



WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Financial Statements
and Supplementary Information

June 30, 2012 and 2011

(With Independent Auditors' Report thereon)

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Table of Contents

| | Page(s) |
|--|----------------|
| Independent Auditors' Report | 1 |
| Consolidated Balance Sheets | 2 |
| Consolidated Statements of Operations | 3 |
| Consolidated Statements of Changes in Net Assets | 4 |
| Consolidated Statements of Cash Flows | 5 |
| Notes to Consolidated Financial Statements | 6 – 27 |
| Consolidating Balance Sheet Information | 28 – 29 |
| Consolidating Statement of Operation Information | 30 – 31 |
| Consolidating Statement of Changes in Net Assets Information | 32 |



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

Independent Auditors' Report

The Board of Directors
Western Maryland Health System Corporation:

We have audited the accompanying consolidated balance sheets of Western Maryland Health System Corporation (the Health System) as of June 30, 2012 and 2011 and the related consolidated statements of operations, changes in net assets and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Health System's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Western Maryland Health System Corporation as of June 30, 2012 and 2011, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary information included in Schedules 1 through 3 is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

KPMG LLP

October 22, 2012

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Balance Sheets

June 30, 2012 and 2011

(Dollars in thousands)

| Assets | 2012 | 2011 |
|--|-------------|-------------|
| Current assets: | | |
| Cash and cash equivalents | \$ 44,573 | 45,019 |
| Investments | 31,951 | 21,158 |
| Funds on deposit with trustee | 15,303 | 15,138 |
| Accounts receivable, less allowance for uncollectible accounts of \$5,907 in 2012 and \$7,539 in 2011 | 41,515 | 44,625 |
| Pledge receivable, net | 941 | 1,708 |
| Other receivables, less allowance for uncollectible accounts of \$2,022 in 2012 and \$2,548 in 2011 | 3,831 | 4,968 |
| Inventories and other current assets | 10,208 | 12,533 |
| Total current assets | 148,322 | 145,149 |
| Funds on deposit with trustee | 32,701 | 24,171 |
| Board designated investments | 945 | 840 |
| Other long-term investments | 636 | 677 |
| Investments restricted by donor or grantor | 2,221 | 2,865 |
| Beneficial interest in trustee held Foundation assets | 1,728 | 1,789 |
| Property and equipment, net | 354,451 | 373,141 |
| Unamortized financing fees | 4,258 | 4,568 |
| Investments in affiliates | 17,012 | 16,363 |
| Other assets | 4,241 | 392 |
| Total assets | \$ 566,515 | 569,955 |
| Liabilities and Net Assets | | |
| Current liabilities: | | |
| Current portion of long-term debt | \$ 7,863 | 7,514 |
| Accounts payable and accrued liabilities | 7,193 | 6,968 |
| Accrued bond interest payable | 7,858 | 8,018 |
| Accrued salaries and benefits | 15,099 | 13,067 |
| Payable to third-party payors | 8,050 | 6,051 |
| Total current liabilities | 46,063 | 41,618 |
| Long-term debt, net of current portion | 328,663 | 337,210 |
| Pension benefits in excess of pension assets | 60,202 | 21,501 |
| Other liabilities | 13,380 | 8,582 |
| Total liabilities | 448,308 | 408,911 |
| Commitments and contingencies | | |
| Net assets: | | |
| Unrestricted: | | |
| Unrestricted net assets | 111,282 | 152,651 |
| Noncontrolling interest in consolidated subsidiaries (see note 16) | 2,094 | 2,031 |
| Total unrestricted net assets | 113,376 | 154,682 |
| Temporarily restricted | 2,862 | 4,327 |
| Permanently restricted | 1,969 | 2,035 |
| Total net assets | 118,207 | 161,044 |
| Total liabilities and net assets | \$ 566,515 | 569,955 |

See accompanying notes to consolidated financial statements.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Statements of Operations

Years ended June 30, 2012 and 2011

(Dollars in thousands)

| | 2012 | 2011 |
|--|-------------|-------------|
| Unrestricted revenues, gains and other support: | | |
| Net patient service revenue | \$ 289,334 | 291,257 |
| Other revenue | 5,365 | 5,214 |
| Total revenues, gains and other support | 294,699 | 296,471 |
| Expenses: | | |
| Salaries and wages | 109,711 | 100,384 |
| Employee benefits | 33,736 | 34,938 |
| Professional fees | 9,129 | 8,390 |
| Purchased services | 19,155 | 17,865 |
| Supplies | 61,169 | 57,720 |
| Utilities | 4,497 | 5,344 |
| Insurance | 4,761 | 4,833 |
| Bad debts | 5,817 | 5,832 |
| Interest | 15,788 | 16,114 |
| Depreciation and amortization | 28,774 | 29,551 |
| Other | 8,001 | 8,789 |
| Total expenses | 300,538 | 289,760 |
| Operating (loss) income (see note 16) | (5,839) | 6,711 |
| Nonoperating income: | | |
| Equity in income of affiliates | 4,649 | 4,691 |
| Investment income, including realized gains on trading portfolio | 2,686 | 2,653 |
| Unrealized gains on trading portfolio | 619 | 1,277 |
| Other | 131 | 95 |
| Total nonoperating income | 8,085 | 8,716 |
| Excess of revenues over expenses (see note 16) | \$ 2,246 | 15,427 |

See accompanying notes to consolidated financial statements.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Statements of Changes in Net Assets

Years ended June 30, 2012 and 2011

(Dollars in thousands)

| | Unrestricted net assets | Temporarily restricted net assets | Permanently restricted net assets | Total net assets |
|---|------------------------------------|--|--|-----------------------------|
| Balance at June 30, 2010 | \$ 126,565 | 5,702 | 1,737 | 134,004 |
| Excess of revenues over expenses | 15,427 | — | — | 15,427 |
| Investment income | — | 11 | — | 11 |
| Donations | — | 373 | — | 373 |
| Grants | 15 | 1,024 | — | 1,039 |
| Change in funded status of pension plan | 14,018 | — | — | 14,018 |
| Net assets released for purchase of property and equipment | 2,783 | (2,783) | — | — |
| Change in beneficial interest of trustee-held Foundation assets | — | — | 298 | 298 |
| Distributions to noncontrolling interest in consolidated subsidiaries | (4,126) | — | — | (4,126) |
| Change in net assets | <u>28,117</u> | <u>(1,375)</u> | <u>298</u> | <u>27,040</u> |
| Balance at June 30, 2011 | <u>154,682</u> | <u>4,327</u> | <u>2,035</u> | <u>161,044</u> |
| Excess of revenues over expenses | 2,246 | — | — | 2,246 |
| Investment income | — | 5 | — | 5 |
| Donations | — | 112 | — | 112 |
| Grants | — | 735 | — | 735 |
| Change in funded status of pension plan | (39,795) | — | — | (39,795) |
| Net assets released for purchase of property and equipment | 808 | (808) | — | — |
| Net assets released for operations | — | (1,509) | — | (1,509) |
| Change in beneficial interest of trustee-held Foundation assets | — | — | (66) | (66) |
| Distributions to noncontrolling interest in consolidated subsidiaries | (4,565) | — | — | (4,565) |
| Change in net assets | <u>(41,306)</u> | <u>(1,465)</u> | <u>(66)</u> | <u>(42,837)</u> |
| Balance at June 30, 2012 | \$ <u><u>113,376</u></u> | <u><u>2,862</u></u> | <u><u>1,969</u></u> | <u><u>118,207</u></u> |

See accompanying notes to consolidated financial statements.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidated Statements of Cash Flows

Years ended June 30, 2012 and 2011

(Dollars in thousands)

| | 2012 | 2011 |
|---|-------------|-------------|
| Cash flows from operating activities: | | |
| Change in net assets | \$ (42,837) | 27,040 |
| Adjustments to reconcile change in net assets to net cash provided by operating activities: | | |
| Depreciation and amortization | 28,774 | 29,551 |
| Amortization of bond premium | 684 | 694 |
| Change in funded status of pension plan | 39,795 | (14,018) |
| Provision for bad debts | 5,817 | 5,832 |
| Distributions to noncontrolling interest holder | 4,565 | 4,126 |
| Equity in income of affiliates | (4,649) | (4,691) |
| Realized and unrealized gains on investments | (1,725) | 2,629 |
| Change in beneficial interest in trustee held Foundation assets | 66 | (298) |
| Changes in assets and liabilities: | | |
| Accounts receivable | (2,707) | (13,865) |
| Other receivables | 1,137 | (2,041) |
| Inventories and other current assets | 2,325 | 806 |
| Accounts payable and accrued liabilities, accrued bond interest payable and accrued salaries and benefits | 2,097 | (1,648) |
| Payable to third-party payors | 1,999 | (902) |
| Other assets, funded status of pension plan, and other liabilities | (1,513) | (13,881) |
| Net cash provided by operating activities | 33,828 | 19,334 |
| Cash flows from investing activities: | | |
| Purchase of long-lived assets | (9,774) | (7,647) |
| Change in funds on deposit with trustee | (8,695) | (1,994) |
| Net change in investments | (7,660) | (4,279) |
| Distributions from unconsolidated entities | 4,000 | 2,000 |
| Net cash used in investing activities | (22,129) | (11,920) |
| Cash flows from financing activities: | | |
| Repayments of long-term debt | (7,120) | (6,990) |
| Capital lease payments | (394) | (372) |
| Restricted investment (loss) income | (66) | 298 |
| Distributions to noncontrolling interest holder | (4,565) | (4,126) |
| Net cash used in financing activities | (12,145) | (11,190) |
| Net decrease in cash and cash equivalents | (446) | (3,776) |
| Cash and cash equivalents at beginning of year | 45,019 | 48,795 |
| Cash and cash equivalents at end of year | \$ 44,573 | 45,019 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for interest | \$ 15,699 | 16,362 |

See accompanying notes to consolidated financial statements.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

(1) **Mission and Organization**

Western Maryland Health System Corporation (the Health System or WMHS) is a not-for-profit community health system. The mission of the Health System is to improve the health status and quality of life of the individuals and the communities served, especially those in need. The Health System provides patient and family centered services through responsible management of human and fiscal resources. The Health System is a values-driven health system that respects and supports life, preserves the dignity of each individual, and promotes a healthy and just society through collaboration with others who share the Health System's values.

The Health System accepts patients regardless of their ability to pay. Those patients who meet certain criteria under its charity care policies receive services at no charge or at an amount less than full charges. Essentially, these policies define charity services as those services for which no payment is anticipated. In addition to providing charity care, the Health System provides other programs and services for the general community. The Health System offers over 90 community health programs that include programs that target health education programs and health screenings to patients. A wide variety of health screenings are offered throughout the year for the general community that are free of charge or offered for a nominal fee. The Health System provides free education programs on a variety of health topics. The Health System also sponsors an annual community health fair, which provides health screenings, education and activities targeted to health and safety.

The Health System comprises the following wholly or partially owned, and controlled, consolidated subsidiaries in Cumberland, Maryland:

(a) *Acute Care Hospital*

Western Maryland Regional Medical Center – a full service community hospital located in Cumberland, Maryland, licensed for 275 acute care beds, owned and operated by the Health System.

(b) *Long-Term Care*

Frostburg Nursing and Rehabilitation Center (Frostburg).

(c) *Other*

Western Maryland Health System Foundation, Inc. (Foundation)
Western Maryland Insurance Company, Ltd. (WMIC)
Haystack Consolidated Services Inc. (Haystack)
Cumberland Properties, Inc.
Memorial Medical Center Services, Inc. (MMCS)
Johnson Heights Medical Building Partnership (Johnson Heights)
Haystack Imaging Services, LLC (Haystack Imaging)

In addition, the Health System has investments in several unconsolidated affiliates which are accounted for on the cost or equity methods of accounting, as appropriate (see note 6).

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

(2) Summary of Significant Accounting Policies

(a) *Principles of Consolidation*

The consolidated financial statements are prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles, and include the accounts of the Health System and its subsidiaries and controlled entities. Significant intercompany accounts and transactions have been eliminated in consolidation. The Health System's consolidated financial statements reflect the respective interests of the minority investors in the joint ventures' net assets and changes in net assets.

(b) *Investments in Affiliates*

Investments in certain joint ventures, which are not controlled by the Health System, are accounted for using the cost or equity method of accounting as appropriate (see note 6). These investments are included as investments in affiliates in the accompanying consolidated balance sheets. The Health System's proportionate share of income or loss of the unconsolidated joint ventures is included in nonoperating income in the accompanying consolidated statements of operations.

(c) *Cash Equivalents*

Cash equivalents consist primarily of temporary investments with maturities of three months or less when purchased and certain overnight repurchase agreements. Overnight repurchases are principally unsecured and are subject to normal credit risk.

(d) *Accounts Receivable*

Patient accounts receivable are stated at estimated net realizable amounts from patients, third-party payors and other insurers when services are provided. The Health System bills the insurer directly for services provided. Insurance coverage and credit information is obtained from patients when available. No collateral is obtained for accounts receivable.

(e) *Inventories*

Inventories primarily consist of medical supplies and drugs and are carried at lower of cost or market. Cost is determined principally using the average cost method, which approximates the first-in first-out (FIFO) method.

(f) *Investments*

The Health System's investment portfolio, including board designated investments and investments restricted by donor or grantor, is considered a trading portfolio and is classified as current or noncurrent assets based on management's intention as to use. Accordingly, realized and unrealized gains and losses are included in investment income in the accompanying consolidated statements of operations. Dividend and interest income, as well as realized gains on sales of securities, are included in investment income.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the balance sheet. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess of revenues over expenses unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the excess of revenues over expenses unless the investments are trading securities.

(g) *Property and Equipment*

Property and equipment are stated at cost or, if donated, at fair market value at date of gift. Depreciation is determined using a straight-line basis over the estimated useful lives of the related assets. Repairs and maintenance are expensed as incurred.

Gifts of long-lived assets, such as land, building or equipment, or cash gifts to be used for purchase of long-lived assets, are reported as unrestricted support, and are excluded from the excess of revenues over expenses, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are reported are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as temporarily restricted net assets. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported as released from restrictions when the donated or acquired long-lived assets are placed in service.

The Health System opened a 275-bed, state-of-the-art hospital on November 21, 2009. Adjacent to the hospital is a 120,000-square-foot medical office building (MOB) previously owned and operated by a third-party medical office building developer until the purchase of the MOB by WMHS on February 17, 2011. The MOB includes both hospital services and physicians' office space.

(h) *Impairment of Long-Lived Assets*

Management regularly evaluates whether events or changes in circumstances have occurred that could indicate an impairment in the value of long-lived assets. In accordance with the provisions of Accounting Standards Codification (ASC) Subtopic 360-10, *Accounting for the Impairment or Disposal of Long-Lived Assets*, if there is an indication that the carrying amount of an asset is not recoverable, the Health System projects 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 discounted cash flows.

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 Health System groups the assets at the lowest level for which there are identifiable cash flows independent of other groups of assets. If such

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

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.

(i) *Financing Costs*

Financing costs incurred in issuing long-term debt have been deferred and are shown separately on the balance sheet. These costs are being amortized using the effective interest method over the term of the related debt. The unamortized balances were \$4,258 and \$4,568 at June 30, 2012 and 2011, respectively.

(j) *Temporarily and Permanently Restricted Net Assets*

Temporarily restricted net assets are limited as to use by donors to a specific time period or purpose. Permanently restricted net assets are to be held in perpetuity at the instruction of the donor. Income from permanently restricted net assets is used as defined by the donor.

(k) *Net Patient Service Revenue*

On November 16, 2010, The Health System and the Health Services Cost Review Commission (HSCRC) agreed to a three-year contract for the System to implement the Total Patient Revenue (TPR) methodology, effective July 1, 2010. The TPR agreement establishes a prospective, fixed revenue base, the "TPR cap", for the upcoming year. This includes both inpatient and outpatient regulated services. Under TPR, the System's revenue for all HSCRC regulated services is predetermined for the upcoming year, regardless of changes in volume, service mix intensity, or mix of inpatient or outpatient services that occurred during the year. The TPR agreement allows the System to adjust unit rates, within certain limits, to achieve the overall revenue base for the System at year end. Any overcharge or undercharge versus the TPR cap is prospectively added to the subsequent year's TPR cap. Although the TPR cap does not adjust for changes in volume or service mix, the TPR cap is adjusted annually for inflation, and for changes in payor mix and uncompensated care. Beginning in year three of the three-year contract, the System will receive an annual adjustment to its cap for the change in population in the System's service area. TPR is designed to encourage hospitals to operate efficiently by reducing utilization and managing patients in the appropriate care delivery setting.

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. Because the Health System does not pursue collection of amounts determined to qualify as charity care, such amounts are not reported as revenue.

The Maryland Medicaid program is administered primarily through independent licensed managed care organizations. The State of Maryland has contracts with these independent managed care organizations to manage the care to eligible participants. Amounts due from the Medicaid program in Maryland are primarily due from the independent managed care organizations.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

(l) Excess of Revenues over Expenses

The statement of operations includes the performance indicator, excess of revenues over expenses. Changes in unrestricted net assets, which are excluded from excess of revenues over expenses, include unrealized gains and losses on other than trading securities, change in funded status of the pension plan, permanent transfers of assets to and from affiliates for other than goods and services, and 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).

(m) Charity Care

The Health System, as an integral part of its mission, accepts and treats all patients without regard to their ability to pay. A patient is classified as a charity patient in accordance with established criteria. Charity care is the recognition of services rendered for which no payment is expected.

(n) Donations

Unconditional donations are included in income when pledged or received. Donations restricted as to use by the donor are reflected as additions to temporarily or permanently restricted net assets. Expenditures of temporarily restricted net assets are transferred to unrestricted net assets if for capital additions, or reported as other revenue if for operating purposes.

(o) Income Taxes

The Health System and substantially all of its affiliates are exempt from federal income tax, except for unrelated business income, which is nonexistent, under Section 501(c)(3) of the Internal Revenue Code. Accordingly, no provision for income taxes is made in the consolidated financial statements for these entities.

Johnson Heights is a general partnership and Haystack Imaging is a limited liability company and both are not directly subject to income taxes. The results of their operations are included in the tax returns of their partners. Haystack and MMCS are taxable for profit entities, which recognized an immaterial amount of taxable net income during 2012 and 2011.

(p) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

(q) Western Maryland Health System Foundation

The Foundation is controlled by the Health System and thus its assets, liabilities, net assets and results of operations are consolidated within the Health System financial statements.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

(r) Beneficial Interest in Trustee Held Assets

The Health System records a beneficial interest in several trusts (the assets of which are to be held in perpetuity) for which a portion of the income is to be distributed to the Health System. These changes in the fair value of the trusts are recorded as unrealized gains/losses in permanently restricted net assets.

(s) Pension Plan

For employees hired prior to July 1, 2011, the Health System has a noncontributory defined benefit pension plan covering substantially all of its employees upon their retirement. Since 2008, the benefits are based on age, years of service and career average pay. Grandfathered employees prior to 2008 are based on age, years of service and final average pay based on their 5 highest paid years of their last 10 years of service. Effective July 1, 2011, employees hired or rehired will not participate in the plan. These employees will participate in a new defined contribution plan that has been developed.

For the defined benefit pension plan, the Health System records annual amounts relating to its pension plan based on calculations that incorporate various actuarial and other assumptions including, discount rates, mortality, assumed rates of return, compensation increases, turnover rates and healthcare cost trend rates. The Health System reviews its assumptions on an annual basis and makes modifications to the assumptions based on current rates and trends when it is appropriate to do so. The Health System believes that the assumptions utilized in recording its obligations under its plans are reasonable based on its experience and market conditions.

(t) Reclassifications

Certain prior year amounts have been reclassified to conform to current period presentation. The reclassifications had no impact on previously reported net assets or changes in net assets.

(u) New Accounting Pronouncements

In August 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2010-23, *Health Care Entities (ASC Topic 954): Measuring Charity Care for Disclosure*. ASU No. 2010-23 is intended to reduce the diversity in practice regarding the measurement basis used in the disclosure of charity care. ASU No. 2010-23 requires that cost be used as the measurement basis for charity care disclosure purposes and that cost be identified 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 Hospitals on January 1, 2011. The adoption did not impact the financial position or results of operations of the Health System. See note 8 for related disclosure information.

In August 2010, the FASB issued ASU No. 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

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

ASU was effective for Hospitals on January 1, 2011. The adoption of this guidance resulted in the Health System recording an additional accrual for medical malpractice claims liability and an insurance recoveries receivable of \$3,854 on the balance sheet. Such amounts are included in other noncurrent assets and other noncurrent liabilities. The Health System did not retroactively adopt the provision of this ASU. The adoption of this guidance did not have any impact on the results of operations or cash flows of the Health System.

In July 2011, the FASB issued ASU No. 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 No. 2011-07 is effective for the Health System beginning July 1, 2012.

(3) Accounts Receivable and Business Concentrations

During fiscal years 2012 and 2011 net patient service revenue was received from the following payors:

| | 2012 | 2011 |
|------------|-------------|-------------|
| Medicare | 55% | 56% |
| Medicaid | 13 | 13 |
| Blue Cross | 13 | 13 |
| Self-pay | 3 | 3 |
| Other | 16 | 15 |
| | 100% | 100% |

Gross accounts receivable at June 30, 2012 and 2011 consisted of the following payors:

| | 2012 | 2011 |
|------------|-------------|-------------|
| Medicare | 42% | 40% |
| Medicaid | 12 | 13 |
| Blue Cross | 13 | 11 |
| Self-pay | 18 | 18 |
| Other | 15 | 18 |
| | 100% | 100% |

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

(4) Investments

Investments, which include Funds on deposit with trustees, Board designated investments and Investments restricted by donor or grantor, consist of the following as of June 30:

| | 2012 | 2011 |
|-----------------------------|-------------|-------------|
| U.S. government obligations | \$ 6,346 | 1,158 |
| Corporate bonds/notes | 14,618 | 9,069 |
| Money market funds | 2,695 | 3,429 |
| Corporate stocks and other | 12,056 | 11,884 |
| Fixed income securities | 48,042 | 39,309 |
| | \$ 83,757 | 64,849 |

Investments have been classified in the accompanying consolidated balance sheets as follows as of June 30:

| | 2012 | 2011 |
|--|-------------|-------------|
| Short-term investments | \$ 31,951 | 21,158 |
| Funds on deposit with trustee | 48,004 | 39,309 |
| Board designated investments | 945 | 840 |
| Other long-term investments | 636 | 677 |
| Investments restricted by donor or grantor | 2,221 | 2,865 |
| | \$ 83,757 | 64,849 |

Investment income and gains for assets limited as to use, cash equivalents, and other investments comprise the following for the years ended June 30:

| | 2012 | 2011 |
|--|-------------|-------------|
| Income: | | |
| Investment income | \$ 1,580 | 1,301 |
| Realized gains on trading investment portfolio | 1,106 | 1,352 |
| Unrealized gains on trading investment portfolio | 619 | 1,277 |
| | \$ 3,305 | 3,930 |

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

(5) Property and Equipment

Property and equipment and estimated useful lives (in years) are summarized as follows as of June 30:

| | <u>2012</u> | <u>2011</u> |
|---|-------------------|----------------|
| Land and land improvements (2 – 25 years) | \$ 16,191 | 16,191 |
| Buildings and improvements (5 – 40 years) | 400,563 | 401,509 |
| Equipment (3 – 20 years) | 171,357 | 162,404 |
| Construction in progress | <u>109</u> | <u>1,917</u> |
| | 588,220 | 582,021 |
| Less accumulated depreciation | <u>233,769</u> | <u>208,880</u> |
| Property and equipment, net | \$ <u>354,451</u> | <u>373,141</u> |

Depreciation expense for the year ended June 30, 2012 was \$28,464 including an impairment of long-lived assets for \$2,125. Depreciation expense for the year ended June 30, 2011 was \$29,238 including an impairment of long-lived assets for \$4,000.

(6) Investments in Affiliates

Investments in affiliates and equity in income (loss) of affiliates are as follows as of and for the years ended June 30:

| <u>Name</u> | <u>Interest</u> | <u>Business</u> | <u>Investment</u> | | <u>Equity in income (loss)</u> | |
|--------------------------------|-----------------|---|-------------------|---------------|--------------------------------|--------------|
| | | | <u>2012</u> | <u>2011</u> | <u>2012</u> | <u>2011</u> |
| Maryland Physicians Care, Inc. | 25.00% | State of Maryland Medicaid managed care | \$ 16,752 | 15,865 | 4,887 | 4,677 |
| Other affiliates | 0.21% to 33.33% | Supply purchasing and medical equipment | <u>260</u> | <u>498</u> | <u>(238)</u> | <u>14</u> |
| | | | \$ <u>17,012</u> | <u>16,363</u> | <u>4,649</u> | <u>4,691</u> |

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

(7) Long-Term Debt

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

| | 2012 | 2011 |
|---|-------------|-------------|
| Maryland Health and Higher Educational Facilities Authority (MHHEFA) Series 2006, Series A and B Revenue (FHA Insured) Bonds, interest rate 4.0 to 5.3% | \$ 325,360 | 332,480 |
| Capital leases | 977 | 1,371 |
| Net unamortized bond premium | 10,189 | 10,873 |
| Long-term debt | 336,526 | 344,724 |
| Less current portion of long-term debt | 7,863 | 7,514 |
| Long-term debt less current portion | \$ 328,663 | 337,210 |

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

| | | |
|------------|----|---------|
| 2013 | \$ | 7,863 |
| 2014 | | 8,229 |
| 2015 | | 8,300 |
| 2016 | | 8,565 |
| 2017 | | 8,975 |
| Thereafter | | 284,405 |

In November 2006, proceeds from issuance of \$348,650 and \$2,180 Maryland Health and Higher Education Facilities Authority Series 2006, Series A and B bonds were obtained for the purpose of (1) financing the costs of acquisition, construction and equipping of the Western Maryland Regional Medical Center (see note 1), and (2) to refund prior debt issuances. The Health System redeemed \$11,360 of the Series 2006A bonds in conjunction with their final endorsement in 2010.

Principal payments on the Series 2006A revenue bonds commence on July 1, 2010, and are due semi-annually through January 1, 2035. Interest payments are due semi-annually commencing July 1, 2007. The total outstanding balance on the Series 2006B revenue bonds was paid on July 1, 2010. Interest on the Series 2006A bonds accrue at a rate of 4.0% to 5.3% per annum.

The Federal Housing Authority (FHA) has issued a commitment for mortgage insurance with respect to the project. The financing document contains quantitative and qualitative covenants (measured quarterly). The quantitative covenants include a debt service coverage ratio, a day's cash on hand requirement, current ratio requirement, a net days in accounts receivable requirement, and restrictions on operating losses and revenue over expenses.

In 2009, the Health System amended their line of credit agreement with a bank that permits the Health System to borrow up to \$1,000,000. There is no expiration date on the line of credit and the interest rate as

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

of June 30, 2012 was 4.50%. The line of credit primarily supports a letter of credit agreement in the amount of \$700,000. There was no outstanding balance as of June 30, 2012.

(8) Charity Care

The Health System utilizes a cost to charge ratio methodology to convert charity care to cost. Costs incurred are estimated based on the ratio of total operating expenses to gross charges applied to charity care charges. The amount of charges foregone for services and supplies furnished under the Health System's Charity Care policy aggregated approximately \$15,949 and \$12,444 for the years ended June 30, 2012 and 2011, respectively. The total direct and indirect costs to provide the care amounted to approximately \$13,078 and \$10,204 for the years ended June 30, 2012 and 2011, respectively.

(9) Retirement Plans

The WMHS Retirement Plan (the Plan) is a noncontributory defined benefit plan, which covers substantially all full-time employees who meet certain age and service requirements. The Plan's funding policy is to contribute, annually, the pension costs as determined by the Plan's actuary, subject to adjustment for full funding limitations as defined by the Internal Revenue Code.

The Health System's investment policy, established by the Investment Committee of the Finance Committee and approved by the Health System's Board of Directors, is to ensure current and future benefit obligations are adequately funded in a cost effective manner. The investment guidelines are based on a time horizon of greater than five years. In establishing the risk tolerances, the ability to withstand short and intermediate term variability with some interim fluctuations in market value and rates of return may be tolerated in order to achieve the longer-term objectives.

The measurement date of the Plan is June 30.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

The component of the Plan's funded status, net periodic benefit costs and actuarial assumptions used in accounting for defined benefit plans for the years ended June 30, 2012 and 2011 are as follows:

| | <u>2012</u> | <u>2011</u> |
|---|---------------------------|---------------------------|
| Change in projected benefit obligation: | | |
| Projected benefit obligation at beginning of year | \$ 163,136 | 161,122 |
| Service cost | 5,447 | 5,337 |
| Interest cost | 9,139 | 8,646 |
| Assumptions | 36,369 | (4,749) |
| Actuarial loss | 829 | — |
| Benefits paid | <u>(6,572)</u> | <u>(7,220)</u> |
| Projected benefit obligation at end of year | <u>208,348</u> | <u>163,136</u> |
| Change in plan assets: | | |
| Plan assets at fair value at beginning of year | 141,634 | 127,247 |
| Actual return | 5,084 | 14,608 |
| Employer contributions | 8,000 | 7,000 |
| Benefits paid | <u>(6,572)</u> | <u>(7,220)</u> |
| Fair value of plan assets at end of year | <u>148,146</u> | <u>141,635</u> |
| Funded status at end of year | \$ <u><u>(60,202)</u></u> | \$ <u><u>(21,501)</u></u> |
| | <u>2012</u> | <u>2011</u> |
| Components of net periodic benefit costs: | | |
| Service cost | \$ 5,447 | 5,337 |
| Interest cost | 9,139 | 8,646 |
| Expected return on plan assets | (9,680) | (8,673) |
| Recognized prior service cost | (593) | (593) |
| Recognized net loss | <u>2,593</u> | <u>3,928</u> |
| Net periodic pension cost | \$ <u><u>6,906</u></u> | \$ <u><u>8,645</u></u> |

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

Deferred pension costs, which have not yet been recognized in periodic pension expense but are accrued in unrestricted net assets, are \$74,891 and \$35,096 at June 30, 2012 and 2011, respectively. Deferred pension costs represents unrecognized actuarial losses or unexpected changes in the projected benefit obligation and plan assets over time primarily due to changes in assumed discount rates and investment experience, unrecognized prior service costs which is the impact of changes in plan benefits applied retrospectively to employee service previously rendered. The amount of deferred pension costs expected to be recognized as a component of net period pension costs during the year ending June 30, 2013 is \$4,946.

| | <u>2012</u> | <u>2011</u> |
|--|-------------|-------------|
| Weighted average assumptions – benefit obligations: | | |
| Discount rate | 4.12% | 5.69% |
| Salary scale | 2.00 | 2.00 |
| Return on assets | 7.00 | 7.00 |
| Weighted average assumptions – net periodic expense: | | |
| Discount rate | 5.69% | 5.48% |
| Salary scale | 2.00 | 2.00 |
| Return on assets | 7.00 | 7.00 |

The accumulated benefit obligation for the defined benefit pension plan was \$202,432 and \$160,552 at June 30, 2012 and 2011, respectively.

The Health System’s pension plan weighted average asset allocations at the measurement dates of June 30, 2012 and 2011, by asset category are as follows:

| | <u>Percentage of plan assets</u> | | |
|--------------|----------------------------------|-------------|-------------|
| | <u>Target allocation</u> | <u>2012</u> | <u>2011</u> |
| Asset class: | | | |
| Equities | 40% | 38% | 37% |
| Fixed | 60 | 62 | 63 |

The Health System expects to contribute \$8,000 to the Plan for the fiscal year ending June 30, 2013.

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

| | | |
|-------------|----|--------|
| 2013 | \$ | 6,583 |
| 2014 | | 7,027 |
| 2015 | | 7,421 |
| 2016 | | 7,991 |
| 2017 | | 8,624 |
| 2018 – 2021 | | 56,631 |

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

The expected benefits to be paid are based on the same assumptions used to measure the Health System's benefit obligation as of June 30, 2012.

Effective July 1, 2011, employees hired or rehired will not participate in the Plan. These employees will participate in a new defined contribution plan that has been developed, which allows employees to contribute amounts tax-deferred up to certain limits allowable under Internal Revenue Service (IRS) guidelines. The Health System has not contributed to the defined contribution plan during the year ended June 30, 2012 but has accrued \$109 in anticipation of a 100% match of employee contributions up to 3% of employee salaries for the current fiscal year, to be contributed during 2013.

The Health System also sponsors a defined contribution retirement plan in accordance with Section 403(b) of the Internal Revenue Code. The Health System's expense related to this plan for the years ended June 30, 2012 and 2011 was \$1,853 and \$1,565, respectively, and is included in employee benefits in the accompanying consolidated statements of operations.

(10) Self-Insurance Programs

(a) *General and Professional Liability (GLPL)*

On December 14, 2004, the Health System formed a new wholly owned insurance subsidiary, Western Maryland Insurance Company, Ltd. (WMIC), an exempted company under the Companies Law of the Cayman Islands, to provide GLPL insurance to the Health System and certain affiliates. Effective January 1, 2005, this subsidiary insures the Health System for its GLPL risks under a claims-made policy with a limit of \$1,000 per claim and \$8,000 in the aggregate. Claims in excess of \$1,000 per claim and \$8,000 in the aggregate, up to a limit of \$20,000, have been reinsured with Zurich American Insurance Company, an independent third-party insurance company. The Health System's retained self-insurance risk under these policies is \$1,000 per occurrence.

Management's estimate of the liability for GLPL claims, including incurred but not reported claims, is principally based on actuarial estimates performed by an independent third-party actuary. The Company's estimated liability for GLPL claims, including incurred but not reported claims, totaled \$12,377 and \$7,681 as of June 30, 2012 and 2011, respectively. These amounts are included in other noncurrent liabilities in the accompanying financial statements. While management believes that this liability is adequate as of June 30, 2012, the ultimate liability may exceed the amount recorded. Additionally, the Health System has recorded an additional insurance recoveries receivable of \$3,854, included in other noncurrent assets as of June 30, 2012.

(b) *Workers' Compensation Insurance*

In 2012 and 2011, the Health System participated in a self-insured plan for workers' compensation claims. Stop-loss coverage has been purchased through a commercial carrier for claims in excess of \$400.

The Health System has accrued a liability of \$2,586 and \$2,173 as of June 30, 2012 and 2011, respectively, for known and incurred but not reported claims. Management believes this accrual is adequate to provide for all workers' compensation claims that have been incurred through June 30,

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

2012. Additionally, there are no material insurance recoveries related to workers' compensation as of June 30, 2012.

(c) Health Insurance

The Health System is self-insured for employee health claims. Under these self-insurance plans, the Health System has accrued a liability of \$1,699 and \$1,784 as of June 30, 2012 and 2011, respectively, for known claims and incurred but not reported claims. Management believes this accrual is adequate to provide for all employee health claims that may have been incurred through June 30, 2012. Additionally, there are no material insurance recoveries related to employee health claims as of June 30, 2012.

(11) Lease Commitments

Future minimum payments under noncancelable operating leases with terms in excess of one year or more for the years ending June 30 are as follows:

| | | | |
|------------|--|----|-------|
| 2013 | | \$ | 2,158 |
| 2014 | | | 1,386 |
| 2015 | | | 666 |
| 2016 | | | 213 |
| 2017 | | | 68 |
| Thereafter | | | — |
| Total | | \$ | 4,491 |

Rental expense under operating leases amounted to \$2,748 and \$3,839 for the years ended June 30, 2012 and 2011, respectively.

(12) Temporarily and Permanently Restricted Net Assets

Temporarily and permanently restricted net assets as of June 30, 2012 and 2011 are available for the following purposes:

| | | 2012 | 2011 |
|---|----|-------|-------|
| Temporary restrictions: | | | |
| Specific support of healthcare services | \$ | 2,862 | 4,327 |
| Permanent restrictions: | | | |
| Trustee held assets to be held in perpetuity, the income from which primarily is expendable to support health care services | | 1,969 | 2,035 |

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

(13) Fair Value of Financial Instruments

(a) *Fair Value of Financial Instruments*

The following methods and assumptions were used by the Health System in estimating the fair value of their financial instruments:

Cash and cash equivalents, investments, funds on deposit with trustee, board designated investments, patient accounts receivable, other assets, accounts payable, and accrued liabilities, payable to third-party payors, and other long term liabilities – The carrying amounts reported in the consolidated balance sheets approximate the related fair values.

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 Health System's own judgments about the assumptions that market participants would use in pricing the asset or liability. Those judgments are developed by the Health System 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, line of credit, 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 are measured using quoted market prices at the reporting date multiplied by the quantity held.

(b) *Long-Term Debt*

The Series 2006 Bonds bear interest at fixed rates and, accordingly, had a carrying amount and fair value of \$325,360 and \$344,886.

The fair value of the Health System's 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 Health System's credit standing. In determining an appropriate spread to reflect its credit standing, the Health System considers credit default swap spreads, bond yields of other long-term debt offered by the Health System, and interest rates currently offered for similar debt instruments of comparable maturities by the Health System's bankers as well as other banks that regularly compete to provide financing to the Health System.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

(c) ***Fair Value Hierarchy***

The Health System adopted ASC Topic 820, *Fair Value Measurements and Disclosures*, on July 1, 2008 for fair value measurements of financial assets and financial liabilities and for fair value measurements of nonfinancial items that are recognized or disclosed at fair value in the consolidated financial statements on a recurring basis. ASC Topic 820 establishes 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 measurements involving significant unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Health System has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are unobservable inputs for the asset or liability.

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

The table below presents assets that are measured at fair value as of June 30, 2012 aggregated by the three level valuation hierarchy:

| | | 2012 | | | |
|-----------------------------|----|----------------|----------------|----------------|--------------|
| | | Level 1 | Level 2 | Level 3 | Total |
| Assets: | | | | | |
| U.S. government obligations | \$ | 6,346 | — | — | 6,346 |
| Corporate bonds/notes | | — | 14,618 | — | 14,618 |
| Money market funds | | 2,695 | — | — | 2,695 |
| Corporate stocks and other | | 12,056 | — | — | 12,056 |
| Fixed income securities | | — | 48,042 | — | 48,042 |
| Total assets | \$ | 21,097 | 62,660 | — | 83,757 |

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

The table below presents assets that are measured at fair values as of June 30, 2011 aggregated by the three level valuation hierarchy:

| | 2011 | | | |
|-----------------------------|------------------|----------------|----------------|---------------|
| | Level 1 | Level 2 | Level 3 | Total |
| Assets: | | | | |
| U.S. government obligations | \$ 1,158 | — | — | 1,158 |
| Corporate bonds/notes | — | 9,069 | — | 9,069 |
| Money market funds | 3,429 | — | — | 3,429 |
| Corporate stocks and other | 11,884 | — | — | 11,884 |
| Fixed income securities | — | 39,309 | — | 39,309 |
| Total assets | \$ <u>16,471</u> | <u>48,378</u> | <u>—</u> | <u>64,849</u> |

For the years ended June 30, 2012 and June 30, 2011, there were no significant transfers between levels 1, 2 or 3.

The table below presents the pension plan's investable assets as of June 30, 2012 aggregated by the three level valuation hierarchy:

| | 2012 | | | |
|-------------------------|-------------------|----------------|----------------|----------------|
| | Level 1 | Level 2 | Level 3 | Total |
| Assets: | | | | |
| Money market funds | \$ 7,430 | — | — | 7,430 |
| Mutual funds | 126,680 | — | — | 126,680 |
| Fixed income securities | — | 6,365 | — | 6,365 |
| Other funds | — | 7,671 | — | 7,671 |
| Total assets | \$ <u>134,110</u> | <u>14,036</u> | <u>—</u> | <u>148,146</u> |

The table below presents the pension plan's investable assets as of June 30, 2011 aggregated by the three level valuation hierarchy:

| | 2011 | | | |
|-------------------------|-------------------|----------------|----------------|----------------|
| | Level 1 | Level 2 | Level 3 | Total |
| Assets: | | | | |
| Money market funds | \$ 3,523 | — | — | 3,523 |
| Mutual funds | 127,482 | — | — | 127,482 |
| Fixed income securities | — | 2,508 | — | 2,508 |
| Other funds | — | 8,122 | — | 8,122 |
| Total assets | \$ <u>131,005</u> | <u>10,630</u> | <u>—</u> | <u>141,635</u> |

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

For the years ended June 30, 2012 and June 30, 2011, there were no significant transfers between levels 1, 2 or 3.

(14) Commitments and Contingencies

(a) *Litigation*

From time to time, the Health System and its subsidiaries 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 Health System's future financial position or results from operations.

(b) *Other Matters*

The Health System has contracts with various physician groups to provide certain emergency, obstetric, and surgical services. Those contracts include certain income guarantee levels, which eliminate as volumes related to services provided increase. The Health System paid \$1,854 and \$1,822 related to the guarantee provisions of the contracts in 2012 and 2011, respectively.

(15) Regulation and Reimbursement

The Health System provides health care services primarily through one general acute care hospital. The Health System 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; and
- Lawsuits alleging malpractice and related claims.

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

The Medicare and state Medicaid reimbursement programs represent a substantial portion of the Health System's revenues and the Health System's operations are subject to a variety of other federal, state and local regulatory requirements. Failure to maintain required regulatory approvals and licenses and/or changes in such regulatory requirements could have a significant adverse effect on the Health System.

Change in federal and state reimbursement funding mechanisms and related government budgetary constraints could have a significant adverse effect on the Health System.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

The current rate of reimbursement for services to patients under the Medicare and Medicaid programs is based on an agreement between the Center for Medicaid and Medicare Services (CMS) and the HSCRC. This agreement is based upon a waiver from Medicare prospective pay system reimbursement principles granted to the State of Maryland under Section 1814(b) of the Social Security Act and will continue as long as all third-party payors elect to be reimbursed in Maryland under this program and the rate of increase for costs per hospital inpatient admission in Maryland is below the national average.

On November 16, 2010, the Health System and the HSCRC agreed to a three-year contract for the Health System to implement the TPR methodology, effective July 1, 2010. The TPR agreement establishes a prospective, fixed revenue base, the "TPR cap", for the upcoming year. This includes both inpatient and outpatient regulated services. Under TPR, the Health System's revenue for all HSCRC regulated services is predetermined for the upcoming year, regardless of changes in volume, service mix intensity, or mix of inpatient or outpatient services that occurred during the year. The TPR agreement allows the Health System to adjust unit rates, within certain limits, to achieve the overall revenue base for the Health System at year end. Any overcharge or undercharge versus the TPR cap is prospectively added to the subsequent year's TPR cap. Although the TPR cap does not adjust for changes in volume or service mix, the TPR cap is adjusted annually for inflation, and for changes in payor mix and uncompensated care. Beginning in year three of the three-year contract, the Health System will receive an annual adjustment to its cap for the change in population in the Health System's service area. TPR is designed to encourage hospitals to operate efficiently by reducing utilization and managing patients in the appropriate care delivery setting.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

(16) Noncontrolling Interest

Effective June 30, 2011, the Health System adopted accounting guidance that requires a not-for-profit reporting entity to account for and present noncontrolling interests in a consolidated subsidiary as separate component of the appropriate class of consolidated net assets (equity). The reconciliation of noncontrolling interest reported in unrestricted net assets is as follows:

| | <u>WMHS Corporation</u> | <u>Noncontrolling interest</u> | <u>Unrestricted net assets</u> |
|---|-----------------------------|------------------------------------|------------------------------------|
| Balance at June 30, 2010 | \$ 124,649 | 1,916 | 126,565 |
| Operating income | 2,470 | 4,241 | 6,711 |
| Nonoperating income | 8,716 | — | 8,716 |
| Excess of revenues over expenses | 11,186 | 4,241 | 15,427 |
| Grants | 15 | — | 15 |
| Change in funded status of pension plan | 14,018 | — | 14,018 |
| Net assets released for purchase of property and equipment | 2,783 | — | 2,783 |
| Distributions to noncontrolling interest in consolidated subsidiaries | — | (4,126) | (4,126) |
| Change in net assets | 28,002 | 115 | 28,117 |
| Balance at June 30, 2011 | 152,651 | 2,031 | 154,682 |
| Operating income | (10,467) | 4,628 | (5,839) |
| Nonoperating income | 8,085 | — | 8,085 |
| Excess of revenues over expenses | (2,382) | 4,628 | 2,246 |
| Change in funded status of pension plan | (39,795) | — | (39,795) |
| Net assets released for purchase of property and equipment | 808 | — | 808 |
| Distributions to noncontrolling interest in consolidated subsidiaries | — | (4,565) | (4,565) |
| Change in net assets | (41,369) | 63 | (41,306) |
| Balance at June 30, 2012 | \$ 111,282 | 2,094 | 113,376 |

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Notes to Consolidated Financial Statements

June 30, 2012 and 2011

(Dollars in thousands)

(17) Functional Expenses

The Health System considers healthcare services and general and administrative to be its primary functional categories for purposes of expense classification. The Health System's operating expenses by functional classification are as follows for the years ended June 30:

| | <u>2012</u> | <u>2011</u> |
|----------------------------|-------------------|----------------|
| Healthcare services | \$ 266,577 | 259,045 |
| General and administrative | 33,961 | 30,715 |
| | <u>\$ 300,538</u> | <u>289,760</u> |

(18) Subsequent Events

Management evaluated all events and transactions that occurred after June 30, 2012 and through October 22, 2012. The Health System did not have any material recognizable subsequent events during this period.

SUPPLEMENTARY INFORMATION

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Balance Sheet Information

June 30, 2012

(Dollars in thousands)

| Assets | Western Maryland Health System Corporation | Frostburg Nursing & Rehabilitation Center | Haystack Consolidated Services, Inc. | Western Maryland Health System Foundation Inc. | Eliminations | Consolidated |
|--|---|--|---|---|---------------------|---------------------|
| Current assets: | | | | | | |
| Cash and cash equivalents | \$ 33,893 | 6,394 | 1,452 | 2,834 | — | 44,573 |
| Short-term investments | 28,190 | — | 639 | 3,122 | — | 31,951 |
| Funds on deposit with trustee | 15,303 | — | — | — | — | 15,303 |
| Accounts receivable, net | 40,315 | 1,200 | — | — | — | 41,515 |
| Pledge receivable, net | — | — | — | 941 | — | 941 |
| Other receivables, net | 5,170 | — | 288 | 7 | (1,634) | 3,831 |
| Inventories and other current assets | 11,855 | 1 | — | 2 | (1,650) | 10,208 |
| Total current assets | <u>134,726</u> | <u>7,595</u> | <u>2,379</u> | <u>6,906</u> | <u>(3,284)</u> | <u>148,322</u> |
| Funds on deposit with trustee | 32,701 | — | — | — | — | 32,701 |
| Board designated investments | 945 | — | — | — | — | 945 |
| Other long-term investments | 78 | — | — | 558 | — | 636 |
| Investments restricted by donor or grantor | 732 | — | — | 1,489 | — | 2,221 |
| Beneficial interest in trustee held and Foundation's assets | — | — | — | 1,728 | — | 1,728 |
| Property and equipment, net | 354,151 | 300 | — | — | — | 354,451 |
| Unamortized financing fees | 4,258 | — | — | — | — | 4,258 |
| Investments in affiliates | 16,893 | — | 119 | — | — | 17,012 |
| Other assets | 4,241 | — | — | — | — | 4,241 |
| Total assets | <u>\$ 548,725</u> | <u>7,895</u> | <u>2,498</u> | <u>10,681</u> | <u>(3,284)</u> | <u>566,515</u> |

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Balance Sheet Information

June 30, 2012

(Dollars in thousands)

| Liabilities and Net Assets | Western Maryland Health System Corporation | Frostburg Nursing & Rehabilitation Center | Haystack Consolidated Services, Inc. | Western Maryland Health System Foundation Inc. | Eliminations | Consolidated |
|--|---|--|---|---|---------------------|---------------------|
| Current liabilities: | | | | | | |
| Current portion of long-term debt | \$ 7,863 | — | — | — | — | 7,863 |
| Accounts payable and accrued liabilities | 6,958 | 573 | 1,312 | 1,634 | (3,284) | 7,193 |
| Accrued bond interest payable | 7,858 | — | — | — | — | 7,858 |
| Accrued salaries and benefits | 14,822 | 277 | — | — | — | 15,099 |
| Payable to third-party payors | 8,050 | — | — | — | — | 8,050 |
| Total current liabilities | 45,551 | 850 | 1,312 | 1,634 | (3,284) | 46,063 |
| Long-term debt, net of current portion | 328,663 | — | — | — | — | 328,663 |
| Pension benefits in excess of pension assets | 60,202 | — | — | — | — | 60,202 |
| Other liabilities | 13,380 | — | — | — | — | 13,380 |
| Total liabilities | 447,796 | 850 | 1,312 | 1,634 | (3,284) | 448,308 |
| Net assets: | | | | | | |
| Unrestricted: | | | | | | |
| Unrestricted net assets | 98,102 | 7,045 | 1,186 | 4,949 | — | 111,282 |
| Noncontrolling interest in consolidated subsidiaries | 2,094 | — | — | — | — | 2,094 |
| Total unrestricted net assets | 100,196 | 7,045 | 1,186 | 4,949 | — | 113,376 |
| Temporarily restricted | 492 | — | — | 2,370 | — | 2,862 |
| Permanently restricted | 241 | — | — | 1,728 | — | 1,969 |
| Total net assets | 100,929 | 7,045 | 1,186 | 9,047 | — | 118,207 |
| Total liabilities and net assets | \$ 548,725 | 7,895 | 2,498 | 10,681 | (3,284) | 566,515 |

See accompanying independent auditors' report.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Statement of Operations Information

Year ended June 30, 2012

(Dollars in thousands)

| | Western Maryland Health System Corporation (see note 1) | Frostburg Nursing & Rehabilitation Center | Haystack Consolidated Services, Inc. | Western Maryland Health System Foundation Inc. | Eliminations | Consolidated |
|---|--|--|---|---|---------------------|---------------------|
| Unrestricted revenues, gains and other support: | | | | | | |
| Net patient service revenue | \$ 282,255 | 7,079 | — | — | — | 289,334 |
| Other revenue | 5,630 | 57 | — | — | (322) | 5,365 |
| Total revenues, gains and other support | <u>287,885</u> | <u>7,136</u> | <u>—</u> | <u>—</u> | <u>(322)</u> | <u>294,699</u> |
| Expenses: | | | | | | |
| Salaries and wages | 106,327 | 3,384 | — | — | — | 109,711 |
| Employee benefits | 32,647 | 1,089 | — | — | — | 33,736 |
| Professional fees | 9,088 | 41 | — | — | — | 9,129 |
| Purchased services | 18,343 | 812 | — | 291 | (291) | 19,155 |
| Supplies | 60,552 | 617 | — | 2 | (2) | 61,169 |
| Utilities | 4,346 | 151 | — | — | — | 4,497 |
| Insurance | 4,757 | 2 | — | 2 | — | 4,761 |
| Bad debts | 5,402 | 415 | — | — | — | 5,817 |
| Interest | 15,788 | — | — | — | — | 15,788 |
| Depreciation and amortization | 28,714 | 60 | — | — | — | 28,774 |
| Other | 7,152 | 573 | 1 | 304 | (29) | 8,001 |
| Total expenses | <u>293,116</u> | <u>7,144</u> | <u>1</u> | <u>599</u> | <u>(322)</u> | <u>300,538</u> |
| Operating loss | <u>(5,231)</u> | <u>(8)</u> | <u>(1)</u> | <u>(599)</u> | <u>—</u> | <u>(5,839)</u> |

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Statement of Operations Information

Year ended June 30, 2012

(Dollars in thousands)

| | Western Maryland Health System Corporation | Frostburg Nursing & Rehabilitation Center | Haystack Consolidated Services, Inc. | Western Maryland Health System Foundation Inc. | Eliminations | Consolidated |
|--|---|--|---|---|---------------------|---------------------|
| Nonoperating income: | | | | | | |
| Equity in income of affiliates | \$ 4,887 | — | (238) | — | — | 4,649 |
| Investment income | 2,578 | 9 | 23 | 76 | — | 2,686 |
| Unrealized gains (losses) on trading portfolio | 665 | — | 4 | (50) | — | 619 |
| Other | 2 | 2 | — | 127 | — | 131 |
| | <u>8,132</u> | <u>11</u> | <u>(211)</u> | <u>153</u> | <u>—</u> | <u>8,085</u> |
| Total nonoperating income | | | | | | |
| Excess (deficiency) of revenues over (under) expenses | \$ <u>2,901</u> | <u>3</u> | <u>(212)</u> | <u>(446)</u> | <u>—</u> | <u>2,246</u> |

See accompanying independent auditors' report.

WESTERN MARYLAND HEALTH SYSTEM CORPORATION

Consolidating Statement of Changes in Net Assets Information

Year ended June 30, 2012

(Dollars in thousands)

| | Western Maryland Health System Corporation | Frostburg Nursing & Rehabilitation Center | Haystack Consolidated Services, Inc. | Western Maryland Health System Foundation Inc. | Consolidated |
|---|---|--|---|---|---------------------|
| Unrestricted net assets: | | | | | |
| Balance at June 30, 2011 | \$ 140,847 | 7,042 | 1,398 | 5,395 | 154,682 |
| Excess of revenues over expenses | 2,901 | 3 | (212) | (446) | 2,246 |
| Change in funded status of pension plan | (39,795) | — | — | — | (39,795) |
| Net assets released for purchase of property and equipment | 808 | — | — | — | 808 |
| Distributions to noncontrolling interest in consolidated interest | (4,565) | — | — | — | (4,565) |
| Balance at June 30, 2012 | <u>100,196</u> | <u>7,045</u> | <u>1,186</u> | <u>4,949</u> | <u>113,376</u> |
| Temporarily restricted net assets: | | | | | |
| Balance at June 30, 2011 | 1,333 | — | — | 2,994 | 4,327 |
| Investment income | — | — | — | 5 | 5 |
| Donations | — | — | — | 112 | 112 |
| Grants | 735 | — | — | — | 735 |
| Net assets released from restrictions used for operations | (768) | — | — | (741) | (1,509) |
| Net assets released for purchase of property and equipment | (808) | — | — | — | (808) |
| Balance at June 30, 2012 | <u>492</u> | <u>—</u> | <u>—</u> | <u>2,370</u> | <u>2,862</u> |
| Permanently restricted net assets: | | | | | |
| Balance at June 30, 2011 | 246 | — | — | 1,789 | 2,035 |
| Change in beneficial interest of trustee-held assets | (5) | — | — | (61) | (66) |
| Balance at June 30, 2012 | <u>241</u> | <u>—</u> | <u>—</u> | <u>1,728</u> | <u>1,969</u> |
| Net assets at June 30, 2012 | <u>\$ 100,929</u> | <u>7,045</u> | <u>1,186</u> | <u>9,047</u> | <u>118,207</u> |

See accompanying independent auditors' report.