KPMG

ST. MARY'S HOSPITAL OF ST. MARY'S COUNTY, INC. AND SUBSIDIARIES

Consolidated Financial Statements and Supplemental Information

June 30, 2010

(With Independent Auditors' Report Thereon)

ST. MARY'S HOSPITAL OF ST. MARY'S COUNTY, INC. AND SUBSIDIARIES

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KPMG LLP
1 East Pratt Street
Baltimore, MD 21202-1128

Independent Auditors' Report

The Board of Directors
St. Mary's Hospital of St. Mary's County, Inc. and Subsidiaries:

We have audited the consolidated balance sheet of St. Mary's Hospital of St. Mary's County, Inc. and Subsidiaries (the Hospital) as of June 30, 2010 and the related consolidated statements of operations and changes in net assets, and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Hospital's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit 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 the Hospital's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides 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 St. Mary's Hospital of St. Mary's County, Inc. and Subsidiaries as of June 30, 2010, and the results of their operations and their cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

Our audit was made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The 2010 consolidating information included in schedules 1 and 2 is presented for purposes of additional analysis of the 2010 consolidated financial statements rather than to present the financial position, and results of operations of the individual companies. The 2010 consolidating information has been subjected to the auditing procedures applied in the audit of the 2010 consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

KPMG LLP

October 28, 2010

ST. MARY'S HOSPITAL OF ST. MARY'S COUNTY, INC. AND SUBSIDIARIES

Consolidated Balance Sheet

June 30, 2010

Assets

Current assets:		
Cash and cash equivalents	$	24,837,882
Investments		2,304,526
Assets whose use is limited or restricted		3,602,953
Receivables:		
From patient services (less allowances for uncollectible accounts of $4,889,337)		17,178,138
Notes receivables, current portion		432,381
Other		701,730
		18,312,249
Inventories		2,603,143
Prepaids and other current assets		1,127,569
Total current assets		52,788,322
Assets whose use is limited or restricted		11,116,413
Property and equipment, net		75,830,533
Investments in unconsolidated affiliates		2,523,693
Notes receivables, net of current portion		632,498
Deferred financing costs, net		706,112
Total assets	$	143,597,571

(Continued)

ST. MARY'S HOSPITAL OF ST. MARY'S COUNTY, INC. AND SUBSIDIARIES

Consolidated Balance Sheet

June 30, 2010

Liabilities and Net Assets

Current liabilities:		
Accounts payable and accrued expenses	$	6,936,874
Accrued salaries, benefits, and payroll taxes		3,918,039
Amounts due to third-party payors		2,811,311
Current portion of long-term debt		4,762,583
Current portion of self insurance liabilities		757,656
Other current liabilities		3,853,185
Total current liabilities		23,039,648
Long-term debt, net of current portion		32,134,719
Self insurance liabilities, net of current portion		1,475,000
Pension liabilities		2,941,627
Other long-term liabilities, net of current portion		3,049,236
Total liabilities		62,640,230
Net assets:		
Unrestricted		77,363,854
Temporarily restricted		3,493,487
Permanently restricted		100,000
Total net assets		80,957,341
Total liabilities and net assets	$	143,597,571

See accompanying notes to consolidated financial statements.

ST. MARY'S HOSPITAL OF ST. MARY'S COUNTY, INC. AND SUBSIDIARIES

Consolidated Statement of Operations

Year ended June 30, 2010

Unrestricted revenues, gains, and other support:	
Net patient service revenue:	
Hospital inpatient services	$ 59,226,782
Hospital outpatient services	53,312,453
Other patient service revenue	2,098,246
Total net patient service revenue	114,637,481
Other operating revenue	3,213,058
Net assets released from restrictions for operations	772,129
Interest income and dividends	206,123
Realized net losses on investments	(7,207)
Unrealized net gains on investments	118,986
Earnings from unconsolidated affiliates	217,090
Total unrestricted revenues, gains, and other support	119,157,660
Expenses:	
Personnel	59,301,896
Supplies	18,709,179
Purchased services	11,843,749
Other operating	9,863,493
Provision for bad debts	5,568,010
Interest expense	1,267,450
Depreciation and amortization	7,398,774
Pension and other expenses related to merger	1,576,391
Loss on disposal of equipment	261,714
Total expenses	115,790,656
Excess of revenues, gains, and other support over expenses	$ 3,367,004

See accompanying notes to consolidated financial statements.

(Continued)

ST. MARY'S HOSPITAL OF ST. MARY'S COUNTY, INC. AND SUBSIDIARIES

Consolidated Statement of Changes in Net Assets

Year ended June 30, 2010

Unrestricted net assets:		
Excess of revenues, gains and other support over expenses	$	3,367,004
Change in funded status of defined benefit plans		979,575
Equity transfer from Parent		826,944
Increase in unrestricted net assets		5,173,523
Temporarily restricted net assets:		
Contributions		437,006
Net assets released from restrictions for operations		(772,129)
Decrease in temporarily restricted net assets		(335,123)
Increase in net assets		4,838,400
Net assets, beginning of year		76,118,941
Net assets, end of year	$	80,957,341

See accompanying notes to consolidated financial statements.

ST. MARY'S HOSPITAL OF ST. MARY'S COUNTY, INC. AND SUBSIDIARIES

Consolidated Statement of Cash Flows

Year ended June 30, 2010

Cash flows from operating activities:		
Change in net assets	$	4,838,400
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation		7,362,486
Amortization of bond financing costs and bond premiums		36,288
Loss on sale of property and equipment		261,714
Equity transfer from Parent		(826,944)
Earnings on investments in unconsolidated affiliates		(217,090)
Change in funded status of defined benefit plans		(979,575)
Realized losses on investments		7,207
Change in unrealized gains on investments		(118,986)
Provision for bad debts		5,568,010
Temporarily restricted contributions		(437,006)
Changes in operating assets and liabilities:		
Patient services receivables		(8,512,406)
Other receivables		(701,730)
Inventories and other assets		(125,321)
Prepaid and other current assets		110,095
Accounts payable and accrued expenses		1,992,232
Accrued salaries, benefits, and payroll taxes		(5,924,238)
Amounts due to third-party payors		(1,497,175)
Other liabilities		6,183,253
Net cash provided by operating activities		7,019,214
Cash flows from investing activities:		
Increase in investments, net		(238,456)
Decrease in assets whose use is limited or restricted, net		3,754,549
Purchases of property and equipment		(5,618,035)
Proceeds from sale of equipment		68,690
Change in notes receivables		(166,111)
Distribution from investments in unconsolidated affiliates		32,967
Net cash used in investing activities		(2,166,396)
Cash flows from financing activities:		
Repayment of long-term borrowings		(2,225,562)
Equity transfer from Parent		826,944
Temporarily and permanently restricted contributions		437,006
Net cash used in financing activities		(961,612)
Increase in cash and cash equivalents		3,891,206
Cash and cash equivalents at beginning of year		20,946,676
Cash and cash equivalents at end of year	$	24,837,882
Supplemental disclosure of cash flow information:		
Interest paid	$	386,723
Noncash investing and financing activities:		
Amounts included in accounts payable for fixed asset purchases	$	967,603
Investments acquired in restructuring of Foundation		1,388,819

See accompanying notes to consolidated financial statements.

(1) Description of Organization and Summary of Significant Accounting Policies

(a) Organization

St. Mary's Hospital of St. Mary's County, Inc. (the Hospital), St. Mary's Health Alliance, Inc., Hospice of St. Mary's, Inc. and St. Mary's Hospital Foundation, Inc. (referred to collectively as the Hospital) is dedicated to leadership in healthcare for St. Mary's County, Maryland. The Hospital is a nonstock, not-for-profit acute care hospital that provides inpatient, outpatient, emergency, physician, and hospice services in Leonardtown, Maryland. The Hospital is the sole shareholder of the common stock of St. Mary's Health Alliance, Inc. (the Alliance) and the sole member of Hospice of St. Mary's, Inc. (the Hospice).

On September 30, 2009, the Hospital and MedStar Health, Inc. (MedStar) closed on an affiliation transaction whereby MedStar became the sole member of the Hospital. The transaction was accounted for as an "as if" pooling of interests, whereby there was no change in the basis of the carrying values of the reported assets or liabilities of the Hospital.

The Alliance is a for-profit corporation and the sole member of St. Mary's Health Network, LLC (the Network). The Network is a for-profit limited liability company, but presently is inactive. The Hospice is a not-for-profit corporation whose primary purpose is to raise funds and offer advice regarding hospice issues for the benefit of the Hospital.

In September 2009, the Hospital became the sole member of the St. Mary's Hospital Foundation, Inc. (the Foundation). This transaction was accounted for as an "as if" pooling of interests, whereby there was no change in the basis of the carrying values of the assets or liabilities of the Foundation. The operations of the Foundation are included in the operating results of the Hospital effective July 1, 2009. The Foundation raises funds to support the operations of the Hospital.

(b) Basis of Presentation

The consolidated financial statements are prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles. All majority owned and direct member entities are consolidated. All entities where the Hospital exercises significant influence but for which it does not have control are accounted for under the equity method. All other entities are accounted for under the cost method. All significant intercompany accounts and transactions have been eliminated.

(c) Use of Estimates

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

(d) Cash Equivalents

All highly liquid investments with a maturity date of three months or less when purchased are considered to be cash equivalents. The Hospital maintains cash balances and temporary cash investments at several financial institutions. At June 30, 2010, amounts deposited in the financial institutions exceed the amounts covered by federal insurance.

(e) Investments and Assets Whose Use is Limited or Restricted

The Hospital's investment portfolio is considered trading and is classified as current or noncurrent assets based on management's intention as to use. All debt and equity securities are reported at fair value principally based on quoted market prices. Purchases and sales of securities are recorded on a trade-date basis.

Investments in joint ventures are accounted for under the cost or equity method of accounting, as appropriate and are included in other assets in the consolidated balance sheets. The Hospital utilizes the equity method of accounting for its investments in entities over which it exercises significant influence or where the Hospital maintains an ownership/control position of 20% to 50%.

Investments limited as to use or restricted include assets held by trustees under bond indenture, self-insurance trust arrangements, an unemployment insurance trust arrangement, assets restricted by donor, and assets designated by the Board of Directors for future capital improvements and other purposes over which it retains control and may, at its discretion, use for other purposes. Amounts from these funds required to meet current liabilities have been classified in the consolidated balance sheets as current assets.

Investment income (interest and dividends) including realized gains and losses on investment sales are reported within the excess of revenues over expenses in the accompanying consolidated statements of operations unless the income or loss is restricted by the donor or law. Investment income on funds held in trust for self-insurance purposes is included in other operating revenue. Investment income and net gains (losses) that are restricted by the donor are recorded as a component of changes in temporarily or permanently restricted net assets, in accordance with donor imposed restrictions. Realized gains and losses are determined based on the specific security's original purchase price or adjusted cost if the investment was previously determined to be other-than-temporarily impaired.

(f) Inventories

Inventories, which primarily consist of medical supplies, food, and pharmaceuticals, are stated at the lower of cost or market, with cost being determined primarily under the average cost or first-in, first-out methods.

(g) Property and Equipment

Property and equipment acquisitions are recorded at cost and are depreciated or amortized over the estimated useful lives of the assets. Estimated useful lives range from three to forty years. Amortization of assets held under capital leases is computed using the shorter of the lease term or the estimated useful life of the leased asset and is included in depreciation and amortization expense. The Hospital periodically evaluates the recoverability of property and equipment based upon projected undiscounted cash flows and operating income for each business. Depreciation is computed on a straight-line basis. Major classes and estimated useful lives of property and equipment are as follows:

Leasehold improvements	Lease term
Buildings and improvements	10 – 40 years
Equipment	3 – 20 years

Gifts of long-lived assets such as land, buildings, or equipment are reported as unrestricted support, and are excluded from the excess of revenues over expenses, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

(h) Deferred Financing Costs

Financing costs incurred in issuing bonds have been capitalized and included in other assets. These costs are being amortized over the estimated duration of the related debt using the effective interest method. Amortization expense for the year ended June 30, 2010 was $27,116 and accumulated amortization totaled $497,446 at June 30, 2010.

(i) Bond Premiums

Bond premiums are classified as a reduction of long-term debt and are amortized on the effective interest method over the term of the related debt.

(j) Estimated Professional Liability Costs

The provision for estimated self-insured professional liability claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported. These estimates are based on actuarial analysis of historical trends, claims asserted and reported incidents.

(k) Leases

Lease arrangements, including assets under construction, are capitalized when such leases convey substantially all the risks and benefits incidental to ownership. Capital leases are amortized over either the lease term or the life of the related assets, depending upon available purchase options and lease renewal features. Amortization related to capital leases is included in the statement of operations within depreciation and amortization expense.

(Continued)

(l) Net Patient Service Revenue

Net patient service revenue is recognized as services are rendered at the estimated net realizable amounts from patients and third-party payors based on rates in effect when the related services are provided. Rates for patient services in Maryland hospitals are subject to investigation, review, and approval by the Health Services Cost Review Commission (HSCRC), an independent commission created by a State of Maryland legislative act. All third-party payors are required to pay the HSCRC approved rates. The major government third-party payors (Medicare and Medicaid) as recognized by the HSCRC, are generally allowed discounts of 6% on approved rates. Blue Cross and other HSCRC approved insurance programs and health maintenance organizations are generally allowed discounts of 2% on approved rates.

The Hospital has a charge per case (CPC) agreement with the HSCRC. The CPC agreement establishes a prospectively approved average charge per inpatient case and an estimated case mix index. The agreement allows the Hospital to adjust approved unit rates, within certain limits, to achieve the average charge per case target. The HSCRC allows for certain corridors related to the approved rates such that variances within those corridors do not adversely impact the Hospital. The Hospital's policy is to defer revenue above the approved amounts and beyond the approved corridors. In no event, to the extent an undercharge occurs, does the Hospital accrue additional revenue. No amounts were deferred at June 30, 2010.

(m) Charity Care

The Hospital provides care to patients who meet certain criteria under its charity care policies without charge or at amounts less than established rates. The Hospital identifies charity care by assessing the patient's ability to pay utilizing generally recognized poverty income levels for the community. The Hospital also participates in Health Share, a county program, whereby charity care is provided to patients who meet certain criteria established by the Department of Social Services. Because the Hospital does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue.

(n) Grants

Federal and state grants are accounted for as either an exchange transaction or as a contribution based on terms and conditions of the grant. If the grant is accounted for as an exchange transaction, revenue is recognized as other operating revenue when earned. If the grant is accounted for as a contribution, the revenues are recognized as either other operating revenue, or as temporarily restricted contributions depending on the restrictions within the grant.

(o) Contributions

Unconditional promises to give cash and other assets to the Hospital are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted 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 as unrestricted net assets and reported in the statement of operations as net assets released from restrictions.

(Continued)

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

(p) Income Taxes

The Hospital has been recognized as a public charity and is generally exempt from federal income taxation under 501(c)(3) of the Internal Revenue Code pursuant to determination letter issued by the IRS in 1951.

The Alliance is a for-profit entity subject to federal and state income taxes. Income taxes are accounted for under the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The Hospital accounts for uncertain tax positions in accordance with the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 740, *Income Taxes*.

(q) Excess of Revenues, Gains and Other Support over Expenses

The consolidated statements of operations and changes in net assets include excess of revenues, gains and other support over expenses. Changes in unrestricted net assets that are excluded from excess of revenues, gains and other support over expenses, include unrealized gains and losses on investments classified as other-than-trading securities, contributions of long-lived assets (including assets acquired using contributions that by donor restriction were to be used for the purpose of acquiring such assets), certain changes in accounting principle and defined benefit obligations in excess of recognized pension cost, among others.

(r) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the Hospital or individual operating units has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the Hospital or individual operating units in perpetuity.

(s) Fair Value of Financial Instruments

The following methods and assumptions were used to estimate the fair value of financial instruments:

Cash and cash equivalents, receivables, inventories, prepaid and other current assets, other assets, current liabilities and long-term liabilities: The carrying amount reported in the consolidated balance sheets for each of these assets and liabilities approximates their fair value.

The fair value of long term debt is discussed in note 8.

(t) New Accounting Pronouncements

In June 2009, the FASB issued guidance that eliminates the hierarchy of authoritative accounting and reporting guidance on nongovernmental GAAP and replaces it with a single authoritative source, the FASB Accounting Standards Codification (ASC). The ASC affects the way in which users refer to GAAP and perform accounting research, but does not change GAAP. This guidance is effective for reporting periods ending after September 15, 2009. The Hospital adopted the provisions of this guidance as of September 30, 2009. The adoption did not have an impact on the Hospital's financial position or results of operations.

In December 2008, the FASB issued ASC Topic 715, *Compensation – Retirement Benefits*, which amended previously issued guidance. The purpose of the guidance is to enhance disclosures and provide users' with information regarding the types of assets and associated risks in an employer's defined benefit pension or other postretirement plan and events in the economy and markets that could have a significant effect on the value of plan assets. The disclosures about plan assets required shall be provided for fiscal years ending after December 15, 2009. The Hospital adopted this disclosure requirement for the year ended June 30, 2010.

In April 2009, the FASB issued Accounting Standards Update (ASU) No. 2010-07, *Not-for-Profit Entities: Mergers and Acquisitions* (Topic 958). This ASU establishes principles and requirements for how a not-for-profit entity determines whether a combination is a merger or an acquisition and makes other accounting literature fully applicable to not-for-profit entities. The ASU is effective for mergers for which the merger date is on or after the beginning of an initial reporting period beginning on or after December 15, 2009; therefore, effective for the Hospital on January 1, 2010. The ASU is effective for acquisitions for which the acquisition date is on or after the beginning of the first *annual* reporting period beginning on or after December 15, 2009; therefore, effective for the Hospital on July 1, 2010. It may not be applied to mergers or acquisitions before those dates.

In September 2009, the FASB issued ASU 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value Per Share (or Its Equivalent)* The guidance amends ASC Topic 820 and permits, as a practical expedient, fair value of investments within its scope to be estimated using net asset value or its equivalent determined as of the reporting entity's measurement date. Net asset value, in many instances, may not equal fair value that would be calculated pursuant to ASC Topic 820.

In January 2010, the FASB issued ASU 2010-06, *Improving Disclosures about Fair Value Measurements*. ASU 2010-06 amends ASC Topic 820, *Fair Value Measurements and Disclosures*, to require a number of additional disclosures regarding fair value measurements. Effective fiscal year 2010, ASU 2010-06 requires disclosure of the amounts of significant transfers between Level I and Level II investments and the reasons for such transfers, the reasons for any transfers in or out of Level III, and disclosure of the policy for determining when transfers among levels are recognized. ASU 2010-06 also clarified that disclosures should be provided for each class of assets and liabilities and clarified the requirement to disclose information about the valuation techniques and inputs used in estimating Level II and Level III measurements. Effective fiscal year 2011, ASU 2010-06 also requires that information in the reconciliation of recurring Level III measurements about purchases, sales, issuances and settlements be provided on a gross basis. The adoption of ASU 2010-06 only required additional disclosures and did not have an impact on the consolidated financial statements. As the Hospital does not have significant transfers between Levels, or any Level III measurements, no additional disclosures were necessary.

In August 2010, the FASB issued ASU No. 2010-23, *Health Care Entities (Topic 954)*: *Measuring Charity Care for Disclosure*. ASU 2010-23 is intended to reduce the diversity in practice regarding the measurement basis used in the disclosure of charity care. ASU 2010-23 requires that cost be used as the measurement basis for charity care disclosure purposes and that cost be identified as the direct and indirect cost of providing the charity care, and requires disclosure of the method used to identify or determine such costs. This ASU is effective for the Hospital on July 1, 2011. The Hospital is currently evaluating the impact on its disclosures from the adoption of this pronouncement.

(u) Subsequent Events Review

Management evaluated all events and transactions that occurred after June 30, 2010 and through October 28, 2010. The Hospital did not have any material recognizable or reportable subsequent events during this period.

(2) Investments and Assets Whose Use Is Limited or Restricted

Investments and assets whose use is limited or restricted as of June 30, 2010, at fair value, consist of the following:

U.S. Treasury bills and agency notes	$	12,550,086
Equity securities		686,856
Cash and money market		3,786,950
Total investments and assets whose use is limited or restricted		17,023,892
Less short-term investments and assets whose use is limited or restricted		(5,907,479)
Long-term assets whose use is limited or restricted	$	11,116,413

Assets whose use is limited or restricted as of June 30, 2010, included in the preceding table, consist of the following:

Funds held by trustees under indenture agreement	$	10,490,378
Funds held by trustees under employment insurance agreement		642,092
Funds designated by Board		1,418,749
Funds restricted by donors for specific purposes		2,068,147
Permanently restricted endowment funds		100,000
		14,719,366
Less assets required for current obligations		(3,602,953)
	$	11,116,413

Investment income and realized and unrealized gains and losses for assets whose use is limited, cash equivalents and other investments comprise the following for the year ending June 30, 2010:

Interest income and dividends	$	206,123
Realized net losses on sale of investments		(7,207)
Unrealized gains on investments		118,986
Total investment return	$	317,902

(3) Fair Value of Financial Instruments

The Hospital adopted FASB ASC Topic 820, *Fair Value Measurements and Disclosures* on July 1, 2008. The guidance provides for the following:

- Defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, and establishes a framework for measuring fair value;
- Establishes a three-level hierarchy for fair value measurement;
- Requires consideration of the Hospitals' nonperformance risk when valuing liabilities; and
- Expands disclosures about instruments measured at fair value.

The three-level valuation hierarchy for fair value measurements is based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Hospitals' market assumptions. The three level valuation hierarchy is defined as follows:

- Level 1 – Quoted prices for identical instruments in active markets;

- Level 2 – Quoted prices for similar instruments in active markets; quoted prices for identical or similar investments in markets that are not active; and model derived valuations whose significant inputs are observable; and
- Level 3 – Instruments whose significant inputs are unobservable.

Assets and liabilities classified as Level 1 are valued using unadjusted quoted market prices for identical assets or liabilities in active markets. The Hospital uses techniques consistent with the market approach and the income approach for measuring fair value of its Level 2 and Level 3 assets and liabilities. The market approach is a valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. The income approach generally converts future amounts (cash flows or earnings) to a single present value amount (discounted).

The level in the fair value hierarchy within which a fair value measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

As of June 30, 2010, the Level 2 assets and liabilities listed in the fair value hierarchy tables below utilize the following valuation techniques and inputs:

U.S. agency mortgage backed securities

The fair value of investments in U.S. agency mortgage backed securities is primarily determined using techniques consistent with the income approach. Significant observable inputs to the income approach include data points for benchmark constant maturity curves and spreads.

Corporate bonds (included in pension plan assets, see note 9)

The fair value of investments in U.S. and international corporate bonds, including commingled funds that invest primarily in such bonds, and foreign government bonds is primarily determined using techniques that are consistent with the market approach. Significant observable inputs include benchmark yields, reported trades, observable broker/dealer quotes, issuer spreads, and security specific characteristics, such as early redemption options.

The following table presents the Hospital's investable assets as of June 30, 2010, aggregated by the three level valuation hierarchy:

	Level 1	Level 2	Level 3	Total
Assets:				
Cash and cash equivalents	$ 1,750,280	—	—	1,750,280
Certificates of deposit	244,818	—	—	244,818
Mutual funds	3,274,502	—	—	3,274,502
U.S. government obligations	3,662,895	—	—	3,662,895
U.S. agency mortgage backed securities	—	8,091,397	—	8,091,397
	$ 8,932,495	8,091,397	—	17,023,892

(4) Pledges Receivable

Contributions and pledges to raise funds are recorded as temporarily restricted net assets until the donor-intended purpose is met and the cash is collected. Future pledges are discounted to reflect the time value of money and an allowance for potentially uncollectible pledges has been established.

Pledges receivable included in other receivables consist of the following as of June 30:

Pledges receivable, net of unamortized discount of $7,449	$	141,518
Less allowance for uncollectible pledges		(7,448)
	$	134,070

Gross pledges receivable, categorized by year of expected collection, consist of the following:

2011	$	115,115
2012		16,047
2013		17,805
	$	148,967

(5) Property and Equipment

Property and equipment as of June 30, 2010 consist of the following:

Land	$	3,927,676
Buildings and improvements		66,216,417
Equipment		40,283,598
Equipment under capital leases		8,277,555
		118,705,246
Less accumulated depreciation		(47,877,589)
		70,827,657
Construction in progress		5,002,876
	$	75,830,533

Construction in progress includes a variety of ongoing capital projects at the Hospital as of June 30, 2010. The Hospital entered into a construction contract for the construction of a medical annex building adjacent to the main hospital building. The Hospital had unspent commitments under the construction contract of $6,516,950 as of June 30, 2010.

Depreciation expense related to property and equipment amounted to $7,362,486 for the year ended June 30, 2010.

Equipment under capital leases financed with capital lease obligations were $8,277,555 as of June 30, 2010. Accumulated amortization related to the equipment under capital leases was $1,723,910 at June 30, 2010.

(6) Investments in Unconsolidated Affiliates

The Hospital has investments in unconsolidated affiliates, accounted for using the cost or equity method, aggregating $2,523,693 as of June 30, 2010, in the following:

Joint venture	Type of organization	Business purpose	Percent ownership 2010
Chesapeake-Potomac Healthcare Alliance (CPHA)	Not-for-profit	Healthcare related services	33.3%
NRH/CPT/St. Mary's/Civista Regional Rehab, LLC (Rehab)	For-profit	Medical, rehabilitative, and therapy services	15.0
Maryland eCare, LLC (eCare)	Not-for-profit	Remote monitoring technology	8.5

The Hospital's investment in unconsolidated affiliates balance and equity in earnings (proportionate share of losses) of the joint ventures as of and for the year ended June 30 is as follows:

	Investment balance	Equity in earnings (losses)
CPHA	$ 2,462,223	187,501
Rehab	55,470	29,589
Maryland eCare	6,000	—
Total	$ 2,523,693	217,090

Summary combined financial information (unaudited) for these investments in unconsolidated affiliates as of and for the year ended June 30 is as follows:

Current assets	$	3,556,901
Noncurrent assets		11,711,482
Total assets	$	15,268,383
Current liabilities	$	1,871,634
Noncurrent liabilities		4,167,496
Net assets		9,229,253
Total liabilities and net assets	$	15,268,383
Total operating revenue	$	12,043,126
Total operating expense		11,332,436
Total operating income	$	710,690

(7) Notes Receivables

The Hospital maintains a Board approved Medical Staff Development Plan and Physicians Recruitment Policy for the purpose of recruiting needed physicians to the community. In conformity with the Hospital's policy, the Hospital entered into several income guarantee contracts with certain local medical groups during fiscal year 2010. Under the agreements, the Hospital is required to advance funds to them in the event that the groups' income falls below predetermined levels. The advances are secured by promissory notes which accrue interest at a rate of prime plus 1% per annum. Each promissory note balance plus interest is payable monthly beginning over a twelve to thirty-six month period. Under the term of the promissory notes, principal and interest payments will be forgiven for any medical group that maintains an active local practice during the repayment period. The balance of these promissory notes was $1,064,879 as of June 30, 2010, of which $432,381 is due within one year and is included in current assets.

(8) Long-Term Debt and Capital Lease

The Hospital's long-term debt consists of the following at June 30, 2010:

Maryland Health and Higher Educational Facilities Authority (MHHEFA) Pooled Loan Program (Series 2009), interest rate is variable and is set weekly at auction and is payable semi-annually. Interest rates ranged from 0.12% to 0.37% during 2010, principal payments began January 1, 2010 and are payable annually through January 1, 2039.	$	15,770,000
County Commissioners of St. Mary's County General Obligation Hospital Bonds (Series 2002), interest payable semi-annually at rates of interest ranging from 3.3% to 4.6%, principal payable annually through October 1, 2022.		15,905,000
Mortgage notes with interest at 6.0%. Principal and interest payable monthly for 15 years beginning June 10, 2001.		633,754
		32,308,754
Plus unamortized bond premium		107,007
		32,415,761
Less current portion of long-term debt		1,261,990
Less long-term debt subject to short-term remarketing agreement		2,358,333
Long-term debt, less current portion	$	28,795,438

The Hospital's capital leases consist of the following at June 30, 2010:

MHHEFA Master Lease and Sublease Agreements: (MHHEFA Lease Agreement), payments due monthly including principal and interest at a rate of 4.37% per annum. Payments are required to cover the principal and interest due on the lease agreement dated December 12, 2006 between MHHEFA and National City Commercial Capital, Inc.	$	3,736,259
MHHEFA Lease Agreement, payments due monthly including principal and interest at a rate of 4.43% per annum. Payments are required to cover the principal and interest due on the lease agreement dated December 12, 2006 between MHHEFA and National City Commercial Capital, Inc.		740,329
Other capital lease obligations at varying rates of imputed interest from 3.7% to 6.4%, collateralized by leased equipment with amortized cost $4,953 as of June 30, 2010.		4,953
		4,481,541
Less current portion		1,142,260
	$	3,339,281

In February 2009, MHHEFA issued $16,000,000 in revenue bonds (Series 2009) on behalf of the Hospital. The Series 2009 bonds are variable rate demand bonds requiring remarketing agents to purchase and remarket any bonds tendered before the stated maturity date. To provide liquidity support for the timely payment of the Series 2009 bonds that are not successfully remarketed, the Hospital has entered into a letter of credit agreement (LOC) with Bank of America (BoA). The LOC has a term of three years expiring February 2012. If the Series 2009 bonds are not successfully remarketed when tendered by the holder, the bonds would be sold to BoA. Accordingly, BoA will advance funds to the Hospital under terms of the LOC, which require principal repayments the earlier of (1) third anniversary of the date of the draw, (2) third anniversary of the LOC expiration date, (3) the date a new letter of credit is issued; or 4) if the LOC is reduced to zero or is terminated. If funds are advanced, the principal payments are due in equal semi-annual installments, commencing on the first day of the seventh month after BoA repurchases the bonds. The Hospital has reflected the amount of its long-term debt that is subject to this short term remarketing arrangement of $2,358,333 as a separate component of current liabilities in its consolidated balance sheet as of June 30, 2010. The reimbursement obligation with respect to the LOC are evidenced and secured by the Hospital under the Series 2009 Master Trust Indenture.

As security for repayment of its obligations under the Master Loan Agreement (MLA), the Hospital granted to MHHEFA a security interest in substantially all of its receipts. In addition, the Series 2009 Bonds are secured by a deed of trust in all assets of the Hospital, including land, leasehold interest, and tangible personal property.

The MLA requires the Hospital to adhere to certain covenants, including limitations on mergers, disposition of assets, additional indebtedness, and certain financial covenants. The financial covenants include a Rate Covenant which requires the Hospital to achieve a debt service coverage ratio of 1.50 as of the last day of each fiscal year and a Liquidity Covenant, which requires the Hospital to maintain 75 days cash on hand, measured as of June 30 in each fiscal year. In the fiscal year ended June 30, 2010, the Hospital met all of its financial covenants as of December 31, 2009 and June 30, 2010.

In 2002, the Hospital borrowed $20,000,000 from the County Commissioners of St. Mary's County (Series 2002). The loan is secured by a deed of trust on all real and personal property and leasehold interest now owned or hereafter acquired. Repayment of this loan is subordinate to repayment of debt under the Series 2009 Master Loan Agreement.

The Hospital entered into two Master Lease and Sublease Agreements (MHHEFA Lease Agreements) with MHHEFA and National City Commercial Capital, Inc. to provide financing for the Hospital to lease certain equipment essential or convenient for the operations of the Hospital. The MHHEFA Lease Agreements expire in November 2013 and November 2016. During the terms of the MHHEFA Lease Agreements, MHHEFA has legal title to the equipment, including any software license components. At the end of the lease term, the Hospital has the option to purchase the equipment for a notional amount of $1.

The Hospital has two mortgage notes payable, which are considered "purchased money mortgages" with an interest rate of 6.0%. The mortgage notes were both signed in 2001 and continue until 2016. The notes are secured by a plot of land adjacent to the Hospital's property.

The fair market value of the MHHEFA Series 2009 pooled loan and the Series 2002 bonds was $32,766,281 at June 30, 2010.

(Continued)

The scheduled annual maturities of long-term debt, in accordance with the original terms of the Master Loan Agreement and all other loan agreements and capital lease obligations for the next five fiscal years and thereafter are as follows:

		Long-term debt	Capital leases	Total
2011	$	1,261,990	1,142,260	2,404,250
2012		1,317,664	1,190,593	2,508,257
2013		1,378,688	1,242,471	2,621,159
2014		1,445,083	602,507	2,047,590
2015		1,511,872	121,753	1,633,625
Thereafter		25,393,457	181,957	25,575,414
	$	32,308,754	4,481,541	36,790,295

If funds are advanced for the Series 2009 variable rate demand bonds under the Bank of America LOC prior to June 30, 2011, annual maturities of long-term debt, including principal payments under the LOC and all other loan agreements , and capital lease obligations for the next five fiscal years and thereafter are as follows:

		Long-term debt	Capital leases	Total
2011	$	3,620,323	1,142,260	4,762,583
2012		6,269,331	1,190,593	7,459,924
2013		6,320,354	1,242,471	7,562,825
2014		3,763,416	602,507	4,365,923
2015		1,206,872	121,753	1,328,625
Thereafter		11,128,458	181,957	11,310,415
	$	32,308,754	4,481,541	36,790,295

(9) Pension Plan

The Hospital has a defined benefit pension plan covering substantially all of its employees. Plan benefits are accumulated based upon a combination of years of service and percent of annual compensation during the highest three consecutive calendar years. The Hospital makes annual contributions to the plan based upon amounts required to be funded under provisions of the Employee Retirement Income Security Act of 1974 (ERISA). Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future. Pension assets are invested primarily in short-term and intermediate-term, fixed income, and stock market index funds.

As previously discussed, in September 2009 the Hospital merged with MedStar Health, Inc. Effective December 31, 2009, the Hospital announced a freeze to benefit accruals under this plan. The freeze constitutes a curtailment in accordance with FASB ASC Topic 958, *Not-for-Profit Entities Section 715, Compensation-Retirement Benefits* and as such, the Hospital remeasured the plans' assets and projected benefit obligations at December 31, 2009. The remeasurement resulted in an increase to net assets of $2,453,886 from recognition of the curtailment. The Hospital's employees will be eligible to participate in MedStar Health, Inc.'s defined benefit plan beginning January 1, 2011.

The Hospital uses a June 30 measurement date for its plan.

The following table sets forth the changes in the benefit obligation as of and for the year ended June 30:

Benefit obligation at beginning of year	$	21,815,348
Service cost		544,499
Interest cost		1,318,340
Curtailments		(2,453,886)
Actuarial loss		3,189,461
Benefits paid		(416,703)
Benefit obligation at the end of the year	$	23,997,059

The following table sets forth the changes in the plan assets as of and for the year ended June 30:

Fair value of plan assets at beginning of the year	$	17,894,146
Actual return on plan assets		3,127,989
Employer contribution		450,000
Benefits paid		(416,703)
Fair value of plan assets at end of the year	$	21,055,432
Funded status and accrued benefit cost	$	2,941,627

The amounts recognized in unrestricted net assets consist of the following as of June 30:

Net actuarial loss	$	2,413,090
Prior service cost		—
Net amount recognized	$	2,413,090

The components of the net periodic benefit cost recognized in operating expenses consist of the following for the year ended June 30:

Service cost	$	544,499
Interest cost		1,318,340
Expected return on plan assets		(1,542,758)
Amortization of prior service cost		(10,549)
Recognized net actuarial loss		38,535
Net periodic benefit cost		348,067
Curtailment Gain due to Plan Freeze		(284,807)
Total periodic benefit cost	$	63,260

The weighted average assumptions used in the accounting for the benefit obligation are as follows as of June 30:

Discount rates	5.40%
Rate of compensation increase	—

The weighted average assumptions used in the accounting for the net periodic benefit cost for the year ended June 30 are as follows:

Discount rate	6.25%
Expected long-term return on plan assets	8.00
Rate of compensation increase	4.00

The overall rate of expected return on assets assumption was based on historical returns, with adjustments made to reflect expectations of future events.

The Hospital’s policy is to provide for growth of capital with a moderate level of volatility by investing assets per the target average asset allocations stated below as of June 30:

	Actual allocation as of June 30, 2010
Cash and cash equivalents	1.95%
U.S. Treasury bonds equity securities	36.40
Corporate bonds	2.61
Common stocks	59.04
Total	100.00%

(Continued)

The following table presents the Plan's investable assets as of June 30, 2010, aggregated by the three level valuation hierarchy:

	Level 1	Level 2	Level 3	Total
Assets:				
Cash and cash equivalents	$ 411,235	—	—	411,235
U.S. Treasury bonds	7,664,922	—	—	7,664,922
Corporate bonds	—	548,715	—	548,715
Common stocks	12,430,560	—	—	12,430,560
Total assets	$ 20,506,717	548,715	—	21,055,432

Effective January 1, 2010 the Hospital froze the benefits accruals to this plan. And as previously discussed, substantially all Hospital employees will be eligible to participate in MedStar Health, Inc's benefit plan effective January 1, 2011. In lieu of accruing benefits during this time of non-participation in a retirement plan, the Hospital approved a benefit payment amount to all of its eligible employees if certain employment criteria were met at June 30, 2010 and 2011. As of June 30, 2010, the Hospital accrued a liability of $1,294,771, which represents the portion of benefit payments due where the criteria have been met for the year ended June 30, 2010.

The following benefit payments, which reflect expended future service, as appropriate, are expected to be paid from plan assets for the years ended June 30:

2011	$ 539,115
2012	578,634
2013	622,744
2014	684,230
2015	759,356
Thereafter	4,922,471
	$ 8,106,550

The expected benefits to be paid are based on the same assumptions used to measure the Hospital's benefit obligation as of June 30, 2010.

The Hospital also has various contributory, deferred compensation, tax deferred annuity and savings plans with participation available to certain employees. The Hospital matches employee contributions up to 3% of compensation in certain plans. The Hospital employee recorded contribution expense of $657,287 during the year ended June 30, 2010.

(10) Business and Credit Concentrations

The Hospital provides healthcare services through its inpatient and outpatient care facilities located in St. Mary's County. The Hospital generally does not require collateral or other security in extending credit; however, it routinely obtains assignment of (or is otherwise entitled to receive) patients' benefits receivable under their health insurance programs, plans or policies (e.g., Medicare, Medicaid, Blue Cross, Workers' Compensation, health maintenance organizations (HMOs) and other commercial insurance policies).

A summary of net patient service revenue by major category of payor for the year ended June 30, 2010 is as follows:

Medicare	34%
Medicaid	3
Carefirst Blue Cross Blue Shield	22
Other third-party payors	36
Self-pay	5
	100%

A summary of net patient service receivables by major category of payor as of June 30, 2010 is as follows:

Medicare	32%
Medicaid	10
Carefirst Blue Cross Blue Shield	17
Other third-party payors	34
Self-pay	7
	100%

The Hospital's policy is to write-off all patient accounts that have been identified as uncollectible. An allowance for uncollectible accounts is recorded for accounts not yet written off, which are expected to become uncollectible in future periods.

(11) Amounts Due to Third-Party Payors

Advances from third-party payors represent funds advanced from CareFirst Blue Cross Blue Shield, the State of Maryland and others for the operation of the respective payors' programs, and are subject to periodic adjustment.

(12) Other Long-Term Liabilities

Other long-term liabilities at June 30, 2010 consist of the following:

Accrued vacation for legacy employees	$ 1,138,640
Deferred compensation arrangements	762,975
Third party settlement payable	1,087,621
Other	60,000
	$ 3,049,236

(13) Certain Significant Risks and Uncertainties

The Hospital provides general acute healthcare services in the State of Maryland. The Hospital and other healthcare providers 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 or other claims.

Such inherent risks require the use of certain management estimates in the preparation of the Hospital’s consolidated 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 the Hospital’s revenues and the Hospital’s 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 the Hospital.

Changes in federal and state reimbursement funding mechanisms and related government budgetary constraints could have a significant adverse effect on the Hospital.

The healthcare industry is subject to numerous laws and regulations from federal, state and local governments. The Hospital’s compliance with these laws and regulations can be subject to periodic governmental review and interpretation, which can result in regulatory action unknown or unasserted at this time. Management is aware of certain asserted and unasserted legal claims and regulatory matters arising in the ordinary course of business, none of which, in the opinion of management, is expected to result in losses in excess of insurance limits or have a materially adverse effect on the Hospital’s financial position.

The federal government and many states have aggressively increased enforcement under Medicare and Medicaid anti-fraud and abuse laws and physician self-referral laws (STARK law and regulation). Recent federal initiatives have prompted a national review of federally funded healthcare programs. In addition, the federal government and many states have implemented programs to audit and recover potential overpayments to providers from the Medicare and Medicaid programs. In September 2009, the Hospital was notified that the recovery audit contractors (RAC) are beginning their audits in 2010. The Hospital has implemented a compliance program to monitor conformance with applicable laws and regulations, but the possibility of future government review and interpretation exists.

Insurance Programs

The Hospital maintains certain insurance programs for professional and general liability risks and employee health. Estimated liabilities have been recorded based on an actuarial estimation of reported and incurred but not reported claims. The combined accrued liabilities for these programs as of June 30, 2010 were as follows:

Professional and general liability	$	1,475,000
Employee health		757,656
Total liabilities		2,232,656
Less current portion		(757,656)
	$	1,475,000

The Hospital's insurance program for professional and general liability, employee health and dental unemployment, and workers compensation insurance is responsible for the following exposures at June 30, 2010:

(a) Professional and General Liability Coverage

The Hospital maintains professional liability coverage with a commercial insurer. The Hospital's professional liability insurance coverage is on a claims made basis, with $1 million per incident coverage, up to a maximum of $3 million in the aggregate annually, contains a $25,000 per incident deductible and includes prior acts coverage. The Hospital also maintains an umbrella policy in the amount of $5 million. The current policy extends coverage through October 2010. The Hospital accrues for the estimated cost of uninsured asserted and unasserted medical malpractice claims when incidents occur. The Hospital also maintains a stop-loss policy to help mitigate additional risk.

(b) Employee Health and Dental Insurance

The Hospital is self-insured against employee medical and dental claims and is covered under a policy with a commercial insurer, which has a $75,000 deductible for other claims through June 30, 2011. Plan expenses include claims incurred and provisions for unreported claims.

(c) Unemployment Insurance

The Hospital has elected to be a reimbursable employer in lieu of making contributions under the Unemployment Insurance Law of the State of Maryland. Accordingly, the Hospital is required to maintain collateral in the amount of $534,857. The Hospital maintains an investment in an escrow account for this purpose of $642,092, which is included in assets whose use is limited at June 30, 2010.

(d) Workers Compensation Insurance

The Hospital participates in a trust and indemnity agreement (the Trust) with certain member hospitals of the Maryland Hospital Association (MHA). The Trust was established to enable group member hospitals to collectively insure their workers compensation and employers' liability

(Continued)

insurance claims and administrative costs. All of the Hospital's payments to the trust have been treated as a period expense.

Litigation

The Hospital is subject to certain legal proceedings and claims arising in the ordinary course of business. After consultation with legal counsel, it is management's opinion that the ultimate resolution of these claims will not have a material adverse effect on the Hospital's financial position or results of operations as of June 30, 2010.

(14) Temporarily and Permanently Restricted Net Assets

Temporarily and permanently restricted net assets as of June 30, 2010 are available for the following purposes:

Temporary restrictions:		
Hospice	$	2,945,877
Foundation		455,221
Other		92,389
	$	3,493,487
Permanent restrictions:		
Investments to be held in perpetuity, the income from which is available to support healthcare services	$	100,000

Temporarily restricted net assets are available for the purposes of purchasing property and equipment, providing health education and other healthcare services and programs.

(15) Endowment Net Assets

The Hospital's endowments consist of individual donor-restricted funds established for a variety of purposes. As required by GAAP, net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

(a) Interpretation of Relevant Law

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

(7) The investment policies of the Hospital

(b) Endowment Net Assets Consist of the Following at June 30, 2010:

		Unrestricted	Temporarily restricted	Permanently restricted	Total
Donor-restricted endowment funds	$	—	—	100,000	100,000
Total endowed net assets	$	—	—	100,000	100,000

(c) Investment Strategies

The Hospital has adopted policies for corporate investments, including endowment assets, that seeks to maximize risk-adjusted returns with preservation of principal. Endowment assets include those assets of donor-restricted funds that the Hospital must hold in perpetuity or for a donor-specified period(s).The endowment assets are invested in a manner that is intended to hold a mix of investment assets designed to meet the objectives of the account. The Hospital expects its endowment funds, over time, to provide an average rate of return that generates earnings to achieve the endowment purpose.

To satisfy its long-term rate-of-return objectives, the Hospital relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). The Hospital employs a diversified asset allocation structure to achieve its long-term return objectives within prudent risk constraints.

The Hospital monitors the endowment funds returns and appropriates average returns for use. In establishing this practice, the Hospital considered the long-term expected return on its endowment. This is consistent with the Hospital's objective to maintain the purchasing power of the endowment assets held in perpetuity or for a specified term as well as to provide additional real growth through new gifts and investment return.

(16) Charity Care

The following information shows the level of charity care provided for the year ended June 30, 2010.

Charges foregone, based on established rates	$	3,924,478

In addition to charity care, the Hospital funds numerous programs designed to benefit the healthcare interests of the communities it serves, examples of which are: health education programs and services, health information and referral services, public health screenings and home care. The costs associated with these programs are recorded in the appropriate operating expense categories.

(17) Leases

The Hospital is obligated under various operating leases with initial terms of one year or more. Aggregate future minimum payments as of June 30, 2010 are as follows:

2011	$	154,478
2012		104,470
2013		78,492
2014		44,524
2015		7,021
Total minimum lease payments	$	388,985

(18) Related Party Transactions

The Hospital receives management, and other services from MedStar including certain administrative and consulting services including interest costs, medical services and supplies, computer services, telecommunications, office space, and rental. The Hospital incurred charges of $826,944 for the year ended June 30, 2010, for these services, which are included in expenses in the accompanying statement of operations.

The Hospital has eliminated net amounts payable to MedStar and accordingly, has recorded an equity transfer from parent, which is included in the changes in unrestricted net assets for the year ended June 30, 2010.

(19) Functional Expenses

The Hospital considers healthcare services and management and general to be its primary functional categories for purposes of expense classification. Management and general include information systems, general corporate management, advertising and marketing. Functional categories of expenses for the year ended June 30, 2010 are as follows:

Healthcare services	$ 101,701,524
Management and general	13,672,392
Fundraising	416,740
	$ 115,790,656

ST. MARY'S HOSPITAL OF ST. MARY'S COUNTY, INC. AND SUBSIDIARIES

Consolidating Balance Sheet

June 30, 2010

Assets	St. Mary's Hospital of St. Mary's County, Inc.	Hospice of St. Mary's, Inc.	St. Mary's Hospital Foundation, Inc.	St. Mary's Health Alliance, Inc.	Eliminations	St. Mary's Hospital consolidated
Current assets:						
Cash and cash equivalents	$ 24,231,925	187,321	229,419	189,217	—	24,837,882
Investments	2,304,526	—	—	—	—	2,304,526
Assets whose use is limited or restricted	1,634,045	791,693	1,177,215	—	—	3,602,953
Receivables:						
From patient services (less allowances for uncollectible accounts of $4,889,337)	17,178,138	—	—	—	—	17,178,138
Notes receivables, current portion	432,381	—	—	—	—	432,381
Other	567,660	—	134,070	—	—	701,730
	18,178,179	—	134,070	—	—	18,312,249
Inventories	2,603,143	—	—	—	—	2,603,143
Prepaids and other current assets	1,123,069	—	4,500	—	—	1,127,569
Total current assets	50,074,887	979,014	1,545,204	189,217	—	52,788,322
Assets whose use is limited or restricted	11,116,413	—	—	—	—	11,116,413
Property and equipment, net	75,607,192	6,353	—	216,988	—	75,830,533
Investments in unconsolidated affiliates	5,460,469	—	—	55,470	(2,992,246)	2,523,693
Notes receivables	632,498	—	—	—	—	632,498
Deferred financing costs, net	706,112	—	—	—	—	706,112
Total assets	$ 143,597,571	985,367	1,545,204	461,675	(2,992,246)	143,597,571

(Continued)

ST. MARY’S HOSPITAL OF ST. MARY’S COUNTY, INC. AND SUBSIDIARIES

Consolidating Balance Sheet

June 30, 2010

Liabilities and Net Assets	St. Mary’s Hospital of St. Mary’s County, Inc.	Hospice of St. Mary’s, Inc.	St. Mary’s Hospital Foundation, Inc.	St. Mary’s Health Alliance, Inc.	Eliminations	St. Mary’s Hospital consolidated
Current liabilities:						
Accounts payable and accrued expenses	$ 6,936,874	—	—	—	—	6,936,874
Accrued salaries, benefits, and payroll taxes	3,918,039	—	—	—	—	3,918,039
Amounts due to third-party payors, net	2,811,311	—	—	—	—	2,811,311
Current portion of long-term debt	4,762,583	—	—	—	—	4,762,583
Current portion of self insurance liabilities	757,656	—	—	—	—	757,656
Other current liabilities	3,853,185	—	—	—	—	3,853,185
Total current liabilities	23,039,648	—	—	—	—	23,039,648
Long-term debt, net of current portion	32,134,719	—	—	—	—	32,134,719
Self insurance liabilities, net of current portion	1,475,000	—	—	—	—	1,475,000
Pension liabilities	2,941,627	—	—	—	—	2,941,627
Other long-term liabilities, net of current portion	3,049,236	—	—	—	—	3,049,236
Total liabilities	62,640,230	—	—	—	—	62,640,230
Net assets:						
Unrestricted	77,363,854	—	—	461,675	(461,675)	77,363,854
Temporarily restricted	3,493,487	985,367	1,545,204	—	(2,530,571)	3,493,487
Permanently restricted	100,000	—	—	—	—	100,000
Total net assets	80,957,341	985,367	1,545,204	461,675	(2,992,246)	80,957,341
Total liabilities and net assets	$ 143,597,571	985,367	1,545,204	461,675	(2,992,246)	143,597,571

See accompanying notes to consolidated financial statements.

ST. MARY’S HOSPITAL OF ST. MARY’S COUNTY, INC. AND SUBSIDIARIES

Consolidating Statement of Operations

Year ended June 30, 2010

	St. Mary’s Hospital of St. Mary’s County, Inc.	Hospice of St. Mary’s, Inc.	St. Mary’s Hospital Foundation, Inc.	St. Mary’s Health Alliance, Inc.	Eliminations	St. Mary’s Hospital consolidated
Unrestricted revenues, gains, and other support:						
Net patient service revenue:						
Hospital inpatient services	$ 59,226,782	—	—	—	—	59,226,782
Hospital outpatient services	53,312,453	—	—	—	—	53,312,453
Other patient service revenue	2,098,246	—	—	—	—	2,098,246
Total net patient service revenue	114,637,481	—	—	—	—	114,637,481
Other operating revenue	2,796,318	187,321	229,419	—	—	3,213,058
Net assets released from restrictions for operations	772,129	—	—	—	—	772,129
Interest income and dividends	132,957	59,921	13,026	219	—	206,123
Realized net losses on trading investments	(11,254)	4,047	—	—	—	(7,207)
Unrealized net gains on trading investments	(32,295)	5,521	116,171	29,589	—	118,986
Earnings from unconsolidated affiliates	445,584	—	—	—	(228,494)	217,090
Total revenues, gains, and other support	118,740,920	256,810	358,616	29,808	(228,494)	119,157,660
Expenses:						
Personnel	59,301,896	—	—	—	—	59,301,896
Supplies	18,706,880	2,299	—	—	—	18,709,179
Purchased services	11,843,749	—	—	—	—	11,843,749
Other operating	9,453,929	185,022	229,419	952	(5,829)	9,863,493
Provision for bad debts	5,568,010	—	—	—	—	5,568,010
Interest expense	1,267,450	—	—	—	—	1,267,450
Depreciation and amortization	7,393,897	—	—	4,877	—	7,398,774
Pension and other expenses related to merger	1,576,391	—	—	—	—	1,576,391
Loss on disposal of equipment	261,714	—	—	—	—	261,714
Total expenses	115,373,916	187,321	229,419	5,829	(5,829)	115,790,656
Excess of revenues gains, and other support over expenses	$ 3,367,004	69,489	129,197	23,979	(222,665)	3,367,004

See accompanying notes to consolidated financial statements.