HARFORD MEMORIAL HOSPITAL, INC. AND UPPER CHESAPEAKE MEDICAL CENTER, INC.

Combined Financial Statements and Combining Schedules

December 31, 2011 and 2010

(With Independent Auditors' Report Thereon)

HARFORD MEMORIAL HOSPITAL, INC. AND
UPPER CHESAPEAKE MEDICAL CENTER, INC.

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KPMG LLP
1 East Pratt Street
Baltimore, MD 21202-1128

Independent Auditors' Report

The Boards of Directors
Harford Memorial Hospital, Inc. and
Upper Chesapeake Medical Center, Inc.:

We have audited the accompanying combined balance sheets of Harford Memorial Hospital, Inc. and Upper Chesapeake Medical Center, Inc. (the Hospitals or the Obligated Group) as of December 31, 2011 and 2010, and the related combined statements of operations and changes in net assets and cash flows for the years then ended. These combined financial statements are the responsibility of the Hospitals' management. Our responsibility is to express an opinion on these combined financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Hospitals' internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the combined financial position of Harford Memorial Hospital, Inc. and Upper Chesapeake Medical Center, Inc. as of December 31, 2011 and 2010, and the combined results of their operations, the combined changes in their net assets, and their combined cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the combined financial statements as a whole. The supplementary information included in schedules 1 and 2 is presented for purposes of additional analysis and is not a required part of the combined 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 combined financial statements. The information has been subjected to the auditing procedures applied in the audits of the combined financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the combined financial statements or to the combined financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the combined financial statements as a whole.

KPMG LLP

April 26, 2012

HARFORD MEMORIAL HOSPITAL, INC. AND
UPPER CHESAPEAKE MEDICAL CENTER, INC.

Combined Balance Sheets

December 31, 2011 and 2010

(In thousands)

Assets		2011	2010
Current assets:			
Cash and cash equivalents	$	35,903	32,385
Current portion of assets held by trustee (notes 2, 7, and 13)		2,848	2,934
Board-designated and other investments (notes 2, 7, and 13)		84,985	95,890
Patient accounts receivable, net of allowance and contractuals of $17,806 and $11,381 in 2011 and 2010, respectively (note 3)		38,378	30,994
Prepaid expenses and other current assets		11,148	9,771
Total current assets		173,262	171,974
Due from affiliates (note 12)		27,759	9,674
Assets held by trustee, less current portion (notes 2 and 13)		4,069	5,796
Property, plant, and equipment, net (notes 4, 7, and 14)		191,826	181,797
Economic interest in net assets of foundation		7,007	—
Other assets (note 5)		1,641	1,232
Total assets	$	405,564	370,473
Liabilities and Net Assets			
Current liabilities:			
Accounts payable	$	21,382	16,196
Accrued salaries, benefits, and other (notes 8 and 9)		25,994	20,494
Current portion of long-term debt (notes 7 and 13)		895	13,013
Advances from third-party payors		6,833	5,818
Total current liabilities		55,104	55,521
Due to affiliates (note 12)		—	37
Long-term debt, less current portion (notes 7 and 13)		172,898	162,267
Other long-term liabilities (notes 7 and 14)		55,659	37,761
Pension liability (note 8)		10,200	3,842
Total liabilities		293,861	259,428
Unrestricted net assets		104,696	111,045
Temporarily restricted net assets		7,007	—
Total net assets		111,703	111,045
Total liabilities and net assets	$	405,564	370,473

See accompanying notes to combined financial statements.

HARFORD MEMORIAL HOSPITAL, INC. AND
UPPER CHESAPEAKE MEDICAL CENTER, INC.

Combined Statements of Operations and Changes in Net Assets

Years ended December 31, 2011 and 2010

(In thousands)

	2011	2010
Operating activities:		
Unrestricted revenues, gains, and other support:		
Net patient service revenue (notes 3, 7, 9, and 11)	$ 319,551	292,581
Other	5,319	4,519
Total unrestricted revenues, gains, and other support	324,870	297,100
Expenses (note 15):		
Salaries	113,255	108,459
Employee benefits (notes 8 and 9)	26,338	24,723
Provision for bad debts	23,124	21,987
Supplies and other operating expenses	120,842	109,807
Depreciation and amortization (notes 4 and 5)	13,070	12,009
Interest and amortization (notes 4, 5, and 7)	5,624	5,986
Total expenses	302,253	282,971
Operating income	22,617	14,129
Nonoperating income:		
Investment income (note 2)	19	5,215
Change in the fair value and settlement payments on derivative instruments (note 7)	(12,174)	(11,766)
Other	(241)	—
Nonoperating loss	(12,396)	(6,551)
Excess of revenues over expenses	10,221	7,578
Other changes in unrestricted net assets:		
Contributions for purchases of property and equipment (note 12)	701	532
Equity contribution	—	26,750
Pension – related changes other than net periodic pension cost (note 8)	(9,756)	2,793
Transfers to affiliates, net (note 12)	(7,515)	(10,927)
(Decrease) increase in unrestricted net assets	(6,349)	26,726
Increase in temporarily restricted net assets:		
Donor restricted gifts	7,007	—
Net assets, beginning of year	111,045	84,319
Net assets, end of year	$ 111,703	111,045

See accompanying notes to combined financial statements.

HARFORD MEMORIAL HOSPITAL, INC. AND
UPPER CHESAPEAKE MEDICAL CENTER, INC.

Combined Statements of Cash Flows

Years ended December 31, 2011 and 2010

(In thousands)

	2011	2010
Cash flows from operating activities:		
Increase in net assets	$ 658	26,726
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	13,070	12,009
Amortization of deferred financing costs	174	245
Amortization of bond discount	36	35
Provision for bad debts	23,124	21,987
Realized and unrealized loss (gains) on securities	775	(4,464)
Loss on interest rate swaps	8,151	7,597
Contributions for purchases of property and equipment	(701)	(532)
Equity contribution	—	(26,750)
Donor restricted gifts	(7,007)	—
Change in funded status of defined benefit plan	9,756	(2,793)
Loss on debt refinancing	133	—
Transfers to affiliates, net	7,515	10,927
Change in assets and liabilities:		
Increase in patient accounts receivable	(30,508)	(22,342)
(Decrease) increase in prepaid expenses and other current assets	(1,377)	34
Increase in accounts payable, accrued expenses, and advances from third-party payors	10,645	2,975
Increase in amounts due to affiliates, net	(18,123)	(2,584)
Pension liability	(3,398)	(2,366)
Increase (decrease) in other long-term liabilities	9,747	(233)
Net cash provided by operating activities	22,670	20,471
Cash flows from investing activities:		
Property, plant, and equipment additions	(19,589)	(13,045)
Purchases/sales of assets held by trustee, board-designated, other investments, net	11,942	(14,996)
Net cash used in investing activities	(7,647)	(28,041)
Cash flows from financing activities:		
Proceeds of borrowings	122,438	—
Repayment of long-term debt	(123,961)	(2,545)
Repayment of line of credit	—	(2,000)
Payment of financing costs	(876)	—
Contributions for purchases of property and equipment	701	532
Equity contribution	—	26,750
Transfers to affiliates, net	(9,807)	(10,927)
Net cash (used in) provided by financing activities	(11,505)	11,810
Net increase in cash and cash equivalents	3,518	4,240
Cash and cash equivalents, beginning of year	32,385	28,145
Cash and cash equivalents, end of year	$ 35,903	32,385
Supplemental information:		
Transfer of fixed assets from affiliate	$ 2,292	—
Capital additions accrued but not paid	1,056	—

See accompanying notes to combined financial statements.

(1) Summary of Significant Accounting Policies

(a) Organization

Harford Memorial Hospital, Inc. and Upper Chesapeake Medical Center, Inc. (collectively, the Hospitals or the Obligated Group) are nonprofit, nonstock membership corporations formed under the laws of the State of Maryland, organized for charitable purposes and recognized by the Internal Revenue Service (IRS) as tax-exempt organizations under Section 501(c)(3) of the Internal Revenue Code. UCHS/UMMS Venture, LLC (the Venture) is the sole member of the Hospitals. The Venture members are University of Maryland Medical System (UMMS) and Upper Chesapeake Health System, Inc. (UCHS). The Venture, a Maryland limited liability company, is organized to coordinate activities of healthcare facilities and other corporate bodies whose purposes include the provision of healthcare services or financial assistance to healthcare facilities in Harford County, Maryland. The Venture is also the member or sole shareholder of the common stock of each of the following entities:

Harford Memorial Hospital, Inc. (HMH)
Upper Chesapeake Medical Center, Inc. (UCMC)
Upper Chesapeake Medical Services, Inc. (UCMS)
Upper Chesapeake Properties, Inc. (UCP)
Upper Chesapeake Health Foundation, Inc. (UCHF)
Upper Chesapeake Health Ventures, Inc. (UCHV)
Upper Chesapeake Residential Hospice House, Inc. (UCRHH)
Hospice of Harford County, LLC (HHC)
UC Land Development, LLC (UCLD)

On October 1, 2009, the Venture and UMMS executed an Affiliation Agreement (the Agreement) and an Amended and Restated Operating Agreement, which increased UMMS' ownership in the Venture to 34% in exchange for cash, which is designated primarily for use for clinical projects. The Agreement requires profits for each calendar year to be allocated according to ownership percentage.

The Agreement required UMMS to purchase an additional 15% interest in the Venture, which occurred on October 1, 2010. Their total interest in the Venture is 49% as of December 31, 2011. The purchase of the additional 15% interest was in exchange for cash.

Under the terms of the Agreement, the Board of Directors consists of 17 seats, 15 controlled by UCHS and 2 controlled by UMMS.

The Agreement also provides that at some point in the future, UMMS may become the sole member of UCHS by contributing a stated amount of immediately available funds, which will be restricted for use related to capital expansion of health services for the residents of Harford County, Maryland and a final contribution of cash on or before December 31, 2018, which will also be restricted for use.

Under the Agreement, 4% cumulative distributions on the purchase price will be earned by UMMS, and will be payable within 120 days after the end of each fiscal year, commencing with the fiscal year ending December 31, 2017, if net cash is available for distribution as calculated under the Agreement. Such distributions will terminate at the time UMMS becomes the sole member of UCHS.

(b) Basis of Accounting

The combined financial statements are prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles (GAAP), and include the accounts of HMH and UCMC, which comprise the Obligated Group as defined in the Amended and Restated Master Loan Agreement described in note 7. In combination, all material intercompany balances and transactions have been eliminated.

(c) Cash and Cash Equivalents

Cash equivalents consist primarily of temporary investments with original maturities of three months or less.

(d) Assets Held by Trustee, Board-Designated, and Other Investments

The assets held by trustee, board-designated, and other investments are considered trading and are classified as current or noncurrent assets based on management's intention as to use. All debt and equity securities are reported at fair value principally based on quoted market prices on the combined balance sheets.

The Hospitals hold an investment which under GAAP is considered an alternative investment totaling $2,344 as of December 31, 2011, which invests primarily in debt securities of emerging markets. This asset was not held as of December 31, 2010. This fund utilizes various types of debt and equity securities along with derivative instruments in their investment strategy. Alternative investments are recorded under the equity method of accounting.

Assets limited as to use include assets held by the trustee under an indenture agreement. Board designated investments are set aside by the Board of Directors to fund future capital improvements. The board retains control of these assets and may at their discretion use such assets for other corporate purposes.

Investments are exposed to certain risks, such as interest rate, credit, and overall market volatility. Due to the level of risk associated with certain investment securities, changes in the value of investment securities could occur in the near term, and these changes could materially differ from the amounts reported in the accompanying combined financial statements.

Investment income including unrealized gains and losses, realized gains and losses on investment sales, and interest and dividends are recorded on the accrual basis and are reported as nonoperating gains or losses in the excess of revenues over expenses in the accompanying combined statements of

operations and changes in net assets unless the income or loss is restricted by the donor or law. Investment income and net gains that are restricted by the donor are recorded as a component of changes in temporarily or permanently restricted net assets, in accordance with donor-imposed restrictions. Realized gains and losses are determined based on the specific security's original purchase price.

(e) Derivative Instruments and Hedging Activities

The Hospitals account for derivatives and hedging activities in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 815, *Derivatives and Hedging*, which requires entities to recognize all derivative instruments as either assets or liabilities in the balance sheet at their respective fair values.

The Hospitals formally assess, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. Changes in the fair value of a derivative that is highly effective and that is designated and qualifies as a cash flow hedge are recorded in other changes in net assets to the extent that the derivative is effective as a hedge, until earnings are affected by the variability in cash flows of the designated hedged item. The ineffective portion of the change in fair value of a derivative instrument that qualifies as a cash flow hedge is reported in excess of revenues over expenses.

The Hospitals discontinue hedge accounting prospectively when it is determined that the derivative is no longer effective in offsetting changes in the fair value or cash flows of the hedged item, the derivative expires or is sold, terminated, exercised, or management determines that designation of the derivative as a hedging instrument is no longer appropriate.

In all situations in which hedge accounting is discontinued and the derivative is retained, the Hospitals continue to carry the derivative at its fair value on the balance sheet and recognize any subsequent changes in its fair value in excess of revenues over expenses.

(f) Patient Accounts Receivable

Patient accounts receivable are stated at estimated net realizable amounts from patients, third-party payors, and other insurers for services provided.

The Hospitals grant credit to patients, substantially all of whom are local residents. The Hospitals generally do not require collateral or other security in extending credit; however, they routinely obtain assignment of (or are otherwise entitled to receive) patients' benefits receivable under their health insurance programs, plans, or policies.

(Dollars in thousands)

(g) Inventories

Inventories consisting primarily of drugs and medical/surgical supplies are stated at lower of cost or market and are included in prepaid expenses and other current assets on the combined balance sheets. Cost is determined principally using the first-in, first-out method.

(h) Property, Plant, and Equipment

Property, plant, and equipment are recorded at cost or, if donated, at their fair market value on the date of receipt. Depreciation is taken on a straight-line basis over the estimated useful lives of the depreciable assets. The estimated useful lives of the assets are as follows:

Land improvements	3 – 20 years
Buildings	20 – 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 and are excluded from the excess of revenues over expenses, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

Gains and losses on disposal or sale of long-lived assets are recorded as a component of operating income in the combined statement of operations and changes in net assets.

The Hospitals' policy is to capitalize interest cost incurred on debt during the construction of major projects exceeding one year.

The Hospitals entered into an agreement during 2007 to lease space in Medical Office Building II (MOB II), which opened during 2008 and is on the campus of UCMC. A nonaffiliated entity developed, owns and operates the MOB II. The Hospitals determined that due to certain structural elements installed by the Hospitals during construction of the space being leased, the Hospitals are required to be treated, for accounting purposes, as the "owner" of the MOB II in accordance with FASB ASC Subtopic 840-40, *Leases – Sale-Leaseback Transactions.*

(i) Economic Interest in Net Assets of Foundation

The Hospitals account for the activities of the Upper Chesapeake Health Foundation (the Foundation) in accordance with ASC Topic 958 *Not-for-Profit Entities*. For fiscal year ending December 31, 2011 the Hospitals recognized an economic interest in the net assets of the Foundation, a financially interrelated organization, as these fundraising activities were designated for use by the Hospitals.

(j) Deferred Financing Costs

Deferred financing costs, which are classified as other assets, are being amortized on the effective-interest method over the term of the related debt or letters of credit, and are included in interest and amortization.

(k) Bond Discount

The bond discount, which is classified as a reduction of long-term debt, is being amortized on the effective-interest method over the term of the related debt and is included in interest and amortization.

(l) Malpractice Claims

Costs of malpractice claims, which are subject to deductible provisions of the Hospitals' insurance programs are accrued when incidents occur that give rise to the claims if it can be determined that a liability is probable and the amount can be reasonably estimated (note 9).

(m) Temporarily Restricted Net Assets and Donor-Restricted Gifts

Temporarily restricted net assets are those whose use by the Hospitals has been limited by donors to a specific time period or purpose. Unconditional promises to give cash and other assets to the Hospitals are reported at fair value at the date the promise is received. Donor-restricted gifts whose restrictions are met within the same year as received are reported as unrestricted gifts in the accompanying combined statements of operations and changes in net assets. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received.

(n) Net Patient Service Revenue

Patient service revenue of the Hospitals is recorded at rates established by the State of Maryland Health Services Cost Review Commission (HSCRC) and, accordingly, reflects actual charges to patients based on rates in effect during the period in which the services are rendered. The Hospitals have charge per case (CPC) agreements with the HSCRC, which are renewed annually. These CPC agreements establish a prospectively approved average charge per inpatient case (defined as hospital admissions plus births) and an estimated case mix index. These approved CPC targets are adjusted during the rate year for actual changes in case mix. The CPC agreements allow the Hospitals to adjust approved unit rates, within certain limits, to achieve the average CPC target for each rate year ending June 30.

Outpatient service revenue is recorded using a charge per visit (CPV) methodology for hospital based outpatient services, which is similar in nature to the CPC inpatient methodology discussed above. The CPV methodology establishes prospective per visit charges per outpatient visits for approximately 50% of outpatient services provided. The remaining outpatient services are charged using the established HSCRC unit rates. The HSCRC repealed its CPV methodology for hospital based outpatient services, effective July 1, 2011. For rate year 2012, revenue for outpatient services will be charged using the hospitals' approved HSCRC unit rates. The CPV methodology was in

(Continued)

place for rate year 2011 only, however, the 2011 CPV period resulted in one-time and permanent rate adjustments that were applied to 2012 hospital rates. The one-time CPV price adjustment applied to 2012 rates will be reversed on July l, 2012.

Contractual adjustments, which represent the difference between amounts billed as patient service revenue and amounts paid by third-party payors, are accrued in the period in which the related services are rendered.

(o) Charity Care

The Hospitals provide care to patients who meet certain criteria under their charity care policy without charge or at amounts less than their established rates. Because the facilities do not pursue the collection of amounts determined to qualify as charity care, those amounts are not reported as revenue.

(p) Nonoperating Income

Other activities that are largely unrelated to the Hospitals' primary mission are recorded as other nonoperating income, which includes investment income and change in the fair value and settlement payments on derivative instruments.

(q) Impairment of Long-Lived Assets

Management regularly evaluates whether events or changes in circumstances have occurred that could indicate impairment in the value of long-lived assets. If there is an indication that the carrying amount of an asset is not recoverable, the Hospitals estimate the projected undiscounted cash flows, excluding interest, to determine if an impairment loss should be recognized. The amount of impairment loss is determined by comparing the historical carrying value of the asset to its estimated fair value. Estimated fair value is determined through an evaluation of recent and projected financial performance using standard industry valuation techniques.

In addition to consideration of impairment upon the events or changes in circumstances described above, management regularly evaluates the remaining lives of its long-lived assets. If estimates are changed, the carrying value of affected assets is allocated over the remaining lives.

In estimating the future cash flows for determining whether an asset is impaired and if expected future cash flows used in measuring assets are impaired, the Hospitals group the assets at the lowest level for which there are identifiable cash flows independent of other groups of assets. If such assets are impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. Based on management's evaluation, no long-lived assets were identified as impaired for the years ended December 31, 2011 and 2010.

(r) Excess of Revenues over Expenses

The combined statements of operations and changes in net assets include excess of revenues over expenses. Changes in unrestricted net assets, which are excluded from excess of revenues over expenses, consistent with industry practice, include contributions of long-lived assets (including assets acquired using contributions, which by donor restriction were to be used for the purposes of acquiring such assets), equity contributions, changes in funded status of defined benefit plan, and transfers to or from affiliates.

(s) Use of Estimates

The preparation of the combined financial statements in conformity with GAAP 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 combined financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(t) Income Taxes

The Hospitals have been recognized by the IRS as tax-exempt pursuant to Section 501(c)(3) of the Internal Revenue Code.

The Hospitals account for tax provisions in accordance with FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, included in ASC Subtopic 740-10, *Income Taxes – Overall*, which clarifies the accounting for uncertainty in tax provisions. FIN 48 requires that the Hospitals recognize the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs.

(u) Employee Pension Plan

UCHS sponsors a defined benefit pension plan. The plan is actuarially evaluated and involves various assumptions, which are elements of expense and liability measurement. Key assumptions include the discount rate and the expected rate of return on plan assets, retirement, mortality, turnover, and healthcare costs trend rates. UCHS evaluates these assumptions annually and modifies them as appropriate. UCHS froze the defined benefit pension plan as of December 31, 2005.

The Hospitals account for the defined benefit pension plan in accordance with ASC Subtopic 715-20, *Compensation – Retirement Benefits – Defined Benefit Plans – General (ASC Topic 715)*, which requires the recognition of the overfunded or underfunded status of a defined benefit pension plan as an asset or liability in the balance sheet and to recognize any changes in that funded status through unrestricted net assets. Additionally, ASC Topic 715 requires the measurement date for plan assets and liabilities to coincide with the employer's year-end and to disclose in the notes to the combined financial statements additional information about certain effects on net periodic benefit cost for the

next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation.

(v) Fair Value Measurements

The Hospitals utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible. The Hospitals determine fair value based on assumptions that market participants would use in pricing an asset or liability in the principal or most advantageous market. When considering market participant assumptions in fair value measurements, the following fair value hierarchy distinguishes between observable and unobservable inputs, which are categorized in one of the following levels:

- Level 1 Inputs: Unadjusted quoted prices in active markets for identical assets or liabilities accessible to the reporting entity at the measurement date.
- Level 2 Inputs: Other than quoted prices included in Level 1 inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.
- Level 3 Inputs: Unobservable inputs for the asset or liability used to measure fair value to the extent that observable inputs are not available, thereby allowing for situation in which there is little, if any, market activity for the asset or liability at measurement date.

In January 2010, the FASB issued Accounting Standards Update (ASU) 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, which provides additional disclosures for transfers in and out of Levels 1 and 2 and for activity in Level 3. This ASU also clarifies certain other existing disclosure requirements including level of desegregation and disclosures around inputs and valuation techniques. The provisions of the ASU are effective for annual or interim reporting periods beginning after December 15, 2009, except for the requirement to provide the Level 3 activity for purchases, sales, issuances, and settlements on a gross basis, which are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. In the period of initial adoption, the reporting entity shall not be required to provide the disclosures required for any previous periods presented for comparative purposes. The Hospitals adopted the provisions of the ASU in 2010, except for the requirements to provide the Level 3 activity for purchases, sales, issuances and settlements on a gross basis, which were adopted in 2011. The adoption of ASU 2010-06 did not have a material effect on the Hospitals' combined financial statements. See note 13 to the combined financial statements.

(w) New Accounting Pronouncements

In August 2010, the FASB issued ASU No. 2010-23, *Health Care Entities (ASC Topic 954): Measuring Charity Care for Disclosure*. ASU 2010-23 is intended to reduce the diversity in practice regarding the measurement basis used in the disclosure of charity care. ASU 2010-23 requires that cost be used as the measurement basis for charity care disclosure purposes and that cost be identified

(Dollars in thousands)

as the direct and indirect cost of providing the charity care, and requires disclosure of the method used to identify or determine such costs. This ASU was effective for the Hospitals on January 1, 2011. The adoption did not impact the financial position or results of operations of the Hospitals. See note 11 for related disclosure information.

In August 2010, the FASB issued ASU 2010-24, *Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries*. The amendments in the ASU clarify that a healthcare entity may not net insurance recoveries against related claim liabilities. In addition, the amount of the claim liability must be determined without consideration of insurance recoveries. This ASU was effective for the Hospitals on January 1, 2011. The adoption of this guidance resulted in the Hospitals recording an additional accrual for medical malpractice claims liability and an insurance recoveries receivable of $11,428 on the balance sheet. Such amounts are included in Due from affiliates, Accrued salaries, benefits, and other, and other long-term liabilities. The Hospitals did not retroactively adopt the provisions of this ASU. The adoption of this guidance did not have any impact on the results of operations or cash flows of the Hospitals.

In July 2011, the FASB issued ASU 2011-07, *Health Care Entities (Topic 954), Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*, which requires a healthcare entity to change the presentation of their 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 allowance and discounts). Additionally, enhanced disclosures about an entity's policies for recognizing, assessing bad debts, as well as qualitative and quantitative information about changes in the allowance for doubtful accounts are required. The adoption of ASU 2011-07 is effective for the Hospitals beginning January 1, 2012.

(2) Assets Held by Trustee, Board Designated, and Other Investments

Assets held by trustee, board designated, and other investments include the following at December 31:

		2011	2010
Board-designated and other investments	$	82,641	95,890
Alternative investments		2,344	—
Funds held by the trustee		6,917	8,730
	$	91,902	104,620

(Continued)

(Dollars in thousands)

Board-designated and other investments carried at fair value or under the equity method of accounting in the case of alternative investments, consist of the following at December 31:

	2011		2010	
Cash and cash equivalents	$ 13,258	15%	$ 27,526	29%
Common/preferred stock and mutual funds	28,905	34	28,198	29
Mortgage-backed and asset-backed securities	13,506	16	15,125	16
Corporate bonds and U.S. government obligations	26,972	32	25,041	26
Alternative investments	2,344	3	—	—
	$ 84,985	100%	$ 95,890	100%

As described in note 7, funds held by the trustee as of December 31, 2011 and 2010 are limited as to use under the Amended and Restated Master Loan Agreement. Funds held by the trustee, which consist of cash and U.S. government agency obligations, are stated at fair value and include the following funds at December 31:

	2011	2010
Debt service funds	$ 2,848	2,934
Debt service reserve funds	4,069	5,796
Total funds held by the trustee	$ 6,917	8,730

The debt service fund has been established to secure the payment of principal and interest due on the Series 2008C Revenue Bonds (note 7). The debt service reserve fund has been established to provide for future deficiencies, if any, in various bond repayment terms established by the Amended and Restated Master Loan Agreement. If the balance in the debt service reserve funds falls below the minimum requirement as a result of investment losses or withdrawals relating to deficiencies in other specified funds, the Hospitals will be required to make equal monthly payments to the trustee to restore the amount on deposit therein to the minimum required amount within a 24-month period. No requirement to make such payments existed at December 31, 2011 or 2010.

(Continued)

(Dollars in thousands)

Investment income related to unrestricted investments is comprised of the following for the years ended December 31:

		2011	2010
Interest and dividends	$	794	751
Gain (loss) on sale of investments and board-designated investments, net		3,377	(131)
Unrealized gain (loss) on investments and board-designated investments, net		(4,234)	4,661
Unrealized gain (loss) on trustee-held funds		82	(66)
Total investment return	$	19	5,215

(3) Patient Accounts Receivable

The Hospitals had receivables from third-party payors and others, net of contractual allowances, as follows at December 31:

		2011	2010
Medicare	$	14,319	10,459
Medicaid		4,071	2,192
Commercial insurance and HMOs		23,222	16,456
Blue Cross		5,761	5,177
Self-pay and others		8,811	8,091
		56,184	42,375
Less allowance for estimated uncollectibles		17,806	11,381
Patient accounts receivable, net	$	38,378	30,994

Patient service revenue, by payor class, consisted of the following for the years ended December 31:

	2011	2010
Medicare	41%	40%
Medicaid	2	2
Commercial insurance and HMOs	37	35
Blue Cross	15	15
Self-pay and others	5	8
	100%	100%

(Continued)

(Dollars in thousands)

(4) Property, Plant, and Equipment

Property, plant, and equipment are summarized as follows at December 31:

	2011	2010
Land	$ 17,767	16,217
Land improvements	4,687	1,598
Buildings	181,863	178,376
Equipment	125,373	111,910
Leasehold improvements	1,935	1,591
	331,625	309,692
Less accumulated depreciation	147,191	134,027
	184,434	175,665
Construction in process	7,392	6,132
	$ 191,826	181,797

Depreciation expense for the years ended December 31, 2011 and 2010 was $12,929 and $11,848, respectively.

(5) Other Assets

Other assets consist of the following at December 31:

	2011	2010
Deferred financing costs, net	$ 1,259	690
Bed licenses acquired	277	385
Other intangible assets	105	157
	$ 1,641	1,232

As of December 31, 2010, costs incurred with the issuance of the Series 2008C bonds, approximately $690 net of amortization, were deferred and are being amortized over the term of the related debt or letters of credit. During 2011, in connection with the refinancing discussed in note 9, $133 was written off. New financing costs of $876 were incurred relating to Series 2011 A, B and C. Further, the Hospitals incurred amortization expense of $174 and $245 for the years ended December 31, 2011 and 2010, respectively, and is included in the interest and amortization line item on the combined statement of operations and changes in net assets.

Bed licenses acquired associated with the purchase of Fallston General Hospital (FGH) in the amount of $2,999 was capitalized and is being amortized over their estimated useful life of 28 years. These bed

(Dollars in thousands)

licenses were transferred to UCMC when FGH closed in 2000. Accumulated amortization amounted to $2,722 and $2,614 at December 31, 2011 and 2010, respectively, and is included in the depreciation and amortization line item on the combined statements of operations and changes in net assets.

Other intangible assets associated with the acquisition of Surgery Pavilion in the amount of $520 were recorded and are being amortized over their estimated useful life of 10 years. Accumulated amortization amounted to $415 and $363 at December 31, 2011 and 2010, respectively, and is included in depreciation and amortization on the combined statements of operations and changes in net assets.

(6) Line of Credit

The Hospitals had an unsecured discretionary line of credit agreement with a bank that permitted the Hospitals to borrow up to $7,000 at LIBOR plus 125 basis points, which expires in May 2012. There was no outstanding balance at December 31, 2011 and 2010.

(7) Long-Term Debt

Long-term debt consists of the following at December 31:

	2011	2010
Hospital revenue bonds:		
Series 2008 A (due January 1, 2043)	$ —	62,705
Series 2008 B (due January 1, 2043)	—	58,985
Series 2008 C (due January 1, 2038)	53,365	54,210
Series 2011A (due January 1, 2043)	2,558	—
Series 2011B (due January 1, 2040)	59,225	—
Series 2011C (due January 1, 2040)	59,225	—
	174,373	175,900
Less bond discount	580	620
	173,793	175,280
Less current portion	895	13,013
	$ 172,898	162,267

The Series 2008C bonds are fixed rate term bonds obtained pursuant to the Amended and Restated Master Loan Agreement dated August 1, 2008 (the Master Loan Agreement) through the Maryland Health and Higher Educational Facilities Authority (the Authority or MHHEFA), which bear interest at 5.5% at December 31, 2011 and 2010. The Series 2008C Bonds were issued at a discount of $706. Accumulated amortization amounted to $126 and $86 at December 31, 2011 and 2010, respectively. The loan principal is payable annually on January 1 and the loan interest is payable to a trustee semiannually.

(Continued)

(Dollars in thousands)

The Series 2008C bonds are subject to mandatory annual sinking fund requirements. The 2012 sinking fund installment amount is $895. Sinking fund payments vary in increasing amounts from $805 to $3,750, with the final installment of $3,750 due in 2038.

On October 1, 2011, the Obligated Group entered into a Financing Agreement with MHHEFA and a lender for up to $50,000 of tax exempt Revenue Bonds, Series 2011A. The bonds are designated to support a capital project on the campus of UCMC, and bond proceeds are drawn upon as construction progresses. There was $2,558 drawn on the Series 2011A bonds as of December 31, 2011. The Series 2011A bonds bear interest at 3.67% through October 31, 2021, and thereafter at LIBOR plus an applicable spread which is based on prevailing bond rates for similarly rated bonds. Principal payments on the Series 2011A bonds are due in annual installments on January 1 ranging from $935 in 2014 to $2,695 in 2043.

On December 1, 2011, MHHEFA issued $59,225 of tax exempt Revenue Bonds, Series 2011B on behalf of the Obligated Group. Bond proceeds were loaned to the Obligated Group pursuant to a First Supplemental Indenture of Trust and Supplemental Loan Agreement. The Series 2011B bonds bear interest at 1.3655% through December 31, 2011, and at LIBOR plus 1.15% thereafter, subject to prevailing rates on bond spreads. The bond proceeds were used to refund the Series 2008B and a portion of the Series 2008A. Principal payments on the Series 2011B bonds are due in monthly installments ranging from $80 in 2012 to $430 in 2040. The Series 2011B bonds are subject to refinancing at the option of the bank in 2021.

On December 1, 2011, MHHEFA issued $59,225 of tax exempt Revenue Bonds, Series 2011C on behalf of the Obligated Group. Bond proceeds were loaned to the Obligated Group pursuant to a First Supplemental Indenture of Trust and Supplemental Loan Agreement. The Series 2011C bonds bear interest at 1.159% through December 31, 2011, and at LIBOR plus 0.95% thereafter, subject to prevailing rates on bond spreads. The bond proceeds were used to refund the Series 2008A. Principal payments on the Series 2011C bonds are due in monthly installments ranging from $80 in 2012 to $405 in 2040. The Series 2011C bonds are subject to refinancing at the option of the bank in 2017.

Annual principal maturities of long-term liabilities including sinking fund payments at December 31, 2011 are as follows:

2012	$	4,176
2013		9,808
2014		11,758
2015		12,027
2016		12,043
Thereafter		124,561
	$	174,373

The Hospitals are jointly and severally liable under the Master Loan Agreement. Pursuant to the Master Loan Agreement, the Hospitals are required to maintain certain funds on deposit with the trustee as

described in note 2. As security for the performance of its obligations under the Master Loan Agreement, the Obligated Group has granted the Authority a security interest in its revenues.

The Obligated Group is also subject to certain qualitative and quantitative financial covenants as defined in the Master Loan Agreement and in the First Supplemental Indenture of Trust and Supplemental Loan Agreements, as long as the bonds are outstanding. The Obligated Group is in compliance with the debt covenants as of December 31, 2011.

Interest payments were $4,821 and $4,923 for the years ended December 31, 2011 and 2010, respectively.

Total cost of capital for the years ended December 31, 2011 and 2010 was 5.3% and 5.4%, respectively.

The Hospitals use interest rate swaps as a part of its risk management strategy to manage exposure to fluctuations in interest rates and to manage the overall cost of its debt. The interest rate swaps are not used for speculative purposes and are measured at fair value in the combined balance sheet. The fair value of the interest rate swap agreements is the estimated amount that the Hospitals would receive or pay to terminate the swap agreements at the reporting date, taking into account current interest rates and the current creditworthiness of the swap counterparties. The swap agreements are valued based on readily observable market parameters for all substantial terms of the contracts and are therefore categorized as Level 2 securities. The fair market value of the swap agreements is included in other long-term liabilities and other in the accompanying combined balance sheet.

A derivative instrument (interest rate swap) was entered into in conjunction with the 2007 Series Bond issuance, with a notional amount of $118,325 at December 31, 2011 at a fixed rate of 3.915% and a floating rate of 67% of one-month LIBOR. The purpose of the swap is to convert variable rate debt to fixed rate debt. The unrealized loss of $(10,265) and $(4,772) is included in nonoperating income for the years ended December 31, 2011 and 2010, respectively. The fair value of the interest rate swap was approximately $(31,299) and $(21,034) at December 31, 2011 and 2010, respectively, and is included in other long-term liabilities.

A derivative instrument (basis swap) was entered into in 2006 with a notional amount of $93,050 at December 31, 2011. The unrealized gain (loss) of $2,114 and $(2,825) is included in nonoperating income for the years ended December 31, 2011 and 2010, respectively. The fair value of the basis swap was approximately $(1,097) and $(3,211) at December 31, 2011 and 2010, respectively, and is included in other long-term liabilities.

Settlement payments for the years ended December 31, 2011 and 2010 of $(4,023) and $(4,169), respectively, are included in the change in the fair value and settlement payments on derivative instruments.

(Continued)

(Dollars in thousands)

(8) Employee Benefit Plans

Defined Contribution Plan

UCHS sponsors a defined contribution benefit plan, which allows employees to contribute amounts tax-deferred up to certain limits allowable under IRS guidelines. The Hospitals are required to match up to 100% of employee contributions up to 4% of employee salaries, based on years of service. The Hospitals are also required to make a contribution of 1% of each employee's salary for all employees who work more than 1,000 hours annually. Additional contributions are required to be made by the Hospitals for employees aged 50 and older, who have completed 10 years of service. Employees vest in amounts contributed by the Hospitals ratably over a five-year period.

For the years ended December 31, 2011 and 2010, the Hospitals' expenses related to the defined contribution plan were approximately $3,301 and $2,620, respectively, and are included in the employee benefits line item on the combined statements of operations and changes in net assets located on page 3.

Defined Benefit Plan

The Hospitals participate in a noncontributory defined benefit pension plan (the Plan), administered by UCHS, which covers substantially all employees of HMH, UCMC, UCHF, UCHS and UCSJHC who have completed six months of employment and attained the age of twenty and a half years. UCHS and certain of its subsidiaries make annual contributions to the Plan equal to the minimum funding requirement pursuant to ERISA regulations. UCHS is the plan sponsor and elected to freeze the defined benefit plan on December 31, 2005.

The following tables set forth the changes in the projected benefit obligation, the changes in Plan assets, the Plan's funded status, and amounts recognized in the combined financial statements at December 31:

		2011	2010
Projected benefit obligation, at beginning of year	$	55,567	52,000
Actual benefit payments		(1,774)	(1,554)
Loss due to differences between actual and assumed experience		6,041	1,853
Interest cost		3,298	3,268
Projected benefit obligation, at end of year		63,132	55,567
Fair value of plan assets, at beginning of year		51,725	42,999
Contributions		4,485	4,425
Actual benefit payments		(1,774)	(1,554)
Return on plan assets		(1,504)	5,855
Fair value of plan assets, at end of year		52,932	51,725
Funded status	$	(10,200)	(3,842)

(Continued)

(Dollars in thousands)

		2011	2010
Amounts recognized in unrestricted net assets:			
Net actuarial loss	$	(30,986)	(21,222)
Prior service cost		(32)	(40)
Accumulated amount in net assets	$	(31,018)	(21,262)

The estimated amounts that will be amortized from unrestricted net assets into net periodic pension cost in fiscal year ending December 31, 2012 are as follows:

Net actuarial loss	$	3,525
Prior service cost		8
	$	3,533

		2011	2010
Components of net periodic pension costs:			
Interest cost	$	3,298	3,268
Expected return on plan assets		(4,457)	(3,569)
Loss		2,238	2,351
Net amortization and deferral		8	8
Net periodic pension cost	$	1,087	2,058

Assumptions used to determine benefit obligations as of December 31, 2011 and 2010 were as follows: discount rate of 5.27% and 6.05% in 2011 and 2010, respectively, and expected long-term rate of return on assets of 8.5% in 2011 and 2010. Salary increases are not applicable to 2011 and 2010 because the Plan was frozen on December 31, 2005.

Assumptions used to determine net costs for 2011 and 2010 were as follows: discount rate of 6.05% and 6.41% in 2011 and 2010, respectively, and expected long-term rate of return on assets of 8.5% in 2011 and 2010.

The overall long-term rate of return was developed by estimating the expected long-term real return for each asset class within the portfolio, computing an average weighted real rate of return for the portfolio as a whole, reflecting both the Plan's expected asset class allocation and the correlations between the various asset classes and adding that expected real rate of return to the expected long-term rate of inflation. The expected long-term rate of return reflects an expected real rate of return and an underlying inflation component per year.

(Dollars in thousands)

The investment objective of the Plan is to produce a rate of return as determined by the Plan actuary. The Plan is diversified into equities, fixed income obligations, and cash and cash equivalents, so as to provide a reasonable assurance that no single security or class of securities will have a disproportionate impact on the Plan's rate of return. Equity securities are targeted at 55% with a range from 40% to 70%. Fixed income obligations and cash equivalents are targeted at 30% with a range from 10% to 50%. Periodic rebalancing takes place to maintain the desired allocation. Management may change these allocations at its discretion, although such changes are likely to occur infrequently.

The Plan's asset allocation at December 31, by asset category, is as follows:

	2011	2010
Asset category:		
Cash and equivalents	7%	10%
Common/preferred stock and mutual funds	52	70
Government bonds	30	6
Corporate bonds	11	9
Mortgage-backed securities	—	5
Total	100%	100%

The following tables present the Plan's assets measured at fair value at December 31, 2011 and 2010:

	2011			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash and cash equivalents	$ 3,975	—	—	3,975
Common/preferred stock	17,558	—	—	17,558
Equity mutual funds and exchange traded funds	9,839	—	—	9,839
U.S. agency mortgage-backed and asset-backed securities	4,074	—	—	4,074
Corporate bonds	15,693	—	—	15,693
U.S. government obligations	1,237	—	—	1,237
Municipal bonds	556	—	—	556
Total assets	$ 52,932	—	—	52,932

(Continued)

(Dollars in thousands)

	2010			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets:				
Cash and cash equivalents	$ 5,365	—	—	5,365
Common/preferred stock	22,983	—	—	22,983
Equity mutual funds and exchange traded funds	13,320	—	—	13,320
U.S. agency mortgage-backed and asset-backed securities	2,262	—	—	2,262
Corporate bonds	4,619	—	—	4,619
U.S. government obligations	2,994	—	—	2,994
Municipal bonds	182	—	—	182
Total assets	$ 51,725	—	—	51,725

Equity and debt securities and fixed income obligations are measured using quoted market prices at the reporting date multiplied by the quantity held. Mortgage and asset-backed securities are measured using quoted market prices at the reporting date multiplied by the quantity held.

The Hospitals expect to contribute $4,000 to the Plan in 2012.

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

	Expected benefit payments
Fiscal years:	
2012	$ 2,339
2013	2,560
2014	2,754
2015	3,008
2016	3,248
2017 – 2021	18,928

(Continued)

(9) Certain Significant Risks and Uncertainties

(a) Regulation and Reimbursement

The Hospitals provide general acute healthcare services. The Hospitals and other healthcare providers in Maryland are subject to certain inherent risks, including the following:

- Dependence on revenues derived from reimbursement by the federal Medicare and state Medicaid programs
- Regulation of hospital rates by the HSCRC
- Government regulation, government budgetary constraints, and proposed legislative and regulatory changes
- Lawsuits alleging malpractice and related claims

Such inherent risks require the use of certain management estimates in the preparation of the Hospitals' combined financial statements and it is reasonably possible that a change in such estimates may occur.

The Medicare and state Medicaid reimbursement programs represent a substantial portion of the Hospitals' revenues and the Hospitals' operations are subject to a variety of other federal, state, and local regulatory requirements. Failure to maintain required regulatory approvals and licenses and/or changes in such regulatory requirements could have a significant adverse effect on the Hospitals. Changes in federal and state reimbursement funding mechanisms and related government budgetary constraints could have a significant adverse effect on the Hospitals.

The healthcare industry is also subject to numerous laws and regulations from federal, state and local governments, and the government has aggressively increased enforcement of Medicare and Medicaid anti-fraud and abuse laws. The Hospitals' compliance with these laws and regulations is subject to periodic governmental review, which could result in enforcement actions unknown or unasserted at this time. Management is aware of certain asserted and unasserted legal claims by the government, and is presently unable to determine the outcome of these claims.

The federal government and many states have aggressively increased enforcement under Medicare and Medicaid anti-fraud and abuse laws and physician self referral laws (STARK law and regulation). Recent federal initiatives have prompted a national review of federally funded healthcare programs. In addition, the federal government and many states have implemented programs to audit and recover potential overpayments to providers from the Medicare and Medicaid programs. In 2010, the Hospitals were notified that the recovery audit contractors (RAC) would begin auditing company operations in 2011 and the Hospitals received their first request for records in June 2011. The Hospitals continue to receive these requests from the RAC and has implemented a response program as well as a compliance program to monitor conformance with applicable laws and regulations, but the possibility of future government review and enforcement action exists.

As a result of recently enacted and pending federal healthcare reform legislation, substantial changes are anticipated in the United States healthcare system. Such legislation includes numerous provisions affecting the delivery of healthcare services, the financing of healthcare costs, reimbursement to healthcare providers and the legal obligations of health insurers, providers and employers. These provisions are currently slated to take effect at specified times over the next decade. This federal healthcare reform legislation did not affect the 2011 or 2010 combined financial statements.

(b) Malpractice

Claims alleging malpractice have been asserted against the Hospitals and are currently in various stages of litigation. Additional claims may be asserted arising from services provided to patients through December 31, 2011.

On October 1, 2005, the Hospitals entered into an insurance agreement whereby the malpractice claims are being administered through a captive insurance company (Upper Chesapeake Insurance Company LTD or the Captive) domiciled in the Cayman Islands, which is wholly owned by UCHS. The Captive is managed by HSBC, a management company based in the Cayman Islands, using information provided by their claims administrator, SISCO and actuarial information provided by Towers Watson. The Hospitals incurred premiums for claims-made insurance policies of $3,379 and $3,149 for the years ended December 31, 2011 and 2010, respectively. Retention limits on which the Captive assumes the risk of loss was based on an annual occurrence basis of $1,000 per occurrence and $3,000 in the aggregate through September 30, 2011, and thereafter, is based on an annual occurrence basis of $1,000 per occurrence and $6,000 in the aggregate.

In addition, the Hospitals have accrued $2,505 and $2,180 at December 31, 2011 and 2010, respectively, recorded in accrued salaries, benefits, and other in the accompanying combined balance sheets, for claims that are incurred but not reported.

In the opinion of management, based upon information provided by its advisors, estimated malpractice costs accrued at December 31, 2011 and 2010 are adequate to provide for potential losses resulting from pending or threatened litigation or for losses incurred but not reported claims.

(c) Welfare Benefit Plan

The Hospitals participate in a welfare benefit plan established by UCHS effective January 1, 1998. The purpose of this plan is to provide eligible employees and their dependents with coverage for hospital and medical expenses on a self-insured basis, subject to risk retention limits, and to provide dental and vision benefits pursuant to specified insurance policies and contracts. An estimate for incurred-but-not-reported health insurance claims of $1,403 and $1,347 has been accrued and recorded in accrued salaries, benefits, and other in the accompanying combined balance sheets at December 31, 2011 and 2010, respectively.

(Dollars in thousands)

(d) Workers' Compensation

The Hospitals participate in a self-insured plan for workers' compensation claims. Stop-loss coverage has been purchased through a commercial insurer for claims in excess of $400. Accrued claims of $3,046 and $2,634 include estimates for incidents incurred but not reported and are included in accrued salaries, benefits, and other in the accompanying combined balance sheets at December 31, 2011 and 2010, respectively. The Hospitals maintain a surety bond in the amount of $4,200 and a letter of credit in the amount of $1,680 to secure payments on the outstanding workers' compensation claims as required by the State of Maryland Workers' Compensation Commission.

(e) Unemployment

The Hospitals maintain a letter of credit in the amount of $1,328 for the purpose of securing unemployment benefit payments as required by the State of Maryland.

(f) Litigation

From time to time, the Hospitals are 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 material adverse effect on the Hospitals' future financial position or results of operations.

(g) Asset Retirement Obligation

The Hospitals have recorded an Asset Retirement Obligation (ARO) for asbestos removal. The liability is recognized at its net present value with a corresponding increase to the carrying amount of the long-lived asset to which the ARO relates. The estimated asbestos removal costs are $1,303 and $1,347 as of December 31, 2011 and 2010, respectively, and are included in other long-term liabilities. During 2011, there were payments made of $61 related to asbestos removal, along with annual accretion of $17.

(10) Leases

UCMC, as lessor, expects to receive minimum rents from tenants under operating leases as follows:

2012	$	820
2013		628
2014		614
2015		538
2016 and thereafter		519
	$	3,119

(Continued)

(Dollars in thousands)

The Hospitals have several operating lease agreements for office space, computer and medical equipment, office machines and vehicles. Total rent expense recorded by the Hospitals under these leases was approximately $4,619 and $4,490 for the years ended December 31, 2011 and 2010, respectively.

Future rental payments under noncancelable operating leases with durations in excess of one year are as follows:

2012	$	3,901
2013		2,681
2014		1,395
2015		479
2016		55
	$	8,511

(11) Charity Care and Other Deductions from Revenue

The Hospitals provide care to patients regardless of their ability to pay. In identifying charity care, the Hospitals assess the patient's ability to pay, utilizing generally recognized poverty income levels for the community, and identify certain cases where incurred charges are considered to be beyond the patient's ability to pay. The Hospitals maintain records to identify and monitor the level of charity care they provide. These records reflect the amount of charges forgone under their charity care policy and amounted to approximately $7,214 and $3,855 for the years ended December 31, 2011 and 2010, respectively. The total direct and indirect costs to provide the care amounted to approximately $5,331 and $2,951 for the years ended December 31, 2011 and 2010, respectively.

In addition to the direct charity care noted above, all patients covered by the Medicare and Medicaid and other third-party payors programs are accepted. These programs reimburse the Hospitals at less than the established charges for services provided to recipients. During 2011, the state instituted a charge based on the amount of revenue covered by hospitals for Medicaid Services rendered (Medicaid Assessment). The difference between the charges for these services and the related reimbursement amounts for these and other third-party payors are as follows for the years ended December 31:

		2011	2010
Medicare	$	20,806	13,901
Medicaid		606	530
Medicaid assessment		—	2,620
Other third-party payors		4,711	4,399
	$	26,123	21,450

(Continued)

The Hospitals also provide free services to the community through their "Healthlink" program. The "Healthlink" program provides health information, wellness programs, health screenings, and educational programs.

(12) Related-Party Transactions

UCHS provides management, promotion, and other support services to the Hospitals. Fees relating to such services are allocated to these entities based on management's estimate of UCHS resources consumed at each entity. Such services were allocated 88.5% and 89.5% to the Hospitals in 2011 and 2010, respectively. Fees to UCHS included in other operating expenses were $10,823 and $9,902 in 2011 and 2010, respectively.

UCMS provides physician and other support services to the Hospitals. Fees to UCMS included in operating expenses were $3,535 and $3,124 for the years ended December 31, 2011 and 2010, respectively. The Obligated Group transferred $10,024 and $8,349 during 2011 and 2010, respectively, to UCMS, representing an equity contribution. The Hospitals have entered into an agreement with a bank whereby the Hospitals are the guarantor for an unsecured discretionary line of credit agreement between the bank and UCMS. The line of credit agreement permits UCMS to borrow up to $3,500. The amount outstanding under this agreement was $1,200 as of December 31, 2011 and 2010, respectively.

UCHF contributed $701 and $532 to the Hospitals for capital improvements and equipment purchases for the years ended December 31, 2011 and 2010, respectively. These amounts are presented as contributions for purchases of property and equipment in the combined financial statements. UCHF contributed $12 and $14 to the Hospitals for operations for the years ended December 31, 2011 and 2010, respectively.

The Obligated Group transferred $3,104 during 2010 to UCP representing an equity contribution. On December 31, 2011, UCP contributed property with a book value of $2,292, which supports the provision of healthcare services at HMH to the Obligated Group.

As a result of the sale of UCSJHC assets, the Venture received a cash distribution from its joint venture, UCSJHC, and then contributed $217 to the Obligated Group.

On July 14, 2010, UCHS and UMMS executed a shareholder operating agreement and declaration of trust (the Trust Agreement) to form the UCHS/UMMS Real Estate Trust. On July 16, 2010, the UCHS/UMMS Real Estate Trust purchased the Barker Property in Havre de Grace, Maryland for approximately $16,500. The Hospitals transferred $3,109 to UCHS for the purchase of the land utilizing proceeds from the UMMS equity contribution.

The Obligated Group recognizes its rights to assets held by recipient organizations, which accept cash or other financial assets from a donor and agree to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both, to the Obligated Group. In 2011 UCF embarked on the campaign for the Cancer Center at Upper Chesapeake Health. The contributions will be used for the benefit of the Cancer Center which will be on the campus of UCMC. As such, the Obligated Group recorded an economic interest in the net assets of UCF of $7,007. The donor restricted gifts are included as an increase in temporarily restricted net assets in the combined statement of operations and changes in net assets.

(Continued)

(Dollars in thousands)

As discussed in notes 1(v) and 9(b), the Hospitals recorded an additional accrual for medical malpractice claims which resulted in an additional liability and related intercompany receivable of $11,428 as of December 31, 2011.

Net amounts receivable from (payable to) affiliates at December 31 are summarized as follows:

	2011	2010
UCHS and subsidiary	$ 3,951	6,283
UCLD	3,341	—
UCMS	6,465	3,016
Captive	11,684	(20)
UCRHH	366	375
UCP	64	—
UCHV	339	(17)
UCF	1,549	—
	$ 27,759	9,637

(13) Fair Value Measurements

(a) Fair Value of Financial Instruments

The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Those fair value measurements maximize the use of observable inputs. However, in situations where there is little, if any, market activity for the asset or liability at the measurement date, the fair value measurement reflects the Hospitals own judgments about the assumptions that market participants would use in pricing the asset or liability. Those judgments are developed by the Hospitals based on the best information available in the circumstances.

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

Cash and cash equivalents, accounts receivable, due from affiliates, other assets, accounts payable, advances from third-party payors, due to affiliates, and accrued expenses: The carrying amounts, at face value or cost plus accrued interest, approximate fair value because of the short maturity of these instruments.

Board-designated and other investments: Equity and debt securities classified as trading and fixed income obligations are measured using quoted market prices at the reporting date multiplied by the quantity held. Mortgage and asset-backed securities are measured using quoted market prices at the reporting date multiplied by the quantity held.

(Dollars in thousands)

Derivative instruments: The fair value of derivative instruments is determined using pricing models developed based on the LIBOR swap rate and other observable market data. The value was determined after considering the potential impact of collateralization and netting agreements, adjusted to reflect nonperformance risk of both the counterparty and the Obligated Group.

(b) Long-Term Debt

The Series 2008C and Series 2011A, B and C bonds bear interest at variable rate and fixed rates and, at December 31, 2011, had a fair value of $178,676. The fair value of the outstanding debt at December 31, 2010 was $177,151.

The fair value of the Hospitals' long-term debt is measured using quoted offered-side prices when quoted market prices are available. If quoted market prices are not available, the fair value is determined by discounting the future cash flows of each instrument at rates that reflect, among other things, market interest rates and the Hospitals' credit standing. In determining an appropriate spread to reflect its credit standing, the Hospitals consider credit default swap spreads, bond yields of other long-term debt offered by the Hospitals, and interest rates currently offered to the Hospitals for similar debt instruments of comparable maturities by the Hospitals' bankers as well as other banks that regularly compete to provide financing to the Hospitals.

(c) Fair Value Hierarchy

The following tables present assets and liabilities that are measured at fair value on a recurring basis at December 31, 2011 and 2010:

	2011			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets:				
Cash and cash equivalents	$ 13,258	—	—	13,258
Common/preferred stock	14,495	—	—	14,495
Equity mutual funds and exchange traded funds	14,410	—	—	14,410
U.S. agency mortgage-backed and asset-backed securities	13,506	—	—	13,506
Corporate bonds	22,243	1,203	—	23,446
U.S. government obligations	9,807	—	—	9,807
Municipal bonds	636	—	—	636
Total assets	$ 88,355	1,203	—	89,558
Liabilities:				
Derivative instruments	$ —	32,396	—	32,396

(Continued)

(Dollars in thousands)

	2010			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets:				
Cash and cash equivalents	$ 27,526	—	—	27,526
Common/preferred stock	17,930	—	—	17,930
Equity mutual funds and exchange traded funds	10,268	—	—	10,268
U.S. agency mortgage-backed and asset-backed securities	15,125	—	—	15,125
Corporate bonds	20,787	—	—	20,787
U.S. government obligations	12,808	—	—	12,808
Municipal bonds	176	—	—	176
Total assets	$ 104,620	—	—	104,620
Liabilities:				
Derivative instruments	$ —	24,245	—	24,245

The Hospitals' accounting policy is to recognize transfers between levels of the fair value hierarchy on the date of the event or change in circumstances that caused the transfer. There were no significant transfers into or out of Level 1 for the year ended December 31, 2011.

(14) Medical Office Building II

As discussed in note 1, the Hospitals are required to be treated as the "owner" of MOB II. The asset and financing obligation will be reflected on the Hospitals' combined balance sheets until completion of the lease term, when they will be removed from the Hospitals' combined financial statements. At such time, the net of the remaining obligation and carrying value of the asset will be recognized as a gain on disposal. At December 31, 2011, the recorded amount for the asset is $11,479 and the related liability is $11,960, which are included in buildings and other long-term liabilities, respectively.

(Continued)

(Dollars in thousands)

The future minimum payments under the financing obligation for the initial lease term (10 years) are as follows:

2012	$	913
2013		941
2014		969
2015		998
2016		1,028
Thereafter		1,779
Total future minimum financing obligation payments		6,628
Less interest		4,071
Present value of future minimum financing obligation payments	$	10,699

(15) Functional Expenses

The Hospitals provide general healthcare services to residents within their geographic locations. Expenses related to providing these services, based on management's estimates of expense allocations, are as follows for the years ended December 31:

		2011	2010
Healthcare services	$	252,627	237,587
General and administrative		49,626	45,384
	$	302,253	282,971

(16) Subsequent Events

The Hospitals evaluated all events and transactions that occurred after December 31, 2011 and through April 26, 2012. The Hospitals did not have any material recognizable subsequent events during this period.

Schedule 1

HARFORD MEMORIAL HOSPITAL, INC. AND UPPER CHESAPEAKE MEDICAL CENTER, INC.

Combining Balance Sheet Information

December 31, 2011

(In thousands)

Assets	Upper Chesapeake Medical Center, Inc.	Harford Memorial Hospital, Inc.	Eliminations	Combined
Current assets:				
Cash and cash equivalents	$ 18,019	17,884	—	35,903
Current portion of assets held by trustee	2,392	456	—	2,848
Board-designated and other investments	41,081	43,904	—	84,985
Patient accounts receivable, net	26,207	12,171	—	38,378
Prepaid expenses and other current assets	6,950	4,198	—	11,148
Total current assets	94,649	78,613	—	173,262
Due from affiliates	58,890	3,428	(34,559) (a)	27,759
Assets held by trustee, less current portion	3,419	650	—	4,069
Property, plant, and equipment, net	155,786	36,040	—	191,826
Economic interest in net assets of foundation	7,007	—	—	7,007
Other assets	1,511	130	—	1,641
Total assets	$ 321,262	118,861	(34,559)	405,564
Liabilities and Net Assets				
Current liabilities:				
Accounts payable	$ 6,563	14,819	—	21,382
Accrued salaries, benefits and other	18,011	7,983	—	25,994
Current portion of long-term debt	751	144	—	895
Advances from third-party payors	5,065	1,768	—	6,833
Total current liabilities	30,390	24,714	—	55,104
Due to affiliates	—	34,559	(34,559) (a)	—
Long-term debt, less current portion	145,644	27,254	—	172,898
Other long-term liabilities	51,356	4,303	—	55,659
Pension liability	7,140	3,060	—	10,200
Total liabilities	234,530	93,890	(34,559)	293,861
Unrestricted net assets	79,725	24,971	—	104,696
Temporarily restricted net assets	7,007	—	—	7,007
Total net assets	86,732	24,971	—	111,703
Total liabilities and net assets	$ 321,262	118,861	(34,559)	405,564

Combining eliminations:

(a) Eliminate intercompany receivables and payables.

See accompanying independent auditors' report.

Schedule 2

HARFORD MEMORIAL HOSPITAL, INC. AND
UPPER CHESAPEAKE MEDICAL CENTER, INC.

Combining Statement of Operations Information

Year ended December 31, 2011

(In thousands)

	Upper Chesapeake Medical Center, Inc.	Harford Memorial Hospital, Inc.	Combined
Operating activities:			
Unrestricted revenues, gains, and other support:			
Net patient service revenue	$ 229,798	89,753	319,551
Other	3,739	1,580	5,319
Total unrestricted revenues, gains, and other support	233,537	91,333	324,870
Expenses:			
Salaries	77,300	35,955	113,255
Employee benefits	17,808	8,530	26,338
Provision for bad debts	13,890	9,234	23,124
Supplies and other operating expenses	89,938	30,904	120,842
Depreciation and amortization	9,544	3,526	13,070
Interest and amortization	4,164	1,460	5,624
Total expenses	212,644	89,609	302,253
Operating income	20,893	1,724	22,617
Nonoperating income:			
Investment income	619	(600)	19
Change in the fair value and settlement payments on derivative instruments	(12,174)	—	(12,174)
Other	(220)	(21)	(241)
Nonoperating loss	(11,775)	(621)	(12,396)
Excess of revenues over expenses	9,118	1,103	10,221
Other changes in unrestricted net assets:			
Contributions for purchases of property and equipment	343	358	701
Pension – related changes other than net periodic pension cost	(6,829)	(2,927)	(9,756)
Transfers (to) from affiliates, net	(9,807)	2,292	(7,515)
(Decrease) increase in unrestricted net assets	(7,175)	826	(6,349)
Increase in temporarily restricted net assets:			
Donor restricted gifts	7,007	—	7,007
Net assets, beginning of year	86,900	24,145	111,045
Net assets, end of year	$ 86,732	24,971	111,703

See accompanying independent auditors' report.