT ASSETS	136,525	149,560
PROPERTY AND EQUIPMENT, net -- *Note D*	484,570	359,438
INVESTMENTS AND OTHER ASSETS		
Funds held by trustee or authority, less current portion -- *Note E*	77,298	190,213
Board designated and donor restricted investments -- *Note F*	95,908	74,565
Restricted cash, cash equivalents and investments	47,463	44,798
Long-term investments	35,497	15,291
Long-term pledges receivable, net -- *Note C*	21,644	23,617
Investments in and advances to affiliates	342	342
Reinsurance balances receivable or recoverable -- *Note I*	1,733	1,943
Other assets -- *Note H*	12,668	15,791
TOTAL ASSETS	$ 913,648	$ 875,558

See notes to the consolidated financial statements

Mercy Health Services, Inc. and Subsidiaries
Consolidated Balance Sheets - Continued
(Dollars in thousands)

	June 30, 2010	June 30, 2009
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Current maturities of long-term debt -- *Note J*	$ 5,315	$ 5,268
Accounts payable and accrued expenses	64,477	60,934
Resident prepayments and security deposits	852	844
Construction retainage	10,467	7,419
TOTAL CURRENT LIABILITIES	81,111	74,465
Long-term debt -- *Note J*	456,011	461,275
Accrued interest	3,374	3,375
Provision for outstanding losses -- *Note I*	28,821	28,726
Post-retirement obligation -- *Note M*	5,538	6,975
Other long-term liabilities -- *Note W*	43,856	39,444
TOTAL LIABILITIES	618,711	614,260
NET ASSETS		
Unrestricted	252,398	216,059
Temporarily restricted -- *Note P*	40,361	43,019
Permanently restricted -- *Note P*	2,178	2,220
TOTAL NET ASSETS	294,937	261,298
COMMITMENTS AND CONTINGENCIES -- *Note R and U*		
TOTAL LIABILITIES AND NET ASSETS	$ 913,648	$ 875,558

See notes to the consolidated financial statements

Mercy Health Services, Inc. and Subsidiaries
Consolidated Statements of Operations
(Dollars in thousands)

	Year Ended June 30, 2010	2009
REVENUE		
Net patient service revenue -- *Note B and S*	$ 500,369	$ 494,588
Other operating revenue	20,581	11,138
Net assets released from restriction used for operations	2,423	2,352
TOTAL REVENUE	523,373	508,078
EXPENSES -- *Note Q*		
Salaries and benefits	271,898	260,988
Medical and surgical supplies	39,953	37,377
Pharmacy supplies	25,006	26,335
Other expendable supplies	23,696	23,373
Professional fees	14,337	13,634
Insurance	9,989	9,726
Other purchased services	39,478	40,799
Interest expense	7,208	7,640
Repairs	8,447	7,734
Depreciation and amortization	25,225	24,089
Provision for bad debts	28,088	28,242
TOTAL EXPENSES	493,325	479,937
OPERATING INCOME	30,048	28,141
OTHER INCOME (EXPENSE)		
Investment income (loss) -- *Note F*	1,638	(5,579)
Net unrealized gains on trading securities	2,835	(5,496)
Loss on early extinguishment of debt	(286)	(1,830)
Unrealized loss on interest rate swap	(6,235)	(19,536)
Equity in joint ventures -- *Note G*	565	877
Loss on asset disposal	(25)	(80)
Other	53	(58)
NET OTHER EXPENSE	(1,455)	(31,702)
EXCESS OF REVENUE OVER EXPENSES (EXPENSES OVER REVENUE)	28,593	(3,562)
Changes to post retirement plans obligations	1,991	(2,345)
Net assets released from restrictions for the purchase of property and equipment	5,755	951
INCREASE (DECREASE) IN UNRESTRICTED NET ASSETS	$ 36,339	$ (4,956)

See notes to the consolidated financial statements

Mercy Health Services, Inc. and Subsidiaries
Consolidated Statements of Changes in Net Assets
(Dollars in thousands)

	Unrestricted	Temporarily restricted	Permanently restricted	Total
Net assets, June 30, 2008	$ 221,015	$ 33,676	$ 8,125	$ 262,816
Excess of revenue over expenses	(3,562)	0	0	(3,562)
Net assets released from restrictions for the purchase of property and equipment	951	(951)	0	0
Restricted gifts, bequests, and contributions	0	6,721	20	6,741
Changes to post retirement plans obligations	(2,345)	0	0	(2,345)
Reclassification of net assets	0	5,312	(5,312)	0
Fund transfers	0	613	(613)	0
Net assets released from restrictions used for operations	0	(2,352)	0	(2,352)
Change in net assets	(4,956)	9,343	(5,905)	(1,518)
Net assets, June 30, 2009	$ 216,059	$ 43,019	$ 2,220	$ 261,298
Excess of revenues over expenses	28,593	0	0	28,593
Net assets released from restrictions for the purchase of property and equipment	5,755	(5,755)	0	0
Restricted gifts, bequests, and contributions	0	5,478	0	5,478
Changes to post retirement plans obligations -- *Notes M and N*	1,991	0	0	1,991
Reclassification of net assets	0	42	(42)	0
Net assets released from restrictions used for operations	0	(2,423)	0	(2,423)
Change in net assets	36,339	(2,658)	(42)	33,639
Net assets, June 30, 2010	$ 252,398	$ 40,361	$ 2,178	$ 294,937

See notes to the consolidated financial statements

Mercy Health Services, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(Dollars in thousands)

	Year Ended June 30, 2010	2009
OPERATING ACTIVITIES		
Change in net assets	$ 33,639	$ (1,518)
Adjustments to reconcile change in net assets to net cash and cash equivalents provided by operating activities		
Depreciation and amortization	25,225	24,089
Loss on interest rate swaps	6,235	19,536
Gain in equity of affiliates	(565)	(877)
Realized and unrealized losses on board designated and donor restricted investments	3,519	(11,598)
Restricted gifts, bequests, contributions, and restricted investment income	(7,491)	(4,151)
Loss on early extinguishment of debt	286	1,830
Allowance for bad debt	28,088	28,242
Decrease (increase) in:		
Patient accounts receivable, net	(26,600)	(26,681)
Other amounts receivable and investments in and advances to affiliates	999	(1,544)
Pledges receivable	2,013	(2,590)
Other current assets	(1,495)	1,361
Increase (decrease) in:		
Accounts payable and accrued expenses	3,542	3,792
Provision for outstanding losses	95	2,439
Post-retirement obligation	(1,437)	431
Other long-term liabilities	(1,823)	(7,864)
NET CASH AND CASH EQUIVALENTS PROVIDED BY OPERATING ACTIVITIES	64,230	24,897
INVESTING ACTIVITIES		
Net decrease (increase) short-term investments	(551)	16,462
Purchases of property and equipment	(146,459)	(92,479)
Net increase in restricted cash, cash equivalents and investments	(2,665)	(19,883)
Net decrease in funds held by trustee or authority	112,887	74,073
Net decrease (increase) in board designated and donor restricted investments	(24,862)	24,386
Net decrease (increase) in long term investments	(20,206)	(15,291)
Decrease in other assets	2,631	11,523
NET CASH AND CASH EQUIVALENTS USED IN INVESTING ACTIVITIES	(79,225)	(1,209)

(continued)

Mercy Health Services, Inc. and Subsidiaries
Consolidated Statements of Cash Flows - Continued
(Dollars in thousands)

	Year Ended June 30, 2010	2009
FINANCING ACTIVITIES		
Proceeds from restricted gifts, bequests, contributions, and restricted investment income	7,491	4,151
Bond retirement	0	(35,070)
Proceeds from long term debt	0	35,325
Repayment of long term debt	(5,296)	(5,201)
NET CASH AND CASH EQUIVALENTS PROVIDED BY (USED IN) FINANCING ACTIVITIES	2,195	(795)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(12,800)	22,893
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	81,315	58,422
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 68,515	$ 81,315

See notes to the consolidated financial statements

Mercy Health Services, Inc. and Subsidiaries
Notes to the Consolidated Financial Statements
(Dollars in thousands)

Note A - Organization and Summary of Significant Accounting Policies

Organization and Principles of Consolidation

Mercy Health Services, Inc. (MHS) was formed for the purpose of supporting, benefiting, or carrying out some or all of the purposes of Mercy Medical Center, Inc. (Medical Center or MMC), Stella Maris, Inc. (SMI), Maryland Family Care, Inc. (MFC), St. Paul Place Specialists, Inc. (SPPS), and Mercy Health Foundation (MHF). MHS is the sole member of the Medical Center, SMI, MFC, SPPS, and MHF. The accompanying financial statements include MHS, MMC, SMI, MFC, SPPS, and MHF. All material intercompany balances and transactions have been eliminated.

1. Mercy Medical Center, Inc.

The Medical Center provides inpatient, outpatient, and emergency care services primarily for the citizens of the Baltimore metropolitan area. In addition, the following entities are wholly or partially owned subsidiaries of the Medical Center:

		Ownership Interest	
Name of subsidiary	Tax Status	2010	2009
Mercy Transitional Care Services, Inc (MTC) *Provider of subacute services*	Tax exempt	100%	100%
Greenleaf Insurance Company, Ltd. (GIC) *Provider of self-insured general and malpractice coverage to MHS*	Foreign subsidiary	100%	100%

2. Stella Maris, Inc.

SMI is the sole member of the Stella Maris Operating Corporation, as well as the Cardinal Sheehan Center, Incorporated (CSC). SMI provides sub-acute, hospice, long-term care and adult day care to patients in the central Maryland service area, within its 406-bed long-term care facility.

CSC is engaged in maintaining and providing care and housing of aged and infirmed persons. CSC owns St. Elizabeth Hall, a 200-unit apartment complex for the elderly.

Note A - Organization and Summary of Significant Accounting Policies - Continued

3. **Maryland FamilyCare, Inc.**

   MFC provides primary care physician services within the Baltimore area.

4. **St. Paul Place Specialists, Inc.**

   SPPS provides specialty physician services within the Baltimore area.

5. **Mercy Health Foundation, Inc.**

   MHF was formed to coordinate and strengthen the fundraising function on behalf of MHS.

Income Taxes

MHS, MMC, SMI, MFC, SPPS, and MHF are not-for-profit organizations exempt from Federal income taxes under Section 501(c)(3) of the Internal Revenue Code, and are therefore not subject to federal income tax under current income tax regulations. Taxable subsidiaries of the Health System account for income taxes in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC)740, *Accounting for Income Taxes*. Deferred income taxes are recognized for the tax consequences in future years for differences between the tax basis of assets and liabilities and their financial reporting amounts at each year end. MHS subsidiaries otherwise exempt from federal and state taxation are nonetheless subject to taxation at corporate tax rates at both the federal and state level on their unrelated business income.

In June 2006, the FASB issued FASB ASC 740, *Accounting for Income Taxes*, which provides additional guidance and clarifies the accounting for uncertainty of income tax positions. FASB ASC 740 defines the threshold for recognizing tax return positions in the financial statements as "more likely than not" that the position is sustainable, based on its technical merits. FASB ASC 740 also provides guidance on the measurement, classification and disclosure of tax return positions in the financial statements. During the year ended June 30, 2009, MHS management adopted FASB ASC 740 and believes there is no impact on its consolidated financial statements.

Unrestricted, Temporarily Restricted, and Permanently Restricted Net Assets

Unrestricted net assets represent contributions, gifts, and grants which have no donor-imposed restrictions or which arise as a result of operations.

Note A - Organization and Summary of Significant Accounting Policies - Continued

Unrestricted, Temporarily Restricted, and Permanently Restricted Net Assets - Continued

Temporarily restricted net assets are subject to donor-imposed stipulations that may or will be met either by satisfying a specific purpose and/or the passage of time. Permanently restricted net assets are subject to donor-imposed stipulations that they be maintained in perpetuity. Generally, the donors of these assets permit the use of all or part of the income earned on related investments for specific purposes.

Cash Equivalents and Short-Term Investments

MHS and certain of its subsidiaries invest in money market funds and U.S. Treasury Bills, which are highly liquid and have an original maturity of ninety days or less. These financial instruments are considered cash and cash equivalents and are recorded at cost, which approximates fair value. Short-term investments are highly liquid assets that have an original maturity between three months and one year.

Restricted Cash, Cash Equivalents, and Investments

Restricted cash, cash equivalents and investments represent funds required for interest rate swap collateral and that have been set aside to cover a portion of GIC's estimated outstanding claims and donor restricted funds from permanently and temporarily restricted net assets. At June 30, 2010, restricted cash, cash equivalents and investments of $18,868 was set aside for interest rate swap collateral and $28,595 was set aside to cover estimated outstanding claims and donor restricted funds. At June 30, 2009, restricted cash, cash equivalents and investments of $17,290 was set aside for interest rate swap collateral and $27,508 was set aside to cover estimated outstanding claims and donor restricted funds.

Reclassification

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

Note A - Organization and Summary of Significant Accounting Policies - Continued

Investments

Investments include marketable equity securities with readily determinable fair values based on quoted market prices. Unrestricted investment income or losses are reported in the consolidated statements of operations as part of excess of revenues and gains over expenses and losses unless the income is restricted by donor or law. Investments received by gift or bequest are reported at fair value at the date of the donation. Investment income and changes in the fair value of temporarily restricted and permanently restricted investments are recorded as increases or decreases in unrestricted, temporarily restricted or permanently restricted net assets in accordance with the terms of the donor's original gift or bequest.

Investments also include investments in limited partnerships and other alternative investments, which are made in accordance with the investment policies of MHS and are monitored through quarterly performance reviews. 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 valued using 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 in recorded as a component of investment income in the combined 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.

Note A - Organization and Summary of Significant Accounting Policies – Continued

Donor-Restricted Gifts

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

Inventories

Inventories are stated at the lower of cost, determined by the first-in, first-out method, or market.

Deferred Financing Costs

Costs incurred in obtaining and issuing the Maryland Health and Higher Educational Facilities Authority (MHHEFA) bonds have been capitalized. These expenses are being amortized over the term of the bonds using the straight-line method. Accumulated amortization amounted to $1,707 and $1,596 at June 30, 2010 and 2009, respectively.

Recent Pronouncements

On June 30, 2009, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 168, *The* FASB Accounting Standards Codification and *the Hierarchy of Generally Accepted Accounting Principles - a replacement of FASB Statement No. 162*. On the effective date of this statement, FASB Accounting Standards Codification became the source of the authoritative U.S. accounting and reporting standards for nongovernmental entities.

In June 2009, FASB issued FASB ASC 855, *Subsequent Events*, to establish a general standard of accounting for the disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. FASB ASC 855 requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date. Subsequent events have been evaluated by management through September 1, 2010, which is the date the consolidated financial statements were available to be issued.

Note A - Organization and Summary of Significant Accounting Policies - Continued

Net Patient Service Revenues and Allowances

Net patient service revenues are reported at the estimated net realizable amounts from patients, third-party payers, and others for services rendered. MMC charges are based on rates established by the State of Maryland Health Services Cost Review Commission; accordingly, revenue reflects actual charges to patients based on rates in effect during the period in which the services are rendered (see *Note S*). SMI, MFC and SPPS are paid for services based on negotiated contracts with commercial payers and fee schedules with Medicare and Medicaid.

Contractual adjustments represent the difference between amounts billed as patient service revenue and amounts allowed by third-party payers, and are accrued in the period in which the related services are rendered.

Charity Care

MHS provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because MHS does not pursue collection of amounts determined to qualify as charity care, they are not reported as a component of net patient service revenue or patient accounts receivable (see *Note B*).

Impairment of Long-Lived Assets

MHS accounts for long-lived assets in accordance with the provisions of ASC 360-10, *"Impairment or Disposal of Long-Lived Assets" subsections*. This standard requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. Management believes that no impairment exists at June 30, 2010 and 2009.

Property and Equipment

Property and equipment are recorded at cost. Donated property and equipment are recorded at fair value at the date of the donation. Depreciation is provided on the straight-line method over the estimated useful lives of the assets, which is forty years for buildings and the parking center and ranges from three to ten years for machinery and equipment.

Note A - Organization and Summary of Significant Accounting Policies - Continued

Resident Prepayment Deposits

SMI's private pay residents are required to make a non-interest bearing prepayment of two months' room and board at the time of admission. At the time of discharge or acceptance by Medical Assistance or similar government assistance programs, any prepayment remaining after application to the resident's outstanding bill will be refunded. At June 30, 2010 and 2009, resident prepayment deposits of approximately $862 and $849, respectively, were invested in short-term investments.

Derivative Instruments

FASB ASC 815, *Accounting for Derivative Instruments and Hedging Activities* requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. MHS has entered into interest rate swap agreements to manage their interest rate risk (see *Note J*). The interest rate swaps do not qualify for hedge accounting under the provisions of FASB ASC 815; therefore, management accounts for the derivative instruments as speculative derivative instruments with the change in the fair value reflected in the statements of operations as a component of other non-operating income. Net settlement payments are reported as a component of interest cost with the exception of the instruments used to support the plan of finance for the new clinical tower. These related settlements are capitalized as part of the project during the construction period.

Accounting 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 at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Accordingly, actual results could differ from those estimates.

Excess of Revenue Over Expenses

The statements of operations include excess of revenue over expenses. Changes in unrestricted net assets which are excluded from excess of revenue over expenses, 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, and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets).

Activities that result in gains or losses unrelated to the primary operations of MHS are considered to be nonoperating.

(Dollars in thousands)

Note B – Patient Accounts Receivable, Allowance, and Charity Care

Patient accounts receivable consist of the following at June 30:

	2010	2009
Gross patient accounts receivable	$ 105,511	$ 102,827
Less:		
Allowance for doubtful accounts and contractual adjustments	(42,954)	(42,149)
Third party advances	(24,168)	(20,801)
	$ 38,389	$ 39,877

Approximately 36% and 35% of gross patient accounts receivable were due from Medicare and Medicaid at both June 30, 2010 and 2009, respectively.

The level of charity care provided by MHS, which has been excluded from net patient service revenue, totaled $13,492 and $12,329 for the years ended June 30, 2010 and 2009, respectively. MHS and certain of its subsidiaries provide structured repayment plans to patients without collateral.

Medicare reimburses MTC and SMI under a prospective payment system (PPS) for skilled nursing facility services, under which facilities are paid a fixed fee for virtually all covered services. Under PPS, each patient's clinical status is evaluated and placed into a payment category. The patient's payment category dictates the amount that the provider will receive to care for the patient on a daily basis. The per diem rate covers (i) all routine inpatient costs currently paid under Medicare Part A; (ii) certain ancillary and other items and services previously covered separately under Medicare Part B on a "pass-through" basis; and (iii) certain capital costs.

(Dollars in thousands)

Note C - Pledges Receivable, Net

At June 30, 2010, pledges receivable were $29,369 less an allowance for uncollectible pledges of $901 and a discount of $1,281. Such amounts have been discounted at 1.78%. The payment terms of the pledges receivable less the uncollectible pledges at June 30, 2010 are as follows:

2011	$	5,543
2012		4,937
2013		5,013
2014		2,692
2015		2,607
Thereafter		6,395
		27,187
Less current portion		5,543
Long-term portion	$	21,644

Note D - Property and Equipment

Property and equipment, at cost, consists of the following at June 30:

		2010		2009
Buildings and improvements	$	247,994	$	243,340
Machinery and equipment		168,813		162,094
Construction-in-progress		255,900		125,741
Parking center		41,214		41,214
Land		10,772		9,345
		724,693		581,734
Accumulated depreciation		(240,123)		(222,296)
	$	484,570	$	359,438

(Dollars in thousands)

Note D - Property and Equipment - Continued

MMC signed a construction management contract dated January 2, 2007 with Whiting Turner for the construction of a new clinical tower. The clinical tower will replace the majority of the inpatient rooms and operating rooms of the existing facility. The clinical tower will be approximately 688,000 square feet and accommodate up to 259 single patient rooms, 15 operating rooms, administrative space for certain clinical departments and space for the relocation of MMC's imaging and emergency departments.

The construction management agreement was amended on October 1, 2007. As part of the amended agreement, Whiting Turner has agreed to provide certain construction management services and to complete the construction of and site work for the clinical tower for a guaranteed maximum price not in excess of $256,492. The total cost of the clinical tower is expected to be approximately $331,807. The clinical tower is expected to open December 2010.

Note E - Funds Held by Trustee or Authority

Funds held by trustee or authority, which consist primarily of cash and government obligations (at fair value), are limited as to use as follows at June 30:

	2010	2009
Project fund	$ 71,466	$ 184,599
Debt service fund	6,257	6,229
Debt service reserve	5,151	5,057
Reserve for replacements and residual receipts	681	557
	83,555	196,442
Less current portion	6,257	6,229
Long-term portion	$ 77,298	$ 190,213

(Dollars in thousands)

Note F - Board Designated and Donor Restricted Investments

Board designated investments are set aside by the board of trustees for costs relating to the building program, replacement or improvement of existing assets, or to cover the cost of services rendered as charity care and other programs. All board designated investments are unrestricted, as the board at its discretion may undesignate the use of such funds. Donor restricted investments have been limited by donors to a specific purpose.

Board designated and donor restricted investments consist of the following at June 30:

	2010	2009
Cash	$ 48,491	$ 30,179
Equity	24,486	23,164
Fixed income	18,884	8,955
Fixed income alternatives	3,798	8,468
Equity alternatives	249	3,799
	$ 95,908	$ 74,565

Each of the alternative investments owned by MHS represent less than one-half of one percent of each respective alternative investment fund as of June 30, 2010 and 2009.

(Dollars in thousands)

Note F - Board Designated and Donor Restricted Investments - Continued

The investments above have been allocated, by source, as follow at June 30:

	2010	2009
Board designated	$ 82,735	$ 60,705
Donor restricted (temporary)	13,173	13,860
	$ 95,908	$ 74,565

Permanently restricted donor investments at June 30, 2010 and 2009 of $2,178 and $2,220, respectively are reported as restricted cash.

Earnings (losses) on investments are as follows for the years ended June 30:

	2010	2009
Unrestricted:		
Interest and dividends	$ 954	$ 523
Net realized gains	684	(6,102)
Unrealized gains (loss) on trading securities	2,835	(5,496)
	$ 4,473	$ (11,075)

Note G - Investments In and Advances to Affiliates

Investments in and advances to affiliates include investments in joint ventures in which the Medical Center has ownership interests of 50%. Investments in which the ownership interest is less than 20% are carried at cost, and investments in which the ownership interest is at least 20% and less than 51% are generally carried on the equity method.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note G - Investments In and Advances to Affiliates - Continued

MHS has investments totaling $329 at June 30, 2010 and 2009, in the following joint ventures:

		Percentage of ownership		Investment	
Joint venture	Business purpose	2010	2009	2010	2009
Premier Purchasing Partners, Inc.	Capital balance in group purchasing organization	n/a	n/a	$ 329	$ 329
Mercy Ridge, Inc.	Continuing care retirement community	50%	50%	0	0
				$ 329	$ 329

MHS recorded non-operating income of $565 and $877 related to the operations of the investments in joint ventures for the years ended June 30, 2010 and 2009, respectively.

Note H - Other Assets

Other assets consist of the following at June 30:

	2010	2009
Deferred compensation plan assets	$ 5,908	$ 8,670
Amortizable assets, net	5,292	5,807
Health insurance prepayment	810	768
Notes receivable	201	223
Other investments	457	323
	$ 12,668	$ 15,791

Note I - Reinsurance Receivable/Recoverable and Provision for Outstanding Losses

GIC management based the provision for losses at June 30, 2010 on a report dated July, 2010 prepared by GIC's independent actuaries, Complete Actuarial Solutions Co. of Bethesda, Maryland. In their report, the actuaries estimate outstanding losses at an expected confidence level, on an undiscounted basis, to be $26,749 and $26,337 net of reinsurance as of June 30, 2010 and 2009, respectively. At June 30, 2010 and 2009, GIC had $27,088 and $26,785, respectively, as its provision for outstanding losses net of reinsurance after factoring in actual losses paid to June 30th. The estimates provided by the actuaries are based on the historical data of the program blended together with relevant insurance industry loss development statistics.

Note I - Reinsurance Receivable/Recoverable and Provision for Outstanding Losses - Continued

In the opinion of the GIC management, the provision for outstanding losses relating to losses reported and losses incurred but not reported at the consolidated balance sheet dates is adequate to cover the expected ultimate liability of GIC. However, due to the nature of the insurance risks assumed, these provisions are necessarily estimates, and could vary from the amounts ultimately paid.

Consistent with most companies with similar insurance operations, GIC's provision for outstanding losses is ultimately based on management's reasonable expectations of future events. It is reasonably possible that the expectations associated with these amounts could change in the near term (i.e., within one year) and that the effect of such changes could be material to the consolidated financial statements.

GIC's estimated provision for outstanding losses exceed the GIC's retention limits by $1,733 and $1,943 for the years ended June 30, 2010 and 2009, respectively. These losses are 100% reinsured with reinsurers, and accordingly are recorded as reinsurance balances recoverable in the consolidated balance sheets.

In the event that GIC's reinsurers are unable to meet their obligations under the reinsurance agreements, GIC would still be liable to pay all losses under the insurance policies it issues, but would only receive reimbursement to the extent the reinsurers could meet their above mentioned obligations. GIC considers that all amounts included in reinsurance balances receivable and recoverable in the consolidated balance sheets will be collected in full from the reinsurers.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note J-Long - Term Debt

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

		2010		2009
MHEEFA Revenue Bonds, Mercy Medical Center Issue, Series A 2007, interest rate ranging from 4% to 5.50%, due July 1, 2042	$	153,400	$	154,250
MHEEFA Revenue Bonds, Mercy Medical center Issue, Series B, C, D 2007, variable interest rate (0.24% at June 30, 2010); due July 1, 2042		120,000		150,000
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series B, C 2007 (converted); interest rate 3.87%; due July 1, 2024		30,000		0
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2001; interest rate 5.625%; due July 1, 2031		49,480		49,480
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2006; interest rate 5.69%; due July 1, 2036		34,470		35,000
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2008 (converted); interest rate 3.99%; due July 1, 2022		30,000		0
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2008; variable interest rate (0.31% at June 30, 2010); due July 1, 2022		3,770		35,325
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 1996; interest rate ranging from 4.55% to 6.50%; due July 1, 2026 (includes tender premium of $546)		21,845		22,620
MHHEFA Revenue Bonds, Stella Maris Issue, Series 1997; variable interest rate (0.29% at June 30, 2010); due 2021		15,210		16,120
HUD mortgage loan; interest rate 6.88%; due 2020		4,995		5,237
Construction loan, bank; floating interest rate (2.61% at June 30, 2008); due 2010		0		363
Other		264		335
Total long-term debt		463,434		468,730
Less:				
Unamortized discount		2,108		2,187
Current portion		5,315		5,268
Long -term portion	$	456,011	$	461,275

(Dollars in thousands)

Note J - Long-Term Debt - Continued

Principal payments on long-term debt are as follows for the years ended June 30:

2011	$ 5,315
2012	8,175
2013	8,245
2014	8,601
2015	8,964
Thereafter	424,134
	$ 463,434

Mercy Medical Center Issue, Series 2007 (A, B, C, and D) Bonds and Series 2007 B, C (Converted)

In October 2007, Maryland Health and Higher Educational Facilities Authority ("MHHEFA") authorized the issuance, sale and delivery of its $305,000 Revenue Bonds, Mercy Medical Center Issue, Series 2007 (A, B, C and D). The proceeds were loaned by MHEEFA to MMC to finance the construction of a new replacement hospital facility. The proceeds were also used to refinance the MHHEFA Pooled Loan Revenue Bond. On April 1, 2010, $30,000 of the Revenue Bonds was converted to Bank Qualified Revenue Bonds held by a commercial bank. The converted bonds included $18,080 of the $50,000 Series B and $11,920 of the $50,000 Series C. Principal repayment on the converted bonds series begins July 1, 2012 and is paid annually through the termination date. The termination date is July 1, 2024. The converted Bonds will be subject to mandatory purchase by Mercy on April 1, 2020 at their par value, unless the bank and Mercy agree to an extension. Interest accrues at a fixed rate of 3.87%. The monthly interest payments are made directly to the bank.

Principal repayment of the Series 2007 MHHEFA Bonds began July 1, 2008 and is scheduled to be paid annually through July 1, 2042. On the Series 2007 A Bonds ($155,000 Revenue Bonds), interest accrues at a fixed rate ranging from 4.0% to 5.50%. The Series 2007 A Bonds are net of an original issue discount of $875, which is being amortized over the life of the bonds using the straight line method. Interest is payable semi-annually on January 1st and July 1st.

On the Series 2007 Bonds Series B ($31,920), C ($38,080), and D ($50,000), interest accrues at a variable rate based on the prevailing interest rate in effect as determined by the Remarketing Agent on each Calculation Date. The variable rate of interest is set to be the lower of the Maximum Rate as defined by the Indenture and the minimum rate that would enable the Remarketing Agent to sell all of the Bonds. The Series 2007 B, C, and D Bonds are net of an original issue discount of $225, which is being amortized over the life of the bonds using the straight line method. Payment on these bonds is secured by irrevocable letters of credit of $70,000 and $50,000 provided by Bank of America and Wachovia Bank, respectively. An annual letter of credit fee, equal to 0.35% and 0.38%, respectively, is payable quarterly by MMC. The Bank of America and Wachovia letters of credit expire November 8, 2012 and November 8, 2013, respectively.

Note J - Long-Term Debt – Continued

Mercy Medical Center Issue, Series 2007 (A, B, C, and D) Bonds and Series 2007 B, C (Converted) - Continued

To lower the cost of capital of the hospital replacement project, MMC entered into two interest rate swap agreements. In August 2007, a fixed spread basis swap was entered into with a notional amount of $210,000. Pursuant to the swap agreement, MMC pays the counter party a fixed interest rate equal to the USD-SIFMA Municipal Swap Index and receives interest at a variable rate equal to the sum of 67% of the USD-LIBOR-BBA and 0.54%. The interest rate swap agreement terminates on August 20, 2037. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles. At June 30, 2010 and 2009, the fair value of the interest rate swap was ($12,493) and ($12,447), respectively, and is included in other long-term liabilities in the accompanying consolidated balance sheet. At June 30, 2010 and 2009, an unrealized loss on interest rate swap totaling ($46) and ($11,702), respectively, is reflected in the accompanying consolidated statement of operations.

During October 2007, MMC entered into a fixed payer swap with a notional amount of $65,000. Pursuant to the swap agreement, MMC pays the counter party a fixed rate of 4.093% and receives a variable rate equal to the USD-SIFMA Municipal Swap Index. The interest rate swap agreement terminates on July 1, 2042. At June 30, 2010 and 2009, the fair value of the interest rate swap was ($8,732) and ($4,641), respectively, and is included in other long-term liabilities in the accompanying consolidated balance sheet. An unrealized loss on interest rate swap totaling ($4,091) and ($2,498) is reflected in the accompanying consolidated statement of operations for the fiscal years ending June 30, 2010 and 2009, respectively. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles.

Note J - Long-Term Debt – Continued

Mercy Medical Center Issue, Series 2001 Bonds

In November 2001, MHHEFA authorized the issuance, sale and delivery of its $49,480 Revenue Bonds, Mercy Medical Center Issue, Series 2001, the proceeds of which were loaned by the Authority to MMC, and together with fundraising receipts from MHS' capital campaign and amounts generated from MMC's operations, were used to finance and refinance the costs of the 2001 Additional Facilities. The 2001 Additional Facilities include expansion, renovation and equipping of certain hospital facilities, including construction of an ambulatory services building, acquisition of a parking garage and construction of an additional parking garage.

The Series 2001 Bonds are net of an original issue discount of $1,220, which is being amortized over the life of the bonds using the straight line method. The Series 2001 bonds will be subject to redemption prior to maturity beginning on July 1, 2011, at the principal amount thereof plus accrued interest to the redemption date. Interest is payable semi-annually on January 1st and July 1st. Principal repayment of these bonds begins on July 1, 2023 and is paid annually through July 1, 2031.

On December 1, 2004, the Medical Center entered into a fixed spread basis swap agreement in order to reduce the cost of capital by removing the tax risk to bond holders and transferring the risk to the Medical Center. The fixed spread basis swap matures on December 1, 2024 and the exchanges of cash flows with the counter party began March 1, 2005. The notional amount of the swap is $50,000. Pursuant to the swap agreement, the Medical Center pays the counter party a variable rate equal to the USD-SIFMA Municipal Swap Index and receives interest at a variable rate equal to the sum of 67% of USD-LIBOR-BBA and 0.60%. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles.

At June 30, 2010 and 2009, the fair value of the interest rate swap was ($688) and ($1,079), respectively and is included in other long-term liabilities in the accompanying consolidated balance sheet. An unrealized gain (loss) on interest rate swap totaling $391 and ($1,713) is reflected in the accompanying consolidated statement of operations for the fiscal years ending June 30, 2010 and 2009, respectively.

Note J - Long-Term Debt – Continued

Mercy Medical Center Issue, Series 2008 Bonds and 2009 Bank Qualified Revenue Bonds

In July 2008, MHHEFA authorized the issuance, sale and delivery of its $35,325 Revenue Bonds, Mercy Medical Center Issue, Series 2008, the proceeds of which were loaned by the Authority to MMC in order to refund the Authority's Project and Refunding Revenue Bonds, Mercy Medical Center Issue, Series 2003. On December 16, 2009, $30,000 of the Series 2008 Bonds was converted to Bank Qualified Revenue Bonds with a fixed interest rate period of approximately twelve years. The bank at its discretion has the right to call the converted bonds at the seventh and tenth year anniversary. Principal repayment of the converted bonds begins July 1, 2011 and is paid annually through July 1, 2022. Interest accrues at a fixed rate of 3.9932%. The monthly interest payments are made directly to the bank.

Principal repayment of the original bonds began on July 1, 2009 and is paid annually through July 1, 2011. Interest accrues at a variable rate based on the prevailing interest rate in effect as determined by the remarketing agent on each calculation date. The variable rate of interest is set to be the lower of the Maximum Rate as defined by the Indenture and the minimum rate that would enable the remarketing agent to sell all of the Bonds at a price equal to the principal amount thereof, plus accrued interest.

Payments on the bonds are secured by an irrevocable letter of credit in the amount of $3,770 provided by M&T Bank. The annual letter of credit fee equals 0.6% through July 4, 2010 and thereafter 0.8% of the letter of credit amount. The fee is payable quarterly by MMC. The letter of credit expires July 16, 2011.

Note J - Long-Term Debt – Continued

Mercy Medical Center Issue, Series 2006 Bonds

In August 2006, MHHEFA authorized the issuance, sale and delivery of $35,000 of Mercy Medical Center Series 2006 Revenue Bonds. The proceeds were loaned by the Authority to MMC in order to finance the construction of a new parking garage as well as the financing of certain routine capital expenditures for fiscal years 2006 and 2007.

Principal repayment of these bonds began on July 1, 2009 and is paid annually through July 1, 2036. Interest is paid semiannually on January 1st and July 1st. Interest accrues at a fixed rate of 5.69%.

Simultaneously with the issuance of the bonds, MMC entered into an interest rate swap agreement with a counter party with a notional amount of $35,000 to convert the fixed rate structure to a variable rate. Under this agreement, MMC will receive a fixed interest rate of 5.14% and pay to the counter party the USD-SIFMA Municipal Swap Index. The interest rate swap agreement terminates on August 3, 2016. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles. The value of this contract is based on two components: (i) the accrued but unpaid periodic cash flows and (ii) the termination value as defined in the agreement. By definition, the termination value is equal to the bond amount multiplied by the difference between highest price in the marketplace and the bonds base price (100%). The bonds are currently callable at par (100%) and the call price would be the highest price in the marketplace on the valuation date. This is due to the fact that MHS would be economically inclined to call the bonds at par versus paying any termination payment on the swap and the bonds are carried on MHS' books at par. With MHS prepared to call the bonds at par, the market price should immediately converge on the call price. Additionally, MHS has the right to optionally terminate the contract. The counter party does not have the right to optionally terminate the agreement. The counter party can only terminate the agreement prior to its stated maturity if an event of default or an additional termination event exists. Therefore, as of June 30, 2010 and 2009, the fair value of the swap was zero.

In anticipation of the transaction, MMC entered into a forward interest rate swap agreement on June 28, 2006 with a notional amount of $35,000 in order to convert the variable swap rate to a fixed rate. Pursuant to the swap agreement, MMC pays the counter party a fixed interest rate of 3.976% and receives a variable rate equal to 67% of the USD-LIBOR-BBA. The interest rate swap agreement terminates on July 1, 2036. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles. At June 30, 2010 and 2009, the fair value of the interest rate swap was ($7,179) and ($5,512), respectively and is included in other long-term assets (liabilities) in the accompanying consolidated balance sheet. An unrealized loss on interest rate swap totaling ($1,667) and ($2,511) is reflected in the accompanying statement of operations for the fiscal years ending June 30, 2010 and 2009, respectively.

Note J - Long-Term Debt – Continued

Mercy Medical Center Issues, Series 1996

In May 1996, MHHEFA authorized the issuance, sale and delivery of its $30,000 Revenue Bonds, Mercy Medical Center Issue, Series 1996, the proceeds of which were loaned by the Authority to MMC in order to finance and refinance the costs of the 1996 project. The 1996 project consisted of the construction, acquisition, renovation, and equipping of certain hospital facilities including certain inpatient upgrades, ambulatory care facilities, operating rooms, building infrastructure, and administrative and support service facilities.

The Series 1996 Bonds are net of original issue discounts of $302, which are being amortized over the life of the bonds using the straight line method. Interest is payable semi-annually on January 1st and July 1st. Principal repayment of these bonds began on July 1, 2004 and is paid annually through July 1, 2022.

In 2006, MMC entered into an agreement with a third party to run a tender process for the entire balance of the callable Series 1996 Bonds that totaled $19,700. MMC gave investors the choice of accepting a 1% incremental premium over the existing call premium in exchange for tendering their bonds. Any investor not tendering their bonds had their bonds redeemed at the applicable redemption price. Through the execution of a traditional bond agreement, the third party agreed to purchase the bonds from those investors who tendered their bonds.

Prior to the mailing of notice of redemption for the bonds, MMC was obligated to deposit the redemption price of the bonds with the Bonds Trustee. On June 23, 2006, MMC entered into a Notes Purchase Agreement (the "Note") with Merrill Lynch, Pierce, Fenner & Smith (Merrill Lynch). MMC borrowed $20,094 for the purpose of funding the principal ($19,700) and premium component of the redemption price ($394) of the Mercy Medical Center Issue Series 1996 Bonds. In August 2006, $18,195 of the Bonds was purchased by the third party and the Note was fully repaid. The remaining $1,505 of bonds were called and retired. A tender premium of $546 has been included in the outstanding debt and was repaid August 1, 2008.

To convert the underlying fixed rate structure to a variable rate, simultaneously with the purchase of the bonds, MMC entered into two interest rate swap agreements with a counter party with notional amounts of $13,840 and $4,355. Pursuant to the swap agreements, the counter party pays to Mercy a fixed interest rate of 5.45% and 5.325% and receives a variable rate equal to the USD-SIFMA Municipal Swap Index. The interest rate swap agreements terminate on August 2, 2016 and April 1, 2014, respectively. The interest rate swaps do not qualify for hedge accounting under generally accepted accounting principles. The value of this contract is based on two components: (i) the accrued but unpaid periodic cash flows and (ii) the termination value as defined in the agreement. By definition, the termination value is equal to the bond amount multiplied by the difference between highest price in the marketplace and the bonds base price (100%).

Note J - Long-Term Debt – Continued

Mercy Medical Center Issues, Series 1996 - Continued

The bonds are currently callable at par (100%) and the call price would be the highest price in the marketplace on the valuation date. This is due to the fact that MHS would be economically inclined to call the bonds at par versus paying any termination payment on the swap and the bonds are carried on MHS' books at par. With MHS prepared to call the bonds at par, the market price should immediately converge on the call price. Additionally, MHS has the right to optionally terminate the contract. The counter party does not have the right to optionally terminate the agreement. The counter party can only terminate the agreement prior to its stated maturity if an event of default or an additional termination event exists. Therefore, as of June 30, 2010 and 2009, the fair value of the swap was zero.

On August 1, 2008 the two interest rate swap agreements with the counterparty were amended. Pursuant to the amended swap agreement, the counter party pays to MMC a fixed interest rate of 5.75% and 5.625% and receives a variable rate equal to the sum of the USD-SIFMA Municipal Swap Index and 1.25%. The interest rate swap agreements terminate July 25, 2011.

On June 28, 2006, to convert the structure back to a fixed rate, MMC entered into a forward rate swap agreement with a notional amount of $18,741. Pursuant to the swap agreement, MMC pays the counter party a fixed interest rate of 4.031% and receives a variable rate of 67% of the USD-LIBOR-BBA. The interest rate swap agreement terminates on July 1, 2026. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles. At June 30, 2010 and 2009, the fair value of the interest rate swap was ($3,509) and ($2,685), respectively and is included in other long-term assets (liabilities) in the accompanying consolidated balance sheet. An unrealized loss on interest rate swap totaling ($824) and ($1,112) is reflected in the accompanying consolidated statement of operations for the fiscal years ended June 30, 2010 and 2009, respectively.

The bond agreements contain additional restrictive covenants with which the Medical Center is in compliance at June 30, 2010 and 2009.

Note J - Long-Term Debt - Continued

Stella Maris Issue, Series 1997 Bonds

The Series 1997 Bonds were issued to finance the acquisition by SMI of Stella Maris Operating Corporation and CSC; to advance refund certain nursing home revenue bonds previously issued by MHHEFA, Stella Maris Issue, Series 1991 and to refinance certain outstanding indebtedness of the acquired corporations.

Principal repayment of these bonds began on July 1, 2001 and is paid annually through July 1, 2021. All bonds are subject to redemption prior to maturity beginning March 1, 2001. Interest is accrued at a variable rate based on the prevailing interest rate in effect as determined by the Remarketing Agent on each Calculation Date. Interest on the bonds is payable monthly.

Under the provisions of the bond agreement, SMI has granted to MHHEFA a security interest in all of its real property and the assignment of its leases. In addition, payments on the bonds are secured by an irrevocable letter of credit provided by M&T Bank. An annual letter of credit fee, equal to 0.8% of the letter of credit amount, is payable quarterly by SMI. The letter of credit expires June 20, 2012.

Under the terms of the bond indenture, SMI is required to maintain certain deposits with a trustee. The bond indenture agreement also requires SMI to satisfy certain measures of financial performance as long as the bonds are outstanding. As of June 30, 2010 and 2009, SMI was in compliance with the financial covenant requirements of the bond indenture.

Note J - Long-Term Debt – Continued

HUD Mortgage Loan

The mortgage loan from the U.S. Department of Housing and Urban Development (HUD) was used by CSC to construct St. Elizabeth Hall. The note bears interest at 6.875% per annum and the loan is payable in monthly installments of $43, including interest, with the final payment due November 1, 2020. Concurrent with these monthly mortgage payments, St. Elizabeth Hall is required by the mortgage agreement to make monthly payments of $2 to a reserve fund for the replacement of property and equipment. These payments are required until the mortgage matures and are included in Board designated and donor restricted investments. All disbursements from this fund are contingent upon HUD's prior approval.

In July 1997, CSC received authorization from HUD to suspend its monthly principal and interest payments of $43 through December 2005. In January 2006, CSC resumed making mortgage payments in accordance with the terms of the original agreement with HUD. During this deferral period, all revenue of St. Elizabeth Hall in excess of actual operating expenses, including but not limited to payments to the replacement reserve fund, were required to be segregated and deposited into a separate account for future payments of principal and interest on the mortgage.

The liability of CSC under the mortgage note is limited to the underlying value of the real estate collateral plus other amounts deposited with the lender.

Construction Loan

The 1989 bank term loan was incurred to pay construction costs associated with a physician office building. The loan is collateralized by a first lien mortgage on various real properties. Monthly principal and interest payments are $39 and the interest rate is floating, with various rate options. The loan was paid in full during the year ended June 30, 2010.

Line-of-Credit

The Medical Center also has a $7,000 operating line of credit, and no amounts were outstanding at June 30, 2010 and 2009.

Mercy Health Services has a $15,000 line of credit for equipment and construction with PNC Bank, no amounts were outstanding at June 30, 2010.

Subsequent Events

During August 2010, the Medical Center obtained a $20,000 line of credit for equipment and construction.

Note K - Fair Value of Financial Instruments

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

Cash and cash equivalents, patient receivables, other receivables, accounts payable and accrued expenses, due to third party payers and construction retainage: The carrying amount reported in the balance sheet approximates fair value.

Short-term investments, funds held by trustee or authority and board designated and donor restricted investments: Fair values, which are the amounts reported in the balance sheet, are based on quoted market prices, if available, or estimated using quoted market prices for similar securities.

Long-term debt: Fair values of MHS' revenue bonds and other debt are based on current traded values. At June 30, 2010 and 2009, the fair value of MHS' long-term debt was approximately $450,611 and $428,182, respectively.

Fair value is generally defined 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. In accordance with current accounting standards, MHS categorizes its financial instruments using 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. The following describes the three levels of inputs used to measure fair value:

Level 1: Quoted prices in active markets for identical assets of liabilities. Level 1 assets and liabilities include debt and equity securities that are traded in an active exchange market, as well as U.S. Treasury securities.

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 2 assets and liabilities include debt securities with quoted market prices that are traded less frequently than exchange-traded instruments. This category generally includes certain U.S. government and agency mortgage-backed debt securities, corporate-debt securities, and alternative investments.

Note K - Fair Value of Financial Instruments - Continued

> Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets(s) 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. This category generally includes certain private debt and equity instruments and alternative investments.

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 MHS'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 of equity securities and mutual funds have been determined by MHS from observable market quotations, when available. Cash equivalents comprise short-term fixed income securities. Because of the nature of these assets, carrying amounts approximate fair values, which have been determined from public quotations, when available.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

The following table presents MHS's fair value hierarchy for financial instruments measured at fair value on a recurring basis as of June 30, 2010.

Assets	Level 1	Level 2	Level 3	Total Fair Value
Board designated and donor restricted investments:				
Equity	$ 23,825	$ 661	$ 0	$ 24,486
Equity alternatives	0	0	760	760
Fixed income	1,110	38,949	0	40,059
Fixed income alternatives	0	0	6,308	6,308
Cash and cash equivalents	0	24,295	0	24,295
Restricted funds:				
Equity	6,779	0	0	6,779
Fixed income	26,626	11,535	0	38,161
Cash and cash equivalents	2,523	0	0	2,523
Short-term investments:				
Cash and cash equivalents	1,527	5,391	0	6,918
Long-term investments:				
Equity	1,964	0	0	1,964
Fixed income	15,696	17,837	0	33,533
Funds held by trustee:				
Equity alternatives	0	0	48,645	48,645
Fixed income	0	17,629	0	17,629
Cash and cash equivalents	17,281	0	0	17,281
Total assets fair value	$ 97,331	$ 116,297	$ 55,713	$ 269,341
Liabilities				
Interest rate swap	$ 0	$ 0	$ 32,600	$ 32,600
Total liabilities at fair value	$ 0	$ 0	$ 32,600	$ 32,600

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

The following table presents MHS's fair value hierarchy for financial instruments measured at fair value on a recurring basis as of June 30, 2009.

Assets	Level 1	Level 2	Level 3	Total Fair Value
Board designated and donor restricted investments:				
Equity	$ 20,535	$ 3,928	$ 0	$ 24,463
Equity alternatives	0	0	4,004	4,004
Fixed income	1,349	8,116	0	9,465
Fixed income alternatives	0	0	10,345	10,345
Cash and cash equivalents	0	26,288	0	26,288
Restricted funds:				
Equity	7,982	0	0	7,982
Fixed income	9,085	25,166	0	34,251
Cash and cash equivalents	2,565	0	0	2,565
Short-term investments:				
Cash and cash equivalents	1,736	4,632	0	6,368
Long-term investments:				
Fixed income	15,291	0	0	15,291
Funds held by trustee:				
Equity alternatives	0	0	136,731	136,731
Fixed income	0	41,742	0	41,742
Cash and cash equivalents	17,969	0	0	17,969
Total assets fair value	$ 76,512	$ 109,872	$ 151,080	$ 337,464
Liabilities				
Interest rate swap	$ 0	$ 0	$ 26,365	$ 26,365
Total liabilities at fair value	$ 0	$ 0	$ 26,365	$ 26,365

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

The following table is a rollforward of the consolidated statements of financial position amounts for financial instruments classified by MHS within level 3 of the valuation hierarchy defined above as of June 30, 2010:

	Investments	Interest rate swaps
Fair value June 30, 2009	$ 151,080	$ (26,365)
Realized and unrealized (losses) gains, net	6,160	(6,235)
Purchases, issuances, and settlements, net	(101,527)	0
Fair value June 30, 2010	$ 55,713	$ (32,600)

The following table is a rollforward of the consolidated statements of financial position amounts for financial instruments classified by MHS within level 3 of the valuation hierarchy defined above as of June 30, 2009:

	Investments	Interest rate swaps
Fair value June 30, 2008	$ 189,773	$ (6,829)
Realized and unrealized (losses) gains, net	1,873	(19,536)
Purchases, issuances, and settlements, net	(40,566)	0
Fair value June 30, 2009	$ 151,080	$ (26,365)

Note L - Pension and Profit Sharing Plans

MHS has a qualified 401(k) plan covering substantially all employees of the Medical Center and SMI who have completed at least one year of service and are at least twenty-one years of age. MHS makes an annual contribution on behalf of all eligible employees based on either the employee's contributions to the Plan or their annual compensation. MHS will match, on a dollar for dollar basis based on age and years of service thresholds, the amount contributed by the employee, not to exceed 6% of the employee's salary. MHS' contributions to the 401(k) plan for all participants employed prior to April 1, 1997 for Medical Center employees or July 1, 1997 for SMI employees, vest at a rate of 25% annually and completely vested on April 1, 2001 for Medical Center employees and July 1, 2001 for SMI employees. MHS' contributions for all participants employed on or after April 1, 1997 for Medical Center employees or July 1, 1997 for SMI employees vest after four years of service, with no vesting prior to four years of service. Contributions under this plan totaled approximately $3,310 and $3,377 for the years ended June 30, 2010 and 2009, respectively.

Note L - Pension and Profit Sharing Plans - Continued

The Medical Center has a nonqualified deferred compensation plan for certain executives and physicians. The deferred compensation plan provides for severance and supplemental retirement benefits as defined in the plan. Compensation expense related to the deferred compensation plan was $517 and $730 for the years ended June 30, 2010 and 2009, respectively. Total deferred compensation obligations of $5,908 and $8,669 are included in other long-term liabilities in the consolidated balance sheets at June 30, 2010 and 2009, respectively. The related deferred compensation plan assets are all invested in level one equity investments and are classified as other assets in the consolidated balance sheets for the years ended June 30, 2010.

(Dollars in thousands)

Note M - Post-Retirement Benefit Plan

MHS has an unfunded contributory health and medical post-retirement benefit plan available to all eligible employees who meet certain age and length of service requirements. The plan provides for health and medical benefits including primary care physician and specialist visits, hospitalization and emergency care, prescription drugs, vision care, and Medicare supplemental coverage.

The following table sets forth the components of the MHS' obligation at June 30:

	2010	2009
Change in Benefit Obligation		
Benefit obligation at beginning of year	$ 7,145	$ 6,706
Service cost	148	163
Interest cost	271	397
Actuarial loss (gain)	(1,732)	74
Benefit paid	(130)	(195)
Benefit obligation at end of year	5,702	7,145
Change in Plan Assets		
Employer contribution	130	195
Plan participant's contribution	396	395
Medicare Part D reimbursement	93	86
Benefits paid	(619)	(676)
Fair value of plan assets at end of year	0	0
Fund status	(5,702)	(7,145)
Unrecognized actuarial loss	0	0
Accrued post-retirement benefit cost for MHS Plan	(5,702)	(7,145)
Less current portion, included in accounts payable and accrued expenses	(164)	(164)
Total accrued post-retirement benefit cost, long-term portion	$ (5,538)	$ (6,981)

(Dollars in thousands)

Note M - Post-Retirement Benefit Plan – Continued

Net periodic post-retirement benefit cost included the following for the years ended June 30:

	2010	2009
Service cost - benefits attributed to service during the period	$ 148	$ 163
Interest cost on accumulated post-retirement benefit obligation	271	397
Net post-retirement benefit cost	$ 419	$ 560

The weighted average discount rate used in determining the accumulated post-retirement benefit obligation (APBO) for the Medical Center's Plan was 5.0% and 6.0% for the years ended June 30, 2010 and 2009, respectively. For measurement purposes, the health care cost trend rates used in determining the APBO for the Medical Center's Plan was 8.0% and 8.5% in 2010 and 2009, respectively. Increasing the health care cost trend rates by 1% would increase the APBO by $972 and aggregate service and interest cost by $112 at June 30, 2010.

Note N - Retirement Annuity Plan

MHS had a pension plan that was terminated on April 1, 1997 and established a retirement annuity plan (the Plan) under which certain participants of the terminated plan were entitled to annuity payments. Participants to the plan include (a) the retirees and beneficiaries entitled to benefits from the terminated plan on April 1, 1997 and (b) other participants with benefits worth more than $4 that elected an annuity. All benefits are vested and based on the frozen accrued benefits at April 1, 1997.

(Dollars in thousands)

Note N - Retirement Annuity Plan – Continued

The measurement dates for fiscal years 2010 and 2009 were June 30, 2010 and June 30, 2009, respectively. The following table sets forth the funded status of the retirement annuity plan and amounts recognized in MHS' financial statements:

	2010	2009
Change in Benefit Obligation		
Benefit obligation at beginning of year	$ 11,030	$ 12,011
Interest cost	620	846
Actuarial loss	597	13
Benefit paid	(1,378)	(1,840)
Benefit obligation at end of year	10,869	11,030
Change in Plan Assets		
Fair value of plan assets at beginning of year	7,073	10,387
Actuarial return on plan assets	1,270	(1,474)
Benefits paid	(1,378)	(1,840)
Fair value of plan assets at end of year	6,965	7,073
Fund status	(3,904)	(3,957)
Unrecognized actuarial loss (gain)	0	0
Prepaid (accrued) benefit cost	$ (3,904)	$ (3,957)

The discount rate was 5.0% and 6.0% for 2010 and 2009, respectively. The expected rate of return on plan assets was 6.50% for 2010 and 2009. The Medical Center had net pension cost of $206 in 2010 and $62 in 2009.

MHS' expected rate of return is evaluated annually and is based on the current interest rate environment, rate of inflation, allocation of the plan assets among various investment options and other market conditions.

(Dollars in thousands)

Note N - Retirement Annuity Plan - Continued

The fair value of the plan assets as of June 30, 2010 was $6,965. MHS' retirement annuity plan weighted-average asset allocations as of June 30, 2010 and 2009, by asset category were as follows:

	June 30,	
	2010	**2009**
Asset Category		
Equity securities	48%	59%
Fixed income alternatives	18%	31%
Cash and cash equivalents	30%	6%
Equity alternatives	4%	4%
Total	100%	100%

MHS' asset allocation guidelines at June 30, 2010 are as follows:

	Ranges	Target Allocation
TOTAL EQUITY	30-65%	50%
Domestic equity	30-65%	40%
International equity	0-15%	10%
EQUITY ALTERNATIVES	0-50%	0%
FIXED INCOME ALTERNATIVES	0-40%	35%
CASH	5-25%	15%

The fair values of the Plan assets as of June 30, 2010 by asset category are as follows:

Assets	Level 1	Level 2	Level 3	Total Fair Value
Board Designated and Donor Restricted Investments:				
Equity	$ 3,135	$ 0	$ 0	$ 3,135
Equity alternatives	0	0	302	302
Fixed income alternatives	0	0	1,257	1,257
Cash and cash equivalents	82	2,189	0	2,271
Total assets fair value	$ 3,217	$ 2,189	$ 1,559	$ 6,965

(Dollars in thousands)

Note N - Retirement Annuity Plan - Continued

The following table is a rollforward of the fair value amounts for financial instruments classified by the Plan within level 3 of the valuation hierarchy above:

	Alternative Investments
Fair value June 30, 2009	$ 2,531
Realized and unrealized (losses) gains, net	151
Purchases, issuances, and settlements, net	(1,123)
Fair value June 30, 2010	$ 1,559

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

	Pension Benefits
2011	$ 1,338
2012	1,278
2013	1,219
2014	1,154
2015	1,088
Years 2016 - 2020	4,386

Note O - Supplemental Cash Flow Information

Cash payments for interest, net of amounts capitalized and swap payments, were $7,130 in 2010 and $7,589 in 2009. Capitalized interest related to construction activities includes, interest payments to creditors on bonds, net payments/receipts to counterparties on interest rate swap arrangements, and income received on trustee-held funds, totaling $4,373 for 2010 and ($3,012) for 2009.

(Dollars in thousands)

Note P-Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following health care services at June 30:

	2010	2009
Capital improvements	$ 26,984	$ 30,003
Departmental expenses	5,199	4,784
Pastoral Care	4,763	4,763
Research programs	1,752	1,808
Indigent care	1,430	1,377
Education programs	173	273
Other	60	11
	$ 40,361	$ 43,019

Permanently restricted net assets consist of the following at June 30:

	2010	2009
SMI Hospice Endowment	$ 1,055	$ 1,055
Weinberg Endowment	1,000	1,000
Dr. Goodman Endowment	123	165
	$ 2,178	$ 2,220

During fiscal year 2009, in accordance with FASB ASC 958-205 (see *Note V*), MHS reclassified previously contributed funds that will ultimately become expendable by MHS from permanently restricted to temporarily restricted net assets.

Note Q - Functional Expenses

MHS and its subsidiaries provide general health care services to patients within their geographic location. Expenses related to providing these services are as follows for the years ended June 30:

	2010	2009
Health care services	$ 359,455	$ 339,905
Administrative and support services	133,870	140,032
	$ 493,325	$ 479,937

Note R - Commitments and Contingent Liabilities

Litigation

MHS has outstanding litigation involving claims brought against it in the normal course of business. Litigation in the normal course of business, as well as responses to claims and investigations described below, can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of complex legal proceedings and government investigations are difficult to predict. Attorneys for MHS are representing MHS in all of these matters. Management is currently unable to estimate, with reasonable certainty, the possible loss, or range of loss, if any, for such lawsuits and investigations. Management of MHS is unable to determine the amount of any possible settlements for such lawsuits and investigations, but is of the opinion that all of the lawsuits are covered by MHS' insurance policy.

MHS is subject to asserted and unasserted claims (in addition to litigation) encountered in the ordinary course of business. As a result of the current increased governmental and public concerns with health care fraud and abuse, management recognizes that additional investigative activity could occur in the future. In the opinion of management and after consultation with legal counsel, management believes it has established adequate accrued reserves related to all known matters. The outcome of any potential investigative, regulatory or prosecutorial activity that may occur in the future cannot be predicted with certainty, however, and any associated potential future losses resulting from such activity could have a material adverse effect on the future financial position, results of operations and liquidity of MHS.

Self-Insurance Programs

As discussed in *Notes A* and *I*, Greenleaf Insurance Company, Ltd. (GIC) provides general and professional liability coverage to MHS. Such coverage provides both primary and excess liability coverage. GIC retains the risk related to the primary policy and reinsures the whole of the excess policies. Insurance policy limits vary by year; however, management believes such amounts are appropriate to cover any general and professional liabilities losses, if any.

(Dollars in thousands)

Note R - Commitments and Contingent Liabilities - Continued

GIC provided coverage up to the following primary limits for the periods ending June 30:

	2010	2009
Healthcare Professional Liability	$5,000 per occurrence $15,000 aggregate	$5,000 per occurrence $15,000 aggregate
Managed Care Organization Liability	$5,000 per occurrence $15,000 aggregate	$5,000 per occurrence $15,000 aggregate
Commercial General Liability	$5,000 per occurrence $15,000 aggregate	$5,000 per occurrence $15,000 aggregate

GIC also provides an excess policy to MHS and its subsidiaries for $75,000 per occurrence and $75,000 in the aggregate that is reinsured with a commercial insurance company.

In management's opinion, the assets of GIC are sufficient to meet its obligations as of June 30, 2010. If the financial condition of GIC were to materially deteriorate in the future, and GIC was unable to pay its claim obligations, the responsibility to pay those claims would return to MHS.

MHS and certain of its subsidiaries are self-insured against employee medical claims. Plan expenses include claims incurred and provisions for unreported claims. However, the program has an annual aggregate stop loss provision per employee.

MHS and certain of its subsidiaries are self-insured against workers compensation claims and have surety bonds of $2,200 (for claims arising after June 2004) as collateral for such claims. For claims that occurred between December 18, 2002 and June 2004, the surety coverage is limited to $1,950. For claims that occurred prior to December 18, 2002, the surety coverage is limited to $1,400.

MHS and certain of its subsidiaries are self-insured against unemployment claims and have surety bonds of $1,475 for the Medical Center, Inc and $350 for SMI. The amounts change each October 1st as dictated by the Department of Licensing and Regulation.

(Dollars in thousands)

Note R - Commitments and Contingent Liabilities - Continued

Lease Commitments

The Medical Center and MFC have entered into separate long term leases for commercial space. The leases contain escalation clauses and charges for other costs related to the leased space. Future minimum payments for these leases for each of the years ended June 30 are as follows:

2011	$	2,762
2012		3,419
2013		3,098
2014		2,887
2015		2,639
Thereafter		13,146
	$	27,951

MHS and certain of its subsidiaries have other office space leases. Rent expense for the years ended June 30, 2010 and 2009 was $3,622 and $3,492, respectively.

The Medical Center and MFC have entered into separate long term operating leases for equipment. The leases contain escalation clauses and charges for other costs related to the leased space. Future minimum payments for these leases for each of the years ended June 30 are as follows:

2011	$	1,567
2012		1,450
2013		1,021
2014		516
2015		516
	$	5,070

MHS and certain of its subsidiaries have other operating leases for equipment. Equipment expense for the years ended June 30, 2010 and 2009 was $2,258 and $1,957, respectively.

Note S - Maryland Health Services Cost Review Commission

The Medical Center's charges are subject to review and approval by the State of Maryland Health Services Cost Review Commission (the Commission). Management has made the required filings with the Commission and believes the Medical Center to be in compliance with the Commission's requirements.

The Commission established an uncompensated care fund whereby all hospitals are required to contribute 0.75% of revenues to this fund to help provide for the cost associated with uncompensated care for certain Maryland hospitals above the State average. In December 2008, the Commission modified this mechanism to finance uncompensated care statewide. The new policy implemented 100% pooling and all Maryland hospitals have the same percentage of uncompensated care in rates. High uncompensated care hospitals receive funds and low uncompensated care hospitals pay into the fund. The Medical Center's net receipt $1,561 and $1,271 for 2010 and 2009, respectively.

Effective April 1, 1999, the Medical Center entered into a charge per case (CPC) agreement with the Commission for inpatient services. This reimbursement system provides for periodic (usually annual) updates for inflation, case mix, hospitals' relative charge position, and other factors. On July 1, 2010, the Medical Center entered into a charge per visit (CPV) agreement with the Commission for outpatient services. This outpatient reimbursement system is designed to be similar to the inpatient system providing periodic (usually annual) updates for inflation, case mix, and other factors.

The CPC methodology was in place for the fiscal year ending June 30, 2010. The CPV methodology is expected to be in place for fiscal years beginning July 1, 2010.

Note T - Housing Assistance Payment Contract

The U.S. Federal Housing Administration (FHA) has contracted with CSC under Section 8 of Title II of the Housing and Community Development Act of 1974 to make housing assistance payments to CSC on behalf of certified tenants. For fiscal year 2010, the maximum contract commitment was $1,055 per year. During the years ended June 30, 2010 and 2009, CSC received housing assistance payments of $374 and $540, respectively, which are included in patient service revenue. The contract had automatic annual renewals through March 2010 and has been renewed for automatic renewals through March 2011.

Note U - Certain Risks and Uncertainties

Regulation and Reimbursement

MHS provides health care services primarily through an acute care hospital in Baltimore City and a long-term care facility in Baltimore County, Maryland.

MHS and other healthcare providers in Maryland are subject to certain inherent risks, including the following:

- Dependence on revenues derived from reimbursement by the Federal Medicare and State Medicaid programs;
- Regulation of hospital rates by the State of Maryland Health Services Cost Review Commission;
- Government regulation, government budgetary constraints and proposed legislative and regulatory changes; and
- Lawsuits alleging malpractice and related claims.

Such inherent risks require the use of certain management estimates in the preparation of MHS' financial statements and it is reasonably possible that a change in such estimates may occur.

The Medicare and state Medicaid reimbursement programs represent a substantial portion of MHS' revenues and MHS' operations are subject to a variety of other Federal, state and local regulatory requirements. Failure to maintain required regulatory approvals and licenses and/or changes in such regulatory requirements could have a significant adverse effect on MHS. Changes in Federal and state reimbursement funding mechanisms and related government budgetary constraints could have a significant adverse effect on MHS.

Note U - Certain Risks and Uncertainties - Continued

Investments

MHS and certain of its subsidiaries have funds on deposit with financial institutions in excess of amounts insured by the Federal Deposit Insurance Corporation.

Certain alternative investments held in the MHS portfolio are exposed to potential risks in excess of the risks associated with the other investments in the MHS portfolio. These include, but are not limited to, the following potential risks:

- limited or no liquidity (including "side pocket" arrangements),
- derivative financial instruments that expose the investment funds to market risk (if the market value of the contract is higher or lower than the contract price at the maturity date) and credit risk (arising from the potential inability of counterparties to perform under the terms of the contracts),
- investment in non-marketable securities that are valued without the benefit of an active secondary market,
- substantially less regulation, and
- no current income production.

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 legislative initiatives to ameliorate these conditions, global credit markets have not fully rebounded, and the global economy has sustained a deep and prolonged recession. These conditions create uncertainty regarding MHS's future ability to access capital and the cost of such capital. The resulting impact on the future financial position, results of operations and cash flows of MHS could be material.

Note V – Endowment

In August 2008, the FASB issued FASB ASC 958-205, *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for All Endowment Funds* which, among other things, provides 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 Act of 2006 (UPMIFA) and additional disclosures about an organization's endowment funds. In 2008, the State of Maryland adopted UPMIFA. The adoption of UPMIFA had no effect on accounting for MHS's endowment. The following disclosures are made as required by FASB ASC 958-205.

MHS endowment consists of approximately three individual funds established for a variety of purposes. The endowments include both donor-restricted endowment funds and funds designated by the board of trustees to function as endowments. As required by generally accepted accounting principles, net assets associated with endowment funds, including funds designated by the board of trustees to function as endowments, are classified and reported based on the existence or absence of donor-imposed restrictions.

The board of trustees of MHS 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, MHS classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts donated to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the organization in a manner consistent with the standard of prudence prescribed by SPMIFA. In accordance with SPMIFA, MHS 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 organization 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 organization
(7) The investment policies of the organization.

(Dollars in thousands)

Note V – Endowment - Continued

MHS has adopted an investment policy for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment 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.

To satisfy its long term rate-of-return objectives, MHS 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). MHS targets a diversified asset allocation that places a greater emphasis on equity-based investments to achieve its long-term return objectives within prudent risk constraints.

At June 30, 2010, the endowment net asset composition by type of fund consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted funds	$ 0	$ (435)	$ 2,178	$ 1,743
Total funds	$ 0	$ (435)	$ 2,178	$ 1,743

At June 30, 2009, the endowment net asset composition by type of fund consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted funds	$ 0	$ (658)	$ 2,220	$ 1,562
Total funds	$ 0	$ (658)	$ 2,220	$ 1,562

(Dollars in thousands)

Note V – Endowment - Continued

Changes in endowment net assets for the fiscal year ended June 30, 2010, consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	$ 0	$ (658)	$ 2,220	$ 1,562
Investment return:				
Investment gain	0	225	0	225
Total investment loss	0	225	0	225
Appropriation of endowment asset for expenditure	0	(2)	0	(2)
Other changes:				
Reclassification of net assets	0	0	(42)	(42)
Endowment net assets, end of year	$ 0	$ (435)	$ 2,178	$ 1,743

Changes in endowment net assets for the fiscal year ended June 30, 2009, consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	$ 0	$ (42)	$ 8,125	$ 8,083
Investment return:				
Investment loss	0	(569)	0	(569)
Total investment loss	0	(569)	0	(569)
Contributions	0	0	20	20
Appropriation of endowment asset for expenditure	0	(47)	0	(47)
Other changes:				
Reclassification of net assets	0	0	(5,925)	(5,925)
Endowment net assets, end of year	$ 0	$ (658)	$ 2,220	$ 1,562

(Dollars in thousands)

Note W – Other Long-Term Liabilities

Other long-term liabilities consist of the following at June 30:

	2010	2009
Interest rate swaps	$ 32,600	$ 26,365
Deferred compensation plan	5,908	8,669
Retirement annuity plan	3,904	3,957
GIC claims estimated tail	1,000	0
Other	444	453
	$ 43,856	$ 39,444

COHEN
RUTHERFORD
+ KNIGHT PC
Certified Public Accountants

Report of Independent Auditors on Other Financial Information

The Board of Trustees
Mercy Health Services, Inc. and Subsidiaries
Baltimore, MD

The 2010 audited consolidated financial statements of Mercy Health Services, Inc. and Subsidiaries and our report thereon are presented in the preceding section of this report. The audit was made for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The supplemental consolidating information presented hereinafter as of and for the year ended June 30, 2010 is presented for purposes of additional analysis of the basic consolidated financial statements rather than to present the balance sheets and statements of operations of the individual entities, and is not a required part of the basic consolidated financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic consolidated financial statements taken as a whole.

Cohen, Rutherford + Knight, P.C.

September 1, 2010

6903 Rockledge Drive, Suite 500, Bethesda, MD 20817 Tel: 301.828.1000 Fax: 301.530.3625

Mercy Health Services, Inc. and Subsidiaries
Consolidating Balance Sheet Information
June 30, 2010
(Dollars in thousands)

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	St. Paul Place Specialists, Inc.	Maryland Family Care, Inc.	Eliminations	Consolidated
ASSETS								
CURRENT ASSETS								
Cash, cash equivalents and short term investments	$ 2,465	$ 1,397	$ 61,147	$ 10,285	$ 152	$ (12)	$ 0	$ 75,434
Current portion of funds held by trustee or authority	0	0	5,301	956	0	0	0	6,257
Resident prepayments/security deposits	0	0	0	862	0	0	0	862
Patient receivables, net	0	0	22,654	3,488	9,847	2,400	0	38,389
Other receivables, net	540	0	2,632	(423)	479	8	(845)	2,391
Current pledges receivable, net	0	5,543	0	0	0	0	0	5,543
Other current assets	0	0	7,195	227	188	39	0	7,649
TOTAL CURRENT ASSETS	3,005	6,940	98,929	15,395	10,666	2,435	(845)	136,525
PROPERTY AND EQUIPMENT	0	6	454,082	27,263	820	2,399	0	484,570
INVESTMENTS AND OTHER ASSETS								
Funds held by trustee or authority, less current portion	0	0	76,617	681	0	0	0	77,298
Long-term investments	10,455	0	25,042	0	0	0	0	35,497
Board designated and donor restricted investments	1,378	7,983	77,923	8,624	0	0	0	95,908
Restricted cash	0	2,055	45,408	0	0	0	0	47,463
Interest in net assets of MHF	0	0	32,684	4,419	0	0	(37,103)	0
Long-term pledges receivable, net	0	21,644	0	0	0	0	0	21,644
Investments in and advances to affiliates	9,174	(479)	15,060	(620)	(8,587)	(11,206)	(3,000)	342
Reinsurance balances receivable	0	0	1,733	0	0	0	0	1,733
Other assets	138	0	10,058	476	1,239	757	0	12,668
TOTAL ASSETS	$ 24,150	$ 38,149	$ 837,536	$ 56,238	$ 4,138	$ (5,615)	$ (40,948)	$ 913,648

Mercy Health Services, Inc. and Subsidiaries
Consolidating Balance Sheet Information-Continued
June 30, 2010
(Dollars in thousands)

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	St. Paul Place Specialists, Inc.	Maryland Family Care, Inc.	Eliminations	Consolidated
LIABILITIES AND NET ASSETS								
CURRENT LIABILITIES								
Current maturities of long-term debt	$ 26	$ 0	$ 4,075	$ 1,214	$ 0	$ 0	$ 0	$ 5,315
Accounts payable and accrued expenses	25	46	49,366	6,802	6,706	2,490	(958)	64,477
Resident prepayments/security deposits	0	0	0	852	0	0	0	852
Construction retainage	0	0	10,467	0	0	0	0	10,467
TOTAL CURRENT LIABILITIES	51	46	63,908	8,868	6,706	2,490	(958)	81,111
Long-term debt	238	0	436,782	18,991	0	0	0	456,011
Accrued interest	0	0	0	3,374	0	0	0	3,374
Provision for outstanding losses	0	0	28,821	0	0	0	0	28,821
Post-retirement obligation	0	0	5,538	0	0	0	0	5,538
Other long-term liabilities	0	116	43,740	0	0	0	0	43,856
TOTAL LIABILITIES	289	162	578,789	31,233	6,706	2,490	(958)	618,711
NET ASSETS								
Unrestricted	23,861	884	223,642	17,576	(2,573)	(8,105)	(2,887)	252,398
Temporarily restricted	0	35,048	33,982	6,374	5	0	(35,048)	40,361
Permanently restricted	0	2,055	1,123	1,055	0	0	(2,055)	2,178
TOTAL NET ASSETS	23,861	37,987	258,747	25,005	(2,568)	(8,105)	(39,990)	294,937
TOTAL LIABILITIES AND NET ASSETS	$ 24,150	$ 38,149	$ 837,536	$ 56,238	$ 4,138	$ (5,615)	$ (40,948)	$ 913,648

Mercy Health Services, Inc. and Subsidiaries
Consolidating Statement of Operations Information
Year ended June 30, 2010
(Dollars in thousands)

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	St. Paul Place Specialists, Inc.	Maryland Family Care, Inc.	Eliminations	Consolidated
REVENUES								
Net patient service revenues	$ 0	$ 0	$ 364,986	$ 44,347	$ 69,223	$ 21,813	$ 0	$ 500,369
Other operating revenues	1,147	1,335	17,552	5,915	3,226	407	(9,001)	20,581
Net assets released from restrictions used for operations	0	0	1,266	951	206	0	0	2,423
TOTAL REVENUES	1,147	1,335	383,804	51,213	72,655	22,220	(9,001)	523,373
EXPENSES								
Salaries and benefits	1,114	925	162,846	32,842	58,977	17,966	(2,772)	271,898
Medical and surgical supplies	0	0	38,663	766	291	233	0	39,953
Pharmacy supplies	0	0	22,374	923	256	1,453	0	25,006
Other expendable supplies	0	343	18,506	3,827	649	371	0	23,696
Professional fees	0	0	8,059	2,731	4,428	377	(1,258)	14,337
Insurance	0	0	5,702	799	3,212	264	12	9,989
Other purchased services	6	293	41,172	3,172	(790)	852	(5,227)	39,478
Interest expense	1	0	6,739	468	0	0	0	7,208
Repairs	0	10	7,398	609	178	252	0	8,447
Depreciation and amortization	0	4	21,604	2,180	828	609	0	25,225
Provisions for bad debt	0	0	20,975	735	5,508	870	0	28,088
TOTAL EXPENSES	1,121	1,575	354,038	49,052	73,537	23,247	(9,245)	493,325
OPERATING INCOME (LOSS)	26	(240)	29,766	2,161	(882)	(1,027)	244	30,048

Mercy Health Services, Inc. and Subsidiaries
Consolidating Statement of Operations Information - Continued
Year ended June 30, 2010
(Dollars in thousands)

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	St. Paul Place Specialists, Inc.	Maryland Family Care, Inc.	Eliminations	Consolidated
OTHER INCOME (EXPENSES)								
Investment income	41	55	1,599	2	0	0	(59)	1,638
Equity in gains of affiliates	565	0	0	0	0	0	0	565
Net unrealized gain(loss) on trading securities	613	185	2,076	146	0	0	(185)	2,835
Unrealized loss on interest rate swap	0	0	(6,235)	0	0	0	0	(6,235)
Loss on early extinguishment of debt	0	0	(286)	0	0	0	0	(286)
Gain (loss) on asset disposal	0	0	0	0	(25)	0	0	(25)
Other	0	0	53	0	0	0	0	53
NET OTHER EXPENSES	1,219	240	(2,793)	148	(25)	0	(244)	(1,455)
EXCESS (DEFICIT) OF REVENUES OVER EXPENSES	1,245	0	26,973	2,309	(907)	(1,027)	0	28,593
Changes to post retirement plans obligations	0	0	1,991	0	0	0	0	1,991
Net assets released from restrictions for the purchase of property and equipment	0	0	5,926	(171)	0	0	0	5,755
INCREASE (DECREASE) IN UNRESTRICTED NET ASSETS	$ 1,245	$ 0	$ 34,890	$ 2,138	$ (907)	$ (1,027)	$ 0	$ 36,339

Mercy Medical Center, Inc.
Income Statement
FY Ended 6.30.2010
(Amounts in Thousands)

Net Operating Revenue:		
Net Patient Service Revenue	$	361,150
Other Operating Revenues		13,876
Net Assets Released- Operations		1,266
Total Operating Revenue	$	376,292
Operating Expenses:		
Salaries & Benefits	$	160,626
Medical/Surgical Supplies		38,554
Pharmacy Supplies		22,119
Other Supplies		18,683
Professional Fees		7,999
Insurance		5,924
Other Purchased Services		40,460
Interest Expense		6,739
Repairs		7,398
Depreciation & Amortization		21,583
Provision for Bad Debt		20,975
Total Operating Expense	$	351,060
Income from Operations	$	25,232
Investment Income (Loss)		1,599
Extinguisment of Debt		(286)
Unrealized Gain (Loss) on Interest Rate Swap		(6,235)
Unrealized Gain (Loss) on Trading Securities		2,967
Other		53
Excess of Expenses over Revenue	$	23,330
Change in Post Retirement Plan Oblig		1,991
Released Restricted Assets		5,926
Change in Net Assets	$	31,247

Mercy Medical Center, Inc.
Balance Sheet
6.30.2010
(Amounts in Thousands)

Assets:		
Cash & Short Term Investments	$	58,934
Current Portion of Cash Held by Trustee		5,301
Patient Receivables (Hospital)		21,652
Other Receivables		2,846
Other Current Assets		7,188
Total Current Assets	$	95,921
Plant, Property & Equipment, Net		453,852
Funds Held by Trustee		76,617
Board Designated Funds		77,923
Long Term Investments		17,487
Restricted Cash		19,336
Other Assets		43,608
Due from Subsidiaries		9,907
Total Assets	$	794,651
Liabilities:		
Accounts Payable & Accrued Expenses	$	48,513
Current Portion of Long Term Debt		4,075
Construction Retainage		10,467
Total Current Liabilities	$	63,055
Long Term Debt		436,782
Post Retirement Obligation		5,538
Other Long Term Liabilities		43,740
Total Liabilities	$	549,115
Unrestricted Fund Balance		210,431
Temporarily Restricted Fund Balance		33,982
Permanently Restricted Fund Balance		1,123
Total Liabilities & Fund Balance	$	794,651