Financial Statements

Southern Maryland Hospital, Inc.
Years Ended December 31, 2011 and 2010
With Report of Independent Auditors

Ernst & Young LLP

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Southern Maryland Hospital, Inc.

Financial Statements

Years Ended December 31, 2011 and 2010

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Report of Independent Auditors

Stockholders
Southern Maryland Hospital, Inc.

We have audited the accompanying balance sheets of Southern Maryland Hospital, Inc. (a Maryland corporation) as of December 31, 2011 and 2010, and the related statements of revenues and expenses, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Corporation's internal control over financial reporting. Our audits included 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 Corporation'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, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Southern Maryland Hospital, Inc. at December 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

April 30, 2012

Southern Maryland Hospital, Inc.

Balance Sheets

	December 31 2011	December 31 2010
Assets		
Current assets:		
Cash and cash equivalents	**$ 570,800**	$ 1,296,200
Accounts receivable, less allowance for uncollectible accounts of $23,085,100 and $18,535,700, respectively	**45,168,600**	36,111,600
Prepaid expenses and other assets	**20,419,000**	22,627,600
Inventories	**3,364,800**	3,948,800
Total current assets	**69,523,200**	63,984,200
Advances to related parties, net	**1,456,000**	–
Other long term assets	**1,411,200**	–
Property and equipment:		
Buildings and land under capital leases	**18,615,200**	42,975,700
Furniture, fixtures and minor equipment	**19,262,500**	16,152,700
Major movable equipment	**33,325,800**	30,633,100
Leasehold improvements	**11,786,000**	7,736,400
Construction in progress	**4,666,700**	2,201,400
	87,656,200	99,699,300
Less accumulated depreciation and amortization	**(49,375,300)**	(69,383,700)
Property and equipment, net	**38,280,900**	30,315,600
Total assets	**$ 110,671,300**	$ 94,299,800

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Southern Maryland Hospital, Inc.

Balance Sheets

	December 31 2011	December 31 2010
Liabilities and stockholders' equity		
Current liabilities:		
Short term borrowings	**$ 630,000**	$ –
Short term debt	**4,600,000**	3,000,000
Accounts payable	**1,129,900**	825,100
Accrued salaries, wages and employee benefits	**7,272,800**	5,766,000
Current portion of capital lease obligations	**1,417,000**	4,001,000
Advances from third-party payors	**8,846,000**	8,048,600
Other accrued liabilities	**4,960,200**	5,612,500
Total current liabilities	**28,855,900**	27,253,200
Noncurrent liabilities:		
Capital lease obligations, less current portion	**14,042,900**	13,849,900
Estimated professional liability	**7,607,900**	6,493,600
Long term note payable	**6,400,000**	–
Advances from related parties	**–**	1,316,900
Total noncurrent liabilities	**28,050,800**	21,660,400
Total liabilities	**56,906,700**	48,913,600
Stockholders' equity:		
Common stock, no par value, 10,000 shares authorized; 100 shares issued and outstanding	**100**	100
Additional paid-in capital	**9,943,500**	9,943,500
Retained earnings	**43,821,000**	35,442,600
Total stockholders' equity	**53,764,600**	45,386,200
Total liabilities and stockholders' equity	**$ 110,671,300**	$ 94,299,800

See accompanying notes.

Southern Maryland Hospital, Inc.

Statements of Revenues and Expenses

	Year Ended December 31	
	2011	**2010**
Operating revenues		
Net patient service revenue	**$ 231,025,600**	$ 208,108,100
Net physician revenue	**7,912,900**	14,220,800
Other operating revenue	**913,600**	943,100
Total operating revenues	**239,852,100**	223,272,000
Operating expenses		
Salaries, wages and employee benefits	**103,072,200**	93,704,000
Drugs, hospital supplies and other expenses	**56,055,700**	52,363,200
Purchased services	**35,384,400**	31,503,400
Physician expenses	**12,094,500**	17,152,900
Depreciation and amortization	**5,965,800**	5,831,200
Interest	**1,483,400**	1,720,400
Provision for bad debts	**16,887,500**	15,899,400
Total operating expenses	**230,943,500**	218,174,500
Income from operations	**8,908,600**	5,097,500
Nonoperating gains	**27,600**	121,900
Net income with no income taxes provided	**$ 8,936,200**	$ 5,219,400
Pro forma amounts if the corporation, rather than the stockholders, paid income taxes (unaudited)		
Net income with no income taxes provided	**$ 8,936,200**	$ 5,219,400
Provision for income taxes (at statutory tax rate)	**(3,127,680)**	(1,826,800)
Pro forma net income (unaudited)	**$ 5,808,520**	$ 3,392,600

See accompanying notes.

Southern Maryland Hospital, Inc.

Statements of Changes in Stockholders' Equity

	Common Stock	Additional Paid-in Capital	Retained Earnings	Total
Balance at December 31, 2009	$ 100	$ 9,943,500	$ 30,389,400	$ 40,333,000
Net income with no income taxes provided	–	–	5,219,400	5,219,400
Distributions to stockholders, net	–	–	(166,200)	(166,200)
Balance at December 31, 2010	100	9,943,500	35,442,600	45,386,200
Net income with no income taxes provided	**–**	**–**	**8,936,200**	**8,936,200**
Distributions to stockholders, net	**–**	**–**	**(557,800)**	**(557,800)**
Balance at December 31, 2011	**$ 100**	**$ 9,943,500**	**$ 43,821,000**	**$ 53,764,600**

See accompanying notes.

Southern Maryland Hospital, Inc.

Statements of Cash Flows

	Year Ended December 31	
	2011	**2010**
Operating activities		
Net income with no income taxes provided	**$ 8,936,200**	$ 5,219,400
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss on disposal of property and equipment	**15,600**	49,500
Depreciation and amortization	**5,965,800**	5,831,200
Changes in operating assets and liabilities, net	**(3,444,700)**	1,661,500
Net cash provided by operating activities	**11,472,900**	12,761,600
Investing activities		
Purchases of property and equipment, net	**(12,205,800)**	(6,758,300)
Net cash used in investing activities	**(12,205,800)**	(6,758,300)
Financing activities		
Issuance of note payable	**8,000,000**	–
Short term borrowings	**630,000**	–
Borrowing on line of credit	**3,000,000**	3,000,000
Payments on line of credit	**(3,000,000)**	(3,000,000)
Payments of capital lease obligations	**(4,131,900)**	(5,410,200)
Distributions to stockholders, net	**(557,800)**	(166,200)
Changes in advances from related parties, net	**(3,932,800)**	830,100
Net cash provided by (used in) financing activities	**7,500**	(4,746,300)
Changes in cash and cash equivalents	**(725,400)**	1,257,000
Cash and cash equivalents, at beginning of year	**1,296,200**	39,200
Cash and cash equivalents, at end of year	**$ 570,800**	$ 1,296,200
Changes in operating assets and liabilities		
Changes in accounts receivable, net	**$ (8,774,000)**	$ (4,584,500)
Changes in prepaid expenses and other	**3,085,600**	5,524,600
Changes in inventories	**584,000**	(417,000)
Changes in other long-term assets	**$ (1,411,200)**	–
Changes in accounts payable	**304,700**	436,400
Changes in accrued salaries, wages and employee benefits	**1,506,800**	935,300
Changes in advances from third-party payors	**797,400**	1,257,700
Changes in other accrued liabilities	**(652,300)**	(193,400)
Changes in estimated professional liability	**1,114,300**	(1,297,600)
Changes in operating assets and liabilities, net	**$ (3,444,700)**	$ 1,661,500
Supplemental disclosure of cash flow information		
Cash paid for interest	**$ 1,483,400**	$ 1,721,100
Supplemental disclosure of noncash investing and financing activities		
Equipment and buildings acquired under capital leases	**$ 1,740,900**	$ 1,925,400

See accompanying notes.

1. Organization

Southern Maryland Hospital, Inc. (the Corporation), is a subchapter "S" corporation that operates an acute care hospital in Clinton, Maryland (suburban area in southern Maryland, east of Washington, D.C.). The Corporation is a full-service, regional healthcare facility that provides a complete range of inpatient, outpatient and community services for the residents of southern Maryland. The Corporation also operates a hospital-based sub-acute care unit. The Corporation is a resource center seeking to prevent illness and promote health through education and screening. The Corporation's mission is to assist the residents of southern Maryland in attaining the highest possible level of physical and mental healthcare, and thereby improve the quality of life in the community.

2. Summary of Significant Accounting Policies

New Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update, ("ASU"), No. 2010-24, "Health Care Entities—Presentation of Insurance Claims and Related Insurance Recoveries" ("ASU 2010-24"). ASU 2010-24 clarifies that a health care entity should not net insurance recoveries against a related claim liability. Additionally, the amount of the claim liability should be determined without consideration of insurance recoveries. This guidance is effective for fiscal years beginning after December 15, 2010. Accordingly, the Company prospectively adopted ASU 2010-24 on January 1, 2011. The adoption of this standard resulted in the reclassification of a $1.4 million asset for future insurance recoveries (classified as "Other long term assets" on the balance sheet) from its prior presentation as an offset to the Company's $7.6 million estimated professional liability (these amounts would have been presented as a net liability of $6.2 million, prior to the adoption of this guidance). The prior year balance sheet was not reclassified.

In August 2010, the EITF issued ASU 2010-23, which requires that charity care be measured based on the health care entity's direct and indirect costs of providing services to charity care patients. Any reasonable technique may be used to estimate these costs, but the method must be disclosed in the footnotes to the financial statements. Funds received to subsidize charity services must be separately disclosed. ASU 2010-23 was effective for fiscal years beginning after December 15, 2010 and must be applied retrospectively to all periods presented. The Company retrospectively adopted this guidance on January 1, 2011 The adoption of this guidance did not have an effect on the amounts recorded in the financial statements. However, it did change the charity care disclosure (see "Charity Care" section of Note 2 below) by disclosing charity care amounts at cost as opposed to their revenue equivalent.

2. Summary of Significant Accounting Policies (Continued)

In July 2011, the FASB issued 2011-7, *"Presentation and Disclosure of Patient Service Revenue, Provisions for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities."* ASU 2011-7 requires healthcare organizations to present their provisions for doubtful accounts related to patient service revenue as a deduction from revenue, similar to contractual discounts. In addition, all healthcare organizations will be required to provide certain disclosures designed to help users understand how contractual discounts and bad debts affect recorded revenue in both interim and annual financial statements. For nonpublic entities, the amendments are effective for the first annual period ending after December 15, 2012. Management is evaluating the impact, if any, that its adoption of this update may have on its financial statements.

Use of Estimates

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

Fair Value of Financial Instruments

The carrying amounts of financial instruments, including cash, accounts receivable, prepaid expenses and other assets, due to/from related parties, line of credit, short term borrowings, accounts payable, accrued salaries, wages and employee benefits, advances from third-party payors and other accrued liabilities approximate fair value, given the short-term nature of these financial instruments.

Cash and Cash Equivalents and Short-term Borrowings

Cash and cash equivalents include amounts invested in accounts which are readily convertible to cash. Investments with original maturities of three months or less when purchased are classified as cash and cash equivalents. In accordance with the Company's cash management policy of maximizing the amount of funds invested in income-earning assets, the Company routinely anticipates the timing and amount of future cash flows. This policy frequently results in the existence of negative book cash balances, which are reported as short-term borrowings.

2. Summary of Significant Accounting Policies (Continued)

Accounts Receivable and Contractual Allowances

The Corporation provides services to patients in southern Maryland, the majority of whom are covered by third-party health insurance. The Corporation bills the insurer directly for services provided. Insurance coverage and credit information is obtained from patients upon admission, when available. The Corporation's policy is to perform in-house collection procedures for approximately 120 days. A determination is made at that time as to what additional collection efforts to pursue. A provision for uncollectible accounts is recorded for amounts not yet written off, which are expected to become uncollectible.

The major payors routinely review patient billings and deny payment for certain charges as medically unnecessary or as performed without appropriate preauthorization. Accounts receivable from these third-party payors have been adjusted to reflect the difference between charges and the estimated reimbursable amounts.

Approximately 27% of accounts receivable were due from the Medicare program at December 31, 2011 and 2010, respectively. Approximately 11% and 14% of accounts receivable were due from CareFirst at December 31, 2011 and 2010, respectively.

Prepaid Expenses and Other Assets

At December 31, 2011 and 2010, the Corporation has prepaid expenses and other assets of $20,419,000 and $22,627,600, respectively, which relates to various purchased services and supplies. Included in these balances are amounts prepaid to related parties (see Note 4).

Inventories

Inventories of supplies are carried at lower of cost or market, using the first-in, first-out method.

2. Summary of Significant Accounting Policies (Continued)

Property and Equipment

Buildings and land under capital leases, furniture, fixtures and minor equipment, major movable equipment and leasehold improvements are recorded at cost and depreciated and amortized using the straight-line method over the lesser of the estimated useful lives of the assets or the terms of these leases as follows:

Buildings and land under capital leases	3 to 30 years
Furniture, fixtures and minor equipment	3 to 20 years
Major movable equipment	5 to 20 years
Leasehold improvements	5 to 25 years

For purposes of determining these lives, it is assumed that the operating lease for the main hospital building whose term currently expires in 2016 will be extended at least through the lives of the leasehold improvements and other related capital leases. Management believes that such an extension is probable.

Short Term Debt, Long Term Note Payable, Line of Credit and Letters of Credit

The Corporation has a $3,000,000 line of credit with a bank which has an indefinite maturity. Borrowings bear interest at the bank's prime interest rate, as defined, which was 3.25% at December 31, 2011 and 2010. As of December 31, 2011 and 2010, the balance outstanding was $3,000,000. This line of credit is payable on demand. All of the assets of the Corporation are pledged as collateral for this line of credit. Amounts outstanding under the line of credit as of December 31, 2010 were repaid in January 2011, and amounts outstanding as of December 31, 2011 were repaid in January 2012.

On December 21, 2011 the Corporation executed a $8,000,000 Term Loan Agreement with Suntrust Bank. The loan bears interest at 3.23% per annum, with 59 consecutive monthly installments of $144,700 ending on December 21, 2016. All of the assets of the Corporation are pledged as collateral for this Term loan. The Corporation was in compliance with all debt covenants relating to this term loan as of December 31, 2011.

As of December 31, 2011 the Corporation was obligated under a $9,630,000 letter of credit from Suntrust bank related to its professional liability insurance coverage (see Note 7) which has no expiration date.

2. Summary of Significant Accounting Policies (continued)

Net Patient Service Revenue

Net patient service revenue is reported at the estimated realizable amounts from patients, third-party payors and others for services rendered. A significant portion of the Corporation's patient service revenue is reimbursed through Medicare and Medicaid. Reimbursements by these third-party payors are based upon the Corporation's approved billing rates less a 6% discount. Contractual discounts and certain denials of payment for services rendered are recorded as reductions of net patient service revenue.

Patient service revenue reimbursed through these programs has been recorded at the net realizable amount in the accompanying statements of revenues and expenses. All other payors reimburse the Corporation at the Corporation's standard rates, adjusted for certain prompt pay discounts, which do not exceed 2%.

The Corporation's principal sources of net patient service revenue may be summarized as follows:

	Year Ended December 31	
	2011	**2010**
Medicare	**40%**	39%
Commercial Insurers (including Health Maintenance Organizations (HMO))	**17**	18
Blue Cross	**16**	16
Medicaid (including Medicaid HMO)	**17**	18
Other	**10**	9
	100%	100%

A substantial amount of the Corporation's revenues are received from health maintenance organizations and other managed care payors. Managed care payors generally use case management activities to control hospital utilization. These payors also have the ability to select health care providers offering the most cost-effective care. Management does not believe that the Corporation has undue exposure to any managed care payor.

2. Summary of Significant Accounting Policies (continued)

The provision for bad debts is based upon management's assessment of historical and expected net collections considering economic conditions, trends in health care coverage and other collection indicators. During the year, management assesses the adequacy of the allowance for uncollectible accounts based upon historical write-off experience by payor category. The results of this review are then utilized in the determination of the provision for bad debts to establish an appropriate allowance for uncollectible receivables.

Net Physician Revenue

The Corporation employs physicians in several hospital-based specialties including anesthesia, emergency room, cardiology, pediatrics/neonatology, obstetrics, intensive care, and hospitalists. The Corporation bills for the services provided by these physicians. The net physician revenue is recognized when the services are provided and recorded at the estimated net realizable value based on the contractual arrangements with third-party payors and the expected payments from the third-party payors and the patients. The differences between the billed charges and the estimated net realizable value are recorded as a reduction in physician revenue when the services are provided. As of December 31, 2011 and 2010, approximately $1,651,600 and $2,941,300, respectively, of net physician accounts receivable are included in accounts receivable in the accompanying balance sheets. During 2011, several of the physician groups that were previously employed became independent contractors and the hospital ceased billing for their services.

Charity Care

The Corporation provided care to patients who met certain criteria under its charity care policy, without charge or at amounts less than its approved rates. Because the Corporation did not pursue collection of amounts determined to qualify as charity care, they are not reported as net patient service revenue in the accompanying statements of revenues and expenses. The amounts written off as charity care for 2011 and 2010 were $1,390,700 and $2,926,700, respectively. These amounts represent direct and indirect charity care costs, which are calculated by taking the gross revenue related to the charity care services and reducing it by the company's profit margin, which is calculated by taking net income with no income taxes provided and dividing by total gross patient revenue. The state of Maryland rate system includes components within the rates to partially compensate hospitals for uncompensated care.

2. Summary of Significant Accounting Policies (continued)

Income Taxes

The Corporation has elected to be taxed as a Subchapter "S" corporation for federal and state income tax purposes, reporting corporate taxable income or loss on the stockholders' individual income tax returns. The unaudited pro forma provision for income taxes in the accompanying statements of revenues and expenses reflects an amount equal to the provision for income taxes on the Corporation's net income at corporate statutory income tax rates that would have been recognized by the Corporation had the "S" election not been in effect.

3. Health Care Regulation

Health Services Cost Review Commission

The Corporation's rate structure for most hospital-based services is subject to review and approval by the Maryland Health Services Cost Review Commission (HSCRC). Under the HSCRC rate setting system, the Corporation's inpatient charges are subject to an inpatient charge per case target (the Charge Per Case Target). The Charge Per Case Target is adjusted annually for inflation, case mix changes and other factors. Under the Charge Per Case Target methodology, the Corporation monitors its average charge per case compared to HSCRC case mix adjusted targets on a monthly basis.

The current rate of reimbursement for principally all inpatient services and certain other services to patients under the Medicare and Medicaid programs is based on an agreement between the Centers for Medicare and Medicaid Services and the HSCRC. This agreement is based upon a waiver from the Medicare prospective payment system reimbursement principles granted to the State of Maryland under Section 1814(b) of the Social Security Act and will continue as long as all third-party payors elect to be reimbursed in Maryland under this agreement and the rate of increase for costs per hospital inpatient admission in Maryland is below the national average. Management expects this agreement will remain in effect at least through December 31, 2012.

The HSCRC's rate-setting methodology for hospital service centers that provide both inpatient and outpatient services or only outpatient services consists of establishing an acceptable unit rate for defined inpatient and outpatient service centers within the hospital. The actual average unit charge for each service center is compared to the approved rate monthly and annually. Over charges and under charges due to price variances, plus penalties where applicable, are applied to decrease (in the case of overcharges) or increase in the case of undercharges) future approved rates on an annual basis.

3. Health Care Regulation (continued)

The Corporation's policy is to recognize revenue based on actual charges for services to patients in the year in which the services are performed. The Corporation's revenues may be subject to adjustment as a result of examination by government regulations, medical diagnosis, charge coding, medical necessity, or other contract terms. The resolution of these matters, if any, often is not finalized until subsequent to the period during which the services were rendered.

As of December 31, 2011, the Corporation's actual average charge per case was greater than the HSCRC's target average charge per case. In addition, as of December 31, 2011, the Corporation's actual average outpatient unit charges were greater than the approved charges. The net amount overcharged by the Corporation was $1,452,400 at December 31, 2011. Provided the Corporation remains in compliance with other rate corridors, the Corporation will be able to adjust rates during the period from January 1, 2012 through June 30, 2012 to achieve compliance with the HSCRC Charge Per Case Target rate and approved outpatient unit charges. Management believes that the Corporation will be within the HSCRC rate corridors and in compliance with the HSCRC's target average charge per case and outpatient unit charges at June 30, 2012 and, therefore, no liability has been recorded as of December 31, 2011. As of December 31, 2010, the net amount overcharged by the Corporation was $684,800 which was adjusted through lower rates in 2011.

Other

The Medicare and Medicaid reimbursement programs represent a substantial portion of the Corporation's revenues and its operations are subject to the numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement for patient services and Medicare and Medicaid fraud and abuse.

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements and reimbursement for patient services. Recently, government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by health care providers. Violations of these laws and regulations could result in expulsion from government health care programs, together with the imposition of fines and penalties, as well as repayments for patient services previously billed. Compliance with such laws and regulations can be subject to future government review and interpretation. Also, future changes in federal and state reimbursement funding mechanisms and related government budgeting constraints could have an adverse effect on the Corporation.

4. Related Party Transactions

Capital Leases

From July 1, 1979, through June 30, 2011, the Corporation leased its land, buildings and certain fixed and movable equipment under a 32-year lease (the "original lease") from Southern Maryland Hospital Center (the Partnership), a related party. Management negotiated a five-year extension of the lease (the "renewal lease") with the Partnership following the expiration of the original lease on June 30, 2011. The original lease was accounted for as a capital lease and was capitalized at $24,972,000, which was the fair market value of the property as determined by independent appraisal at the inception of the original lease. For the period ended December 31, 2011 original lease payments under the main building lease were $6,027,200 and the renewal lease payments under the main building lease were $6,027,200, while for the period ended December 31, 2010 the main building lease payments were $11,829,700. Based on the CPI Housing Index, rentals increased 1.9% during 2011 and increased 0.3% during 2010, respectively, related to changes in utility costs, property taxes and changes in the market value of the property. The lease renewal has been classified as an operating lease. Given the change from a capital lease to an operating lease, on the day the original lease expired, the $25 million of capitalized building and land and the $25 million of accumulated depreciation related to that building and land were removed from the balance sheet

The Corporation leases additional space, known as C-corridor, from a related party that was capitalized in 1983 at $225,000, with annual lease payments of $58,200, as adjusted for escalation of costs. This lease was recapitalized in 2006 for renovations associated with cardiac services at $1,125,700, with annual lease payments of $113,000.

In 1996, the Corporation began leasing warehouse space, which was capitalized at $594,600, with annual lease payments of $60,000, as adjusted for escalation of costs. This lease is with the Partnership and it will expire in 2026. In addition to this original lease, this space was renovated and effective November 2010, the Corporation began leasing the newly renovated space, known as 2-north, from the Partnership under an additional new capital lease, which was capitalized at $1,925,400, with annual lease payments of $195,000 as adjusted for escalation of costs. This lease expires in 2025.

Effective July 1, 1996, the Corporation began leasing two additional building spaces for the sub-acute unit under capital leases which were capitalized at $3,567,100, and $134,100, with annual lease payments of $399,000, and $15,000 as adjusted for escalation of costs. These leases are with the Partnership and expire in 2016.

4. Related Party Transactions (continued)

The Corporation leases building space, known as bed tower II, housing women's services, support services, and storage space which was capitalized for $8,456,000, with annual lease payments of $928,200, as adjusted for escalation of costs. The leases are with the Partnership and expire in 2026.

Effective July 1, 1998, the Corporation began leasing additional parking lots, known as employee parking, from the Partnership. The lease was capitalized at $1,670,000, with annual lease payments of $215,400, as adjusted for escalation of costs. This lease expires in 2013.

Effective October 1, 2003, the Corporation began leasing additional building space for the emergency room from the Partnership under a capital lease, which was capitalized at $1,989,200, with annual lease payments of $193,300, as adjusted for escalation of costs. This lease expires in 2023.

Effective March 2011, the Corporation began leasing newly constructed space for a sleep lab from the Partnership under a capital lease, which was capitalized at $1,740,900, with annual lease payments of $176,300 as adjusted for escalation of costs. This lease expires in 2026.

Included in the accompanying statements of revenues and expenses for the years ended December 31, 2011 and 2010 are $1,436,000 and $1,721,100, respectively, of interest expense and $5,742,000 and $9,745,100, respectively, of executory costs related to the above capital leases.

Since these capital lease obligations were entered into with the Partnership, which is a related party, the fair value of these obligations is not readily determinable.

Operating Leases

As mentioned above, the building and land lease with the partnership became an operating lease on July 1, 2011. Rental payments for the six-month period ended December 31, 2011 were $6,027,200.

The Corporation rents several office suites in a professional building owned by the minority stockholder (2010 only) of the Corporation. The total rental payments in 2011 and 2010 were $180,800 and $160,200, respectively. The annual rental payments under these operating leases are commensurate with those charged to other tenants of the professional building.

4. Related Party Transactions (continued)

The Corporation also rents a warehouse, known as Butler II, owned by the stockholders of the Corporation. Annual rental payments were $46,000 in 2011 and $46,000 in 2010.

The Corporation also rents parking lot facilities from the minority stockholder (2010 only) of the Corporation. Annual rental payments were $76,400 in 2011 and $76,400 in 2010.

Other Transactions

The principal stockholder of the Corporation is the sole owner of several companies, which provided administrative, financial, data processing and certain operational services to the Corporation during 2011 and 2010. Charges for these services are covered by a management fee of 10% of the Corporation's gross patient service revenue during 2011 and 2010.

The Corporation has prepaid amounts for rental payments, leases, administrative and financial services to related parties. These amounts were $9,140,600 and $9,981,300 as of December 31, 2011 and 2010, respectively, and are included in prepaid expenses and other assets in the accompanying balance sheets.

The Corporation uses a nursing agency owned by the principal stockholder of the Corporation to staff temporary nursing positions. Total nursing fees paid (which approximated local market rates) to the nursing agency in 2011 and 2010 were $1,477,900 and $1,093,100, respectively.

The Corporation uses Professional Billing Inc. (PBI) owned by the principal stockholder of the Corporation, to process its physician billings. Total PBI service fees paid in 2011 and 2010 were $1,168,200 and $1,589, 400, respectively.

The Corporation uses Chesapeake Receivables Management, owned by an executive (and minority stockholder in 2011 only) of the Corporation, to provide collection services. Total service fees paid in 2011 and 2010 were $516,500 and $730,500, respectively.

Advances to related parties as of December 31, 2011 and advances from related parties as of December 31, 2010 represent net amounts payable and receivable, respectively, from the Partnership and other entities owned by the stockholders of the Corporation for funds advanced by or owed to the Corporation.

4. Related Party Transactions (continued)

Guarantee of Partnership Debt

In December 2010, the Corporation became a guarantor for a new $4,000,000 term loan that the Partnership obtained from a bank. The term loan matures in December 2017 and carries an annual variable interest rate of LIBOR plus 2.18%. The proceeds of the term loan were used by the Partnership to finance the construction of two new facilities that have been leased by the Corporation under long-term capital leases. The Corporation expects that the Partnership will be able to fully repay the term loan and therefore, at December 31, 2011 the Corporation is not required to recognize a liability under ASC 450, *Contingencies*, for this guarantee.

5. Lease Commitments

Capital Leases

The Corporation has capitalized land, buildings, and fixed and movable equipment leases with a basis of $27,323,900 and $51,684,500 and accumulated amortization of $17,221,600 and $40,484,200 as of December 31, 2011 and 2010, respectively under capital leases. Amortization of assets recorded under capital leases is included with depreciation expense in the accompanying statements of revenues and expenses.

Future minimum lease payments under these capital leases, as of December 31, 2011, are as follows:

2012	$ 3,853,300
2013	3,303,800
2014	3,136,500
2015	3,124,800
2016	2,822,800
Thereafter	21,926,500
Total	38,167,700
Less – amount representing executory costs (such as supply and service contracts, property taxes, heat, light, power, rent escalation and profit, included in total minimum lease payments)	(12,708,800)
Net minimum lease payments	25,458,900
Less – amount representing interest	(9,999,000)
Present value of future minimum lease payments	$ 15,459,900

5. Lease Commitments (continued)

Included in total present value of future minimum lease payments are amounts due to related parties. As of December 31, 2011, such amounts were $13,308,300.

Operating Leases

The building and land lease with the partnership became an operating lease on July 1, 2011. Rental payments for the six-month period ended December 31, 2011, were $6,027,200.

The Corporation has entered into operating leases for equipment and office suites. As of December 31, 2011, future minimum rental payments are $124,100. All amounts are due in 2012.

Included in future minimum rental payments are amounts due to related parties. As of December 31, 2011, such amounts were $54,311,000. Rental expense for 2011 and 2010 was $6,474,100 and $452,800, respectively. The increase in rent expense is primarily driven by the change of the building lease from a capital lease to an operating lease as of June 30, 2011 as discussed above.

Future minimum lease payments under these operating leases, as of December 31, 2011, are as follows:

2012	$ 12,128,100
2013	12,070,100
2014	12,070,400
2015	12,070,700
2016	6,030,000
Thereafter	–
Total	$ 54,369,300

6. Defined Contribution Plan

In 2011 and 2010, the Corporation maintained a defined contribution 401(k) plan covering substantially all employees who have completed at least 500 hours of service within the first six consecutive months of employment. Eligible employees may contribute a percentage of their salary in any taxable year not to exceed a dollar limit, which is set by law.

6. Defined Contribution Plan (continued)

The Corporation's contributions vest 20% each year after completing one year of service until they are fully vested after six years of service. The Corporation contributed approximately $910,126 and $965,800, respectively, for the years ended December 31, 2011 and 2010.

7. Insurance

The Corporation participates in the Maryland Hospital Association Workers' Compensation Self-Insurance Group (the Group). Under this arrangement, the Corporation pays monthly premiums based on estimated payroll costs. Total premiums for the years ended December 31, 2011 and 2010 were $718,900 and $1,185,000, respectively. In 2011, the Corporation received a dividend of $514,300 related to 2011 and prior-year premiums paid, which was applied against the 2011 gross premium expense of $718,900, reducing it to $204,600. In 2010, the Corporation also received a dividend of $801,000 related to 2010 and prior-year premiums paid, which was applied against the 2010 gross premium expense of $1,185,000 reducing it to $384,000.

The Corporation has a claims-made policy for its professional liability insurance coverage and its general liability coverage. Should the claims-made policy not be renewed or replaced with equivalent insurance, claims based on occurrences during its term but reported subsequently will be uninsured. However, the insurance carrier has a contractual obligation to provide coverage, at an undetermined price, for incidents which occurred during the years covered by a claims-made policy but reported subsequent to the claims-made policy's term. The Corporation renewed its general and professional liability policies through November 16, 2012.

During 2001, the Corporation's former insurance carrier filed for bankruptcy protection and coverage was replaced with another carrier on November 16, 2001. As a result, the former insurance carrier may not be able to provide coverage for incidents that were reported but not paid up to the termination date of its policy. The State of Maryland established the Property and Casualty Insurance Guarantee Corporation, which covers up to $300,000 per incident, less a $100 deductible for claims that would have been covered by the bankrupt insurer, subject to the review and approval of the administrators of this fund. As of December 31, 2011 and 2010, management of the Corporation does not believe that the Corporation has exposure for claims reported to its former carrier that may not be covered under its policy or covered by the State of Maryland Property and Casualty Insurance Guarantee Corporation. Therefore, the Corporation has not recorded estimates for any such exposures as of December 31, 2011 and 2010.

7. Insurance (Continued)

For the period from November 16, 2004 through November 15, 2005, the Corporation's professional liability coverage was subject to a deductible of $250,000 per incident and a $750,000 annual maximum. For the periods from November 16, 2005 through November 15, 2009, the annual maximum was changed to $2,500,000. For the period from November 16, 2009 through November 15, 2012, the deductible was increased to $500,000 per case with no annual maximum.

As of December 31, 2011 and 2010, the Corporation has estimated its exposures related to deductibles and incurred but not reported claims based on an undiscounted actuarial analysis of the outstanding known claims and incurred but not reported claims and discussion with legal counsel. These amounts are included in estimated professional liability in the accompanying balance sheets. Management believes, after consultation with legal counsel, that the ultimate liability from these matters will not have a material adverse effect on the accompanying financial statements.

8. Litigation

There are several lawsuits pending in which the Corporation has been named as a defendant. In the opinion of the Corporation's management, after consultation with legal counsel, the amount of liability, if any, not covered by insurance will not have a material adverse impact on the Corporation's financial position.

9. Subsequent Events

Subsequent to December 31, 2011, the majority owner of the Corporation transferred his entire ownership of the Corporation and the Partnership to members of his immediate family. The Corporation evaluated the impact of subsequent events through April 30, 2012, representing the date at which the financial statements were available to be issued, and noted no other subsequent events that required disclosure.

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