



FINANCIAL STATEMENTS AND
SUPPLEMENTARY INFORMATION

Peninsula Regional Medical Center
Years Ended June 30, 2012 and 2011
With Reports of Independent Auditors

Ernst & Young LLP

 **ERNST & YOUNG**

Peninsula Regional Medical Center
Financial Statements and Supplementary Information
Years Ended June 30, 2012 and 2011

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Report of Independent Auditors

Board of Trustees
Peninsula Regional Medical Center

We have audited the accompanying balance sheets of Peninsula Regional Medical Center (the Hospital) as of June 30, 2012 and 2011, and the related statements of operations and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Hospital'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 Hospital'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 Hospital's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Peninsula Regional Medical Center at 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 U.S. generally accepted accounting principles.



September 21, 2012

Peninsula Regional Medical Center

Balance Sheets (In Thousands)

	June 30	
	2012	2011
Assets		
Current assets:		
Cash and cash equivalents	\$ 24,709	\$ 25,638
Short-term investments	8,503	5,836
Accounts receivable, less allowance for uncollectible accounts (2012 – \$7,292; 2011 – \$7,072)	39,081	35,572
Inventories and other	13,928	13,119
Total current assets	86,221	80,165
Long-term investments	152,080	136,117
Board-designated investments	16,745	16,420
Assets limited as to use:		
Debt service reserve fund	9,311	9,349
Donor-restricted fund	24,489	23,607
Self-insurance fund	12,479	14,459
	46,279	47,415
Property and equipment, net	200,235	206,154
Unamortized financing costs, net of accumulated amortization (2012 – \$569; 2011 – \$471)	2,352	2,450
Other assets	4,055	3,687
Total assets	\$ 507,967	\$ 492,408

	June 30	
	2012	2011
Liabilities and net assets		
Current liabilities:		
Current portion of long-term debt	\$ 2,930	\$ 2,810
Current portion of accrued self-insured liabilities	1,895	1,895
Accounts payable and accrued liabilities	32,798	26,507
Advances from third-party payors	9,958	8,461
Total current liabilities	<u>47,581</u>	<u>39,673</u>
Long-term debt, net	128,332	131,566
Other liabilities	20,826	12,134
Total liabilities	<u>196,739</u>	<u>183,373</u>
Net assets:		
Unrestricted	287,903	286,635
Temporarily restricted	15,254	14,335
Permanently restricted	8,071	8,065
Total net assets	<u>311,228</u>	<u>309,035</u>
Total liabilities and net assets	<u><u>\$ 507,967</u></u>	<u><u>\$ 492,408</u></u>

See accompanying notes.

Peninsula Regional Medical Center

Statements of Operations and Changes in Net Assets
(In Thousands)

	Year Ended June 30	
	2012	2011
Unrestricted revenue and other support:		
Net patient service revenue	\$ 378,035	\$ 380,052
Other operating revenue	2,360	2,357
Total unrestricted revenue and other support	<u>380,395</u>	382,409
Operating expenses:		
Salaries and wages	146,085	138,742
Supplies and other expenses	147,182	146,120
Employee benefits	36,207	36,169
Depreciation	21,812	21,829
Bad debts	16,616	17,411
Interest	6,259	6,591
Total operating expenses	<u>374,161</u>	366,862
Income from operations	6,234	15,547
Nonoperating income:		
Investment income	6,974	12,164
Basis swap income	2,629	3,128
	<u>9,603</u>	15,292
Excess of unrestricted revenue and other support over expenses	15,837	30,839

(continued)

Peninsula Regional Medical Center

Statements of Operations and Changes in Net Assets (continued)
(In Thousands)

	Year Ended June 30	
	2012	2011
Unrestricted net assets:		
Excess of unrestricted revenue and other support over expenses	\$ 15,837	\$ 30,839
Net assets released from restrictions	40	1,200
Unrealized (loss) gains on investments	(516)	13,006
Pension adjustment	(14,093)	10,216
Increase in unrestricted net assets	<u>1,268</u>	<u>55,261</u>
Temporarily restricted net assets:		
Change in equity interest in the Foundation	931	1,141
Donations	43	-
Net realized gains on investments	563	1,222
Unrealized (loss) gains on investments	(351)	1,613
Net assets released from restrictions	(267)	(1,521)
Increase in temporarily restricted net assets	<u>919</u>	<u>2,455</u>
Permanently restricted net assets:		
Donations	-	5
Net realized gains on investments	7	4
Unrealized (loss) gain on investments	(1)	5
Increase in permanently restricted net assets	<u>6</u>	<u>14</u>
Increase in net assets	2,193	57,730
Net assets at beginning of year	309,035	251,305
Net assets at end of year	<u>\$ 311,228</u>	<u>\$ 309,035</u>

See accompanying notes.

Peninsula Regional Medical Center

Statements of Cash Flows (In Thousands)

	Year Ended June 30	
	2012	2011
Operating activities		
Change in net assets	\$ 2,193	\$ 57,730
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation of property and equipment	21,812	21,829
Amortization of original issue premium	(304)	(299)
Amortization of intangible assets	98	98
Loss (gain) on sale of property and equipment	43	(32)
Net unrealized loss (gains) on investments	631	(13,021)
Net realized gains on investments	(4,529)	(7,478)
Non-cash change in donor-restricted fund	(665)	(2,038)
Proceeds from restricted contributions and realized losses on restricted investments	570	1,226
Changes in operating assets and liabilities:		
Accounts receivable	(3,509)	(90)
Inventories and other assets	(1,177)	(2,718)
Accounts payable and accrued liabilities	6,292	532
Accrued self-insured and other liabilities	8,692	(14,247)
Advances from third-party payors	1,497	303
Net cash provided by operating activities	31,644	41,795
Investing activities		
Purchase of investments	(96,050)	(99,550)
Proceeds from sales of investments	80,991	79,990
Purchases of property and equipment	(15,935)	(15,286)
Change in assets limited as to use	1,801	(2,660)
Net cash used in investing activities	(29,193)	(37,506)
Financing activities		
Proceeds from restricted contributions and realized losses on restricted investments	(570)	(1,226)
Repayments of long-term debt	(2,810)	(2,720)
Net cash used in financing activities	(3,380)	(3,946)
Net (decrease) increase in cash and cash equivalents	(929)	343
Cash and cash equivalents at beginning of year	25,638	25,295
Cash and cash equivalents at end of year	\$ 24,709	\$ 25,638

See accompanying notes.

Peninsula Regional Medical Center

Notes to Financial Statements (In Thousands)

June 30, 2012

1. Organization and Mission

Peninsula Regional Medical Center (the Hospital) is a not-for-profit, nonstock corporation founded in 1897 to serve the health care needs of its region. Primary service areas include the Maryland counties of Wicomico, Somerset and Worcester, south Delaware and the northern Eastern Shore of Virginia. The Hospital's mission is to improve the health care of the community by providing exceptional quality primary, secondary and selected tertiary health care services to patients in a competent and compassionate manner, designed to elicit a high degree of customer satisfaction. The Hospital provides services regardless of race, creed, sex, national origin, handicap or age.

The Hospital is a wholly owned subsidiary of Peninsula Regional Health System, Inc. (the Health System) which serves as the parent company to the Hospital, Peninsula Regional Medical Center Foundation, Inc. (the Foundation) and Peninsula Health Ventures, Inc. (Health Ventures). The Health System is a not-for-profit Maryland membership corporation established to manage the integrated delivery of health care services to the community. The Health System is the sole corporate member of the Hospital, the Foundation and Health Ventures. In its capacity as sole member of these entities, the Health System will appoint trustees, approve major expenditures and approve long-term borrowings.

2. Significant Accounting Policies

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 amounts could differ from those estimates.

Reclassifications

Certain amounts from the prior year financial statements have been reclassified in order to conform to the current year presentation.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

2. Significant Accounting Policies (continued)

Fair Value of Financial Instruments

The carrying amounts of financial instruments, including cash and cash equivalents, accounts receivable, accounts payable, and advances from third-party payors, approximate fair value given the short-term nature of these financial instruments.

Cash and Cash Equivalents

Cash and cash equivalents include surplus operating funds invested in money market funds and highly liquid corporate, U.S. government and agency obligations, all with maturities of less than three months when purchased.

Investments and Investment Income

Investments are carried at fair value. All such investments are considered available for sale and are classified as current or noncurrent assets based on management's intention as to use. Short-term investments represent investments with contractual maturities within one year and current investments in money market funds which have been designated for long-term investment purposes. Assets limited as to use by donor restriction are recorded at fair value at the date of donation and changes in fair value are recognized in the period in which the change occurs. Investment income from all unrestricted investments is reported as nonoperating income. Investment income on investments of restricted assets is added to or deducted from the appropriate restricted net assets when restricted as to use by the donor.

The value of securities sold is based on the specific identification method.

The Hospital periodically evaluates whether any declines in the fair value of investments are other-than-temporary. This evaluation consists of a review of several factors, including but not limited to: length of time and extent that a security has been in an unrealized loss position; the existence of an event that would impair the issuer's future earnings potential; the near-term prospects for recovery of the market value of a security; and the intent and ability of the Hospital to hold the security until the market value recovers. Realized gains or losses are included in nonoperating (expense) income in the accompanying statements of operations. Declines in fair value below cost that are deemed to be other-than-temporary would be recorded as realized losses within nonoperating (expense) income. Based on its evaluation, the Hospital has recorded no other-than-temporary impairments for the years ended June 30, 2012 and 2011.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

2. Significant Accounting Policies (continued)

Derivative Instruments

The Hospital entered into a forward-starting interest rate exchange agreement on August 9, 2005 with Morgan Stanley Capital Services Inc. (the Counterparty) to reduce the risk of changing interest rates with a notional amount of \$137,845. Under the agreement, the Hospital paid a fixed rate of approximately 3.5% and received a variable rate of 68% of three-month London Interbank Offered Rate (LIBOR). The Hospital unwound the agreement on January 24, 2006 and paid the Counterparty a termination payment of \$1,575 on February 9, 2006 from proceeds of the 2006 Bond issue. The termination payment of \$1,575 has been recognized as unamortized financing costs and is being amortized over the life of the 2006 Bond issue using the straight-line method, which approximates the effective interest method.

On January 26, 2006, the Hospital amended the August 9, 2005 agreement with the Counterparty and entered into an interest rate swap (the Basis Swap) on a notional amount of \$142,910 under which the Hospital will pay the Counterparty floating rate payments based upon the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index and will receive floating rate payments based upon 68% of three-month LIBOR, plus a fixed spread of 0.523%. Under Accounting Standards Codification (ASC) No. 815, *Derivatives and Hedging*, the Hospital has recognized its derivative instruments in the balance sheets at fair value. As these derivative instruments are not designated as hedges, the changes in fair value have been recognized in the accompanying statements of operations and changes in net assets as mark-to-market adjustments, included within basis swap income.

The fair market value of the swap agreement is included in other liabilities or other assets in the accompanying balance sheets. The fair market value calculation includes a credit valuation adjustment (CVA) as required by ASC 820, *Fair Value Measurements and Disclosures*. At June 30, 2012, the valuation of the interest rate swap asset was decreased by \$13 when applying the CVA. At June 30, 2011, the valuation of the interest rate swap agreement liability position was reduced by \$447 when applying the CVA. The change in the fair market value of the swap agreement is recorded in the performance indicator, as the swaps are 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.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

2. Significant Accounting Policies (continued)

The Hospital's derivative agreement does not contain any credit support provisions that require it to post collateral if there are declines in the derivative value or its credit rating.

At June 30, 2012, the value of this instrument was a \$2,068 asset position, recorded in other assets. At June 30, 2011, the value of this instrument was a \$357 asset position, recorded in other assets.

Accounts Receivable and Contractual Allowances

The Hospital provides services to patients in the Eastern Shore area of Maryland, Delaware and Virginia, the majority of whom are covered by third-party health insurance. The Hospital bills the insurer directly for services provided.

Insurance coverage and financial information is obtained from patients upon admission when available. The Hospital's policy is to perform in-house collection procedures for approximately 85 days. A determination is made at that time as to what additional collection efforts to pursue. A provision for uncollectible accounts is recorded for amounts not yet written off, which are expected to become uncollectible.

Discounts ranging from 2% to 6% of charges are given to Medicare, Medicaid and certain approved commercial health insurance and health maintenance organization programs for regulated services. Discounts in varying percentages are given for certain unregulated services. These major payors routinely review patient billings and deny payment for certain charges as medically unnecessary or as performed without appropriate preauthorization. Discounts and denials are recorded as reductions of net patient service revenue. Accounts receivable from these third-party payors have been adjusted to reflect the difference between charges and the estimated reimbursable amounts.

Approximately 37% and 33%, respectively, of accounts receivable were due from the Medicare program as of June 30, 2012 and 2011, respectively.

The Medicare and Medicaid reimbursement programs represent a substantial portion of the Hospital's revenues. The Hospital'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.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

2. Significant Accounting Policies (continued)

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 Hospital.

Inventories and Other

Inventories and other primarily includes inventories of supplies and prepaid expenses. Inventories of supplies are carried at lower of cost or market, using the first-in, first-out method.

Other Assets

Other assets primarily include an investment in a limited partnership. This investment is accounted for under the equity method of accounting.

Assets Limited as to Use

Assets limited as to use primarily includes assets held by trustees under indenture agreements, assets held by trustees under irrevocable self-insurance trust agreements and assets whose use has been limited by the donor of the underlying funds. Assets limited as to use also includes the Hospital's beneficial interest in the Foundation's temporarily restricted net assets. Amounts required to meet current liabilities of the Hospital have been classified in the balance sheets as current assets.

Board-Designated Investments

Board-designated investments include assets set aside by the Board of Trustees for future capital improvements and expansion. The Board of Trustees retains control of these assets and may, at its discretion, subsequently use them for other purposes.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

2. Significant Accounting Policies (continued)

Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. 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.

Gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted donations. Absent explicit donor stipulations about how long those assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

Unamortized Financing Costs

Financing costs incurred in issuing the Maryland Health and Higher Educational Facilities Authority Project and Refunding Revenue Bonds have been capitalized and are being amortized using the straight-line method over the life of the bonds, which approximates the effective interest method. The amount amortized is recorded as an operating expense.

Estimated Self-Insurance Liabilities and Workers' Compensation

The provision for estimated professional liability claims, general liability claims and workers' compensation claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported.

Pension Benefits

Pension benefits are recorded in accordance with ASC No. 715, *Compensation – Retirement Benefits*, which requires the recognition of the funded status of pension plans within the accompanying balance sheets. As of June 30, 2012 and 2011, the funded status of the pension plan has been recorded within other long-term liabilities and other long-term assets, respectively.

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the Hospital has been limited by donors to a specific time period or purpose. Temporarily restricted net assets are to be used for capital purposes and other health care services.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)

(In Thousands)

2. Significant Accounting Policies (continued)

Permanently restricted net assets have been restricted by donors to be maintained by the Hospital in perpetuity.

Net Patient Service Revenue

Net patient service revenue is reported at the estimated realizable amounts from patients, third-party payors and others for services rendered. During 2012 and 2011, approximately 48% and 49% of net patient service revenue was received under the Medicare program, 14% and 13% from CareFirst Blue Cross Blue Shield, 30% and 30% from contracts with other third parties, and 8% and 8% from other sources, respectively.

The following table sets forth the detail of net patient service revenue:

	Year Ended June 30	
	2012	2011
Gross patient service revenue	\$ 476,777	\$ 457,035
Revenue deductions:		
Charity care	18,575	15,662
Contractual and other allowances	80,167	61,321
Net patient service revenue	<u>\$ 378,035</u>	<u>\$ 380,052</u>

The Hospital employs physicians in several hospital-based specialties. The Hospital bills for the services provided by these physicians. Net physician revenue is recognized when the services are provided and recorded at the estimated net realizable amount based on the contractual arrangements with third-party payors and the expected payments from the third-party payors and the patients. The difference between the billed charges and the estimated net realizable amounts are recorded as a reduction in physician revenue when the services are provided. At June 30, 2012 and 2011, approximately \$1,834 and \$1,372, respectively, of net physician accounts receivable are included in accounts receivable in the accompanying balance sheets.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

2. Significant Accounting Policies (continued)

Charity Care

The Hospital provided care to patients who met certain criteria under its charity care policy, without charge or at amounts less than its approved rates. Because the Hospital did not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. The amounts written off as charity care for 2012 and 2011 were \$14,577 and \$12,572, respectively. These amounts represent direct and indirect charity care costs, which are calculated using the Hospital's cost to charge ratio. The state of Maryland rate system includes components within the rates to partially compensate hospitals for uncompensated care.

Donor-Restricted Gifts

Unconditional promises to give cash and other assets to the Hospital are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted donations 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 the purpose of the restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statements of operations and changes in net assets as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying financial statements.

Investment Income

Investment income primarily includes income from short-term and long-term investments, board-designated investments and investments within assets limited as to use. In addition, investment income is also recorded for certain equity method investments that are included within other assets.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

2. Significant Accounting Policies (continued)

The components of investment income are as follows:

	Year Ended June 30	
	2012	2011
Interest and dividend income	\$ 3,694	\$ 3,356
Realized gains, net	1,803	7,478
Income earned on equity method investments	1,456	1,316
Other	21	14
Total	<u>\$ 6,974</u>	<u>\$ 12,164</u>

Income Taxes

The Hospital is a not-for-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code and is exempt from federal income taxes on related income pursuant to Section 501(a) of the Code.

Performance Indicator

The performance indicator for the Hospital is excess of unrestricted revenue and other support over expenses, which includes all changes in unrestricted net assets except for changes in unrealized gains and losses on investments, pension adjustments in accordance with ASC No. 958-715 – *Not for Profit Entities – Compensation – Retirement Benefits* and net assets released from restrictions for property acquisitions.

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 did not have an impact on the Hospital's financial statements.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

2. Significant Accounting Policies (continued)

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 Hospital for the fiscal year ending June 30, 2013. The Hospital is currently evaluating the impact of this guidance.

3. Property and Equipment

A summary of property and equipment follows:

	Estimated Useful Lives	June 30 2012	2011
Land	–	\$ 10,636	\$ 10,492
Land improvements	20	13,856	13,695
Buildings and improvements	15 – 40	188,061	184,304
Fixed equipment	20	32,235	32,235
Movable equipment	7 – 10	189,644	191,851
		434,432	432,577
Less accumulated depreciation		(245,183)	(233,750)
		189,249	198,827
Construction in progress		10,986	7,327
Property and equipment, net		\$ 200,235	\$ 206,154

Peninsula Regional Medical Center

Notes to Financial Statements (continued)

(In Thousands)

3. Property and Equipment (continued)

As of June 30, 2012, the Hospital was committed to building and equipment purchases totaling approximately \$2,983.

4. Other Liabilities

The components of other liabilities are as follows:

	June 30	
	2012	2011
Long-term benefit obligation	\$ 9,112	\$ -
Self insurance obligations	11,156	11,695
Other	558	439
Total	<u>\$ 20,826</u>	<u>\$ 12,134</u>

Peninsula Regional Medical Center

Notes to Financial Statements (continued)

(In Thousands)

5. Long-Term Debt

Long-term debt consists of the following:

	June 30	
	2012	2011
Maryland Health and Higher Educational Facilities Authority Revenue Bonds Series 2006:		
Serial bonds with interest rates ranging from 3.50% to 5.00% and effective rates ranging from 3.49% to 4.67% due in various annual amounts on July 1 of each year from 2007 through 2021 and 2027	\$ 33,765	\$ 36,560
5.00% term bonds with effective rate of 4.44% due July 1, 2026	24,635	24,635
5.00% term bonds with effective rate of 4.63% due July 1, 2036	69,505	69,505
Property acquisition note:		
5.50% due March 1 of each year from 2007 to 2015	45	60
	127,950	130,760
Less:		
Current portion of Maryland Health and Higher Educational Facilities Authority Series 2006 serial bonds	2,915	2,795
Property acquisition note	15	15
	125,020	127,950
Original issue premium	3,312	3,616
Long-term debt, less current portion	\$ 128,332	\$ 131,566

On February 9, 2006, the Maryland Health and Higher Educational Facilities Authority (MHHEFA) authorized the issuance of \$142,910 aggregate principal amount of Revenue Bonds (Series 2006 Bonds) at a premium of \$5,333. The proceeds of the issue, after payment of financing costs, were used primarily (i) to finance and refinance a portion of the costs of construction, renovation, acquisition and equipping of the 2006 Project; (ii) to refund outstanding 1993 bonds; (iii) to pay a portion of the interest accruing on the Series 2006 Bonds for a period to extend to January 1, 2009; and (iv) to pay the Counterparty a termination payment of \$1,575 in connection with a forward starting interest rate exchange agreement entered into on August 9, 2005 and unwound on January 24, 2006.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

5. Long-Term Debt (continued)

Under the terms of the 2006 project and refunding revenue bonds, the Hospital is required to maintain certain deposits with a trustee. Such deposits are included within assets limited as to use. The revenue note indenture also places limits on the incurrence of additional borrowings and requires that the Hospital satisfy certain measures of financial performance as long as the notes are outstanding.

The Hospital is required to make semiannual payments to the trustee sufficient to meet the annual debt service requirements of the refunding bond issue for the succeeding year. Annual sinking fund installments for the term bonds range from \$3,690 on July 1, 2027 to \$8,820 at maturity. The premium on the Series 2006 Bonds is being amortized over the life of the bonds using the effective interest method.

As security for the debt service requirements of the Series 2006 Bonds, MHHEFA has a first lien and claim on all receipts of the Hospital. The terms of the indenture agreement restrict the Hospital's ability to create additional indebtedness and its use of the facilities, and require the Hospital to maintain stipulated insurance coverage and a rate structure in each year sufficient to meet certain rate covenant requirements.

On March 1, 2006, the Hospital entered into a promissory note for the acquisition of property in the amount of \$135 (\$45 outstanding at June 30, 2012). The interest rate is 5.50% with principal and interest due annually through 2015.

On October 30, 2001, Delmarva Surgery Center, LLC (the Company), a 55%-owned subsidiary of Health Ventures, entered into variable rate loan agreements with M&T Bank in the amount of \$4,500 (\$0 outstanding at June 30, 2012) with monthly payments in various amounts through May 2012 to build and equip an ambulatory surgery center. Health Ventures guaranteed the M&T Bank Loan limited to its pro rata interest. In addition, the Hospital entered into an agreement M&T Bank to guarantee with Health Ventures' commitment for this loan. However, it has not guaranteed any portion of the BB&T Bank loan.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

5. Long-Term Debt (continued)

Scheduled principal repayments on long-term debt for the years ending June 30 are as follows:

2013	\$ 2,930
2014	3,055
2015	3,185
2016	3,330
2017	3,495
2018 and thereafter	111,955
	<u>\$ 127,950</u>

Fair values of long-term debt are estimated using discounted cash flow analyses, based on current incremental borrowing rates for similar types of borrowing arrangements.

The fair market value of the Hospital's long-term debt outstanding as of June 30, 2012 and 2011 was \$136,177 and \$130,631, respectively.

Total interest paid for fiscal years 2012 and 2011 was \$6,213 and \$6,544, respectively.

6. Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes:

	June 30	
	2012	2011
Health care services:		
Capital purposes	\$ 10,384	\$ 10,310
Patient services	3,973	3,295
Educational purposes	897	730
	<u>\$ 15,254</u>	<u>\$ 14,335</u>

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

6. Temporarily and Permanently Restricted Net Assets (continued)

Permanently restricted net assets are restricted to:

	June 30	
	2012	2011
	<u>2012</u>	<u>2011</u>
Investments to be held in perpetuity, the income from which is expendable to support health care services	\$ 8,071	\$ 8,065

The Foundation initiated a major fundraising campaign for capital funds during fiscal year 2005 to support the Hospital's capital plans that include expansion and modernization of facilities. The Foundation has raised approximately \$14,643 as of June 30, 2012, which includes net pledges receivable present valued at approximately \$1,742. There were two large donations that represent approximately 46% and 34%, respectively, of the net pledges receivable at year-end. The Foundation expects to receive payment on the majority of the pledges by 2014 and all payments by 2025. Additionally, during 2011, the Foundation launched a fundraising campaign to support the Operating Room expansion. This campaign has raised \$1,451 as of June 30, 2012 which includes net pledges receivable present valued at \$579. Pledges receivable are included in assets limited to in use in the accompanying balance sheets.

Scheduled payments on pledges receivable for the years ending June 30 are as follows:

2013	\$ 819
2014 – 2017	755
2018 and thereafter	<u>655</u>
	2,229
Less:	
Impact of discounting of pledges receivable to net present value	(220)
Allowance for uncollectible pledges	<u>(267)</u>
Net pledges receivable, capital campaign	1,742
Other pledges receivable (includes OR net receivable of \$579)	<u>584</u>
Total pledges receivable	<u><u>\$ 2,326</u></u>

Peninsula Regional Medical Center

Notes to Financial Statements (continued)

(In Thousands)

7. Functional Expenses

The Hospital considers health care services and management and general to be its primary functional categories for purposes of expense classification. Depreciation and interest costs are included in health care services. The Hospital's operating expenses by functional classification are as follows:

	Year Ended June 30	
	2012	2011
Health care services	\$ 339,231	\$ 335,768
Management and general	34,930	31,094
	<u>\$ 374,161</u>	<u>\$ 366,862</u>

8. Estimated Self-Insured Liability Claims and Workers' Compensation

The Hospital is self-insured for professional liability claims up to an annual limit of \$2,000 per claim and \$8,000 in aggregate. The Hospital carries an excess liability insurance policy for claims above these limits. There are known claims and incidents that may result in the assertion of additional claims, as well as claims from unknown incidents that may be asserted arising from services provided to patients. The Hospital has employed independent actuaries to estimate the ultimate costs, if any, of the settlement of such claims. The accrued self-insured professional liability losses have been discounted at 2% and 4% respectively, and in management's opinion provide an adequate reserve for loss contingencies. As of June 30, 2012 and 2011, respectively, \$10,220 and \$10,953 have been reserved for professional liability loss contingencies.

The Hospital established a trust for the purpose of setting aside assets based on actuarial funding recommendations. Under the trust agreement, the trust assets can only be used for payment of malpractice losses, related expenses and the cost of administering the trust. The assets of the trust are reported in assets limited as to use; income from trust assets, administrative costs and the Hospital's annual estimate of malpractice losses are reported in the statements of operations and changes in net assets.

The Hospital is self-insured for general liability claims beginning March 1, 2004 up to an annual limit of \$1,000 per claim and \$3,000 in aggregate. The Hospital carries an excess liability insurance policy for claims above these limits.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

8. Estimated Self-Insured Liability Claims and Workers' Compensation (continued)

The Hospital is also self-insured for workers' compensation up to an annual limit of \$400 per occurrence. The Hospital carries an excess liability insurance policy for workers' compensation claims above this limit. As of June 30, 2012 and 2011, respectively, \$2,786 and \$2,592 have been reserved for workers' compensation loss contingencies.

9. Investments

The following methods and assumptions were used by the Hospital in estimating the fair value of its financial instruments:

Fair values of all investments, including short-term investments, long-term investments, board-designated investments, and assets limited to use are based on quoted market prices and/or prices obtained from a third party using other market data for the same or comparable instruments and transactions in establishing the prices. Assets limited as to use also include the beneficial interest in the Foundation's temporarily restricted net assets which primarily consist of pledges receivable. Certain long-term pledges receivable have been discounted.

Fair value of investments and certain assets limited as to use held by the Hospital is summarized as follows:

	June 30	
	2012	2011
Investments:		
Cash and cash equivalents	\$ 15,068	\$ 14,368
U.S. treasury securities	22,360	20,118
Corporate bonds	45,607	37,067
Equity securities	114,965	111,410
Government sponsored mortgage-backed securities	22,479	19,013
Other (including pledges receivable held at the Foundation)	5,721	4,169
Total	<u>\$ 226,200</u>	<u>\$ 206,145</u>

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

9. Investments (continued)

ASC No. 320, *Investments – Debt and Equity Securities*, provides guidance on the recognition and presentation of other-than-temporary impairments. In addition, additional disclosures are required related to other-than-temporary impairments. Under this revised guidance, if a debt security is in an unrealized loss position and the Hospital has the intent to sell the debt security, or it is more likely than not that the Hospital will have to sell the debt security before recovery of its amortized cost basis, the decline in value is deemed to be other-than-temporary and is recorded to other-than-temporary impairment losses recognized in the performance indicator in the statements of operations. For impaired debt securities that the Hospital does not intend to sell or it is more likely than not that the Hospital will not have to sell such securities, but the Hospital expects that it will not fully recover the amortized cost basis, the credit component of the other-than-temporary impairment is recognized in other-than-temporary impairment losses recognized in the performance indicator in the statements of operations and the non-credit component of the other-than-temporary impairment is recognized as a change in unrestricted net assets.

The credit component of an other-than-temporary impairment is determined by comparing the net present value of projected future cash flows with the amortized cost basis of the debt security. The net present value is calculated by discounting the best estimate of projected future cash flows at the effective interest rate implicit in the debt security at the date of acquisition. Cash flow estimates are driven by assumptions regarding probability of default, including changes in credit ratings, and estimates regarding timing and amount of recoveries associated with a default. Furthermore, unrealized losses entirely caused by non-credit-related factors related to debt securities for which the Hospital expects to fully recover the amortized cost basis continue to be recognized as an unrealized loss on investments within the changes in unrestricted net assets.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

9. Investments (continued)

The following table shows the gross unrealized losses and fair value of the Hospital's investments with unrealized losses that are not deemed to be other than temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2012 and 2011:

	Fair Value < 1 year	Unrealized Losses < 1 year	Fair Value > 1 year	Unrealized Losses > 1 year	Total Unrealized Losses
June 30, 2012					
U.S. Treasury Government sponsored mortgage-backed securities	\$ 10,471	\$ 100	\$ -	\$ -	\$ 100
Corporate debt securities	5,838	55	-	-	55
Equity securities	2,807	40	-	-	40
Total investments	<u>\$ 39,891</u>	<u>\$ 1,713</u>	<u>\$ 31</u>	<u>\$ 2</u>	<u>\$ 1,715</u>
June 30, 2011					
Government sponsored mortgage-backed securities	\$ 10,647	\$ 111	\$ -	\$ -	\$ 111
Corporate debt securities	6,429	86	-	-	86
Equity securities	14,395	922	1,260	146	1,068
Total investments	<u>\$ 31,471</u>	<u>\$ 1,119</u>	<u>\$ 1,260</u>	<u>\$ 146</u>	<u>\$ 1,265</u>

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

10. Fair Value Measurements

ASC No. 820, *Fair Value Measurements and Disclosures*, establishes a framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under ASC No. 820 are described below:

- Level 1 – Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Hospital has the ability to access.
- Level 2 – Inputs to the valuation methodology include:
 - Quoted prices for similar assets or liabilities in active markets;
 - Quoted prices for identical or similar assets or liabilities in inactive markets;
 - Inputs other than quoted prices that are observable for the asset or liability; and
 - Inputs that are derived principally from or corroborated by observable market data by correlation or other means.
- Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

10. Fair Value Measurements (continued)

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Hospital believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

The following table presents the Hospital's assets and liabilities measured at fair value, aggregated by level in the fair value hierarchy within which those measurements fall:

	Assets at Fair Value as of June 30, 2012			
	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents	\$ 15,068	\$ —	\$ —	\$ 15,068
U.S. treasury securities	22,360	—	—	22,360
Corporate debt securities	—	45,607	—	45,607
Mortgage-backed securities	—	22,479	—	22,479
Publicly traded equity securities	114,965	—	—	114,965
Other	928	2,467	2,326	5,721
Total assets	\$ 153,321	\$ 70,553	\$ 2,326	\$ 226,200

	Assets at Fair Value as of June 30, 2011			
	Level 1	Level 2	Level 3	Total
Assets				
Cash and cash equivalents	\$ 14,368	\$ —	\$ —	\$ 14,368
U.S. treasury securities	20,118	—	—	20,118
Corporate debt securities	—	37,067	—	37,067
Mortgage-backed securities	—	19,013	—	19,013
Publicly traded equity securities	111,010	400	—	111,410
Other	873	357	2,939	4,169
Total assets	\$ 146,369	\$ 56,837	\$ 2,939	\$ 206,145

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

10. Fair Value Measurements (continued)

The fair values of securities are 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.

Long-term pledges receivable, which are measured at fair value on a non-recurring basis, are discounted to net present value upon receipt using an appropriate risk-free discount rate based on the term of the receivable. Pledges receivable are recorded net of an allowance for uncollectible pledges. The following table provides a reconciliation of the beginning and ending balances of pledges receivable at fair value that used significant unobservable inputs (Level 3):

	Year Ended June 30	
	2012	2011
Pledges receivable		
Balance at July 1	\$ 2,939	\$ 3,187
New pledges	275	482
Collections on pledges	(815)	(667)
Write-off of pledges	(197)	(133)
Changes in reserves	124	70
Balance at June 30	<u>\$ 2,326</u>	<u>\$ 2,939</u>

11. Pension Plan

The Hospital has a cash balance-type defined benefit pension plan covering substantially all of its employees. The Plan benefits are based on years of service and the employees' compensation during the last five years of covered employment. The Hospital's funding policy is to make sufficient contributions to the Plan to comply with the minimum funding provisions of the Employee Retirement Income Security Act. Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future.

The Peninsula Regional Medical Center PensionPlus Plan (the Plan) provides annual allocations to a participant's hypothetical account. When a participant retires, the participant has the choice to receive a lump-sum distribution equal to the value of the hypothetical account or to receive an annuity based on the value of the hypothetical account.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)

(In Thousands)

11. Pension Plan (continued)

Prior to January 1, 2009, the Plan provided three different allocations: (i) a service-related allocation, (ii) an age-related allocation and (iii) a matching allocation. Both the service-related allocation and the age-related allocation were determined by multiplying a participant's annual compensation by a certain percentage. The matching allocation operated to provide an annual allocation in the Plan based on the participant's contribution to the Hospital's 403(b) Plan.

The IRS issued new regulations that were effective as of January 1, 2009. The new regulations prohibited a pension plan from providing a matching allocation based on a participant's contributions to a different plan. The Plan provided a matching allocation based on a participant's contribution to a 403(b) Plan. In order to comply with the new tax law requirements, the Plan was amended effective as of December 31, 2008, to eliminate future matching allocations in the Plan. At the same time, the Hospital adopted a 403(b) plan effective as of January 1, 2009 and provided a replacement matching contribution in the 403(b) plan.

The assets of the Plan are available to pay the benefits of eligible employees of all participating entities. The Plan had an unfunded liability of \$9,112 and a prepaid asset of \$2,016 as of June 30, 2012 and 2011, respectively.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

11. Pension Plan (continued)

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:

	<u>2012</u>	<u>2011</u>
Accumulated benefit obligation	\$ 94,241	\$ 79,466
Projected benefit obligation, beginning of year	\$ 85,231	\$ 80,834
Service cost	3,926	3,825
Interest cost	5,024	4,444
Actuarial loss (gain)	11,094	(1,133)
Benefits paid	(3,634)	(2,739)
Projected benefit obligation, end of year	<u>101,641</u>	<u>85,231</u>
Fair value of plan assets, beginning of year	87,247	66,224
Actual gain on plan assets	1,816	12,762
Employer contributions	7,100	11,000
Benefits paid	(3,634)	(2,739)
Fair value of plan assets, end of year	<u>92,529</u>	<u>87,247</u>
Fair value of plan assets (less than)/ greater than projected benefit obligation	<u>(9,112)</u>	<u>2,016</u>
(Accrued)/prepaid pension cost recorded in the balance sheets	<u>\$ (9,112)</u>	<u>\$ 2,016</u>

Components of net periodic benefit cost are as follows:

	<u>Year Ended June 30</u>	
	<u>2012</u>	<u>2011</u>
Service cost	\$ 3,926	\$ 3,825
Interest cost	5,025	4,444
Expected return on plan assets	(6,796)	(6,214)
Amortization of prior service credit	(126)	(126)
Recognized net actuarial loss	2,106	2,661
Net periodic benefit cost	<u>\$ 4,135</u>	<u>\$ 4,590</u>

Peninsula Regional Medical Center

Notes to Financial Statements (continued)

(In Thousands)

11. Pension Plan (continued)

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

	<u>2012</u>	<u>2011</u>
Net actuarial loss	\$ 44,308	\$ 30,341
Prior service credit	(566)	(692)
Total recognized in unrestricted net assets	<u>\$ 43,742</u>	<u>\$ 29,649</u>

The estimated net actuarial loss and prior service credit for the Plan that will be amortized from unrestricted net assets into net periodic benefit cost over the next fiscal year are \$3,343 and (\$126), respectively.

Weighted average assumptions used to determine projected benefit obligations and net periodic benefit costs at June 30 were as follows:

	<u>2012</u>	<u>2011</u>
Projected benefit obligation		
Discount rate	4.00%	6.00%
Rates of increase in compensation levels	3.70	3.70
	<u>2012</u>	<u>2011</u>
Net periodic benefit cost		
Discount rate	6.00%	5.60%
Rates of increase in compensation levels	3.70	5.00
Expected long-term rate of return on assets	7.50	7.75

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

11. Pension Plan (continued)

The defined benefit pension plan asset allocation as of the measurement date (June 30) and the target asset allocation, presented as a percentage of total plan assets, were as follows:

	2012	2011	Target Allocation
Debt securities	33%	30%	25% –40%
Equity securities	64	65	45% –75%
Cash and cash equivalents	3	5	1% –10%
Total	100%	100%	

The Hospital’s defined benefit plan invests in a diversified mix of traditional asset classes. Investments in U.S. equity securities and fixed income securities are made to maximize long-term results while recognizing the need for adequate liquidity to meet ongoing benefit and administrative obligations. Risk tolerance of unexpected investment and actuarial outcomes is continually evaluated by understanding the pension plan’s liability characteristics. This is performed through forecasting and assessing ranges of investment outcomes over short- and long-term horizons, and by assessing the Hospital’s financial condition and its future potential obligations from both the pension and general operational requirements. Complementary investment styles, such as growth and value equity investing techniques, are utilized by the Hospital’s investment advisors to further improve portfolio and operational risk characteristics. Equity investments, both active and passively managed, are used primarily to increase overall plan returns. Fixed income investments provide diversification benefits and liability hedging attributes that are desirable, especially in falling interest rate environments.

Asset allocations and investment performance are formally reviewed at regularly scheduled meetings of the Hospital’s Financial Resources Committee.

The overall rate of expected return on assets assumption was based on historical returns, with adjustments made to reflect expectations of future returns. The extent to which the future expectations were recognized included the target rates of return for the future, which have not historically changed.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)
(In Thousands)

11. Pension Plan (continued)

The fair value of the Hospital's pension plan assets as of June 30, 2012 and June 30, 2011, by asset category (see Note 10, *Fair Value Measurements*, for a description of the asset categories) are as follows:

June 30, 2012	Level 1	Level 2	Level 3	Total
Assets				
Investments at fair value:				
Cash and cash equivalents	\$ 3,114	\$ –	\$ –	\$ 3,114
U.S. Treasuries	7,499	–	–	7,499
Government sponsored mortgage-backed securities	–	5,102	–	5,102
Corporate debt securities	–	24,251	–	24,251
Publically traded equity securities	52,155	–	–	52,155
Other	408	–	–	408
Total investments	\$ 63,176	\$ 29,353	\$ –	\$ 92,529
June 30, 2011	Level 1	Level 2	Level 3	Total
Assets				
Investments at fair value:				
Cash and cash equivalents	\$ 864	\$ –	\$ –	\$ 864
U.S. Treasuries	5,396	–	–	5,396
Government sponsored mortgage-backed securities	–	4,792	–	4,792
Corporate debt securities	–	15,461	–	15,461
Money market funds	4,269	–	–	4,269
Publically traded equity securities	55,929	182	–	56,111
Other	354	–	–	354
Total investments	\$ 66,812	\$ 20,435	\$ –	\$ 87,247

The following methods and assumptions were used to estimate fair value of each class of financial instrument:

U.S. Treasuries: the fair value is determined by an active price for an identical security in an observable market.

Peninsula Regional Medical Center

Notes to Financial Statements (continued)

(In Thousands)

11. Pension Plan (continued)

Corporate debt securities and government sponsored mortgage-backed securities: the fair value is estimated using quoted prices for similar assets in active markets or quoted prices for identical or similar assets in non-active markets (few transactions, limited information, non-current prices, and high variability over time).

Money market funds: the carrying value of these money market funds approximates fair value as the maturities are less than three months.

Publically traded equity securities: the fair value is determined by market quotes for an identical security in an observable market.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Hospital believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

Cash Flows

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid as follows for the years ending June 30:

2013	\$	8,405
2014		8,565
2015		8,610
2016		8,411
2017		8,050
2018 – 2022		40,064

The Hospital intends to make voluntary contributions to the defined benefit pension plan of \$6 million through June 30, 2013. This funding level exceeds any regulatory requirements for 2012.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

12. Commitments and Contingencies

Agreement with the Office of Inspector General

The Hospital received several subpoenas from the Office of Inspector General of the U.S. Department of Health and Human Services (“OIG”), requiring the production of certain documents related to claims for physician health care services provided by a former Medical Staff Member. These subpoenas were issued in connection with a civil investigation being conducted by the U.S. Attorney’s Office for the District of Maryland. In January 2011, the Hospital reached a tentative “Agreement in Principle”, which was ultimately approved by the U.S. Department of Justice, the OIG, the Office of Personnel Management (OPM), and the state of Maryland in August 2011, to resolve all remaining potential civil claims arising out of the Hospital’s medical services to patients of the physician. The Hospital reached this agreement without admitting liability in order to avoid the expense and uncertainty of litigation and to allow the Hospital to move forward. In this regard and consistent with the settlement, an amount of \$1.8 million was paid in June 2011 and recorded as an other expense in the accompanying 2011 statement of operations and changes in net assets. The settlement also includes a five year Corporate Integrity Agreement that will require the Hospital to establish and/or enhance various compliance processes and also have several independent peer review reports completed on an annual basis.

Other

The Hospital has been named as a defendant in various lawsuits arising from the performance of its normal activities. In the opinion of the Hospital’s management, after discussion with legal counsel, the amount, if any, of the Hospital’s ultimate liability under these lawsuits will not have a material adverse effect on the financial position of the Hospital.

A portion of the Hospital’s revenues is received from health maintenance organizations and other managed care payors. Managed care payors generally use case management activities to control utilization. These payors also have the ability to select providers offering the most cost-effective care. Management does not believe that the organization has undue exposure to any one managed care payor.

The Hospital’s revenues may be subject to adjustment as a result of examination by government agencies or contractors based upon 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

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

12. Commitments and Contingencies (continued)

were rendered. Section 302 of the Tax Relief and Health Care Act of 2006 authorized a permanent program involving the use of third-party recovery audit contractors (RACs) to identify Medicare overpayments and underpayments made to providers. We have established protocols to respond to RAC requests and payment denials. Payment recoveries resulting from RAC reviews are appealable through administrative and judicial processes, and we intend to pursue the reversal of adverse determinations where appropriate. In addition to overpayments that are not reversed on appeal, we will incur additional costs to respond to requests for records and pursue the reversal of payment denials. As of June 30, 2012, the Hospital has recorded an estimated reserve regarding the Medicare overpayments. In the opinion of the Hospital's management, the ultimate settlement of this matter will not have a material adverse effect on the financial position of the Hospital.

As part of a national investigation, the Hospital is working on a data request by the Department of Justice (DOJ) regarding the Medicare programs coverage guidelines for the implantation of implantable cardioverter defibrillators (ICD's). As of June 30, 2012, no case or demand for payment has been initiated by DOJ or Centers for Medicare and Medicaid Services (CMS).

On June 22, 2012, the Hospital filed a self disclosure to CMS, reporting technical violations of the self referral regulations (referred to as Stark). As of June 30, 2012, the Hospital does not believe the settlement of this issue will have a material adverse effect on the entity's financial statements.

13. Maryland Health Services Cost Review Commission

Certain Hospital charges are subject to review and approval by the Maryland Health Services Cost Review Commission (the Commission). Hospital management has filed the required forms with the Commission and believes the Hospital to be in compliance with Commission requirements.

The current rate of reimbursement for principally all inpatient services and certain other services to patients under the Medicare and Medicaid programs is based on an agreement between the Centers for Medicare and Medicaid Services and the Commission. This agreement is based upon a waiver from Medicare prospective payment system reimbursement principles granted to the State of Maryland under Section 1814(b) of the Social Security Act and will continue as long as the rate of increase for costs per hospital inpatient admission in Maryland is below the national average. Management expects this agreement will remain in effect at least through June 30, 2013.

Peninsula Regional Medical Center

Notes to Financial Statements (continued) (In Thousands)

13. Maryland Health Services Cost Review Commission (continued)

The Commission and the Hospital entered into an agreement that is based on a rate methodology for those hospital service centers that provide inpatient services. Under this methodology, a target average charge per case is established for the Hospital based on past actual charges and case mix indices. The actual average charge per episode is compared with the target average charge per episode, and to the extent that the actual average exceeds or is less than the target, the difference adjusted for applicable penalties will reduce or increase the approved target for future rate years. For the year ended June 30, 2012, the Hospital was in compliance with its average charge per case target.

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

The timing of the Commission's rate adjustments for the Hospital could result in an increase or reduction in rates due to the variances and penalties described above in a year subsequent to the year in which such items occur, and there is at least a possibility that the amounts may be material. The Hospital's policy is to record revenue based on actual charges for services to patients in the year in which the services are performed. The Hospital recognizes unbilled revenue for in-house patients.

14. Subsequent Events

The Hospital has evaluated subsequent events through September 21, 2012, the date the financial statements were issued.

Supplementary Information

Report of Independent Auditors on Supplementary Information

Board of Trustees
Peninsula Regional Medical Center

Our audit was conducted for the purpose of forming an opinion on the June 30, 2012 financial statements taken as a whole. The June 30, 2012 supplementary information is presented for purposes of additional analysis and is 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

September 21, 2012

Peninsula Regional Medical Center

Summary of Operations
(In Thousands)

	Year Ended June 30				
	2012	2011	2010	2009	2008
Gross patient revenue	\$ 476,777	\$ 457,035	\$ 426,582	\$ 418,478	\$ 399,948
Deductions from revenue	98,742	76,983	58,173	50,440	45,406
Net patient service revenue	378,035	380,052	368,409	368,038	354,542
Other operating revenue	2,360	2,357	2,059	1,976	1,080
	380,395	382,409	370,468	370,014	355,622
Operating expenses	374,161	366,862	363,438	357,978	327,422
Income from operations	6,234	15,547	7,030	12,036	28,200
Nonoperating income (expense):					
Nonoperating income (expense)	6,974	12,164	10,304	(14,533)	12,033
Basis swap income (loss)	2,629	3,128	1,753	(3,344)	(1,927)
	9,603	15,292	12,057	(17,877)	10,106
Excess (deficit) of unrestricted revenue and other support over expenses	\$ 15,837	\$ 30,839	\$ 19,087	\$ (5,841)	\$ 38,306

Peninsula Regional Medical Center

Gross Patient Revenue
(In Thousands)

	Year Ended June 30	
	2012	2011
Total gross patient revenue:		
Routine care:		
Daily hospital care	\$ 102,899	\$ 115,624
Daily hospital care – nursery	6,129	6,550
Emergency services	22,241	21,364
Admissions charge	2,962	3,393
	<u>134,231</u>	<u>146,931</u>
Professional services:		
Pathology and clinical laboratory	33,858	32,298
Operating room	33,258	30,546
Pharmacy	55,219	50,150
Radiology:		
Diagnostic	5,454	4,738
Nuclear medicine	2,536	2,293
Special procedures	3,966	3,013
Ultrasound lab	3,497	3,077
C/T scanning and magnetic resonance imaging	7,999	7,596
Vascular lab	4,354	3,492
Radiation oncology	14,595	14,085
Medical oncology	6,463	6,232
Respiratory care and pulmonary function	9,545	9,811
Blood bank	1,860	1,959
Medical and surgical supplies	58,702	57,004
Delivery service	7,091	6,536
Anesthesiology	2,862	3,257
Electrocardiogram	516	429
Cardiac laboratory	14,500	12,652
Intravenous solutions	600	688
Lithotripsy	57	44
Physical, speech and occupational therapy	4,929	4,724
Neurological diagnostics	3,927	1,974
Cardiac rehabilitation	1,290	1,391
Family practice, clinic and diagnostic centers	18,396	17,650
Specialty practices	29,793	19,627
Transitional care	8,009	7,621
Recovery care	6,174	6,756
Observation service	3,096	461
	<u>342,546</u>	<u>310,104</u>
Gross patient revenue	<u>\$ 476,777</u>	<u>\$ 457,035</u>

Peninsula Regional Medical Center

Operating Expenses
(In Thousands)

	Year Ended June 30		Increase
	2012	2011	(Decrease)
Nursing services	\$ 97,092	\$ 94,459	\$ 2,633
Buildings and grounds	14,071	14,545	(474)
Laboratory	13,766	13,844	(78)
Materials management	6,330	7,184	(854)
Administration	26,227	26,020	207
Food services	3,996	4,066	(70)
Financial affairs and information systems	18,118	17,571	547
Respiratory services	5,137	5,325	(188)
Pharmacy	35,343	32,924	2,419
Radiology	14,318	14,369	(51)
Radiation oncology	5,002	4,706	296
Medical oncology	6,952	6,338	614
Physician services	6,552	7,518	(966)
Electrocardiology, neurological diagnostic, cardiac catheterization laboratory, family practice, lithotripsy, diagnostic and breast care centers	40,302	35,971	4,331
Physical, speech and occupational therapy	3,111	3,101	10
Admitting and registration	2,485	2,318	167
Education and training	1,396	1,258	138
Transitional care	2,276	2,241	35
Employee benefits, child care (exclusive of FICA)	27,000	27,274	(274)
Bad debts	16,616	17,411	(795)
Depreciation	21,812	21,829	(17)
Interest	6,213	6,544	(331)
Amortization of financing costs and deferred charge for retirement of debt	46	46	-
	\$ 374,161	\$ 366,862	\$ 7,299

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