Consolidated Financial Statements and Supplementary Information

Frederick Regional Health System, Inc. and Subsidiaries
Years Ended June 30, 2012 and 2011
With Reports of Independent Auditors

Ernst & Young LLP

ERNST & YOUNG

Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Financial Statements and Supplementary Information

Years Ended June 30, 2012 and 2011

Contents

Ernst & Young LLP
621 East Pratt Street
Baltimore, MD 21202
Tel: + 1 410 539 7040
Fax: + 1 410 783 3832
www.ey.com

Report of Independent Auditors

The Board of Directors
Frederick Regional Health System, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Frederick Regional Health System, Inc. and Subsidiaries as of June 30, 2012 and 2011, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of Frederick Regional Health System, Inc. and Subsidiaries' (the Company'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 Company'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 Company'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 consolidated financial position of the Company at June 30, 2012 and 2011, and the consolidated results of their operations, changes in net assets, and cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

October 15, 2012

Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Balance Sheets

(In Thousands)

	June 30	
	2012	**2011**
Assets		
Current assets:		
Cash and cash equivalents	**$ 32,216**	$ 27,295
Patient receivables, net	**50,241**	45,977
Other receivables	**1,492**	1,155
Inventory	**4,649**	4,356
Prepaid expenses	**2,497**	2,446
Assets limited as to use	**3,796**	3,702
Promises to give, net	**570**	613
Total current assets	**95,461**	85,544
Net property and equipment	**194,864**	180,833
Other assets:		
Assets limited as to use	**7,383**	14,003
Investments – donor restricted	**2,977**	2,896
Promises to give, net	**2,567**	2,665
Long-term investments	**100,827**	105,795
Other investments	**3,092**	3,423
Debt issuance costs, net	**1,590**	1,694
Other assets	**3,425**	177
Total other assets	**121,861**	130,653
Total assets	**$ 412,186**	$ 397,030

	June 30	
	2012	**2011**
Liabilities and net assets		
Current liabilities:		
Current maturities of long-term debt and capital lease obligations	**$ 4,119**	$ 3,732
Accounts payable	**21,602**	14,500
Accrued expenses	**20,629**	21,553
Advances from third-party payors	**10,065**	8,178
Other current liabilities	**2,983**	2,987
Total current liabilities	**59,398**	50,950
Long-term liabilities, net of current portion:		
Long-term debt and capital lease obligations	**140,725**	142,567
Interest rate swap contract	**16,513**	9,715
Accrued pension expense	**26,368**	16,476
Other long-term liabilities	**13,633**	9,481
Total long-term liabilities, net of current portion	**197,239**	178,239
Total liabilities	**256,637**	229,189
Net assets:		
Unrestricted	**149,432**	161,667
Temporarily restricted	**5,141**	5,198
Permanently restricted	**976**	976
Total net assets	**155,549**	167,841
Total liabilities and net assets	**$ 412,186**	$ 397,030

See accompanying notes.

Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Statements of Operations
(In Thousands)

	June 30	
	2012	**2011**
Unrestricted revenue and other support:		
Net patient service revenue	**$ 346,012**	$ 341,584
Other operating revenues	**12,419**	9,831
Gifts, bequests, and contributions	**3,049**	2,294
Net assets released from restriction used for operations	**251**	368
Total unrestricted revenue and other support	**361,731**	354,077
Operating expenses:		
Salaries and wages	**147,029**	140,080
Employee benefits	**39,051**	35,401
Professional fees	**12,022**	11,768
Cost of goods sold	**52,711**	49,869
Supplies	**10,998**	10,740
Contract services	**35,022**	32,708
Other	**11,447**	11,996
Utilities	**4,406**	4,541
Insurance	**5,070**	4,737
Depreciation and amortization	**20,342**	19,304
Interest	**4,571**	4,665
Provision for uncollectible accounts	**13,851**	13,801
Total operating expenses	**356,520**	339,610
Operating income	**5,211**	14,467
Other income (loss), net:		
(Loss) gain on sale of assets	**(67)**	5
Investment gain, net	**5,824**	3,893
Change in unrealized (losses) gains on trading securities, net	**(4,016)**	8,391
Realized and unrealized losses on interest rate swap contract, net	**(9,386)**	(1,068)
Other non-operating income, net	**304**	61
Total other (loss) income, net	**(7,341)**	11,282
Excess (deficit) of unrestricted revenue and other support over expenses	**(2,130)**	25,749
Other changes in unrestricted net assets:		
Pension adjustment	**(10,303)**	6,504
Released from restriction used to purchase capital	**198**	256
(Decrease) increase in unrestricted net assets	**$ (12,235)**	$ 32,509

See accompanying notes.

Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Statements of Changes in Net Assets
(In Thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Net assets, June 30, 2010	$ 129,158	$ 4,683	$ 976	$ 134,817
Excess of unrestricted revenue and other support over expenses	25,749	–	–	25,749
Pension adjustment	6,504	–	–	6,504
Released from restriction used to purchase capital	256	(256)	–	–
Assets released from restrictions	–	(368)	–	(368)
Restricted gifts, bequests and contributions	–	1,139	–	1,139
Changes in net assets	32,509	515	–	33,024
Net assets, June 30, 2011	161,667	5,198	976	167,841
Deficit of unrestricted revenue and other support over expenses	**(2,130)**	**–**	**–**	**(2,130)**
Pension adjustment	**(10,303)**	**–**	**–**	**(10,303)**
Released from restriction used to purchase capital	**198**	**(198)**	**–**	**–**
Assets released from restrictions	**–**	**(251)**	**–**	**(251)**
Restricted gifts, bequests and contributions	**–**	**392**	**–**	**392**
Changes in net assets	**(12,235)**	**(57)**	**–**	**(12,292)**
Net assets, June 30, 2012	**$ 149,432**	**$ 5,141**	**$ 976**	**$ 155,549**

See accompanying notes.

Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(In Thousands)

	Year Ended June 30	
	2012	**2011**
Cash flows from operating activities		
Change in net assets	**$ (12,292)**	$ 33,024
Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities:		
Depreciation of property and equipment	**20,342**	19,304
Amortization of original issue discount and bond issue costs	**201**	204
Equity in earnings of joint ventures	**(331)**	(384)
(Gain) loss on sale of property and equipment	**67**	(5)
Gain on sale of joint venture	**–**	(3,300)
Investments in subsidiaries	**–**	(620)
Change in unrealized (gains) losses on trading securities, net	**4,016**	(8,391)
Proceeds from realized (gains) losses on investments-trading	**(2,266)**	(1,338)
(Increase) decrease in investments-trading	**3,137**	(28,573)
(Increase) decrease in assets limited as to use-trading net	**6,595**	(2,716)
Proceeds from restricted contributions	**(449)**	(624)
Change in pledges receivable	**141**	(165)
Realized and unrealized (gains) losses in interest rate swap, net	**9,386**	1,068
Change in operating assets and liabilities:		
Receivables, patient and other	**(4,601)**	(1,583)
Other assets	**(3,248)**	143
Inventories and other assets	**318**	413
Accounts payable	**7,102**	(1,369)
Accrued expenses	**(924)**	3,189
Accrued pension expense	**9,892**	(5,940)
Advances from third-party payors	**1,887**	130
Other short-term liabilities	**(4)**	(60)
Other long-term liabilities	**4,152**	2,876
Net cash provided by (used in) operating activities	**43,121**	5,283
Cash flows from investing activities		
(Increase) decrease in assets limited as to use, non-trading, net	**(69)**	(1,057)
Realized gains (losses) on interest rate swap contract	**(2,588)**	(2,620)
Purchases of property and equipment	**(32,075)**	(14,322)
Net proceeds from sale of assets	**(67)**	2,445
Net proceeds from sale of joint venture	**–**	4,000
Other investing activities	**–**	300
Net cash used in investing activities	**(34,799)**	(11,254)
Cash flows from fundraising and financing activities		
Proceeds from restricted contributions	**449**	624
Repayments of long-term debt	**(3,850)**	(2,163)
Net cash (used in) provided by fundraising and financing activities	**(3,401)**	(1,539)
Net increase (decrease) in cash and cash equivalents	**4,921**	(7,510)
Cash and cash equivalents at the beginning of the year	**27,295**	34,805
Cash and cash equivalents at the end of the period	**$ 32,216**	$ 27,295
Supplemental disclosures		
Net capital lease obligation	**$ 2,298**	$ 6,584
Cash paid for interest	**$ 4,599**	$ 4,655

See accompanying notes.

1. Organization and Mission

On June 28, 2011 the Frederick Memorial Hospital, Inc. (FMH) Board of Directors approved a corporate restructuring which included the creation of a non-profit 501(c)3 Parent Corporation known as Frederick Regional Health System, Inc. (the System). Additionally two other non-profit entities were organized, Monocacy Insurance, LTD (MIL) and Monocacy Health Partners, LLC (MHP), both of which are 100% owned by the System. The reorganization was effective as of July 1, 2011 and had no impact on the comparability of the overall consolidated operating results. FMH is a wholly owned subsidiary of the System. MIL is a Cayman Islands domiciled single parent captive to provide a flexible risk financing structure to meet the needs of the System. MHP will serve as a physician enterprise, providing governance, management and support functions for employed physicians. Currently the employed physicians and related functions are part of FMH. The System is a not-for-profit Parent Corporation formed on June 23, 2011 to be exempt from income tax under Section 501(a) of the Internal Revenue Code (the Code) as an organization described in Section 501(c)(3) whereby only unrelated business income as defined by Section 512(a)(1) of the Code, is subject to federal income tax. The System has filed for, but not yet received a determination letter from the Internal Revenue Service (IRS) stating that they are exempt from federal income taxes under Section 501(c) of the Code.

FMH is a not-for-profit hospital, exempt from federal income tax under Section 501(a) of the Code as an organization described in Section 501(c)(3) whereby only unrelated business income as defined by Section 512(a)(1) of the Code, is subject to federal income tax. The Hospital is located in Frederick, Maryland, and provides health care services primarily to residents of Frederick County. FMH has received a determination letter from the IRS stating that they are exempt from federal income taxes under Section 501(c) of the Internal Revenue Code.

MIL is a Cayman Islands domiciled single parent captive incorporated on May 24, 2011 and holds an Unrestricted Class B insurance license issued under Section 7(2) of the Cayman Island Insurance Law. MIL directly provides primary medical professional liability and primary general liability coverage to the System.

MHP will serve as a physician enterprise, providing governance, management and support functions for employed physicians. MHP is a not-for-profit corporation, formed on June 23, 2011 to be exempt from income tax under Section 501(a) of the Code as an organization described in Section 501(c)(3) whereby only unrelated business income as defined by Section 512(a)(1) of the Code, is subject to federal income tax. MHP has filed for, but not yet received a determination letter for the Internal Revenue Service (IRS) stating that they are exempt from federal income taxes under Section 501(c) of the Internal Revenue Code. There were no operations related to MHP during 2012 or 2011.

1. Organization and Mission (continued)

Frederick Health Services Corporation (FHSC) is a Maryland for-profit corporation, all of the stock of which is owned by the System. FHSC is subject to federal and state income taxes. No provision for income taxes has been recorded for 2012 and 2011 as FHSC does not have taxable income or current tax liabilities.

2. Significant Accounting Policies

Principles of Consolidation

The accompanying financial statements include the accounts and transactions of the System and its wholly-owned subsidiaries; FMH, MIL, FHSC, and MHP.

FMH has two wholly-owned subsidiaries; Hospice of Frederick County, Inc. (HFC) and Emmitsburg Properties, LLC both of which have been consolidated with FMH into the System in the accompanying financial statements. HFC, an independent 501(c)(3) organization controlled by FMH, operates as a fundraising organization for the benefit of hospice services and operates the Kline Hospice House.

FHSC has three wholly-owned subsidiaries: Rosehill of Frederick, LLC and Corporate Occupational Health Solutions, LLC, which are for-profit limited liability companies, and Frederick Surgical Services Corporation, all of which have been consolidated with FHSC into the System in the accompanying financial statements.

The accompanying consolidated financial statements include the accounts of the System and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Donor-Restricted Gifts

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

2. Significant Accounting Policies (continued)

unrestricted net assets if restricted for capital or reported in the statements of operations as net assets released from restrictions if restricted for operating purposes. Donations received with no restrictions and donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying consolidated statements of operations as other operating revenues.

Cash and Cash Equivalents

Cash and cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less. Those cash and money market funds which are classified as long-term investments are excluded from cash and cash equivalents.

Patient Receivables and Allowances

The System's policy is to write off all patient accounts that have been identified as uncollectible. An allowance for doubtful accounts is recorded for accounts not yet written off that are anticipated to become uncollectible in future periods. Insurance coverage and credit information are obtained from patients when available. No collateral is obtained for accounts receivable. Accounts receivable from third-party payors have been adjusted to reflect the difference between charges and the estimated reimbursable amounts. Recoveries of previously written off patient receivables are recorded when received.

Inventory

Inventory is stated at the lower of cost or market. Cost is determined using the first-in, first-out (FIFO) method.

Cost of Goods Sold

Cost of goods sold consists primarily of drugs, medical supplies, and surgical implants used in the care and treatment of patients.

2. Significant Accounting Policies (continued)

Investments and Assets Limited as to Use

The fair values of individual investments are based on quoted market prices of individual securities or investments or estimated amounts using quoted market prices of similar investments. Private equity investments are carried at cost and hedge funds are accounted for using the equity method. Realized and unrealized investment return from all unrestricted investments and assets limited as to use is included in the consolidated statements of operations as part of nonoperating gains and losses. Investment income (loss) on investments of temporarily and permanently restricted assets is added to or deducted from the appropriate restricted fund balance if the income is restricted. The cost of securities sold is based on the specific-identification method. Investments are classified as either current or noncurrent based on maturity dates and availability for current operations.

Substantially all of the System's investment portfolio (excluding certain assets limited as to use) is classified as trading, with unrealized gains and losses included in excess of unrestricted revenue and other support over expenses. Certain trusteed assets that are included in assets limited as to use are classified as other-than-trading. These assets primarily consist of debt reserve funds and funds held under trust arrangements related to unreleased bond proceeds.

Investment Risk and Uncertainties

The System invests in professionally managed portfolios that contain corporate bonds, United States Government obligations, municipal obligations, asset-backed securities, marketable equity securities, hedge funds, and money market funds. Such investments are exposed to various risks, such as interest rate, market, and credit. Due to the level of risk associated with such investments and the level of uncertainty related to changes in the value of such investments, it is at least reasonably possible that changes in risks in the near term would materially affect investment balances and the amounts reported in the financial statements.

Property and Equipment

Property and equipment is carried at historical cost. Items acquired by gift are recorded at fair value at the time of acquisition. Depreciation is recorded on the straight-line method over the estimated useful lives of the depreciable assets. Leasehold improvements are amortized using the straight-line method over the shorter of the lease term, or the estimated useful lives of the assets.

2. Significant Accounting Policies (continued)

Valuation of Long-Lived Assets

The System accounts for the valuation of long-lived assets under *Accounting for the Impairment or Disposal of Long-Lived Assets.* This guidance requires that long-lived assets and certain identifiable intangible assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

Recoverability of the long-lived asset is measured by a comparison of the carrying amount of the asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. Assets to be disposed of are reportable at the lower of the carrying amount or fair value, less costs to sell.

Debt Issuance Costs

Debt issuance costs related to the Series 2002 and Series 2008 MHHEFA bonds and the equipment note payable are being amortized over the life of the debt using the effective interest method.

Patient Service Revenue and Allowances

The System has agreements with third-party payors that provide for payments to the System for patient services at amounts different from its established rates. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated adjustments under reimbursement agreements with third-party payors. Estimated adjustments are accrued in the period the related services are rendered and adjusted in future periods as final settlements are determined.

The System's revenues may be subject to adjustment as a result of examination by government agencies or contractors, and as a result of differing interpretation of 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.

2. Significant Accounting Policies (continued)

Other Operating Revenue

The American Recovery and Reinvestment Act of 2009 provides for Medicare and Medicaid incentive payments for eligible hospitals and professionals that implement and achieve meaningful use of certified electronic health record (EHR) technology. For Medicare and Medicaid EHR incentive payments, the Hospital uses a grant accounting method to recognize the revenues. Under this accounting policy, EHR incentive payments are recognized as revenue when attestation that the EHR meaningful use criteria for the required period of time was demonstrated. Accordingly, the System recognized approximately $4,000 of EHR revenues for the year ended June 30, 2012, comprised of $1,200 of Medicaid revenues and $2,800 of Medicare revenues.

These amounts are included in other operating revenue in the consolidated statements of operations. The System's attestation of compliance with the meaningful use criteria is subject to audit by the federal government or its designee. The recognition of revenues is based on management's best estimate. Any subsequent changes in the recognition of the revenue will impact the results of operations in the period in which they occur.

Performance Indicator

The performance indicator is the excess of unrestricted revenue and other support over expenses. Changes in unrestricted net assets, consistent with industry practice, includes pension adjustments and net assets released from restriction for capital purposes.

Fair Value of Financial Instruments

The carrying amounts reported on the consolidated balance sheets for cash and cash equivalents, receivables, accounts payable, accrued expenses, and advances from third-party payors approximate their fair values. The fair value of the System's notes receivable, revenue bond notes, and other long-term debt approximate the carrying amounts, based on loans with similar terms and average maturities.

2. Significant Accounting Policies (continued)

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 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.

Recent Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update, (ASU), No. 2010-24, (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. The adoption of this guidance had the impact of increasing Other Assets and increasing Other Long-term Liabilities by $3,143 on the System's accompanying consolidated balance sheet at June 30, 2012. The adoption of this new standard had no impact on the statement of operations or net assets. Prior year financial statements have not been restated.

In August 2010, the FASB issued ASU 2010-23 which provided guidance on measuring charity care for disclosure purposes. This guidance requires that cost be used as the measurement basis for charity care disclosure purposes and that cost be identified as the direct and indirect costs of providing charity care. Disclosure requirements include the method used to identify or determine such costs. 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.

In July 2011, the FASB issued ASU 2011-07 which provided guidance on the presentation and disclosure of patient service revenue, provisions for bad debts, and the allowance for doubtful accounts for certain health care entities. This guidance changes the presentation of the statement of operations by reclassifying the provision for bad debts associated with patient service revenue from an operating expense to a deduction from patient service revenue (net of contractual allowances and discounts). Additionally, the guidance requires enhanced disclosures about the policies for recognizing revenue and assessing bad debts, as well as qualitative and quantitative information about changes in the allowance for doubtful accounts. This guidance is effective for the System for the fiscal year ending June 30, 2013. The System is currently evaluating the impact of this guidance.

(Dollars in Thousands)

3. Patient Receivables and Patient Service Revenue

Patient receivables consist of the following at June 30:

	2012	2011
Gross patient receivables	**$ 67,366**	$ 64,121
Less estimated uncollectible accounts and contractual allowances	**17,125**	18,144
Net patient receivables	**$ 50,241**	$ 45,977

Patient service revenue consists of the following for the years ended June 30, 2012 and 2011:

	2012	2011
Inpatient charges	**$ 204,339**	$ 209,514
Outpatient charges	**228,258**	210,770
Gross charges	**432,597**	420,284
Less allowances, contractual and other	**86,585**	78,700
Net patient service revenue	**$ 346,012**	$ 341,584

The System provides care to patients who meet certain criteria under its charity care policy. The System charges at its established rates but waives all or a portion of reimbursement. Because the System does not pursue collection of amounts determined to qualify as charity care, these revenues are not reported as net patient service revenue. Using the cost to change ratio to approximate cost, charity care provided for the years ended June 30, 2012 and 2011, was $7,000 and $5,673 respectively. The State of Maryland rate system includes components within the rates to partially compensate hospitals for uncompensated care.

(Dollars in Thousands)

4. Assets Limited as to Use

A summary of assets which are limited as to use substantially for debt service and self insurance at June 30 is as follows:

	2012	2011
Current:		
Principal and interest due – bonds	**$ 3,715**	$ 3,702
Loss escrow account	**81**	–
	$ 3,796	$ 3,702
Noncurrent:		
Debt service reserve funds	**$ 6,514**	$ 6,474
Self insurance trusts	**–**	6,984
Deferred compensation trusts	**869**	545
	$ 7,383	$ 14,003

The assets which are limited as to use consists of the following at June 30:

	2012	2011
Current:		
Cash and money market accounts	**$ 2,289**	$ 3,413
U.S. government obligations	**1,507**	289
	$ 3,796	$ 3,702
Noncurrent:		
Cash and money market accounts	**$ 281**	$ 837
U.S. government obligations	**6,244**	6,037
Corporate obligations	**–**	83
Equity securities	**669**	455
Mutual funds	**189**	6,591
	$ 7,383	$ 14,003

The noncurrent assets limited as to use mutual funds are primarily invested in cash and short-duration debt securities.

(Dollars in Thousands)

5. Promises to Give

Promises to give are discounted and are due as follows at June 30:

	2012	2011
Less than one year	**$ 671**	$ 721
One to five years	**2,023**	2,226
More than five years	**1,453**	1,542
	4,147	4,489
Less discounting and allowance for uncollectible promises	**1,010**	1,211
Total promises to give, net	**3,137**	3,278
Less current portion of promises to give, net	**570**	613
	$ 2,567	$ 2,665

Promises to give include $876 related to charitable remainder trusts. This net amount represents the excess of the fair value of the related trust accounts over the net present value of the annuities to be paid out of the trust to the named beneficiaries over their estimated life expectancy.

6. Investments

Long-term investments represent unrestricted investments and unrestricted income earned on unrestricted, temporarily restricted, and permanently restricted investments.

Donor-restricted investments are designated by the donors for expenses relating to capital projects, replacement or improvement of existing assets, or to cover the cost of services rendered as charity care and other programs.

(Dollars in Thousands)

6. Investments (continued)

Long-term and donor restricted investments consist of the following at June 30:

	2012		2011	
	Cost	**Fair Value**	**Cost**	**Fair Value**
Cash and cash equivalents	**$ 5,712**	**$ 5,680**	$ 8,811	$ 8,807
U.S. government obligations	**3,123**	**3,207**	4,758	4,768
Corporate obligations	**3,131**	**3,345**	3,668	3,759
Mortgage-backed securities	**4,822**	**5,020**	4,011	4,186
Equity securities	**29,498**	**30,628**	30,429	34,026
Private equity	**1,161**	**1,554**	–	–
Mutual funds	**42,332**	**42,022**	38,768	40,799
	$ 89,779	**$ 91,456**	$ 90,445	$ 96,345

The hedge fund is accounted for under the equity method of accounting, which approximates fair value. The carrying value of the funds was $12,741 and $12,346 as of June 30, 2012 and 2011, respectively. Valuation of this equity investment is primarily based on financial data supplied by the underlying investee fund. The System has the ability to liquidate this investment on a quarterly basis. The System must provide notice of intent to redeem its shares 65 days prior to the redemption date. Ninety percent of the redemption value will be returned to the System within 45 days of the redemption date, with the balance payable 30 days after the receipt of the fund's annual audited financial statements. Value may be based on historical cost, appraisals, or other estimates that require varying degrees of judgment. The historic cost of these investments was $11,500 as of both June 30, 2012 and 2011.

The private equity investments are shown at cost on the accompanying financial statements.

(Dollars in Thousands)

6. Investments (continued)

Investments are allocated as follows at June 30:

	2012	2011
Investment allocation:		
Unrestricted long-term investments	**$ 100,827**	$ 105,795
Donor restricted investments	**2,977**	2,896
	$ 103,804	$ 108,691

Investment income, including income from short-term investments, for the years ended June 30 are as follows:

	2012	2011
Unrestricted:		
Net realized gains	**$ 2,265**	$ 1,339
Interest and dividends, net of investment expense	**3,228**	2,170
Income from joint ventures	**331**	384
	$ 5,824	$ 3,893

Investment expense was $417 and $235 for the fiscal years ended June 30, 2012 and 2011, respectively.

Other investments consist of the following at June 30:

	Carrying Value		Income	
	2012	2011	2012	2011
Joint ventures	**$ 3,092**	$ 2,735	**$ 331**	$ 384
Cash surrender value of life insurance policy	**–**	688	**–**	–
	$ 3,092	$ 3,423	**$ 331**	$ 384

(Dollars in Thousands)

6. Investments (continued)

Investments in joint ventures accounted for using the equity method, unless otherwise noted, at June 30 are as follows:

	Entity	Interest %	2012	2011
Colonial Regional Alliance	FMH	14.3%	**$ 30**	$ 30
Carroll Occupational Health, LLC	FHSC	25.0%	**11**	(21)
Comp Claim Management, LLC	FHSC	50.0%	**3**	3
Open MRI of Frederick, LLC	FHSC	50.0%	**136**	195
Glade Valley Nursing and Rehabilitation Center, Inc.	FMH	50.0%	**69**	69
Premier Purchasing Partners (cost method)	FMH	<1.0%	**649**	447
Mt. Airy Health Services, LLC	FMH	50.0%	**398**	434
Mt. Airy Plaza, LLC	FHSC	50.0%	**(330)**	(345)
Mt. Airy Surgical Center LLC	FHSC	50.0%	**187**	167
Frederick Surgical Center, LLC	FHSC	34.7%	**1,939**	1,756
			$ 3,092	$ 2,735

7. Fair Value Measurements

Assets and liabilities recorded at fair value in the consolidated balance sheets are categorized based upon the level of judgment associated with the inputs used to measure their fair value.

FASB guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability (i.e., the “exit price”) in an orderly transaction between market participants at the measurement date, emphasizing that fair value is market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, the FASB establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Level 1 and 2 of the hierarchy) and the reporting entity’s own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy). The Level inputs, as defined by FASB guidance for fair value measurements and disclosures, are as follows:

7. Fair Value Measurements

- Level 1 – Inputs utilize unadjusted quoted prices in active markets for identical assets or liabilities that the System has the ability to access at the measurement date.

- Level 2 – Inputs are inputs other than quoted prices included in Level 1 that are observable for the assets or liabilities, either directly or indirectly. Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the assets or liabilities (other than quoted prices), such as interest rates, foreign exchange rates, and yield curves that are observable at commonly quoted intervals.

- Level 3 – Inputs are unobservable inputs for the assets or liabilities, which are typically based on an entity's own assumptions, as there is little, if any, related market activity.

The determination of the fair value level within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The System's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the assets or liabilities. The following tables present the System's assets and liabilities measured at fair value on a recurring basis, aggregated by the level in the fair value hierarchy within which those measurements fall, as of June 30, 2012 and June 30, 2011:

(Dollars in Thousands)

7. Fair Value Measurements (continued)

		Fair Value Measurements at Reporting Date Using		
	Fair Value at June 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets				
Cash and cash equivalents	$ 40,466	$ 40,466	$ –	$ –
Equity securities	31,298	31,298	–	–
U.S. government obligations	10,958	–	10,958	–
Corporate and other bonds	3,345	–	3,345	–
Mutual funds	42,211	42,211	–	–
Mortgage-backed securities	5,020	–	5,020	–
Private equity	1,554			1,554
Contributions receivable	3,137	–	–	3,137
Total assets	$ 137,989	$ 113,975	$ 19,323	$ 4,691
Liabilities				
Interest rate swap liability	$ (16,513)	$ –	$ (16,513)	$ –
Total liabilities	$ (16,513)	$ –	$ (16,513)	$ –

(Dollars in Thousands)

7. Fair Value Measurements (continued)

		Fair Value Measurements at Reporting Date Using		
	Fair Value at June 30, 2011	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Other Unobservable Inputs (Level 3)**
Assets				
Cash and cash equivalents	$ 40,353	$ 40,353	$ –	$ –
Equity securities	34,480	34,480	–	–
U.S. government obligations	11,094	–	11,094	–
Corporate and other bonds	3,843	–	3,843	–
Mutual funds	47,390	47,390	–	–
Mortgage-backed securities	4,186	–	4,186	–
Private equity	–	–	–	–
Contributions receivable	3,278	–	–	3,278
Total assets	$ 144,624	$ 122,223	$ 19,123	$ 3,278
Liabilities				
Interest rate swap liability	$ (9,715)	$ –	$ (9,715)	$ –
Total liabilities	$ (9,715)	$ –	$ (9,715)	$ –

The fair value of the System's trading securities is determined by third-party service providers utilizing various methods dependent upon the specific type of investment. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Where significant inputs, including benchmark yields, broker-dealer quotes, issuer spreads, bids, offers, the LIBOR curve, and measures of volatility, are used by these third-party dealers or independent pricing services to determine fair values the securities are classified within Level 2. Private equity investments are carried at cost. Hedge fund investments are carried under the equity method of accounting.

7. Fair Value Measurements (continued)

Assets utilizing Level 1 inputs include exchange-traded equity securities and equity and fixed income mutual funds. Assets and liabilities utilizing Level 2 inputs include U.S. government securities, corporate bonds, mortgage-backed securities, and interest rate swaps. Assets utilizing Level 3 inputs are contributions receivable and private equity investments.

Interest Rate Swap

The System entered into an interest rate swap agreement in conjunction with the issuance of variable rate bonds. The swap contract is valued using models based on readily observable market parameters for all substantial terms of the contract. The fair market value of the swap agreement is included as interest rate swap contract in the accompanying balance sheets. The fair market value calculation, includes a credit valuation adjustment (CVA) as required of $1,523 and $918, reducing the interest rate swap agreement liability position on June 30, 2012 and 2011, respectively. The change in the fair market value of the swap agreement is included in excess (deficiency) of unrestricted revenue and other support over expenses, as the swap is not designated as an effective hedge.

Credit exposure associated with non-performance by the counterparty to the derivative instrument is generally limited to the uncollateralized fair value of the asset related to instruments recognized in the balance sheets.

Assets utilizing Level 3 inputs are contributions receivable and private equity investments. Contributions receivable are recorded net of allowance for uncollectible pledges and discounted to net present value. The present value of estimated future cash flows using a discount rate commensurate with the risks involved is an appropriate measure of fair value for unconditional promises to give cash and is considered Level 3. The private equity investments are carried at cost of $1,161 on the accompanying financial statements.

(Dollars in Thousands)

7. Fair Value Measurements (continued)

The following table provides a reconciliation of the beginning and ending balances of items measured at fair value on a recurring basis in the table above that used significant unobservable inputs (Level 3):

	Contributions Receivable	Private Equity	Total
Balance at June 30, 2010	$ 3,113	$ –	$ 3,113
Purchases, issuances and settlements	165	–	165
Balance at June 30, 2011	3,278	–	3,278
Purchases, issuances and settlements	**(141)**	**1,554**	**1,413**
Balance at June 30, 2012	**$ 3,137**	**$ 1,554**	**$ 4,691**

8. Property and Equipment

Property and equipment consist of the following at June 30:

	Estimated Useful Lives	2012	2011
Land	–	**$ 3,765**	$ 3,765
Land improvements	8 – 20 years	**1,249**	1,249
Buildings	20 – 40 years	**180,740**	180,300
Fixed equipment	10 – 20 years	**16,493**	16,343
Movable equipment	3 – 20 years	**168,213**	148,265
Leasehold improvements	5 – 20 years	**20,265**	19,160
		390,725	369,082
Less accumulated depreciation		**209,150**	190,138
		181,575	178,944
Construction in process, renovations, and deposits	–	**13,289**	1,889
		$ 194,864	$ 180,833

(Dollars in Thousands)

8. Property and Equipment (continued)

Construction-in-progress consists of the System's building renovations. As these projects are completed, the related assets are transferred out of construction-in-progress and into the appropriate asset category and are depreciated over the applicable useful lives.

The net book value of assets under capital lease arrangements totaled $7,025 and $6,669 as of June 30, 2012 and 2011, respectively. Depreciation expense related to assets under capital lease arrangements was $1,880 and $1,404 for the fiscal years ended June 30, 2012 and 2011, respectively.

9. Long-Term Debt

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

	2012	**2011**
MHHEFA Series 2002 Bonds	**$ 66,196**	$ 66,983
MHHEFA Series 2008 Bonds	**70,953**	71,944
Note payable – Emmitsburg	**279**	373
Capital lease obligations	**7,416**	6,999
	144,844	146,299
Less current maturities	**4,119**	3,732
	$ 140,725	$ 142,567

Series 2008 MHHEFA Revenue Bonds

The Series 2008 MHHEFA Revenue Bonds are variable rate demand bonds and are net of original issue discounts of $144 which are being amortized over the life of the bonds using the yield method. Accumulated amortization was $37 at June 30, 2012. During the year ended June 30, 2012, the interest rate on these variable rate demand bonds has varied from 0.07% – 0.24%. Interest is payable monthly through July 1, 2035. The fair value of the Series 2008 MHHEFA Revenue Bonds is estimated based on the quoted market prices for the same or similar issues. As of June 30, 2012, the carrying value of the MHHEFA Series 2008 Bonds approximates fair value. Under the provisions of the bond agreement, the System has granted to the Authority a security interest in all receipts now owned and hereafter acquired. The Series 2008 Bonds are secured ratably with the Series 2002 Bonds.

9. Long-Term Debt (continued)

In conjunction with the issuance of the Series 2008 Bonds, the System secured a three-year letter of credit with a bank covering the entire bond issue. The letter of credit was amended on September 21, 2012, with terms for tender advances of the greater of LIBOR +2.75% or 4.00% for the first 90 days, and the greater of LIBOR +3.25% or 4.00% for days 91-366. Tender advances are due beginning on the 367th day after initial draw and would be repaid over a 48-month period. The new termination date of the letter of credit is July 8, 2015.

There is no debt service reserve requirement associated with the Series 2008 Bonds.

The bond agreement contains certain financial covenants.

Series 2002 MHHEFA Revenue Bonds

In August 2002, the System obtained a loan of $71,715 in MHHEFA Revenue Bonds, Frederick Memorial Hospital, Inc. Issue, Series 2002. The MHHEFA Series 2002 Bonds were issued to finance and refinance costs of construction, renovation, and equipping certain the System facilities. The Series 2002 Bonds are net of an original issue discount of $2,361 which is being amortized over the life of the bonds using the yield method. Accumulated amortization was $912 and $824 at June 30, 2012 and 2011, respectively. The annual interest rate on the bond loan ranges between 3.25% and 5.125%. Interest is payable semiannually on each January 1 and July 1, through July 1, 2035.

The debt service reserve requirement for the Series 2002 Bonds is $6,208.

Series 2002 Bonds maturing on or after July 1, 2012 are subject to redemption or purchase prior to maturity, beginning on July 1, 2012, at the option of the Authority at the principal amount of the Series 2002 Bonds to be redeemed plus accrued interest thereon to the date set for redemption.

Under the provisions of the bond agreement, the System has granted to the Authority a security interest in all receipts now owned and hereafter acquired. The Series 2002 Bonds are secured ratably with the 2008 Bonds. The fair value of the Series 2002 MHHEFA Revenue Bonds is estimated based on the quoted market prices for the same or similar issues. As of June 30, 2012, the fair value of the MHHEFA Series 2002 Bonds is estimated as $67,645. The book value of the 2008 bonds approximates its fair value due to the variable interest rate on these bonds.

(Dollars in Thousands)

9. Long-Term Debt (continued)

The bond agreement contains certain financial covenants.

Note Payable – Emmitsburg

In December 1994, the System acquired a 100% interest in Emmitsburg Properties. In accordance with the terms of the purchase agreement, the System executed two notes payable to the former owners aggregating $1,219. The notes are payable in monthly installments of principal and interest of $10, bear interest at 8%, and are due December 31, 2014.

Capital Lease Obligations

During the fiscal year ended June 30, 2012, the System entered into certain capital lease obligations to secure major medical diagnostic equipment. Future payments under these obligations are as follows:

Years ending June 30:	
2013	$ 2,322
2014	2,225
2015	1,906
2016	1,179
2017	342
Total payments	7,974
Less interest payments	558
Total lease obligations, principal	7,416
Less current portion	2,066
Long-term obligations under capital leases	$ 5,350

(Dollars in Thousands)

9. Long-Term Debt (continued)

Debt service requirements on long-term debt and capital lease obligations, excluding the original issue discounts on the MHHEFA Bonds at June 30, 2012 and 2011, of $1,556 and $1,653, respectively, are as follows:

	Principal
Years ending June 30:	
2013	$ 4,119
2014	4,206
2015	5,653
2016	5,074
2017	4,422
Thereafter	122,926
	$ 146,400

10. Interest Rate Swap Contract

The System records their derivatives as assets or liabilities at fair value. A derivative is typically defined as an instrument, whose value is "derived" from an underlying instrument, index or rate, has a notional amount, requires little or no initial investment, and can be net settled. The System participates in an interest rate swap contract that is considered a derivative financial instrument.

In conjunction with the issuance of the Series 2008 Bonds, the System modified its interest rate swap contract with a third party to a notional amount of $72,160 until July 1, 2010, at which point the notional amount amortizes over the term of the underlying Series 2008 Bonds, with a final maturity of July 1, 2035. The System is exposed to credit loss in the event of nonperformance by the counterparty to the interest rate swap contract. However, the System does not anticipate nonperformance by the counterparty. Under the swap contract, the System pays interest at a fixed rate of 3.804% and receives interest at a variable rate equal to 67% of the one-month London Interbank Offered Rate (LIBOR) (0.2432% as of June 30, 2012). The swap contract requires payments to be made or received monthly. The fair value of the swap contract was a liability of $16,513 and $9,715 at June 30, 2012 and 2011, respectively.

(Dollars in Thousands)

10. Interest Rate Swap Contract (continued)

The System accrued net payments under its interest rate swap program of $2,588 and $2,620 during fiscal years 2012 and 2011, respectively. These amounts are included within realized and unrealized loss on interest rate swap contract, net in the consolidated statements of operations and investing activities in the statement of cash flows.

The interest rate swap contract is not designated as an effective cash flow hedge. The System's objectives of entering into the interest rate swap contract include limiting or hedging variable interest rate payments, to achieve lower overall borrowing costs than a comparable unhedged fixed rate borrowing, to alter the pattern of debt service payments, and to improve asset/liability matching. Changes in the fair value of the derivative financial instrument are recognized in the consolidated statements of as a component of other loss. The carrying value of the System's derivative financial instrument approximates fair value. The interest rate swap contract is valued using models based on readily observable market parameters for all substantial terms of the contract.

Credit exposure associated with non-performance by the counterparties to derivative instruments is generally limited to the uncollateralized fair value of the asset related to instruments recognized in the consolidated balance sheets. The System attempts to mitigate the risk of non-performance by selecting counterparties with high credit ratings and monitoring their creditworthiness.

Our derivative agreements do not contain any credit support provisions that require us to post collateral if there are declines in the derivative value or our credit rating.

	Fair Value	
Balance Sheet Location	**2012**	**2011**
Asset derivatives		
Derivatives not designated as hedging instruments:		
Interest rate contracts	**$ –**	$ –
Liability derivatives		
Long-term liabilities	**$ 16,513**	$ 9,715
Total derivatives not designated as hedging instruments	**$ 16,513**	$ 9,715

(Dollars in Thousands)

10. Interest Rate Swap Contract (continued)

A summary of the effect of the non-hedging derivatives on the System's income statement for the year ended June 30, 2012, is as follows:

Type of Non-Hedging Derivatives	Income Statement Location of Loss Recognized	Derivative Loss Recognized
Interest rate swap contract – realized losses	Other loss	$ (2,588)
Interest rate swap contract – unrealized losses	Other loss	(6,798)
Total		$ (9,386)

A summary of the effect of the non-hedging derivatives on the System's income statement for the year ended June 30, 2011, is as follows:

Type of Non-Hedging Derivatives	Income Statement Location of Loss Recognized	Derivative Loss Recognized
Interest rate swap contract – realized losses	Other loss	$ (2,620)
Interest rate swap contract – unrealized gains	Other income	1,552
Total		$ (1,068)

11. Employee Benefit Plans

The System has a trusteed, defined benefit pension plan that covers substantially all employees. The System's funding policy is to make a minimum annual contribution equal to net periodic pension cost for the Plan year as determined by its actuary. The System uses a measurement date of June 30 to determine plan assets and benefit obligations. Effective June 30, 2007, the System approved a curtailment of the Plan. The curtailment is such that participants will no longer accrue benefits under the Plan and no new participants will be accepted. Current participant

11. Employee Benefit Plans (continued)

accounts will not receive any service credits beyond June 30, 2007; however, the System will make annual contributions to the plan in accordance with actuarially determined amounts to meet future accumulated benefit obligations under the frozen plan. Effective July 1, 2007, a modified defined contribution plan (403b) was implemented as described below.

Effective January 1, 2011 the Plan was amended, as required by SFAS No. 87, by changing the prior plan balance interest crediting rate from 8.5% to 4.5% resulting in a $643 reduction to the projected benefit obligation at June 30, 2012.

The following provides a reconciliation of the changes in fair value of the Plan's assets and projected benefit obligations, and the Plan's funded status based on a June 30, 2012 and 2011, measurement date:

	2012	2011
	(In Thousands)	
Accumulated benefit obligation	**$ 84,407**	$ 73,238
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	**$ 73,238**	$ 72,489
Service cost	**354**	374
Interest cost	**4,047**	3,939
Plan Amendment	**–**	(643)
Actuarial loss (gain)	**8,587**	(1,389)
Benefits paid	**(1,819)**	(1,532)
Projected benefit obligation at end of year	**84,407**	73,238
Change in plan assets:		
Fair value of plan assets at beginning of year	**56,762**	50,073
Actual return on plan assets	**1,085**	6,247
Employer contribution	**2,011**	1,974
Benefits paid	**(1,819)**	(1,532)
Fair value of plan assets at end of year	**58,039**	56,762
Funded status	**(26,368)**	(16,476)
Net amount recognized	**$ (26,368)**	$ (16,476)

(Dollars in Thousands)

11. Employee Benefit Plans (continued)

Actuarial assumptions that decreased the projected benefit obligation as of June 30, 2012, included a decrease in the rate on conversion of cash balance to annuity from 4.5% to 3.5% and a decrease cash balance interest accumulation rate from 4.5% to 4.0%. The total impact of these assumption changes were to decrease the projected benefit obligation by approximately $9,500. This was offset by an approximately $18,000 increase in the projected benefit obligation due to a reduction in the discount rate.

Net amount recognized in unrestricted net assets that have not been recognized in net periodic benefit cost are as follows:

	June 30	
	2012	**2011**
Net actuarial loss	**$ 29,796**	$ 19,442
Prior service cost	**392**	443
Total recognized in unrestricted net assets	**$ 30,188**	$ 19,885

The following table sets forth the weighted-average assumptions used to determine benefit obligations:

	June 30	
	2012	**2011**
Discount rate	**4.2%**	5.60%
Rate of compensation increase	**N/A**	N/A

The following table sets forth the weighted-average assumptions used to determine net periodic benefit cost:

	Year Ended June 30	
	2012	**2011**
Discount rate	**5.60%**	5.50%
Expected return on plan assets	**7.00%**	7.00%
Rate of compensation increase	**N/A**	N/A

(Dollars in Thousands)

11. Employee Benefit Plans (continued)

Net periodic pension cost included the following components:

	2012	2011
Service cost	**$ 354**	$ 373
Interest cost	**4,047**	3,939
Expected return on plan assets	**(3,989)**	(3,550)
Amortization of prior service cost	**51**	127
Unrecognized net actuarial loss	**1,137**	1,649
Net periodic pension cost	**$ 1,600**	$ 2,538

The estimated net loss that is expected to be amortized from other changes in unrestricted net assets into net periodic benefit cost for the year ending June 30, 2013, is $2,803.

The System determines the expected long-term rate of return on Plan assets by taking into consideration the historical returns of various asset classes and the types of investments the Plan is expected to hold.

The defined benefit pension plan asset allocation as of the measurement date presented as a percentage of total plan assets were as follows:

	2012	2011
Equity securities	**23.4%**	25.0%
Debt securities	**58.2**	55.9
Cash	**1.8**	2.1
Hedge funds	**16.6**	17.0
Total	**100.0%**	100.0%

The Plan assets are recorded at fair value and are categorized based upon the level of judgment associated with the inputs used to measure their fair value.

11. Employee Benefit Plans (continued)

FASB guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability (i.e., the “exit price”) in an orderly transaction between market participants at the measurement date, emphasizing that fair value is market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, the FASB establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Level 1 and 2 of the hierarchy) and the reporting entity’s own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy). The Level inputs, as defined by FASB guidance for fair value measurements and disclosures, are as follows:

- Level 1 – Inputs utilize unadjusted quoted prices in active markets for identical assets or liabilities that the System has the ability to access at the measurement date.

- Level 2 – Inputs are inputs other than quoted prices included in Level 1 that are observable for the assets or liabilities, either directly or indirectly. Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the assets or liabilities (other than quoted prices), such as interest rates, foreign exchange rates, and yield curves that are observable at commonly quoted intervals.

- Level 3 – Inputs are unobservable inputs for the assets or liabilities, which are typically based on an entity’s own assumptions, as there is little, if any, related market activity.

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

(Dollars in Thousands)

11. Employee Benefit Plans (continued)

The System's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the assets or liabilities. The following tables present the Plan's assets and liabilities measured at fair value on a recurring basis, aggregated by the level in the fair value hierarchy within which those measurements fall, as of June 30, 2012 and 2011:

		Fair Value Measurements at Reporting Date Using		
	Fair Value at June 30, 2012	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Other Unobservable Inputs (Level 3)**
Assets				
Cash and cash equivalents	**$ 1,019**	**$ 1,019**	**$ –**	**$ –**
Equity securities	**13,600**	**13,600**	**–**	**–**
Fixed income mutual funds	**33,817**	**33,817**	**–**	**–**
Hedge funds	**9,603**	**–**	**–**	**9,603**
Total assets	**$ 58,039**	**$ 48,436**	**$ –**	**$ 9,603**

		Fair Value Measurements at Reporting Date Using		
	Fair Value at June 30, 2011	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Other Unobservable Inputs (Level 3)**
Assets				
Cash and cash equivalents	$ 1,220	$ 1,220	$ –	$ –
Equity securities	14,163	14,163	–	–
Fixed income mutual funds	31,744	31,744	–	–
Hedge funds	9,635	–	–	9,635
Total assets	$ 56,762	$ 47,127	$ –	$ 9,635

(Dollars in Thousands)

11. Employee Benefit Plans (continued)

The following table provides a reconciliation of the beginning and ending balances of items measured at fair value on a recurring basis in the table above that used significant unobservable inputs (Level 3):

	Hedge Funds	Total
Balance at June 30, 2010	$ 6,406	$ 6,406
Purchases, issuances and settlements	3,229	3,229
Balance at June 30, 2011	9,635	9,635
Purchases, issuances and settlements	(32)	(32)
Balance at June 30, 2012	$ 9,603	$ 9,603

The fair value of the Plan's trading securities is determined by third-party service providers utilizing various methods dependent upon the specific type of investment. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Assets utilizing Level 1 inputs include exchange-traded equity securities and equity and fixed income mutual funds. Assets utilizing Level 3 inputs are hedge funds.

The hedge fund is accounted for at fair value which has been estimated using the net asset value per share of the fund as of June 30, 2012. The Plan has the ability to liquidate this investment on a quarterly basis. The Plan must provide notice of intent to redeem its shares 65 days prior to the redemption date. Ninety percent of the redemption value will be returned to the Plan within 45 days of the redemption date, with the balance payable 30 days after the receipt of the fund's annual audited financial statements.

Assets of the Plan are invested in a manner consistent with fiduciary standards of the Employees Retirement Income Security Act of 1974 (ERISA); namely, (a) the safeguards and diversity to which a prudent investor would adhere must be present, and (b) all transactions undertaken on behalf of the Plan must be for the sole interest of Plan participants and beneficiaries, to provide benefits in a prudent manner. Investment objectives of the Plan also include:

- Achieve an annualized total return that equals or exceeds the actuarial target

(Dollars in Thousands)

11. Employee Benefit Plans (continued)

- Preserve the value of the Plan's assets
- Diversify assets sufficiently, and, in accordance with modern portfolio theory, avoid large specific risks (losses) and minimize the volatility of the portfolio
- Provide sufficient liquidity to plan benefit payment outflows and meet the Plan's requirements

The strategic target asset allocation for the Plan is 24% in equities, 59% in debt securities, and 17% in other investments.

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

2013	$ 1,993
2014	2,207
2015	2,411
2016	2,623
2017	2,870
2018 – 2022	18,142

The System also has a tax-deferred annuity savings (403b) plan available to substantially all employees. In conjunction with the curtailment of the defined benefit pension plan, the System modified the 403b plan effective July 1, 2007. Under the terms of the modified plan, every eligible employee receives a base contribution of 2.5% of earnings. The System will match 50% – 70% on employee contributions up to 5% of employee earnings depending on years of service. In addition, certain employees are eligible for transition credits based on age and years of service to the System. The System's contribution for base matching and transition credits totaled $5,249 and $4,787 for fiscal years 2012 and 2011, respectively.

The System is partially self-insured against employee medical claims. Plan expenses include claims paid and a provision for claims incurred but not reported. As of June 30, 2012 and 2011, the System has recorded a liability for claims incurred but not reported of $2,057 and $1,600, respectively. The program has an annual aggregate stop loss provision of $325 per employee.

(Dollars in Thousands)

11. Employee Benefit Plans (continued)

In December 2005, the System adopted two non-qualified deferred compensation plans with an effective date of December 15, 2004, for certain members of executive management. Under the plans, participating employees may contribute amounts from their compensation to the plan and may receive a discretionary employer contribution. Employees are fully vested in all employee contributions to the plans. Vesting in employer contributions occurs in accordance with the underlying plan documents. All assets of the plans are held in separate trusts. Total contributions by the System to the plans were $278 and $220 for the years ended June 30, 2012 and 2011, respectively.

12. Concentration of Credit Risk

The System has funds on deposit with financial institutions in excess of amounts insured by the Federal Deposit Insurance Corporation. The System grants credit without collateral to its patients, most of who are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors (in percentages) at June 30 was as follows:

	2012	2011
Medicare	**26%**	21%
Medicaid	**14**	10
Blue Cross	**17**	18
HMOs and PPOs	**18**	19
Commercial insurance and other third-party payors	**6**	6
Patients	**19**	26
	100%	100%

13. Functional Expenses

The System and its subsidiaries provide general health care services to residents within its geographic location. Expenses related to providing these services are as follows:

	2012	2011
Health care services	**$ 314,952**	$ 304,010
General and administrative	**41,568**	35,600
	$ 356,520	$ 339,610

(Dollars in Thousands)

14. Temporarily and Permanently Restricted Net Assets

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

	2012	2011
Health care services:		
Buildings and equipment	**$ 1,542**	$ 1,849
Restricted by time only	**2,677**	2,470
Education programs	**542**	574
Indigent care and research	**380**	305
	$ 5,141	$ 5,198

Permanently restricted net assets consist of investments to be held in perpetuity, the income from which is expendable for:

	2012	2011
General health care services (reported as operating income)	**$ 971**	$ 971
Specific health care services (reported as temporarily restricted income)	**5**	5
	$ 976	$ 976

During 2012 and 2011, net assets were released from donor restrictions by incurring expenses or capital expenditures satisfying the restricted purposes in the amounts of $449 and $624, respectively.

15. Contingencies

The System has been named as a defendant in various legal proceedings arising from the performance of their normal activities. In the opinion of management, after consultation with legal counsel and after consideration of applicable insurance, the amount of the System's ultimate liability under all current legal proceedings will not have a material adverse effect on their consolidated financial position or results of operations.

15. Contingencies (continued)

FMH was insured for professional liability under an occurrence based policy through June 30, 2005. Effective July 1, 2005, FMH established an irrevocable self-insurance trust to set aside funds to cover future professional liability claims. The initial funding to the trust was $1,500. Total disbursements from the fund for a covered loss by one or more persons as a result of any one occurrence were not to exceed $1,000 and $3,000 in the aggregate in any one fiscal year. The funded balance of the trust was $6,984 at June 30, 2011. Concurrently, FMH purchased excess "umbrella" coverage through a commercial carrier with a per-occurrence and aggregate limit of $10,000 per policy period.

As of July 1, 2011, MIL, a single parent captive, was created to provide a flexible risk financing structure to meet the needs of the FRHS organization. MIL coverage limits are $1,000 per incident and $3,000 in the aggregate in any one fiscal year on a mature claims-made basis retroactive to July 1, 2005. Commercial general liability is covered under the captive program for $1,000 per incident on a claims-made basis retroactive to July 1, 2005 as well.

As of June 30, 2012, MIL assumed the FMH Professional Liability and Comprehensive General Liability coverage previously included under the self-insurance trust for incidents occurring between July 1, 2005 and June 30, 2011 that were reported to FMH prior to June 30, 2011. The policy for this period provides limits of $1,000 per medical incident with a $3,000 annual aggregate limit. The FMH self-insurance trust was fully liquidated as of June 30, 2012.

There are known claims and incidents that could result in the assertion of additional claims, as well as claims from unknown incidents that could be asserted arising from services provided to patients. Effective July 1, 2011, the System adopted ASU 2010-23 which clarified that a health care entity should not net insurance recoveries against a related claim liability. The System maintains reserves including excess coverage, in the amount of $10,159, and a related reinsurance receivable of $3,143 at June 30, 2012. FMH maintained reserves in the amount of $6,733 at June 30, 2011 to cover estimated costs incurred within the self-insured period. The System employs an independent actuary to estimate the ultimate settlement of such claims.

These reserves are recorded on an undiscounted basis at June 30, 2012 and 2011. In management's opinion, the amounts recorded provide an adequate reserve for loss contingencies. However, changes in circumstances affecting professional liability claims could cause these estimates to change by material amounts in the short term.

(Dollars in Thousands)

16. Commitments

Operating Leases

The System and its subsidiaries lease facilities under various operating leases, the last of which expires in 2030. The System has various options to renew the leases. The System also leases equipment under various operating leases. Rent expense under all operating leases was $4,128 and $4,953 for 2012 and 2011, respectively. Future minimum payments under non-cancelable operating leases are as follows:

Years ending June 30:		
2013	$	2,729
2014		2,579
2015		2,497
2016		2,227
2017		1,792
Thereafter		22,370
	$	34,194

Workers' Compensation

The System is self-insured against worker's compensation claims, up to $500 per occurrence, and has excess insurance coverage of $1,000 per occurrence. Expenses include claims paid and a provision for claims incurred but not reported.

Supply Chain Management Agreement

The System has a master service agreement with a vendor to provide supply chain management functions. This agreement contains certain purchase volume commitments.

Letter of Credit

The System has a letter of credit issued by a lending institution in the amount of $1,377. This letter of credit is renewed on an annual basis and is required by the State of Maryland as collateral for unemployment benefits.

17. Regulatory Environment

Medicare and Medicaid

The Medicare and Medicaid reimbursement programs represent a substantial portion of the System's revenues. The System's operations are 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, reimbursement for patient services, and Medicare and Medicaid fraud and abuse.

Over the past several years, 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 fraud and abuse standards and other government 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 System.

In 1983, Congress approved a Medicare prospective payment plan for most inpatient services as part of the Social Security Amendment Act of 1983. Hospitals in Maryland are currently exempt from these federal reimbursement regulations under a special waiver. The waiver currently in effect is subject to renewal based upon criteria defined in the federal law. Under these payment arrangements with Medicare, a retroactive adjustment could occur if certain performance standards are not attained by all hospitals on a statewide basis. The impact, if any, of any retroactive adjustment of the Medicare prospective payment system, should hospitals in Maryland become subject to such system, on future operations of the System, has not been determined.

17. Regulatory Environment (continued)

State of Maryland Health Services Cost Review Commission

Beginning in fiscal year 2011, the HSCRC adjusted its Charge Per Case policy and removed one-day stay (ODS) cases from the Hospital's case mix and charge per case revenue. ODS cases are now reimbursed on approved HSCRC charges rather than under the case mix adjusted CPC target.

Beginning in fiscal year 2012, the Hospital entered into a three-year agreement with the HSCRC to participate in the Admission Readmission Revenue (ARR) program. The ARR arrangement is a voluntary revenue constraint program to incentivize hospitals to coordinate care and reduce unnecessary readmissions. The ARR agreement imposes a case mix adjusted Charge per Episode (CPE) target to inpatient admissions and any subsequent readmission within 30 days of the discharge of the initial admission of the same patient. The CPE target is adjusted annually for inflation, case mix charges, and other factors.

Also beginning in fiscal year 2011, the Commission implemented the Charge Per Visit (CPV) methodology for certain outpatient services. Using fiscal year 2010 as the base period, the actual average 2011 CPV is compared with the base period target. Similar to the CPC target, the CPV target is adjusted annually for inflation, case mix changes, and other factors. The outpatient services that are excluded from the CPV methodology are reimbursed on approved HSCRC charges. In March 2012, the HSCRC suspended the outpatient CPV methodology retroactive to July 1, 2011. Until further notice, all outpatient services are reimbursed on approved HSCRC unit rate charge.

The timing of the HSCRC's rate adjustments in any given year could result in an increase or decrease in the succeeding year's rates due to the variances and penalties described above. The Hospital accrues revenue based on actual charges for services to patients in the year in which the services are performed.

The HSCRC established an uncompensated care fund whereby certain hospitals are required to contribute to the fund to help cover the costs associated with uncompensated care for all Maryland hospitals equitably. The Hospital's contribution to the fund was $4,235 and $4,004 for the years ended June 30, 2012 and 2011, respectively.

17. Regulatory Environment (continued)

The Hospital's policy is to recognize revenue based on actual charges for services to patients in the year in which the services are performed. The Hospital's revenues may be subject to adjustment as a result of examination by government agencies or contractors, and as a result of differing interpretation of 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

18. Subsequent Events

The System has evaluated subsequent events for the year ended June 30, 2012 through October 15, 2012, the date these financial statements were issued.

No other significant subsequent events were noted that would require recognition or disclosure at this time.

Supplementary Information

Ernst & Young LLP
621 East Pratt Street
Baltimore, MD 21202
Tel: + 1 410 539 7040
Fax: + 1 410 783 3832
www.ey.com

Report of Independent Auditors on Supplementary Information

The Board of Directors
Frederick Regional Health System, Inc. and Subsidiaries

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating details appearing in conjunction with the consolidated financial statements are presented for purposes of additional analysis and are not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

Ernst & Young LLP

October 15, 2012

Frederick Regional Health System, Inc. and Subsidiaries

Supplementary Consolidating Balance Sheets
(In Thousands)

June 30, 2012

	Frederick Regional Health System, Inc.	Frederick Memorial Hospital Inc.	Monocacy Insurance LTD	Monocacy Health Partners LLC	Frederick Health Services Corporation	Elimination	Consolidated
Assets							
Current assets:							
Cash and cash equivalents	$ –	$ 30,254	$ 101	$ –	$ 1,861	$ –	$ 32,216
Patient receivables, net	–	48,971	–	–	1,270	–	50,241
Other receivables	–	1,583	3,901	–	–	(3,992)	1,492
Inventory	–	4,649	–	–	–	–	4,649
Prepaid expenses	–	2,432	6	–	59	–	2,497
Assets limited as to use	–	3,715	81	–	–	–	3,796
Promises to give, net	–	570	–	–	–	–	570
Total current assets	–	92,174	4,089	–	3,190	(3,992)	95,461
Net property and equipment	–	189,945	–	–	4,919	–	194,864
Other assets:							
Assets limited as to use	–	7,383	–	–	–	–	7,383
Investments – donor restricted	–	2,977	–	–	–	–	2,977
Promises to give, net	–	2,567	–	–	–	–	2,567
Long-term investments	–	99,314	1,513	–	–	–	100,827
Other investments	171,864	17,477	–	–	1,945	(188,194)	3,092
Debt issuance costs, net	–	1,590	–	–	–	–	1,590
Other assets	–	5,861	1,150	–	–	(3,586)	3,425
Total other assets	171,864	137,169	2,663	–	1,945	(191,780)	121,861
Total assets	$ 171,864	$ 419,288	$ 6,752	$ –	$ 10,054	$ (195,772)	$ 412,186

Frederick Regional Health System, Inc. and Subsidiaries

Supplementary Consolidating Balance Sheets (continued)
(In Thousands)

	Frederick Regional Health System, Inc.	**Frederick Memorial Hospital Inc.**	**Monocacy Insurance LTD**	**Monocacy Health Partners LLC**	**Frederick Health Services Corporation**	**Elimination**	**Consolidated**
Liabilities and net assets							
Current liabilities:							
Current maturities of long-term debt and capital lease obligations	$ –	$ 4,119	$ –	$ –	$ –	$ –	$ 4,119
Accounts payable	–	21,532	–	–	307	(237)	21,602
Accrued expenses	–	19,843	57	–	729	–	20,629
Advances from third-party payors	–	10,065	–	–	–	–	10,065
Other current liabilities	–	6,545	414	–	3,380	(7,356)	2,983
Total current liabilities	–	62,104	471	–	4,416	(7,593)	59,398
Long-term liabilities, net of current portion:							
Long-term debt and capital lease obligations	–	140,725	–	–	–	–	140,725
Interest rate swap contract	–	16,513	–	–	–	–	16,513
Accrued pension expense	–	26,368	–	–	–	–	26,368
Other long-term liabilities	–	7,472	6,161	–	–	–	13,633
Total long-term liabilities, net of current portion	–	191,078	6,161	–	–	–	197,239
Total liabilities	–	253,182	6,632	–	4,416	(7,593)	256,637
Net assets:							
Unrestricted	171,864	159,989	120	–	5,638	(188,179)	149,432
Temporarily restricted	–	5,141	–	–	–	–	5,141
Permanently restricted	–	976	–	–	–	–	976
Total net assets	171,864	166,106	120	–	5,638	(188,179)	155,549
Total liabilities and net assets	$ 171,864	$ 419,288	$ 6,752	$ –	$ 10,054	$ (195,772)	$ 412,186

Frederick Regional Health System, Inc. and Subsidiaries

Supplementary Consolidating Statement of Operations and Changes in Net Assets

(In Thousands)

Year Ended June 30, 2012

	Frederick Regional Health System, Inc.	Frederick Memorial Hospital Inc.	Monocacy Insurance LTD	Monocacy Health Partners LLC	Frederick Health Services Corporation	Elimination	Consolidated
Unrestricted revenue and other support:							
Net patient service revenue	$ –	$ 341,623	$ –	$ –	$ 4,574	$ (185)	346,012
Other operating revenues	–	10,152	2,236	–	4,657	(4,626)	12,419
Gifts, bequests, and contributions	–	3,049	–	–	–	–	3,049
Net assets released from restriction used for operations	–	251	–	–	–	–	251
Total unrestricted revenue and other support	–	355,075	2,236	–	9,231	(4,811)	361,731
Operating expenses:							
Salaries and wages	–	142,106	–	–	5,170	(247)	147,029
Employee benefits	–	38,059	–	–	1,029	(37)	39,051
Professional fees	–	11,859	140	–	50	(27)	12,022
Cost of goods sold	–	51,962	–	–	749	–	52,711
Supplies	–	11,080	–	–	–	(82)	10,998
Contract services	–	36,318	–	–	262	(1,558)	35,022
Other	–	11,135	75	–	861	(624)	11,447
Utilities	–	4,332	–	–	74	–	4,406
Insurance	–	5,136	2,054	–	116	(2,236)	5,070
Depreciation and amortization	–	20,024	–	–	318	–	20,342
Interest	–	4,571	–	–	107	(107)	4,571
Provision for uncollectible accounts	–	13,841	–	–	10	–	13,851
Total operating expenses	–	350,423	2,269	–	8,746	(4,918)	356,520
Operating income (loss), net	–	4,652	(33)	–	485	107	5,211

Frederick Regional Health System, Inc. and Subsidiaries

Supplementary Consolidating Statement of Operations and Changes in Net Assets (continued)
(In Thousands)

	Frederick Regional Health System, Inc.	Frederick Memorial Hospital Inc.	Monocacy Insurance LTD	Monocacy Health Partners LLC	Frederick Health Services Corporation	Elimination	Consolidated
Other income (loss)							
(Loss) on sale of assets	$ –	$ (67)	$ –	$ –	$ –	$ –	$ (67)
Investment gain (loss), net	–	5,548	–	–	383	(107)	5,824
Change in unrealized (losses) gains on trading securities, net	–	(4,049)	33	–	–	–	(4,016)
Realized and unrealized losses on interest rate swap contract, net	–	(9,386)	–	–	–	–	(9,386)
Other non operating income, net	–	304	–	–	–	–	304
Total other income (loss)	–	(7,650)	33	–	383	(107)	(7,341)
Excess (deficit) of unrestricted revenue and other support over expenses	–	(2,998)	–	–	868	–	(2,130)
Other changes in unrestricted net assets:							
Pension adjustment	–	(10,303)	–	–	–	–	(10,303)
Released from restriction used to purchase capital	–	198	–	–	–	–	198
Increase (decrease) in unrestricted net assets	$ –	$ (13,103)	$ –	$ –	$ 868	$ –	$ (12,235)

Ernst & Young LLP

Assurance | Tax | Transactions | Advisory

About Ernst & Young
Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 167,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit www.ey.com.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. This Report has been prepared by Ernst & Young LLP, a client serving member firm located in the United States.