KPMG

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

Consolidated Financial Statements and Supplemental Information

June 30, 2011 and 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 accompanying consolidated balance sheets of St. Mary's Hospital of St. Mary's County, Inc. and Subsidiaries (the Corporation) as of June 30, 2011 and 2010, and the related consolidated statements of operations, and changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform 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 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of St. Mary's Hospital of St. Mary's County, Inc. and Subsidiaries as of June 30, 2011 and 2010, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the consolidated financial statements of St. Mary's Hospital of St. Mary's County, Inc. and Subsidiaries taken as a whole. The consolidating information included in schedules 1 and 2 is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, and results of operations and cash flows of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audit of the 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, 2011

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

Consolidated Balance Sheets

June 30, 2011 and 2010

Assets		2011	2010
Current assets:			
Cash and cash equivalents	$	35,476,834	24,837,882
Assets whose use is limited or restricted		3,110,636	3,602,953
Receivables:			
From patient services (less allowances for uncollectible accounts of $4,310,274 and $4,889,337 in 2011 and 2010, respectively)		16,921,369	17,178,138
Notes receivables, current portion		383,270	432,381
Other		372,140	701,730
		17,676,779	18,312,249
Inventories		2,491,322	2,603,143
Prepaids and other current assets		1,012,918	1,127,569
Total current assets		59,768,489	50,483,796
Assets whose use is limited or restricted		3,811,107	11,116,413
Property and equipment, net		77,652,938	75,830,533
Investments		3,161,947	2,304,526
Investments in unconsolidated affiliates		2,915,772	2,523,693
Notes receivables, net of current portion		376,521	632,498
Deferred financing costs, net		530,026	706,112
Prepaid pension asset		1,636,628	—
Total assets	$	149,853,428	143,597,571

(Continued)

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

Consolidated Balance Sheets

June 30, 2011 and 2010

Liabilities and Net Assets		**2011**	**2010**
Current liabilities:			
Accounts payable and accrued expenses	$	5,566,722	6,936,874
Accrued salaries, benefits, and payroll taxes		5,391,913	3,918,039
Amounts due to third-party payors		4,217,409	2,811,311
Current portion of long-term debt and capital lease obligations		17,763,258	4,762,583
Current portion of self insurance liabilities		59,733	757,656
Due to Parent		2,685,094	—
Other current liabilities		3,193,926	3,853,185
Total current liabilities		38,878,055	23,039,648
Long-term debt and capital lease obligations, net of current portion		16,720,621	32,134,719
Self insurance liabilities, net of current portion		1,475,000	1,475,000
Pension liabilities		—	2,941,627
Other long-term liabilities, net of current portion		2,463,035	3,049,236
Total liabilities		59,536,711	62,640,230
Net assets:			
Unrestricted		88,827,050	77,363,854
Temporarily restricted		1,389,667	3,493,487
Permanently restricted		100,000	100,000
Total net assets		90,316,717	80,957,341
Total liabilities and net assets	$	149,853,428	143,597,571

See accompanying notes to consolidated financial statements.

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

Consolidated Statements of Operations

Years ended June 30, 2011 and 2010

	2011	2010
Unrestricted revenues, gains, and other support:		
Net patient service revenue:		
Hospital inpatient services	$ 57,552,686	59,226,782
Hospital outpatient services	60,762,561	53,312,453
Other patient service revenue	2,516,878	2,098,246
Total net patient service revenue	120,832,125	114,637,481
Other operating revenue	2,820,914	3,213,058
Net assets released from restrictions for operations	1,657,903	772,129
Interest income and dividends	94,478	206,123
Realized losses on investments, net	(6,752)	(7,207)
Unrealized gains on investments, net	11,071	118,986
Equity in earnings from unconsolidated affiliates	358,955	217,090
Total unrestricted revenues, gains, and other support	125,768,694	119,157,660
Expenses:		
Personnel	58,739,396	59,301,896
Supplies	19,868,082	18,709,179
Purchased services	13,948,938	11,843,749
Other operating	11,586,463	9,863,493
Provision for bad debts	4,438,523	5,568,010
Interest expense	1,067,757	1,267,450
Depreciation and amortization	7,693,061	7,398,774
Pension and other expenses related to merger	813,828	1,576,391
Loss on disposal of equipment	161,210	261,714
Total expenses	118,317,258	115,790,656
Excess of revenues, gains, and other support over expenses	$ 7,451,436	3,367,004

See accompanying notes to consolidated financial statements.

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

Consolidated Statements of Changes in Net Assets

Years ended June 30, 2011 and 2010

		2011	2010
Unrestricted net assets:			
Excess of revenues, gains and other support over expenses	$	7,451,436	3,367,004
Change in funded status of defined benefit plans		4,196,257	979,575
Net assets released from restrictions used for purchase of property and equipment		642,447	—
Equity transfer (to) from Parent		(826,944)	826,944
Increase in unrestricted net assets		11,463,196	5,173,523
Temporarily restricted net assets:			
Contributions		196,530	437,006
Net assets released from restrictions for operations		(1,657,903)	(772,129)
Net assets released from restrictions for purchase of property and equipment		(642,447)	—
Decrease in temporarily restricted net assets		(2,103,820)	(335,123)
Increase in net assets		9,359,376	4,838,400
Net assets, beginning of year		80,957,341	76,118,941
Net assets, end of year	$	90,316,717	80,957,341

See accompanying notes to consolidated financial statements.

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

Consolidated Statements of Cash Flows

Years ended June 30, 2011 and 2010

		2011	2010
Cash flows from operating activities:			
Change in net assets	$	9,359,376	4,838,400
Adjustments to reconcile change in net assets to net cash provided by operating activities:			
Depreciation		7,526,147	7,362,486
Amortization of bond financing costs and bond premiums		166,914	36,288
Loss on sale of property and equipment		161,210	261,714
Equity transfer to (from) Parent		826,944	(826,944)
Equity in earnings on investments in unconsolidated affiliates		(358,955)	(217,090)
Change in funded status of defined benefit plans		(4,196,257)	(979,575)
Realized losses on investments		6,752	7,207
Change in unrealized gains on investments		(11,071)	(118,986)
Provision for bad debts		4,438,523	5,568,010
Temporarily restricted contributions		(196,530)	(437,006)
Changes in operating assets and liabilities:			
Patient services receivables		(4,181,754)	(8,512,406)
Other receivables		(102,791)	(701,730)
Inventories and other assets		111,821	(125,321)
Prepaid and other current assets		547,032	110,095
Accounts payable and accrued expenses		(1,416,505)	1,992,232
Accrued salaries, benefits, and payroll taxes		1,473,874	(5,924,238)
Amounts due to third-party payors		1,406,098	(1,497,175)
Due to Parent		2,685,094	—
Other liabilities		(2,325,381)	6,183,253
Net cash provided by operating activities		15,920,541	7,019,214
Cash flows from investing activities:			
Increase in investments, net		(857,421)	(238,456)
Decrease in assets whose use is limited or restricted, net		7,801,942	3,754,549
Purchases of property and equipment		(9,464,909)	(5,618,035)
Investments in unconsolidated affiliates		(33,124)	—
Proceeds from sale of equipment		1,500	68,690
Change in notes receivables		305,088	(166,111)
Distribution from investments in unconsolidated affiliates		—	32,967
Net cash used in investing activities		(2,246,924)	(2,166,396)
Cash flows from financing activities:			
Repayment of long-term borrowings and capital lease obligations		(2,404,251)	(2,225,562)
Equity transfer to/from Parent		(826,944)	826,944
Temporarily and permanently restricted contributions		196,530	437,006
Net cash used in financing activities		(3,034,665)	(961,612)
Increase in cash and cash equivalents		10,638,952	3,891,206
Cash and cash equivalents at beginning of year		24,837,882	20,946,676
Cash and cash equivalents at end of year	$	35,476,834	24,837,882
Supplemental disclosure of cash flow information:			
Interest paid	$	1,067,757	386,723
Noncash investing and financing activities:			
Amounts included in accounts payable for fixed asset purchases	$	46,353	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. (the Corporation) are 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 Corporation 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 Corporation maintains cash balances and temporary cash investments at several financial institutions. At June 30, 2011 and 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 Corporation'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 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 and unrealized gains and losses on investments are reported within the excess of revenues, gains and other support over expenses in the accompanying consolidated statements of operations unless the income or loss is restricted by the donor or law. 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.

(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 Corporation 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 years ended June 30, 2011 and 2010 was $176,086 and $27,116, respectively. Included in 2011 amortization expense is $139,600 of deferred financing fees that were written off. Accumulated amortization totaled $533,928 and $497,446, respectively, at June 30, 2011 and 2010.

(i) Bond Premiums

Bond premiums are classified as additions of long term debt 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.

(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.

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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, 2011 and 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 a reduction of 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. 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*. The Corporation had deferred tax assets of $228,000 related to net operating loss carryforwards and has recorded a full valuation allowance as of June 30, 2011.

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

The consolidated statements of operations and changes in net assets include a performance indicator, the 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 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 change in funded status of defined benefit plans, 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 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 required 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 investments 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 in 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 Corporation does not have significant transfers between Levels, or any Level III measurements, no additional disclosures were necessary.

(u) Subsequent Events Review

Management evaluated all events and transactions that occurred after June 30, 2011 and through October 28, 2011. The Corporation did not have any material recognizable or reportable subsequent events during this period that need to be disclosed.

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

Investments and assets whose use is limited or restricted as of June 30, 2011 and 2010, at fair value, consist of the following:

	2011	2010
Assets:		
Cash and cash equivalents	$ 1,605,924	1,750,280
Certificates of deposit	248,432	244,818
Mutual funds	591,587	3,274,502
U.S. government obligations	2,370,352	3,662,895
U.S. agency mortgage backed securities	3,197,028	8,091,397
Investment in MedStar Pool	2,070,367	—
Total investments and assets whose use is limited or restricted	10,083,690	17,023,892
Less investments and assets whose use is limited or restricted	6,272,583	5,907,479
Long-term assets whose use is limited or restricted	$ 3,811,107	11,116,413

Assets whose use is limited or restricted as of June 30, 2011 and 2010, included in the preceding table, consist of the following:

		2011	2010
Funds held by trustees under indenture agreement	$	3,512,242	10,490,378
Funds held by trustees under employment insurance agreement		642,098	642,092
Funds designated by Board		1,353,975	1,418,749
Funds restricted by donors for specific purposes		1,313,428	2,068,147
Permanently restricted endowment funds		100,000	100,000
		6,921,743	14,719,366
Less assets required for current obligations		(3,110,636)	(3,602,953)
	$	3,811,107	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 years ending June 30, 2011 and 2010:

		2011	2010
Interest income and dividends	$	94,478	206,123
Realized net losses on sale of investments		(6,752)	(7,207)
Unrealized gains on investments		11,071	118,986
Total investment return	$	98,797	317,902

(3) Fair Value of Financial Instruments

The Corporation adopted FASB ASC Topic 820, *Fair Value Measurements and Disclosures*. 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 Corporation's 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 Corporation 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, 2011 and 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. 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 Corporation's investable assets as of June 30, 2011, aggregated by the three level valuation hierarchy:

	Level 1	Level 2	Level 3	Total
Assets:				
Cash and cash equivalents	$ 1,605,924	—	—	1,605,924
Certificates of deposit	248,432	—	—	248,432
Mutual funds	591,587	—	—	591,587
U.S. government obligations	2,370,352	—	—	2,370,352
U.S. agency mortgage backed securities	—	3,197,028	—	3,197,028
Investment in MedStar Pool	—	2,070,367	—	2,070,367
	$ 4,816,295	5,267,395	—	10,083,690

The following table presents the Corporation'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

There were no significant transfers between levels 1, 2, and 3 during the years ended June 30, 2011 and 2010.

(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, 2011 and 2010:

		2011	2010
Pledges receivable, net of unamortized discount of $5,907 and $7,448, respectively	$	118,145	141,518
Less allowance for uncollectible pledges		(5,907)	(7,448)
	$	112,238	134,070

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

2012	$	74,045
2013		26,200
2014		17,900
	$	118,145

(5) Property and Equipment

Property and equipment as of June 30, 2011 and 2010 consist of the following:

		2011	2010
Land	$	3,927,676	3,927,676
Buildings and improvements		66,374,656	66,216,417
Equipment		41,932,416	40,283,598
Equipment under capital leases		8,862,051	8,277,555
		121,096,799	118,705,246
Less accumulated depreciation		(54,925,722)	(47,877,589)
		66,171,077	70,827,657
Construction in progress		11,481,861	5,002,876
	$	77,652,938	75,830,533

Construction in progress includes a variety of ongoing capital projects at the Hospital as of June 30, 2011 and 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 $473,140 and $6,516,950, respectively, as of June 30, 2011 and 2010.

Depreciation expense related to property and equipment amounted to $7,526,147 and $7,362,486, respectively, for the years ended June 30, 2011 and 2010.

Equipment under capital leases financed with capital lease obligations was $8,862,051 as of June 30, 2011 and 2010. Accumulated amortization related to the equipment under capital leases was $2,381,926 and $1,723,910 at June 30, 2011 and 2010, respectively.

(6) Investments in Unconsolidated Affiliates

The Corporation has investments in unconsolidated affiliates, accounted for using the cost or equity method, aggregating $2,915,772 and $2,523,693 as of June 30, 2011 and 2010, respectively, in the following:

Joint venture	Type of organization	Business purpose	Percent ownership 2011	Percent ownership 2010
Chesapeake-Potomac Healthcare Alliance, LLC (CPHA)	For-profit	Healthcare related services	33.3%	33.3%
NRH/CPT/St. Mary's/Civista Regional Rehab, LLC (Regional Rehab)	For-profit	Medical, rehabilitative, and therapy services	15.0	15.0
Maryland eCare, LLC (eCare)	For-profit	Remote monitoring technology	8.5	8.5

The Corporation's investment in unconsolidated affiliates balance and equity in earnings (proportionate share of losses) of the joint ventures as of and for the years ended June 30, 2011 and 2010 is as follows:

	2011		
		Investment balance	Equity in earnings
CPHA	$	2,867,151	316,799
Regional Rehab		42,621	42,156
Maryland eCare		6,000	—
Total	$	2,915,772	358,955

	2010		
		Investment balance	Equity in earnings
CPHA	$	2,462,223	187,501
Regional 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 years ended June 30, 2011 and 2010 is as follows:

		2011	2010
Current assets	$	4,282,008	3,556,901
Noncurrent assets		11,737,075	11,711,482
Total assets	$	16,019,083	15,268,383
Current liabilities	$	2,110,253	1,871,634
Noncurrent liabilities		3,016,160	4,167,496
Net assets		10,892,670	9,229,253
Total liabilities and net assets	$	16,019,083	15,268,383
Total operating revenue	$	13,304,878	12,043,126
Total operating expense		11,292,158	11,332,436
Total operating income	$	2,012,720	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 2011. 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 $759,791 and $1,064,879 as of June 30, 2011 and 2010, of which $383,270 and $432,381, respectively, is due within one year and is included in current assets.

(8) Long-Term Debt and Capital Lease Obligations

The Hospital's long-term debt consists of the following at June 30, 2011 and 2010:

	2011	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 .19% to .40% and 0.12% to 0.37% during 2011 and 2010, respectively, principal payments began January 1, 2010 and are payable annually through January 1, 2039.	$ 15,520,000	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.	14,985,000	15,905,000
Mortgage notes with interest at 6.0%. Principal and interest payable monthly for 15 years beginning June 10, 2001.	541,764	633,754
	31,046,764	32,308,754
Plus unamortized bond premium	97,835	107,007
	31,144,599	32,415,761
Less current portion of long-term debt	1,317,664	1,261,990
Less long-term debt subject to short-term remarketing agreement	15,255,000	2,358,333
Long-term debt, less current portion	$ 14,571,935	28,795,438

The Hospital's capital leases consist of the following at June 30, 2011 and 2010:

	2011	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.	$ 2,699,758	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.	638,296	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.	1,226	4,953
	3,339,280	4,481,541
Less current portion	1,190,594	1,142,260
	$ 2,148,686	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 entire amount of its long-term debt related to Series 2009, $15,255,000, as a current liability at June 30, 2011 due to the LOC expiring in February 2012. At June 30, 2010, the hospital reflected the amount of its long-term debt that is subject to the this short term remarking arrangement of $2,358,333 as a separate component of current liabilities in its consolidated balance sheets 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 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 plus accrued interest was $31,491,099 and $32,766,281 at June 30, 2011 and 2010, respectively.

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
2012	$ 16,572,664	1,190,594	17,763,258
2013	1,103,688	1,242,471	2,346,159
2014	1,155,083	602,507	1,757,590
2015	1,206,872	121,753	1,328,625
2016	1,258,457	127,252	1,385,709
Thereafter	9,750,000	54,703	9,804,703
	$ 31,046,764	3,339,280	34,386,044

(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 following table sets forth the changes in the benefit obligation as of June 30, 2011 and 2010:

		2011	2010
Benefit obligations at beginning of year	$	23,997,059	21,815,348
Service Cost		—	544,499
Interest Cost		1,281,476	1,318,340
Curtailments		—	(2,453,886)
Actuarial loss		(1,617,755)	3,189,461
Benefits paid		(491,043)	(416,703)
Benefits obligation at the end of the year	$	23,169,737	23,997,059

The following table sets forth the changes in the plan assets as of and for the years ended June 30, 2011 and 2010:

		2011	2010
Fair value of plan assets at beginning of the year	$	21,055,432	17,894,146
Actual return on plan assets		4,241,977	3,127,989
Employer contribution		—	450,000
Benefits paid		(491,043)	(416,703)
Fair value of plan assets at end of the year	$	24,806,366	21,055,432
Funded status and prepaid (accrued) pension asset (liability)	$	1,636,628	(2,941,627)

(Continued)

The amounts recognized in unrestricted net assets consist of the following as of June 30, 2011 and 2010:

		2011	2010
Net actuarial loss	$	(1,783,358)	2,413,090
Prior service cost		—	—
Net amount recognized	$	(1,783,358)	2,413,090

The components of the net periodic benefit cost recognized in operating expenses consist of the following for the years ended June 30, 2011 and 2010:

		2011	2010
Service cost	$	—	544,499
Interest cost		1,281,476	1,318,340
Expected return on plan assets		(1,663,284)	(1,542,758)
Amortization of prior service cost		—	(10,549)
Recognized net actuarial loss		—	38,535
Net periodic benefit cost		(381,808)	348,067
Curtailment Gain due to Plan Freeze		—	(284,807)
Total periodic benefit cost	$	(381,808)	63,260

The weighted average assumptions used in the accounting for the benefit obligation are as follows as of June 30, 2011 and 2010:

	2011	2010
Discount rates	5.60%	5.40%
Rate of compensation increase	—	—

The weighted average assumptions used in the accounting for the net periodic benefit cost for the years ended June 30, 2011 and 2010 are as follows:

	2011	2010
Discount rate	5.40%	6.25%
Expected long-term return on plan assets	8.00	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, 2011 and 2010:

	Actual allocation as of June 30	
	2011	**2010**
Cash and cash equivalents	0.45%	1.95%
U.S. Treasury bonds equity securities	40.24	36.40
Corporate bonds	2.19	2.61
Common stocks	57.12	59.04
Total	100.00%	100.00%

The following table presents the Plan's investable assets as of June 30, 2011 and 2010, aggregated by the three level valuation hierarchy:

June 30, 2011	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets:				
Cash and cash equivalents	$ 111,973	—	—	111,973
U.S. Treasury bonds	9,983,088	—	—	9,983,088
Corporate bonds	—	542,230	—	542,230
Common stocks	14,169,075	—	—	14,169,075
Total assets	$ 24,264,136	542,230	—	24,806,366

June 30, 2010	**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

There were no significant transfers between levels 1, 2 and 3 during the years ended June 30, 2011 and 2010.

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 nonparticipation 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, 2011 and 2010, the Hospital accrued a liability of $1,048,303 and $1,294,771, respectively, which represents the portion of benefit payments due where the criteria have been met for the years ended June 30, 2011 and 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:

2012	$	595,255
2013		627,254
2014		670,004
2015		734,592
2016		800,689
Thereafter		5,041,462
	$	8,469,256

The expected benefits to be paid are based on the same assumptions used to measure the Hospital's benefit obligation as of June 30, 2011 and 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 recorded contribution expense of $637,703 and $657,287 during the years ended June 30, 2011 and 2010, respectively.

(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 years ended June 30, 2011 and 2010 is as follows:

	2011	**2010**
Medicare	40%	34%
Medicaid	2	3
Carefirst Blue Cross Blue Shield	26	22
Other third-party payors	29	36
Self-pay	3	5
	100%	100%

A summary of net patient service receivables by major category of payor as of June 30, 2011 and 2010 is as follows:

	2011	2010
Medicare	32%	32%
Medicaid	8	10
Carefirst Blue Cross Blue Shield	25	17
Other third-party payors	31	34
Self-pay	4	7
	100%	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, 2011 and 2010 consist of the following:

	2011	2010
Accrued vacation for legacy employees	$ 517,626	1,138,640
Deferred compensation arrangements	591,588	762,975
Third party settlement payable	1,267,621	1,087,621
Other	86,200	60,000
	$ 2,463,035	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 Corporation maintains certain insurance programs for professional and general liability claims 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, 2011 and 2010 were as follows:

		2011	2010
Professional and general liability	$	1,475,000	1,475,000
Employee health		59,733	757,656
Total liabilities		1,534,733	2,232,656
Less current portion		(59,733)	(757,656)
	$	1,475,000	1,475,000

The Corporation'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, 2011 and 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 Corporation also maintains an umbrella policy in the amount of $5 million. The current policy extends coverage through October 2011. 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

Effective January 1, 2011, the Hospital's employees are covered under the MedStar's employee medical and dental coverage policy. Prior to January 1, 2011, the Hospital was self-insured against employee medical and dental claims and was covered under a policy with a commercial insurer, which had 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 Corporation 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 $517,377 and $534,857 for June 30, 2011 and June 30, 2010. The Corporation maintains an investment in an escrow account for this purpose of $642,098 and $642,092, which is included in assets whose use is limited at June 30, 2011 and 2010, respectively.

(Continued)

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

Litigation

The Corporation 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, 2011 and 2010.

(14) Temporarily and Permanently Restricted Net Assets

Temporarily and permanently restricted net assets as of June 30, 2011 and 2010 are available for the following purposes:

		2011	2010
Temporary restrictions:			
Hospice	$	208,479	2,945,877
Foundation		1,059,208	455,221
Other		121,980	92,389
	$	1,389,667	3,493,487
Permanent restrictions:			
Investments to be held in perpetuity, the income from which is available to support healthcare services	$	100,000	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, 2011 and 2010

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

	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 years ended June 30, 2011 and 2010.

		2011	2010
Charges foregone, based on established rates	$	3,387,520	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.

(Continued)

(17) Leases

The Hospital is obligated under various operating leases with initial terms of one year or more. Total rent expense for the years ended June 30, 2011 and 2010 for all operating leases was $1,663,814 and $1,357,618, respectively. Aggregate future minimum payments as of June 30, 2011 are as follows:

2012	$	293,100
2013		195,990
2014		133,214
2015		112,389
2016		21,375
Total minimum lease payments	$	756,068

(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, for these services, which are included in expenses in the accompanying statement of operations. The hospital settled the balance in this account during the year ended June 30, 2011, resulting in a credit balance of $826,944 at June 30, 2011 in equity transfers.

During the year of June 30, 2011, the method of recording these changed to a liability in our Intercompany liabilities. The amount at June 30, 2011 was $2,685,094 and it settled on a quarterly basis with MedStar for Hospital expenses that are included in the accompanying statement of operations.

(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 years ended June 30, 2011 and 2010 are as follows:

		2011	2010
Healthcare services	$	100,697,970	101,701,524
Management and general		15,652,107	13,672,392
Fundraising		1,967,181	416,740
	$	118,317,258	115,790,656

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

Consolidating Balance Sheet

June 30, 2011

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	$ 34,030,823	449,455	762,603	233,953	—	35,476,834
Assets whose use is limited or restricted	1,898,647	702,437	509,552	—	—	3,110,636
Receivables:						
From patient services (less allowances for uncollectible accounts of $4,310,274)	16,921,369	—	—	—	—	16,921,369
Notes receivables, current portion	383,270	—	—	—	—	383,270
Other	258,577	38,988	64,726	9,849	—	372,140
	17,563,216	38,988	64,726	9,849	—	17,676,779
Inventories	2,491,322	—	—	—	—	2,491,322
Prepaids and other current assets	1,008,368	550	4,000	—	—	1,012,918
Total current assets	56,992,376	1,191,430	1,340,881	243,802	—	59,768,489
Assets whose use is limited or restricted	3,811,107	—	—	—	—	3,811,107
Property and equipment, net	77,481,818	6,354	—	164,766	—	77,652,938
Investments	2,303,570	510,182	348,195	—	—	3,161,947
Investments in unconsolidated affiliates	2,873,151	—	—	42,621	—	2,915,772
Notes receivables, net of current portion	376,521	—	—	—	—	376,521
Deferred financing costs, net	530,026	—	—	—	—	530,026
Prepaid pension asset	1,636,628	—	—	—	—	1,636,628
Interest in consolidated subsidiaries	3,653,657	—	—	—	(3,653,657)	—
Total assets	$ 149,658,854	1,707,966	1,689,076	451,189	(3,653,657)	149,853,428

(Continued)

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

Consolidating Balance Sheet

June 30, 2011

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	$ 5,557,357	5,049	4,316	—	—	5,566,722
Accrued salaries, benefits, and payroll taxes	5,391,913	—	—	—	—	5,391,913
Amounts due to third-party payors, net	4,217,409	—	—	—	—	4,217,409
Current portion of long-term debt	17,763,258	—	—	—	—	17,763,258
Current portion of self insurance liabilities	59,733	—	—	—	—	59,733
Intercompany Payables	2,685,094	—	—	—	—	2,685,094
Other current liabilities	3,054,917	—	139,009	—	—	3,193,926
Total current liabilities	38,729,681	5,049	143,325	—	—	38,878,055
Long-term debt, net of current portion	16,720,621	—	—	—	—	16,720,621
Self insurance liabilities, net of current portion	1,475,000	—	—	—	—	1,475,000
Other long-term liabilities, net of current portion	2,416,835	—	46,200	—	—	2,463,035
Total liabilities	59,342,137	5,049	189,525	—	—	59,536,711
Net assets:						
Unrestricted	88,827,050	1,494,438	440,343	451,189	(2,385,970)	88,827,050
Temporarily restricted	1,389,667	208,479	1,059,208	—	(1,267,687)	1,389,667
Permanently restricted	100,000	—	—	—	—	100,000
Total net assets	90,316,717	1,702,917	1,499,551	451,189	(3,653,657)	90,316,717
Total liabilities and net assets	$ 149,658,854	1,707,966	1,689,076	451,189	(3,653,657)	149,853,428

See accompanying independent auditor's report.

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

Consolidating Statement of Operations

Year ended June 30, 2011

	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	$ 57,552,686	—	—	—	—	57,552,686
Hospital outpatient services	60,762,561	—	—	—	—	60,762,561
Other patient service revenue	2,516,878	—	—	—	—	2,516,878
Total net patient service revenue	120,832,125	—	—	—	—	120,832,125
Other operating revenue	3,473,328	387,370	298,632	—	(1,338,416)	2,820,914
Net assets released from restrictions for operations	7,992	1,143,254	506,657	—	—	1,657,903
Interest income and dividends	86,956	3,652	3,610	260	—	94,478
Realized net losses on trading investments	(10,028)	3,216	60	—	—	(6,752)
Unrealized net gains on trading investments	5,855	(1,120)	6,336	—	—	11,071
Earnings from unconsolidated affiliates	316,799	—	—	42,156	—	358,955
Equity in earnings from consolidated subsidiaries	433,041	—	—	—	(433,041)	—
Total revenues, gains, and other support	125,146,068	1,536,372	815,295	42,416	(1,771,457)	125,768,694
Expenses:						
Personnel	58,548,079	—	191,317	—	—	58,739,396
Supplies	19,818,387	34,815	14,880	—	—	19,868,082
Purchased services	13,816,156	19,931	112,851	—	—	13,948,938
Other operating	11,386,218	1,188,637	349,043	981	(1,338,416)	11,586,463
Provision for bad debts	4,442,158	4,332	(7,967)	—	—	4,438,523
Interest expense	1,067,757	—	—	—	—	1,067,757
Depreciation and amortization	7,640,839	—	—	52,222	—	7,693,061
Pension and other expenses related to merger	813,828	—	—	—	—	813,828
Loss on disposal of equipment	161,210	—	—	—	—	161,210
Total expenses	117,694,632	1,247,715	660,124	53,203	(1,338,416)	118,317,258
Excess of revenues gains, and other support over expenses	$ 7,451,436	288,657	155,171	(10,787)	(433,041)	7,451,436

See accompanying independent auditor's report.