Grant Thornton

Consolidated Financial Statements, Supplementary Information, and Report of Independent Certified Public Accountants

Meritus Health, Inc.

June 30, 2012 and 2011

C O N T E N T S

Audit – Tax – Advisory

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Report of Independent Certified Public Accountants

To the Board of Directors
Meritus Health, Inc.

We have audited the accompanying consolidated balance sheets of Meritus Health, Inc. ("Meritus") at 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 Meritus' management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Meritus Healthcare Foundation (the "Foundation"), which statements reflect total assets of approximately three percent of total consolidated assets at June 30, 2011 and total revenues of approximately one percent of the related consolidated total revenues for the year then ended of Meritus. Those statements were audited by other auditors, whose report thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for the Foundation, is based on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America as established by the American Institute of Certified Public Accountants. 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 Meritus' 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 and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Meritus Health, Inc. as of June 30, 2012 and 2011, and the results of its operations and changes in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the accompanying consolidated financial statements, in 2012 Meritus adopted the provisions of the amendments to the presentation and disclosure of patient service revenue, provision for bad debts, and the allowance for doubtful accounts for certain health care entities, which resulted in a change to the presentation of the provision for bad debts on the consolidated statements of operations and changes in net assets and additional disclosures.

Grant Thornton LLP

Baltimore, Maryland
September 26, 2012

CONSOLIDATED FINANCIAL STATEMENTS

Meritus Health, Inc.

CONSOLIDATED BALANCE SHEETS

June 30,

ASSETS	2012	2011
CURRENT ASSETS		
Cash and cash equivalents	$ 27,253,943	$ 18,380,698
Restricted cash	2,746,240	2,614,437
Short-term investments	3,422,557	4,399,794
Current portion of assets whose use is limited	11,649,864	10,232,054
Accounts receivable, net	51,109,894	45,878,319
Supplies	9,417,836	10,252,192
Prepaid and other current assets	5,956,777	5,914,333
Total current assets	111,557,111	97,671,827
EQUITY INVESTMENTS IN AFFILIATES	24,172,098	22,752,291
ASSETS WHOSE USE IS LIMITED		
Board designated funds	79,257,670	75,555,190
Supplemental retirement benefit investments	3,910,091	3,539,997
Temporarily and permanently restricted donor funds	1,164,123	1,165,136
	84,331,884	80,260,323
Assets held by trustee under bond indenture agreement	18,470,251	18,465,329
Funds designated for insurance purposes	8,801,838	7,647,952
	111,603,973	106,373,604
PROPERTY, PLANT AND EQUIPMENT, net	286,424,041	303,540,192
PLEDGES RECEIVABLE, net	3,070,167	3,893,162
DEFERRED FINANCING COSTS, net	2,663,577	2,805,574
OTHER ASSETS	3,056,314	2,327,002
Total assets	$542,547,281	$539,363,652

The accompanying notes are an integral part of these financial statements.

LIABILITIES AND NET ASSETS	2012	2011
CURRENT LIABILITIES		
Accounts payable and accrued expenses	$ 14,125,014	$ 13,203,320
Retainage payable	183,885	1,153,823
Accrued salaries, wages and withholdings	4,959,925	4,151,982
Accrued compensation benefit	16,751,028	18,157,921
Advances from third-party payors	7,620,630	6,684,832
Accrued interest payable	7,764,019	7,795,244
Current portion of long-term debt	7,650,229	9,140,210
Total current liabilities	59,054,730	60,287,332
LONG-TERM DEBT, net of current portion	261,446,958	266,146,562
ACCRUED RETIREMENT BENEFITS	4,210,694	3,900,084
OTHER LONG-TERM LIABILITIES	6,885,711	5,590,232
Total liabilities	331,598,093	335,924,210
NET ASSETS		
Unrestricted		
Meritus	198,081,263	190,332,321
Non-controlling interest	2,609,591	1,440,713
Total unrestricted net assets	200,690,854	191,773,034
Temporarily restricted	9,229,716	10,637,790
Permanently restricted	1,028,618	1,028,618
Total net assets	210,949,188	203,439,442
Total liabilities and net assets	$542,547,281	$539,363,652

Meritus Health, Inc.

CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS

Years ended June 30,

	2012	2011
Unrestricted revenue, gains and other support		
Net patient service revenue	$371,188,105	$354,856,000
Provision for bad debts	13,620,670	14,550,932
Net patient service revenue less provision for bad debts	357,567,435	340,305,068
Other revenue	13,763,772	11,500,617
Equity earnings in affiliates	7,368,120	7,094,777
Net assets released from restriction used for operations	1,541,749	847,815
	380,241,076	359,748,277
Expenses		
Salaries and wages	146,629,910	141,555,417
Professional fees	8,274,998	9,620,750
Supplies and other	174,742,013	166,725,851
Interest	15,336,562	9,212,306
Depreciation and amortization	26,048,473	22,153,445
	371,031,956	349,267,769
Operating income before other items	9,209,120	10,480,508
Other items		
Demolition and transition costs	(620,907)	(3,751,868)
Early retirement costs	-	(569,942)
Pension settlement costs	(689,896)	-
	(1,310,803)	(4,321,810)
Operating income	7,898,317	6,158,698
Non-operating gains (losses), net		
Investment returns, net	4,959,053	12,762,559
Other, net	123,240	874,080
Income tax expense	(4,644,531)	(174,635)
Excess of revenue over expenses	8,336,079	19,620,702
Excess of revenue over expenses attributable to non-controlling interest	(1,448,877)	(296,365)
Excess of revenue over expenses attributable to Meritus	6,887,202	19,324,337

The accompanying notes are an integral part of these financial statements.

	2012	2011
Other changes in unrestricted net assets		
Change in retirement benefit obligation	(88,260)	714,279
Change in non-controlling interests	1,168,878	(223,635)
Net assets released from restriction for property, plant, and equipment	950,000	-
Other	-	85,309
Increase in unrestricted net assets	8,917,820	19,900,290
Temporarily restricted net assets		
Contributions	1,083,675	2,667,532
Net realized and unrealized gains and losses on investments	-	47,798
Net assets released from restriction for property, plant, and equipment	(950,000)	-
Net assets released from restrictions for operations	(1,541,749)	(847,815)
(Decrease) increase in temporarily restricted net assets	(1,408,074)	1,867,515
INCREASE IN NET ASSETS	7,509,746	21,767,805
Net assets		
Beginning of year	203,439,442	181,671,637
End of year	$210,949,188	$203,439,442

Meritus Health, Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended June 30,

	2012	2011
Cash flows from operating activities		
Increase in net assets	$ 7,509,746	$ 21,767,805
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	26,048,473	22,153,445
Provision for bad debts	13,620,670	14,550,932
Change in retirement benefit obligation	88,260	(714,279)
Change in non-controlling interest	(1,168,878)	223,635
Net realized and unrealized gains on investments	677,614	(10,583,839)
(Gain) loss on disposal of assets	(243,046)	197,187
Equity earnings in affiliates	(7,368,120)	(7,094,777)
Accretion of asset retirement obligation	-	165,960
Changes in assets and liabilities		
Accounts receivable	(18,852,245)	(19,044,006)
Supplies, prepaid, and other current assets	791,912	(776,865)
Other assets	93,683	(1,269,476)
Accounts payable, accrued expenses and long-term liabilities	3,386,051	840,914
Accrued salaries, wages and withholdings	807,943	(4,768,997)
Accrued compensation benefit	(1,495,153)	(752,427)
Advances from third-party payors	935,798	20,957
Interest payable	(31,225)	290,488
Accrued retirement benefits	310,610	(1,069,798)
Net cash provided by operating activities	25,112,093	14,136,859
Cash flows from investing activities		
Purchase of property, plant and equipment	(11,001,297)	(66,021,503)
Proceeds from the disposal of assets	3,500,860	5
Purchase of restricted cash, short-term investments, and assets whose use is limited	(98,756,705)	(314,611,853)
Sale of restricted cash, short-term investments, and assets whose use is limited	92,276,346	362,613,394
Equity distributions from affiliates, net	5,948,313	3,775,241
Net cash used in investing activities	(8,032,483)	(14,244,716)

The accompanying notes are an integral part of these financial statements.

	2012	2011
Cash flows from financing activities		
Proceeds from long-term debt	3,230,104	1,300,000
Payments on long-term debt	(11,436,469)	(5,837,128)
Net cash used in financing activities	(8,206,365)	(4,537,128)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	8,873,245	(4,644,985)
Cash and cash equivalents		
Beginning of year	18,380,698	23,025,683
End of year	$ 27,253,943	$ 18,380,698
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 3,384,830	$ 1,041,108
Cash paid for interest, net of amounts capitalized	15,336,562	8,631,330
Supplemental disclosure of non-cash investing and financing activities:		
Assets acquired under capital leases	$ 2,016,780	$ 165,768
Decrease in accrual for the purchase of property, plant and equipment	(969,938)	(13,012,508)

1. DESCRIPTION OF ORGANIZATION

Organization

Meritus Health, Inc. ("Parent"), is the parent corporation of the Meritus Medical Center, Inc. ("Hospital"), the Meritus Medical Center Endowment Fund, Inc. ("Fund"), the Meritus Healthcare Foundation, Inc. ("Foundation"), and the Meritus Insurance Company, Ltd. ("MIC"). The Hospital is the parent corporation of Meritus Holdings, LLC ("Holdings"), which owns Meritus Enterprises ("MEI"). These entities are collectively referred to as "Meritus".

The Hospital is a not-for-profit acute care hospital located in Hagerstown, Maryland and serves the residents of western Maryland, southern Pennsylvania, and the panhandle of West Virginia. The Parent is the sole corporate member of the Hospital. The Hospital currently offers acute general hospital inpatient services including adult medical/surgical care, obstetrics and newborn care, including a family birthing center, cardiac catheterizations, comprehensive inpatient rehabilitation, radiology and diagnostic services, inpatient and outpatient mental health services, a regional Level III Trauma Center, an intensive care unit, a progressive care unit, a coronary care unit, and a pediatric unit. The Hospital completed construction of a replacement hospital, which opened in December 2010.

Holdings is a tax-exempt entity that operates a laboratory, urgent care centers, and other health services. The Hospital is the sole member of Holdings.

MEI is a for-profit corporation that operates retail pharmacies, physician practices, and other health services. In addition, MEI holds a 60% interest in Robinwood Surgery Center which provides ambulatory surgery services and a 50% interest in Diagnostic Imaging Services which provides outpatient imaging services.

The Fund is a not-for-profit corporation which manages gifts, donations or bequests given for the benefit of Meritus. The Parent is the sole corporate member of the Fund. The Fund also acquires real estate properties for rental to medical provider entities and development opportunities. The Fund is the sole member of Meritus Medical Center Endowment Development Company, Inc. ("Development Company") a not-for-profit corporation, which was formed to develop and lease real estate properties for rental to medical provider entities.

The Fund's Bylaws and Articles of Incorporation provide that the Fund is to be operated exclusively for the support and benefit of the Hospital and the Parent or activities or programs which benefit the Hospital or the Parent. Distributions are made to the Hospital or the Parent in amounts and in periods determined by the Fund's Board of Directors, who may also restrict the use of funds. In the event the Fund is dissolved, all remaining assets would be returned to the Hospital or the Parent.

The Foundation is a not-for-profit corporation whose purpose is to raise philanthropic support for the capital and endowment campaigns of the Hospital and the Fund. The Foundation also raises money for the Hospital's medical programs, healthcare objectives, scientific research, educational programs, and related community activities. Resources for the Foundation's activities are primarily provided by donors.

1. DESCRIPTION OF ORGANIZATION - Continued

Organization - continued

MIC is a Cayman Island captive insurance company, wholly-owned by the Parent that provides primary limits of insurance to Meritus for professional liability, employed physicians professional liability, comprehensive general liability, deductible, and stop loss coverage for health insurance.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Parent, the Hospital, Holdings, MEI, the Fund, the Foundation, and MIC. MEI owns a 60% interest in Robinwood Surgery Center, LLC, at June 30, 2012 and 2011, which is included in the consolidated financial statements with the related non-controlling interest reported as a component of net assets. All material inter-company balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements, in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Accordingly, actual results could differ from those estimates. The most significant management estimates and assumptions related to the determination of allowance for doubtful accounts and contractual allowances for patient accounts receivable, tax accruals, useful lives of property, plant and equipment, actuarial estimates for the postretirement benefit plan, self-insured reserves, including professional and general liabilities and the reported fair values of certain assets and liabilities.

Fair Value Measurements

Meritus measures fair value as the price that would be received to sell an asset or paid to transfer a liability (the exit price) in an orderly transaction between market participants at the measurement date. The accounting guidance outlines a valuation framework and creates a fair value hierarchy in order to increase the consistency and comparability of fair value measurements and the related disclosures. The fair value hierarchy is broken down into three levels based on the source of inputs as follows:

Level I - Quoted prices are available in active markets for identical assets or liabilities as of the report date. A quoted price for an identical asset or liability in an active market provides the most reliable fair value measurement because it is directly observable to the market.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Fair Value Measurements - continued

Level II - Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the report date. The nature of these securities include investments for which quoted prices are available but traded less frequently and investments that are fair valued using other securities, the parameters of which can be directly observed.

Level III - Securities that have little to no pricing observability as of the report date. These securities are measured using management's best estimate of fair value, where the inputs into the determination of fair value are not observable and require significant management judgment or estimation.

Financial instruments consist of cash equivalents, patient accounts receivable, investments, excluding those accounted for by the equity method, accounts payable and accrued expenses and long-term debt. The carrying amounts reported in the consolidated balance sheets for cash equivalents, patient accounts receivable, and accounts payable and accrued expenses approximate fair value. Management's estimates of other financial instruments are described elsewhere in the notes to the consolidated financial statements.

Patient Accounts Receivable / Allowance for Doubtful Accounts

Patient accounts receivable result from the healthcare services provided by Meritus. Meritus provides an allowance for doubtful accounts for estimated losses resulting from the unwillingness or inability of patients or third-party payors to make payments for services. The allowance is determined by analyzing specific accounts and historical data and trends. Patient accounts receivable are charged off against the allowance for doubtful accounts when management determines that recovery is unlikely and Meritus ceases collection efforts. Losses have been consistent with management's expectations.

Cash and Cash Equivalents

Cash and cash equivalents consist of short-term, highly liquid investments that are readily convertible to cash and have original maturities of three months or less. Cash and cash equivalents are carried at cost which approximates fair value. Meritus entered into overnight investment repurchase transactions of $15,746,000 and $13,968,000 as of June 30, 2012 and 2011, respectively.

Assets Whose Use is Limited

Assets whose use is limited include assets set aside by the Board of Directors for specific purposes, for supplemental retirement benefit investments, to fulfill donor purposes, assets held by trustees under bond indenture agreement, and funds designated for insurance purposes. Amounts required to meet current liabilities are shown as current assets in the consolidated balance sheets.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Investments and Investment Income

Investments in equity securities (i.e., investments that have readily determinable fair values and are not accounted for by the equity method) and all investments in debt securities are reported at fair value on the consolidated balance sheets, under the fair value option.

Investment income, which includes interest and dividends, on proceeds of borrowings that are held by a trustee, to the extent not capitalized, are reported as other revenue. Other investment income, which includes interest, dividends and realized and unrealized gains and losses on assets limited as to use by Board of Directors and funds designated for insurance purposes are recorded as non-operating gains (losses), net, unless the income or loss is restricted by donor or law.

Meritus' investments are managed by investment managers. Investment securities, in general, are exposed to various risks, such as interest rate, credit and overall market volatility. Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such change could materially affect the amounts reported in the consolidated financial statements.

Supplies

Supplies for the Hospital are carried at the lower of cost or market on a weighted average basis.

Supplies for Holdings and MEI are valued at the lower of cost or market, with the cost being recorded on the first-in, first-out method.

Major classes of supplies as of June 30, are as follows:

	2012	2011
Hospital:		
Surgical and medical supplies	$4,521,316	$ 5,253,327
Other supplies	986,857	1,017,163
	5,508,173	6,270,490
Holdings and MEI:		
Durable medical equipment	531,204	751,414
Surgical and medical supplies	387,216	378,258
Pharmacy and home care infusion	2,474,863	2,354,710
Medical laboratory	516,380	497,320
	3,909,663	3,981,702
	$9,417,836	$10,252,192

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Property, Plant and Equipment

Property, plant and equipment acquisitions are recorded at cost. Those assets acquired by gift are carried at amounts established as fair value at the time of acquisition. Depreciation is provided over the estimated useful life of each class of depreciable assets and is computed using the straight-line method. Equipment under capital lease is amortized by the straight-line method over the shorter of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the consolidated financial statements. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. Durable medical equipment held for resale is included in supplies. The remainder of durable medical equipment is rented to patients and is included in property, plant and equipment. Assets are retired or disposed of at book value and related gains or losses are recorded for assets sold. Useful lives range as follows:

Land improvements	5 - 25 years
Buildings	10 - 40 years
Equipment	5 - 20 years

Gifts of long-lived assets such as land, buildings, or equipment are reported as other changes in unrestricted net assets unless explicit donor stipulations specify how the donated assets must be used. When applicable, 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-lived assets must be maintained, expirations of donor restrictions, occur when the donated or acquired long-lived assets are placed into service.

Meritus continually evaluates whether events and circumstances have occurred that indicate the remaining estimated useful life of long-lived assets is appropriate, or whether the remaining balance may not be recoverable. When factors indicate that long-lived assets should be evaluated for possible impairment, Meritus uses an estimate of the related undiscounted operating income over the remaining life of the long-lived asset in measuring whether the long-lived asset is recoverable. The impairment loss on these assets is measured as the excess of the carrying amount of the asset over its fair value. Fair value is based upon market prices, where available, or discounted cash flows. Management believes that no revision to the remaining useful lives or write-down of long-lived assets is required at June 30, 2012.

Deferred Financing Costs

Financing costs incurred in issuing debt have been capitalized and are being amortized over the life of the debt using the interest method.

Advertising Costs

Advertising costs for the years ended June 30, 2012 and 2011 were $1,649,730 and $718,165, respectively.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Compensated Absences

Meritus records a liability for amounts due to employees for future absences which are attributable to services performed in the current and prior periods. This liability is included in accrued salaries, wages and withholdings on the consolidated balance sheets.

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by Meritus have been limited by donors to a specific time period or purpose. When donor restrictions expire, that is, when a time restriction ends or a purpose restriction is accomplished, temporarily restricted net assets are reclassified into unrestricted net assets and reported as net assets released from restrictions.

Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions if for operating purposes and as other changes in unrestricted net assets if for capital purposes in the consolidated statements of operations and changes in net assets. Permanently restricted net assets have been restricted by donors to be maintained by Meritus in perpetuity.

Excess of Revenue over Expenses

The consolidated statements of operations include the excess of revenue over expenses. Changes in unrestricted net assets that are excluded from the excess of revenues over expenses, consistent with industry practice, include net assets released from restrictions for property, plant and equipment, the change in retirement benefit obligation, change in non-controlling interest and other items.

Net Patient Service Revenue

For services provided at the Hospital campus, all payors are required to pay the Maryland Health Services Cost Review Commission ("HSCRC") approved rates. The major third-party payors, as recognized by the HSCRC, are allowed discounts of up to 6% on approved rates. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered.

The Hospital's charges are subject to review and approval by the HSCRC. The Hospital management has filed the required forms with the HSCRC and believes the Hospital to be in compliance with HSCRC requirements. The total rate of reimbursement for services to patients under the Medicare and Medicaid programs is based on an arrangement between the Centers for Medicare and Medicaid Service and the HSCRC. Management believes that this program will remain in effect at least through June 30, 2013. Effective July 1, 2010, the Hospital entered into an agreement with the HSCRC under a rate regulation concept called Total Patient Revenue ("TPR") for a three year period ending June 30, 2013. TPR is a revenue constraint methodology which provides for inflation, bad debt, payor differential and adjustments for population growth, but excludes case mix and volume changes. For the years ended June 30, 2012 and 2011, the regulated revenue cap was $294,592,054 and $275,699,700 respectively. For the year ending June 30, 2013, the regulated revenue cap is approximately $299,000,000. Management is working with the HSCRC on an agreement for the years beyond fiscal year 2013.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

<u>Net Patient Service Revenue</u> - continued

Services not located on the Hospital campus are not regulated by the HSCRC. Medicare and Medicaid pay the revenues associated with these services based upon established fee schedules. Commercial payors pay at negotiated rates for these services.

Net patient service revenue is reported as estimated net realizable amounts from patients, third-party payors, and others for services rendered and include estimated retroactive revenue adjustments due to future audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, and investigations.

Net revenues from the Medicare and Medicaid programs collectively constitute approximately 48% of Meritus' net patient service revenue for the years ended June 30, 2012 and 2011. Laws and regulations governing the HSCRC, Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Meritus believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. While no such regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action.

Accounts receivable are reduced by an allowance for doubtful accounts. Meritus' allowance for doubtful accounts totaled $3,934,805 and $3,676,453 at June 30, 2012 and 2011, respectively. In evaluating the collectibility of accounts receivable, Meritus analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. Management reviews data about these major payor sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts. For receivables associated with services provided to patients who have third-party coverage, Meritus analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts, if necessary (for example, for expected uncollectible deductibles and copayments on accounts for which the third-party payor has not yet paid, or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely). For receivables associated with self-pay patients, Meritus records a significant provision for bad debts on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the billed rates and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts. Meritus has not experienced significant changes in write-off trends and has not changed its charity care policy for the year ended June 30, 2012.

Patient service revenue for the year ended June 30, 2012, net of contractual allowances and discounts (but before the provision for bad debts), recognized in the period from these major payor sources based on primary insurance designation, is as follows:

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Net Patient Service Revenue - continued

	Third-Party Payors	Self-Pay	Total All Payors
Patient service revenue, net of contractual allowances and discounts	$330,527,178	$27,040,257	$357,567,435

Deductibles and copayments under third-party payment programs within the third-party payor amount above are the patients' responsibility and Meritus considers these amounts in its determination of the provision for bad debts based on collection experience.

Charity Care

Meritus provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Meritus does not pursue collection on amounts deemed to qualify as charity. Meritus also estimates that the direct and indirect cost of services and supplies furnished to patients eligible for charity care using a ratio of cost to gross charges based on internal data is $15,421,891 and $10,738,028 for the years ended June 30, 2012 and 2011, respectively.

Meritus' patient acceptance policy is based upon its mission statement and its charitable purposes. This policy results in Meritus' assumption of higher-than-normal credit risk from its patients. To the extent that Meritus realizes additional losses resulting from such higher credit risks and clients are not identified or do not meet Meritus' defined charity care policy, such additional losses are included in the provision for bad debt.

Meritus also sponsors certain other charitable programs, which provide substantial benefit to the broader community. Such programs include services to needy and elderly populations that require special support, as well as health and education for the general community welfare. In addition, all other uncollectable amounts resulting from the patients' inability to pay are recorded as a reduction to net patient service, consistent with Meritus' policy.

Other Revenue

Other revenue is comprised of investment income on assets whose use is limited under bond indenture agreement, rental income, gains and losses on disposal of assets, incentive payments related to the implementation and meaningful use of certified electronic health records and other miscellaneous items.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Other Revenue - continued

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 Meritus utilizes a grant accounting model to recognize these revenues. Under this accounting policy, EHR incentive payments were recognized as revenues when attestation that the EHR meaningful use criteria for the required period of time was demonstrated. Accordingly, Meritus recognized $1,885,293 of EHR revenues for the year ended June 30, 2012. These amounts are included in other revenue in the consolidated statements of operations and changes in net assets. Meritus' attestation of compliance with the meaningful use criteria is subject to audit by the federal government or its designee. Additionally, Medicare EHR incentive payments received are subject to retrospective adjustment upon final settlement of the applicable cost report from which payments were calculated.

Income Taxes

The Internal Revenue Service has ruled that the Parent, the Hospital, the Fund, the Development Company and the Foundation qualify under Section 501(c)(3) of the Internal Revenue Code and are, therefore, not subject to tax under present income tax regulations.

Holdings is considered a disregarded entity for tax purposes and is reported through the Hospital.

MEI accounts for income taxes through the current recognition of deferred tax liabilities and assets for the expected future tax consequences of temporary differences between tax bases and financial reporting bases of other assets and liabilities.

At present, no income, profit or capital gain taxes are levied in the Cayman Islands and accordingly, no provision for taxation has been made for MIC. In the event that such taxes are levied, MIC has been granted an exemption until September 9, 2023 for any such taxes that might be introduced. MIC intends to conduct its affairs so as not to be liable for taxes in any other jurisdiction.

Meritus follows the accounting guidance for uncertainties in income tax positions which requires that a tax position be recognized or derecognized based on a "more likely than not" threshold. This applies to positions taken or expected to be taken in a tax return. Meritus does not believe its consolidated financial statements include any material uncertain tax positions.

Concentration of Credit Risk

Meritus invests its excess cash, investments, and assets in financial institutions which are federally insured under the Federal Deposit Insurance Act ("FDIA"). Deposits in certain accounts exceed federally insured deposit limits. Meritus has experienced no losses on its deposits.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

Concentration of Credit Risk - continued

Meritus grants credit without collateral to the patients it serves who primarily live in the tri-state area. The majority of these patients have either insurance through Blue Cross, another insurance company or a health maintenance organization, or qualify for the Maryland Medical Assistance or the Centers for Medicare and Medicaid Services ("CMS") programs.

At June 30, Meritus' patient accounts receivable were made up of the following:

	2012	2011
Health maintenance organizations	2%	3%
Medical assistance HMO	12	14
Medicare	32	32
Commercial insurance and other	22	22
Blue Cross/Blue Shield	17	18
Self-pay	15	11
	100%	100%

457(b) Deferred Compensation Plan

The Hospital is party to a 457(b) deferred compensation plan intended to provide retirement benefits to certain eligible employees. Assets are deposited with the plan managers, pursuant to this agreement, such that the value of the assets determined by the fair value approximately equals the related accrued deferred compensation liability. The funds are placed into a range of investment strategies from conservative to aggressive. The liability associated with this plan is included in accrued retirement benefits on the consolidated balance sheets.

Recently Adopted Accounting Pronouncements

In August 2010, the FASB issued guidance to reduce the diversity in practice regarding the measurement basis used in the identification and disclosure of charity care by healthcare entities. The amendments in this guidance require that cost be used as the measurement for charity care disclosure purposes and that cost be identified as the direct and indirect cost of providing the care. The guidance also requires entities to disclose their method used to identify or determine such costs. This authoritative guidance is effective for financial statements issued for fiscal years beginning after December 15, 2010 and should be applied retrospectively to all prior fiscal years presented. Meritus has adopted the provisions of this guidance for the year's ended June 30, 2012 and 2011. The new guidance did not impact the results of operations or financial position; however, changes to the charity care disclosures were required (see note 2, Charity Care).

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Recently Adopted Accounting Pronouncements - continued

In July 2011, the FASB issued authoritative guidance to provide amendments to the presentation of the statement of operations for certain healthcare entities and enhanced disclosure about net patient service revenue and the related allowance for doubtful accounts. These amendments require certain healthcare entities to present their provision for bad debts associated with patient service revenue as a deduction from patient service revenue (net of contractual allowances and discounts). These amendments also require disclosure of patient service revenue (net of contractual allowances and discounts) as well as qualitative and quantitative information about changes in the allowance for doubtful accounts. Additionally, healthcare entities are required to provide enhanced disclosure about their policies for recognizing revenue and assessing bad debts.

The guidance is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2011, with early adoption permitted. The amendments to the presentation of the provision for bad debts related to patient service revenue in the statement of operations should be applied retrospectively to all prior periods presented. The disclosures required by the amendments in this update should be provided for the period of adoption and subsequent reporting periods. Meritus early adopted the provisions of this guidance as of and for the year ended June 30, 2012, and retrospectively applied the presentation requirements to all periods presented. The change in presentation and additional disclosures, as required, are reflected in the consolidated statement of operations and changes in net assets and in Note 2 - Net Patient Service Revenue.

Reclassifications

Certain prior year amounts in the accompanying consolidated financial statements have been reclassified to conform to current year presentation. These reclassifications had no impact on total assets, total liabilities, and net assets or excess of revenue over expenses previously reported.

Subsequent Events

Meritus evaluated subsequent events through September 26, 2012, the date these consolidated financial statements were available to be issued. All material matters are disclosed in the footnotes to the consolidated financial statements.

3. INVESTMENTS AND INVESTMENT INCOME

Investments at June 30 consisted of the following:

	2012	2011
Short-term investments:		
U.S. government securities	$ 3,422,557	$ 4,399,794
Assets whose use is limited:		
Cash and cash equivalents	$ 6,553,559	$ 190,552
Fixed income	31,618,734	29,891,730
Common stock	45,922,290	47,521,106
Mutual funds	237,301	2,656,935
	$84,331,884	$80,260,323
Assets held by trustee for debt service and construction:		
U.S. government securities	$29,170,115	$27,776,762
Funds designated for insurance purposes:		
Fixed income	$ 9,751,838	$ 8,568,573

Meritus had restricted cash of $2,746,240 and $2,614,437 as of June 20, 2012 and 2011, respectively, for unemployment insurance collateral and workers' compensation collateral, in compliance with the self-insurance requirement under the regulations of the State of Maryland Employment Security Administration and Workers' Compensation Administration.

Investment returns, net on investments included in the consolidated statements of operations and changes in net assets are comprised of the following for the years ended June 30:

	2012	2011
Investment returns, net:		
Interest and dividends, net of investment fees of $234,905 and $206,240 in 2012 and 2011, respectively	$ 5,636,667	$ 2,226,518
Net realized gains on investments	988,290	4,217,673
Change in unrealized gains and losses on investments	(1,665,904)	6,318,368
	$ 4,959,053	$12,762,559

4. FAIR VALUE MEASUREMENTS

The following table presents Meritus' assets measured at fair value on a recurring basis using the market approach, as of June 30:

	Level 1	Level 2	Level 3	Total
2012:				
Cash and cash equivalents	$ 27,253,943	$ -	$ -	$ 27,253,943
Restricted cash	2,746,240	-	-	2,746,240
Short-term investments	3,422,557	-	-	3,422,557
Assets whose use is limited	116,746,346	6,507,491	-	123,253,837
Total assets	$150,169,086	$6,507,491	$ -	$156,676,577
2011:				
Cash and cash equivalents	$ 18,380,698	$ -	$ -	$ 18,380,698
Restricted cash	2,614,437	-	-	2,614,437
Short-term investments	4,399,794	-	-	4,399,794
Assets whose use is limited	109,976,297	6,629,361	-	116,605,658
Total assets	$135,371,226	$6,629,361	$ -	$142,000,587

Meritus does not have any Level 3 financial instruments as of June 30, 2012 and 2011.

Pledges receivable are non-recurring fair value measurements. Any multi-year pledge received in fiscal year 2012 and 2011 is recorded at the present value of future cash flows with a discount rate adjusted for any market conditions to arrive at fair value. These are classified as Levl 2 within the fair value hierarchy.

5. ACCOUNTS RECEIVABLE

Accounts receivable at June 30 consist of the following:

	2012	2011
Patient accounts	$57,524,421	$52,034,966
Less: Contractual allowance	(8,101,830)	(5,857,365)
Less: Allowance for doubtful accounts	(3,934,805)	(3,676,453)
	45,487,786	42,501,148
Other receivables	5,622,108	3,377,171
	$51,109,894	$45,878,319

5. ACCOUNTS RECEIVABLE - Continued

Pledges receivable at June 30 consist of the following:

	2012	2011
Capital campaign	$5,455,065	$6,915,922
Other	942,737	298,879
Total unconditional promises to give	$6,397,802	$7,214,801
Receivable in less than one year	$2,511,620	$2,328,567
Receivable in one to five years	3,099,601	4,197,227
Receivable in more than five years	786,581	689,007
Total unconditional promises to give	6,397,802	7,214,801
Less discounts to net present value	(619,575)	(718,414)
Less allowance for uncollectible promises	(623,998)	(630,017)
Net unconditional promises to give	$5,154,229	$5,866,370
Pledges receivable, current portion included in other receivables	$2,084,062	$1,973,208
Pledges receivable, net of current portion	3,070,167	3,893,162
	$5,154,229	$5,866,370

6. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment at June 30 is comprised of the following:

	2012	2011
Land	$ 25,484,072	$ 24,845,055
Buildings and improvements used in operations	179,590,443	177,838,850
Buildings used in rental operations	22,695,770	22,083,494
Equipment	184,246,286	180,542,923
	412,016,571	405,310,322
Less accumulated depreciation and amortization	(125,793,519)	(103,081,471)
	286,223,052	302,228,851
Construction in progress	200,989	1,311,341
Property, plant and equipment, net	$ 286,424,041	$ 303,540,192

6. PROPERTY, PLANT AND EQUIPMENT - Continued

The following equipment is held under capital leases, included in the equipment category of property, plant and equipment:

	2012	2011
Equipment	$12,941,606	$14,670,518
Less accumulated amortization	(7,782,072)	(2,651,757)
	$ 5,159,534	$12,018,761

Total depreciation and amortization expense for the years ended June 30, 2012 and 2011 was $25,906,476 and $22,021,810, respectively.

Meritus had a conditional asset retirement obligation ("CARO") of $1,608,950 at June 30, 2011, (included in accounts payable and accrued expenses,), that related to the removal and disposal of asbestos and two underground fuel storage tanks. Total accretion for the years ended June 30, 2012 and 2011 was $0 and $165,960, respectively.

Demolition payments for the years ended June 30, 2012 and 2011 were $2,229,857 and $1,505,089, which included payments for the CARO of $1,608,950 and $550,510, respectively.

Transition costs for the year ended June 30, 2011 were $2,797,289 resulting from opening the new facility.

7. EQUITY INVESTMENTS IN AFFILIATES

The following investments, recorded under the equity method of accounting, are included in the consolidated balance sheets.

The Hospital holds a 25% equity interest in Maryland Care, Inc. Maryland Care, Inc. is a managed care organization ("MCO") that was established to serve Maryland's Medicaid population as a result of the State's requirement for Medicaid patients to be a member of an MCO.

The Hospital holds a 50% equity interest in Tri-State Health Partners. Tri-State Health Partners is a physician hospital organization ("PHO") established to organize, assemble and facilitate the provision of cost effective healthcare services.

MEI has a 50% interest in Diagnostic Imaging, which provides radiology imaging services, and has a 33.33% interest in Western Maryland Supply, LLC, which provides durable medical equipment for rental or purchase. For the year ended June 30, 2011, the Endoscopy Center at Robinwood, LLC ("Endoscopy Center"), an ambulatory center for gastroenterology procedures, and Endoscopy Real Estate are 50% owned by Robinwood Surgery Center, LLC ("RSC"). During the year ended June 30, 2012, RSC sold its 50% share in Endoscopy Center for $3,300,000 resulting in a gain of $3,008,500. GI Real Estate provides rental property to a group of healthcare practitioners and is 50% owned by MEI.

7. EQUITY INVESTMENTS IN AFFILIATES - Continued

Summary financial information as of June 30, 2012 and 2011 and for the years then ended appears below for the significant equity investments:

	Hospital Maryland Care, Inc.		Hospital Tri-State Health Partners	
	2012	2011	2012	2011
Assets	$194,501,638	$150,200,000	$3,387,984	$2,903,609
Liabilities	127,042,207	86,300,000	292,440	52,852
Equity	$ 67,459,431	$ 63,900,000	$3,095,544	$2,850,757
Net income	$ 16,444,597	$ 18,033,088	$ 189,346	$ 194,869

	MEI Diagnostic Imaging Services, LLC		General Surgery Real Estate, LLC	
	2012	2011	2012	2011
Assets	$ 10,484,787	$ 11,505,376	$ 595,541	$ -
Liabilities	3,358,394	3,920,254	506,859	-
Equity	$ 7,126,393	$ 7,585,122	$ 88,682	$ -
Net income	$ 3,441,271	$ 2,697,098	$ 10,593	$ -

	MEI Endoscopy Center at Robinwood, LLC		MEI Endoscopy Real Estate	
	2012	2011	2012	2011
Assets	$ -	$ 591,356	$1,072,385	$1,261,915
Liabilities	-	28,924	1,170,134	1,231,860
Equity (deficiency)	$ -	$ 562,432	$ (97,749)	$ 30,055
Net income	$ -	$ 1,915,919	$ 97,195	$ 92,609

7. EQUITY INVESTMENTS IN AFFILIATES - Continued

	MEI GI Real Estate		MEI - Western Maryland Medical Supply, LLC	
	2012	2011	2012	2011
Assets	$ 574,483	$ 580,726	$ 948,719	$1,312,866
Liabilities	367,700	408,977	770,346	420,869
Equity	$ 206,783	$ 171,749	$ 178,373	$ 891,997
Net income (loss)	$ 35,034	$ 30,365	$ (713,624)	$ (44,056)

8. LONG-TERM DEBT

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

	2012	2011
MHHEFA Revenue Bonds		
Series 2008 4.00% - 6.00% serial bonds, net of original issue discounts of $1,214,539 and $1,273,796, respectively	$259,750,461	$263,026,204
2001 Taxable Note B to Bank of America	1,530,354	2,522,762
City of Hagerstown note	159,295	177,475
2011 Bank of America Note - 2.13% interest rate	1,013,333	-
Mortgages and equipment loans with banks, with interest rates ranging from 2.3% to 7.75%	2,646,433	3,260,239
Capital lease obligations, with interest rates ranging from 2.9% to 5.0%	3,997,311	6,300,092
	269,097,187	275,286,772
Less current portion of long-term debt	(7,650,229)	(9,140,210)
	$261,446,958	$266,146,562

Meritus uses current market prices in determining the fair value of its Revenue Bonds. The carrying value of other long-term debt approximates fair value. The fair value of total long-term debt, excluding capital lease obligations, was approximately $288,853,000 and $269,175,000 at June 30, 2012 and 2011, respectively.

In February 2008, Meritus issued Maryland Health and Higher Educational Facilities Authority ("MHHEFA") Revenue Bonds Washington County Hospital Issue Series 2008 for the construction of a replacement hospital, funding of the debt service reserve and capitalized interest funds, and to refinance various previously outstanding debt. The Series 2008 Bonds are due in annual principal installments through January 2043. Interest is due semi-annually in January and July.

8. LONG-TERM DEBT - Continued

The long-term debt related to the Series 2008 Bonds is reflected in the consolidated financial statements net of the unamortized original issue bond discounts. The original issue bond discounts are being amortized over the life of the debt and are included in amortization expense in the consolidated statements of operations and changes in net assets.

All bonds are collateralized by a first lien and claims on all receipts of Meritus, except restricted donations and contributions. In connection with the Series 2008 Bonds, MHHEFA has a security interest in existing facilities of Meritus. All bonds require the Obligated Group, which consists of Meritus, the Hospital, and the Fund, to maintain certain financial ratios and stipulated insurance coverage as defined. Meritus was in compliance with these covenants at June 30, 2012 and 2011.

The Fund has entered into guaranty agreements with MHHEFA for the Series 2008 Bonds. Under the terms of these agreements, the Fund guarantees the payment of the principal and interest on the Series 2008 Bonds and the payment of any and all Reserve Fund Loans. In accordance with the provisions of this guaranty agreement, only the unrestricted donations, bequests, and other assets held or owned by the Fund would be available for payment. The terms of the guaranty agreements restrict the Fund’s ability to transfer, lease, sell or otherwise dispose of certain assets or to create additional indebtedness, liens, or encumbrances on non-restricted assets.

The 2001 Taxable Note B to Bank of America was issued for the construction of the Robinwood Medical Center III. The taxable portion of the debt requires monthly principal payments of $82,701 through February 1, 2014. The interest is calculated and payable monthly based upon the outstanding principal balance at the time. The variable interest rates were 1.35% and 1.31%, as of June 30, 2012 and 2011, respectively. The bonds may be repaid, at the option of Meritus, in part or in full at any time with 30 days notice. The bonds are collateralized by a mortgage of the real property of both the Fund and the Hospital.

8. LONG-TERM DEBT - Continued

Scheduled principal repayments on long-term debt including payments on capital lease obligations are as follows for the next five years as of June 30:

	Long-Term Debt	Capital Lease Obligations
2013	$ 5,749,337	$2,095,799
2014	5,165,662	1,175,807
2015	4,526,348	677,080
2016	4,188,790	252,423
2017	4,236,173	-
Thereafter	242,448,105	-
	$266,314,415	4,201,109
Less amount representing interest		(203,798)
		$3,997,311

The Hospital maintains a line of credit with a financial institution which is renewed annually in the amount of $1,000,000, bearing interest on the drawn portion at the bank's prime interest rate. The line was not in use at June 30, 2012 and 2011.

MEI maintains a line of credit with a financial institution which is renewed annually in the amount of $500,000, bearing interest on the drawn portion at the bank's prime interest rate plus 2%. The line was not in use at June 30, 2012 and 2011.

Capitalized Interest

A summary of interest cost and investment income on borrowed funds held by the trustee under the Series 2008 Revenue Bonds for the year ended June 30, 2011 is as follows:

Interest cost:	
Expense	$ 8,500,000
Capitalized	6,825,828
	$15,325,828
Interest income:	
Other income	$ 126,358
Capitalized	618,172
	$ 744,530

9. INCOME TAXES

MEI and its subsidiaries file a consolidated federal return and separate state returns. The income tax expense for the years ended June 30, consists of:

	2012	2011
Current:		
Federal	$3,379,649	$ 174,845
State	843,138	139,130
	4,222,787	313,975
Deferred:		
Federal	363,301	(120,031)
State	58,443	(19,309)
	421,744	(139,340)
	$4,644,531	$ 174,635

Effective July 1, 2011, MEI completed a structural realignment to include the formation of Holdings. The realignment included the conversion of taxable subsidiaries of MEI resulting in a net federal and state conversion tax of $4,000,000.

The significant components of the deferred tax assets and deferred tax liabilities, which are included in prepaid and other current assets and other assets at June 30, are as follows:

	2012	2011
Deferred tax asset:		
Accrued vacation	$ 847,399	$ 1,280,507
Deferred compensation	1,074,769	843,062
Allowance for bad debts	497,885	578,305
Other	292,844	316,561
	2,712,897	3,018,435
Deferred tax liabilities:		
Fixed assets and intangible assets	(1,123,726)	(967,973)
Deferred compensation	-	(4,082)
Captive insurance premiums	(6,346)	(27,174)
Partnership basis	(20,986)	(35,623)
	(1,151,058)	(1,034,852)
	$ 1,561,839	$ 1,983,583

10. POST RETIREMENT BENEFIT PLANS

Defined Contribution Plans

Effective July 1, 2011, Meritus assumed sponsorship of the Antietam Health Services, Inc. Savings Plan from MEI. Meritus amended and restated the plan as of that date renaming it the Meritus Health 401(k) Savings Plan. The plan is available to all Meritus employees. Meritus matches employee contributions for an amount up to 6% of each employee's base salary, subject to limitations.

The Hospital had a 403(b) defined contribution plan available to all Hospital employees. Effective July 1, 2011, the plan was frozen to future contributions. In fiscal year 2011, employees received up to 50% matching contributions, up to 6% of employee's salary based upon meeting years of service requirements, subject to the annual IRS limitations.

In 2011, MEI had an employee savings plan under Section 401(k) of the Internal Revenue Code available to all MEI employees. MEI matches employee contributions for an amount up to 6% of each employee's base salary, subject to limitations, depending upon the length of service with MEI. MEI's contributions vest after the first three years of service. During plan year 2011, MEI Savings Plan failed to satisfy one of the operational requirements of maintaining a qualified retirement plan. To resolve this issue, MEI adopted a resolution for the Hospital to provide a profit sharing allocation under the plan to 575 selected employees.

Amounts charged to expense for the years ended June 30, 2012 and 2011 were $5,046,653 and $4,934,489, respectively.

The Hospital maintains an employee funded supplemental non-qualified retirement plan for certain employees. The plan requires the benefits be paid upon termination, retirement or death. The related liability is $1,064,855 and $883,062 at June 30, 2012 and 2011, respectively. Management has designated investments for the intended purpose of funding the liability when payable. Amounts charged to expense for the years ended June 30, 2012 and 2011 were $23,080 and $0, respectively.

Defined Benefit Plan

Meritus maintains a cash balance pension plan ("Plan"), which was terminated for all participants, effective June 30, 2011. Meritus is in the termination process which ends with the distribution of plan assets to participants and is expected to be complete by December 2012. Disclosure assumptions reflect the termination and pending settlement of the benefit obligations. The Plan covered substantially all current Hospital employees and maintains the balance for MEI employees previously employed by the Hospital. Benefits under the plan are generally based on the participant's age, years of service and compensation levels. Annual contributions are made to the plan in accordance with the Employee Retirement Income Security Act of 1974 ("ERISA") regulations. Employees were fully vested after three years of service.

10. POST RETIREMENT BENEFIT PLANS - Continued

The change in benefit obligation, plan assets, and funded status of the Plan are shown below:

	2012	2011
Change in benefit obligation:		
Benefit obligation at beginning of year	$44,527,620	$45,842,769
Interest cost	324,829	2,374,753
Actuarial loss	1,091,759	2,601,926
Benefits paid	(2,840,652)	(6,291,828)
Benefit obligation at end of year	$43,103,556	$44,527,620
Change in plan assets:		
Fair value of plan assets at beginning of year	$42,579,753	$40,663,757
Actual return on plan assets	54,999	5,907,824
Contributions	-	2,300,000
Benefits paid	(2,840,652)	(6,291,828)
Fair value of plan assets at end of year	$39,794,100	$42,579,753
Net amount recognized:		
Accrued compensation benefits	$ (3,309,456)	$ (1,947,867)
Amounts recognized in unrestricted net assets consist of:		
Net actuarial loss	$11,128,092	$11,018,940
Prior service cost	162,958	183,877
Net amount recognized in unrestricted net assets	$11,291,050	$11,202,817

The accumulated benefit obligation is $43,103,556 and $44,527,620 at June 30, 2012 and 2011, respectively.

Amounts in unrestricted net assets expected to be recognized as components of net periodic benefit cost for the year ending June 30, 2012 are prior service costs of $162,958 and actuarial losses of $6,674.

	2012	2011
Net periodic benefit cost (income):		
Interest cost	$ 324,829	$ 2,374,753
Expected return on plan assets	(324,942)	(3,168,040)
Prior service cost	20,919	48,176
Actuarial loss	562,654	528,245
	583,460	(216,866)
Settlement loss	689,896	-
	1,273,356	(216,866)
Change in amounts recognized in unrestricted net assets	(88,260)	714,279
	$1,185,096	$ 497,413

10. POST RETIREMENT BENEFIT PLANS - Continued

Assumptions

	2012	2011
Weighted-average assumptions used to determine benefit obligations as of June 30:		
Discount rate	3.430%	3.408%
Rate of compensation increase	N/A	N/A
Measurement date	June 30	June 30
Weighted-average assumptions used to determine net periodic benefit cost for the years ended June 30:		
Discount rate	3.408%	5.650%
Expected return on plan assets	0.800%	8.000%
Rate of compensation increase	N/A	N/A

Basis for Expected Long-Term Rate of Return

The expected long-term rate of return reflects the expected return for each major asset class and the weighting of each asset class.

Plan Assets

The Plan's weighted-average asset allocations at June 30, are as follows:

	2012	2011
Asset category:		
Cash and cash equivalent	100%	100%

Description of Investment Policies and Strategies

As a result of the plan termination, during fiscal year 2011, Meritus modified its strategy to protect fund assets from market fluctuations. As such, the plan assets were invested in cash and cash equivalents.

10. POST RETIREMENT BENEFIT PLANS - Continued

Fair Value of Plan Assets

The following fair value hierarch table presents information about each major category of the Plan's financial assets measured at fair value on a recurring basis using the market approach as of June 30:

	Total	(Level 1)
2012:		
Assets		
Cash and cash equivalents	$39,794,100	$39,794,100
2011:		
Assets		
Cash and cash equivalents	$44,852,449	$44,852,449

There are no plan assets that are Level 2 or 3 at June 30, 2012 and 2011.

Contributions

Contributions to the plan for the year ending June 30, 2013 are expected to be approximately $3,300,000.

Estimated Future Benefit Payments

Benefit payments are expected to be paid from the Plan in year ending June 30, 2013 of approximately $43,100,000.

11. INSURANCE COVERAGE

The Parent has a wholly-owned insurance captive, MIC, to provide primary limits of insurance of $1 million per occurrence/$3 million aggregate for professional and general liability. The professional liability coverage is provided on a claims-made basis. In addition, MIC purchased reinsurance from an A rated re-insurer in the amount of $15 million to cover any potential liabilities above the $1 million/$3 million primary limits, which were covered by MIC. The self-insured liabilities determined by an actuary for professional and general are discounted at 4%, and are included in other long-term liabilities in the consolidated balance sheets.

11. INSURANCE COVERAGE - Continued

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

	2012	2011
Reserves for losses and loss adjustment expenses at beginning of year	$ 5,476,000	$ 4,911,145
Less: reinsurance recoverable on unpaid claims	(1,145,437)	(586,725)
Net reserves for losses and loss adjustment expenses at beginning of year	4,330,563	4,324,420
Incurred related to:		
Current fiscal year	1,398,660	1,586,107
Prior fiscal years - change in estimates	(293,817)	108,493
Total losses and loss adjustment expenses incurred, net of reinsurance recoverable	1,104,843	1,694,600
Paid related to:		
Current fiscal year	(156,599)	(267,688)
Prior fiscal years	(773,415)	(1,420,769)
Total losses and loss adjustment expenses paid, net of reinsurance recovery	(930,014)	(1,688,457)
Net provision for losses and loss adjustment expenses at end of year	4,505,392	4,330,563
Add: reinsurance recoverable on unpaid claims	1,229,261	1,145,437
Reserves for losses and loss adjustment expenses at end of year	$ 5,734,653	$ 5,476,000

12. COMMITMENTS AND CONTINGENCIES

Operating Lease Obligations

Meritus leases equipment under non-cancelable lease arrangements. In addition, Meritus leases office space in several locations under operating leases. Some of the leases provide for renewal options. Rent expense under all operating leases was $5,445,697 and $6,264,981 for the years ended June 30, 2012 and 2011, respectively.

12. COMMITMENTS AND CONTINGENCIES - Continued

Operating Lease Obligations - continued

Future minimum lease payments under these non-cancelable operating leases as of June 30 are as follows:

2013	$5,220,645
2014	4,010,710
2015	2,477,926
2016	1,784,819
2017	735,484

Rental Properties

The Fund's real estate is used for rental operations. The leases have five-year terms plus renewal options and include provisions for increased operating costs and taxes. The minimum future rental amounts from unrelated entities, based on non-cancelable leases, exclusive of any future renewal options, as of June 30 are as follows:

2013	$ 100,692
2014	77,590
2015	50,184
2016	7,652

Litigation

Meritus is involved in litigation and regulatory investigations arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without a material adverse effect on Meritus' financial position or results of operations.

13. TEMPORARILY AND PERMANENTLY RESTRICTED NET ASSETS

Temporarily and permanently restricted net assets at June 30 are restricted for the following purposes:

	2012	2011
Temporarily restricted for financial support of patients and hospital programs	$4,331,637	$ 3,937,604
Capital campaign	4,898,079	6,700,186
	$9,229,716	$10,637,790
Permanently restricted investments are to be held in perpetuity, the income of which is expendable to support charity care and healthcare education	$1,028,618	$ 1,028,618

14. FUNCTIONAL EXPENSES

Meritus provides general healthcare services to residents within its geographic location. Expenses related to providing these services for the years ended June 30 are as follows:

	2012	2011
Healthcare services	$348,987,854	$328,586,488
Fundraising	837,706	225,581
Administration	21,206,396	20,455,700
Total expenses	$371,031,956	$349,267,769

SUPPLEMENTARY INFORMATION

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Report of Independent Certified Public Accountants on Supplementary Information

To the Board of Directors
Meritus Health, Inc.

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying consolidating balance sheet as of June 30, 2012, and consolidating statement of operations and changes in net assets for the year then ended, is presented for purposes of additional analysis, rather than to present the financial position, results of operations and cash flows of the individual companies and is not a required part of the consolidated 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 consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures. These additional procedures included comparing and reconciling the information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America established by the American Institute of Certified Public Accountants. In our opinion, the consolidating information is fairly stated in all material respects, in relation to the consolidated financial statements as a whole.

Grant Thornton LLP

Baltimore, Maryland
September 26, 2012

Meritus Health, Inc.

CONSOLIDATING BALANCE SHEET

June 30, 2012

ASSETS	Meritus Medical Center, Inc.	Meritus Medical Center, Endowment Fund, Inc.	Meritus Health, Inc.	Meritus Health Obligated Group Consolidating Adjustments	Meritus Health Obligated Group	Meritus Holdings, LLC Consolidated	Meritus Insurance Company, Ltd.	Meritus Healthcare Foundation	Eliminations	Consolidated Meritus Health, Inc.
CURRENT ASSETS										
Cash and cash equivalents	$ 15,583,391	$ 493,391	$ 268,993	$ (26,006)	$ 16,319,769	$ 9,634,556	$ 913,014	$ 360,598	$ 26,006	$ 27,253,943
Restricted cash	2,746,240	-	-	-	2,746,240	-	-	-	-	2,746,240
Short-term investments	3,422,557	-	-	-	3,422,557	-	-	-	-	3,422,557
Current portion of assets whose use is limited	10,699,864	-	-	-	10,699,864	-	950,000	-	-	11,649,864
Accounts receivable, net	41,707,810	(148)	5,129,582	(1,059,089)	45,778,155	8,258,676	118,583	2,084,062	(5,129,582)	51,109,894
Supplies	5,508,173	-	-	-	5,508,173	3,909,663	-	-	-	9,417,836
Prepaid expenses and other current assets	3,154,258	145,910	-	(474)	3,299,694	2,411,800	243,016	1,792	475	5,956,777
Due from related parties, net	2,856,696	(430,402)	(460,924)	-	1,965,370	(15,635)	-	(248,730)	(1,701,005)	-
Total current assets	85,678,989	208,751	4,937,651	(1,085,569)	89,739,822	24,199,060	2,224,613	2,197,722	(6,804,106)	111,557,111
EQUITY INVESTMENTS IN AFFILIATES	18,446,608	-	3,371,053	21,102,234	42,919,895	3,644,885	-	-	(22,392,682)	24,172,098
ASSETS WHOSE USE IS LIMITED										
Board designated funds	36,415,131	33,385,883	2,389,608	-	72,190,622	-	-	7,067,048	-	79,257,670
Supplemental retirement benefit investments	1,064,855	-	-	-	1,064,855	2,845,236	-	-	-	3,910,091
Temporarily and permanently restricted donor funds	1,164,123	-	-	-	1,164,123	-	-	-	-	1,164,123
	38,644,109	33,385,883	2,389,608	-	74,419,600	2,845,236	-	7,067,048	-	84,331,884
Assets held by trustee under bond indenture agreement	18,470,251	-	-	-	18,470,251	-	-	-	-	18,470,251
Funds designated for insurance purposes	-	-	-	-	-	-	8,801,838	-	-	8,801,838
	57,114,360	33,385,883	2,389,608	-	92,889,851	2,845,236	8,801,838	7,067,048	-	111,603,973
PROPERTY, PLANT AND EQUIPMENT, net	256,218,082	19,547,381	-	(2,287,717)	273,477,746	10,624,994	-	33,584	2,287,717	286,424,041
PLEDGES RECEIVABLE, net	-	-	-	-	-	-	-	3,070,167	-	3,070,167
DEFERRED FINANCING COSTS, net	2,644,089	19,488	-	-	2,663,577	-	-	-	-	2,663,577
DUE FROM RELATED PARTIES	6,681,526	503,454	-	(2,835,362)	4,349,618	1,323,599	1,229,261	-	(3,846,164)	3,056,314
Total assets	$426,783,654	$53,664,957	$10,698,312	$14,893,586	$506,040,509	$42,637,774	$12,255,712	$12,368,521	$(30,755,235)	$542,547,281

Meritus Health, Inc.

CONSOLIDATING BALANCE SHEET - CONTINUED

June 30, 2012

LIABILITIES AND NET ASSETS	Meritus Medical Center, Inc.	Meritus Medical Center, Endowment Fund, Inc.	Meritus Health, Inc.	Meritus Health Obligated Group Consolidating Adjustments	Meritus Health Obligated Group	Meritus Holdings, LLC Consolidated	Meritus Insurance Company, Ltd.	Meritus Healthcare Foundation	Eliminations	Consolidated Meritus Health, Inc.
CURRENT LIABILITIES										
Accounts payable and accrued expenses	$ 8,824,674	$ 88,309	$ -	$ -	$ 8,912,983	$ 4,063,841	$ 1,120,416	$ 27,774	$ -	$ 14,125,014
Retainage payable	183,885	-	-	-	183,885	-	-	-	-	183,885
Accrued salaries, wages and withholdings	3,856,313	-	-	-	3,856,313	1,103,612	-	-	-	4,959,925
Accrued compensation benefits	12,691,308	-	-	-	12,691,308	4,046,650	-	13,070	-	16,751,028
Advances from third-party payors	7,495,097	-	-	-	7,495,097	125,533	-	-	-	7,620,630
Accrued interest payable	7,764,019	-	-	-	7,764,019	-	-	-	-	7,764,019
Current portion of long-term debt	5,314,638	2,091,815	-	(1,099,408)	6,307,045	1,302,864	-	-	40,320	7,650,229
Due to related organizations	-	-	-	-	-	703,519	-	-	(703,519)	-
Total current liabilities	46,129,934	2,180,124	-	(1,099,408)	47,210,650	11,346,019	1,120,416	40,844	(663,199)	59,054,730
LONG-TERM DEBT, net of current portion	258,549,948	3,756,350	-	(3,218,402)	259,087,896	1,976,023	-	-	383,039	261,446,958
ACCRUED RETIREMENT BENEFITS	1,064,854	-	-	-	1,064,854	3,145,840	-	-	-	4,210,694
OTHER LONG-TERM LIABILITIES	-	-	-	-	-	1,151,058	10,864,235	-	(5,129,582)	6,885,711
Total liabilities	305,744,736	5,936,474	-	(4,317,810)	307,363,400	17,618,940	11,984,651	40,844	(5,409,742)	331,598,093
STOCKHOLDERS' EQUITY										
Common stock	-	-	-	-	-	700,000	120,000	-	(820,000)	-
Paid-in capital	-	-	-	-	-	1,150,080	-	-	(1,150,080)	-
Retained earnings	-	-	-	-	-	20,559,163	151,061	-	(20,710,224)	-
Total stockholders' equity	-	-	-	-	-	22,409,243	271,061	-	(22,680,304)	-
NET ASSETS										
Unrestricted										
Meritus	116,322,692	47,728,483	10,698,312	19,211,396	193,960,883	-	-	2,909,464	1,210,916	198,081,263
Non-controlling interest	-	-	-	-	-	2,609,591	-	-	-	2,609,591
Total unrestricted net assets	116,322,692	47,728,483	10,698,312	19,211,396	193,960,883	2,609,591	-	2,909,464	1,210,916	200,690,854
Temporarily restricted	3,687,608	-	-	-	3,687,608	-	-	9,418,213	(3,876,105)	9,229,716
Permanently restricted	1,028,618	-	-	-	1,028,618	-	-	-	-	1,028,618
Total net assets	121,038,918	47,728,483	10,698,312	19,211,396	198,677,109	2,609,591	-	12,327,677	(2,665,189)	210,949,188
Total liabilities and net assets	$426,783,654	$53,664,957	$10,698,312	$14,893,586	$506,040,509	$42,637,774	$12,255,712	$12,368,521	$(30,755,235)	$542,547,281

Meritus Health, Inc.

CONSOLIDATING STATEMENT OF OPERATIONS AND CHANGES IN NET ASSETS

Year end June 30, 2012

	Meritus Medical Center, Inc.	Meritus Medical Center, Endowment Fund, Inc.	Meritus Health, Inc.	Meritus Health Obligated Group Consolidating Adjustments	Meritus Health Obligated Group	Meritus Holdings, LLC Consolidated	Meritus Insurance Company, Ltd.	Meritus Healthcare Foundation	Eliminations	Consolidated Meritus Health, Inc.
Unrestricted revenue, gains and other support										
Net patient service revenue	$288,490,595	$ -	$ -	$ -	$288,490,595	$ 97,597,332	$ -	$ -	$(14,899,822)	$371,188,105
Provision for bad debts	12,327,082	-	-	-	12,327,082	1,293,588	-	-	-	13,620,670
Net patient service revenue less provisions for bad debts	276,163,513	-	-	-	276,163,513	96,303,744	-	-	(14,899,822)	357,567,435
Other revenue	5,623,681	4,101,923	1,482,075	(1,885,824)	9,321,855	2,837,413	2,618,217	641,892	(1,655,605)	13,763,772
Equity earnings in affiliates	4,889,858	-	-	317,686	5,207,544	2,478,262	-	-	(317,686)	7,368,120
Net assets released from restriction used for operations	1,320,116	-	-	-	1,320,116	-	-	2,491,749	(2,270,116)	1,541,749
	287,997,168	4,101,923	1,482,075	(1,568,138)	292,013,028	101,619,419	2,618,217	3,133,641	(19,143,229)	380,241,076
Expenses										
Salaries and wages	107,009,127	-	-	-	107,009,127	39,288,423	-	332,360	-	146,629,910
Professional fees	8,274,998	-	-	-	8,274,998	-	-	-	-	8,274,998
Supplies and other	128,408,568	1,888,838	207,518	(1,920,393)	128,584,531	58,598,202	3,109,598	507,170	(16,057,488)	174,742,013
Interest	15,242,236	166,519	-	(34,373)	15,374,382	141,180	-	-	(179,000)	15,336,562
Depreciation and amortization	23,707,634	827,312	-	-	24,534,946	1,504,190	-	9,337	-	26,048,473
	282,642,563	2,882,669	207,518	(1,954,766)	283,777,984	99,531,995	3,109,598	848,867	(16,236,488)	371,031,956
Operating income (loss) before other items	5,354,605	1,219,254	1,274,557	386,628	8,235,044	2,087,424	(491,381)	2,284,774	(2,906,741)	9,209,120
Other items										
Demolition costs	(620,907)	-	-	-	(620,907)	-	-	-	-	(620,907)
Pension settlement costs	(689,896)	-	-	-	(689,896)	-	-	-	-	(689,896)
	(1,310,803)	-	-	-	(1,310,803)	-	-	-	-	(1,310,803)
Operating income (loss)	4,043,802	1,219,254	1,274,557	386,628	6,924,241	2,087,424	(491,381)	2,284,774	(2,906,741)	7,898,317
Non-operating gains (losses), net										
Investment returns, net	907,647	392,743	31,694	-	1,332,084	3,147,047	491,381	(11,460)	1	4,959,053
Other, net	(239,041)	(150,000)	638,250	-	249,209	-	-	(2,646,081)	2,520,112	123,240
Income tax expense	-	-	-	-	-	(4,644,531)	-	-	-	(4,644,531)
Excess of revenue over expenses	4,712,408	1,461,997	1,944,501	386,628	8,505,534	589,940	-	(372,767)	(386,628)	8,336,079
Excess of revenue attributable to non-controlling interest	-	-	-	-	-	(1,448,877)	-	-	-	(1,448,877)
Excess of revenue over expenses attributable to Meritus	4,712,408	1,461,997	1,944,501	386,628	8,505,534	(858,937)	-	(372,767)	(386,628)	6,887,202

Meritus Health, Inc.

CONSOLIDATING STATEMENT OF OPERATIONS AND CHANGES IN NET ASSETS - CONTINUED

Year end June 30, 2012

	Meritus Medical Center, Inc.	Meritus Medical Center, Endowment Fund, Inc.	Meritus Health, Inc.	Meritus Health Obligated Group Consolidating Adjustments	Meritus Health Obligated Group	Meritus Holdings, LLC Consolidated	Meritus Insurance Company, Ltd.	Meritus Healthcare Foundation	Eliminations	Consolidated Meritus Health, Inc.
Other changes in unrestricted net assets										
Change in retirement benefit obligation	(88,260)	-	-	-	(88,260)	-	-	-	-	(88,260)
Change in non-controlling interest	-	-	-	-	-	1,168,878	-	-	-	1,168,878
Net assets released from restriction for property, plant and equipment	950,000	-	-	-	950,000	-	-	-	-	950,000
Increase (decrease) in unrestricted net assets	5,574,148	1,461,997	1,944,501	386,628	9,367,274	309,941	-	(372,767)	(386,628)	8,917,820
Temporarily restricted net assets										
Contributions	1,070,173	-	-	-	1,070,173	-	-	1,333,618	(1,320,116)	1,083,675
Net assets held by the foundation	(1,361,746)	-	-	-	(1,361,746)	-	-	-	1,361,746	-
Net assets released from restriction for property, plant and equipment	(950,000)	-	-	-	(950,000)	-	-	-	-	(950,000)
Contribution to building fund	950,000	-	-	-	950,000	-	-	(950,000)	-	-
Net assets released from restrictions for operations	(1,320,116)	-	-	-	(1,320,116)	-	-	(1,541,749)	1,320,116	(1,541,749)
Decrease in temporarily restricted net assets	(1,611,689)	-	-	-	(1,611,689)	-	-	(1,158,131)	1,361,746	(1,408,074)
INCREASE (DECREASE) IN NET ASSETS	3,962,459	1,461,997	1,944,501	386,628	7,755,585	309,941	-	(1,530,898)	975,118	7,509,746
Net assets										
Beginning of year	117,076,459	46,266,486	8,753,811	18,824,768	190,921,524	24,708,893	271,061	13,858,575	(26,320,611)	203,439,442
End of year	$121,038,918	$47,728,483	$10,698,312	$19,211,396	$198,677,109	$25,018,834	$ 271,061	$12,327,677	$(25,345,493)	$210,949,188

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