Consolidated Financial Statements and Supplementary Information

Peninsula Regional Medical Center
Years Ended June 30, 2014 and 2013
With Report of Independent Auditors

Ernst & Young LLP

Building a better working world

Peninsula Regional Medical Center

Consolidated Financial Statements and Supplementary Information

Years Ended June 30, 2014 and 2013

Contents

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Report of Independent Auditors

The Board of Trustees
Peninsula Regional Medical Center

We have audited the accompanying consolidated financial statements of Peninsula Regional Medical Center (the "Hospital"), which comprise the consolidated balance sheets as of June 30, 2014 and 2013, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Delmarva Peninsula Insurance Company (DPIC), a wholly-owned subsidiary of the Hospital. DPIC reflects total assets and total revenues constituting 3% and 0% in 2014 of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for DPIC, is based solely on the report of the other auditors. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Hospital's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, based on our audits and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Peninsula Regional Medical Center at June 30, 2014 and 2013, and the results of its operations and changes in net assets and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Supplementary Information

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

Ernst & Young LLP

September 19, 2014

Peninsula Regional Medical Center

Consolidated Balance Sheets
(In Thousands)

	June 30	
	2014	**2013**
Assets		
Current assets:		
Cash and cash equivalents	**$ 27,265**	$ 19,121
Short-term investments	**4,899**	4,757
Accounts receivable, less allowance for uncollectible accounts (2014 – $7,881; 2013 – $7,460)	**38,408**	36,728
Inventories	**9,208**	7,148
Prepaids	**5,235**	6,370
Total current assets	**85,015**	74,124
Long-term investments	**204,703**	171,591
Board-designated investments	**22,224**	18,941
Assets limited as to use:		
Debt service reserve fund	**9,267**	9,245
Donor-restricted fund	**28,610**	26,045
Self-insurance fund	**17,152**	13,154
	55,029	48,444
Property and equipment, net	**203,336**	207,843
Unamortized financing costs, net of accumulated amortization (2014 – $765; 2013 – $667)	**2,156**	2,254
Other assets	**13,413**	2,317
Total assets	**$ 585,876**	$ 525,514

	June 30	
	2014	**2013**
Liabilities and net assets		
Current liabilities:		
Current portion of long-term debt	**$ 3,185**	$ 3,055
Current portion of accrued self-insured liabilities	**2,495**	2,395
Accounts payable	**16,262**	20,131
Accrued liabilities	**14,942**	14,287
Advances from third-party payors	**9,221**	8,054
Total current assets	**46,105**	47,922
Long-term debt, net	**121,517**	124,985
Other liabilities	**14,648**	14,344
Total liabilities	**182,270**	187,251
Net assets:		
Unrestricted	**375,152**	312,181
Temporarily restricted	**20,361**	17,999
Permanently restricted	**8,093**	8,083
Total net assets	**403,606**	338,263
Total liabilities and net assets	**$ 585,876**	$ 525,514

See accompanying notes.

Peninsula Regional Medical Center

Consolidated Statements of Operations and Changes in Net Assets

(In Thousands)

	Year Ended June 30	
	2014	2013
Unrestricted revenue and other support:		
Net patient service revenue	**$ 384,385**	$ 375,278
Provision for bad debts	**(14,313)**	(15,598)
Net patient service revenue less provision for bad debts	**370,072**	359,680
Other operating revenue	**5,789**	6,444
Total unrestricted revenue and other support	**375,861**	366,124
Operating expenses:		
Salaries and wages	**150,202**	149,254
Supplies and other expenses	**148,819**	151,802
Employee benefits	**40,428**	40,044
Depreciation	**22,685**	22,008
Interest	**6,036**	6,151
Total operating expenses	**368,170**	369,259
Income (loss) from operations	**7,691**	(3,135)
Nonoperating income:		
Investment income	**21,729**	13,210
Basic swap income	**–**	644
Total non-operating income	**21,729**	13,854
Excess of unrestricted revenue and other support over expenses	**29,420**	10,719

(continued)

Peninsula Regional Medical Center

Consolidated Statements of Operations and Changes in Net Assets (continued)

(In Thousands)

	Year Ended June 30	
	2014	**2013**
Unrestricted net assets:		
Excess of unrestricted revenue and other support over expenses	**$ 29,420**	$ 10,719
Capital contribution from parent	**6,000**	–
Net assets released from restrictions used for capital expenditure	**1,900**	269
Unrealized gains on investments	**13,567**	8,145
Pension adjustment	**12,084**	5,145
Increase in unrestricted net assets	**62,971**	24,278
Temporary restricted net assets:		
Change in equity interest in the Foundation	**980**	1,059
Donations	**57**	–
Net realized gains on investments	**1,862**	1,002
Unrealized gains on investments	**1,513**	1,112
Net assets released from restrictions	**(2,050)**	(428)
Increase in temporarily restricted net assets	**2,362**	2,745
Permanently restricted net assets:		
Net realized gains on investments	**5**	9
Unrealized gains on investments	**5**	3
Increase in permanently restricted net assets	**10**	12
Increase in net assets	**65,343**	27,035
Net assets at beginning of year	**338,263**	311,228
Net assets at end of year	**$ 403,606**	$ 338,263

See accompanying notes.

Peninsula Regional Medical Center

Consolidated Statements of Cash Flows

(In Thousands)

	Year Ended June 30	
	2014	**2013**
Operating activities		
Change in net assets	**$ 65,343**	$ 27,035
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation of property and equipment	**22,685**	22,008
Amortization of original issue premium	**(283)**	(292)
Amortization of intangible assets	**98**	98
Gain on sale of property and equipment	**(15)**	(193)
Net unrealized gain on investments	**(15,080)**	(7,233)
Net realized gain on investments	**(17,790)**	(10,721)
Non-cash change in donor-restricted fund	**1,070**	569
Proceeds from restricted contributions and realized (gains) losses on restricted investments	**(2,899)**	998
Capital contribution from parent	**(6,000)**	–
Changes in operating assets and liabilities:		
Accounts receivable	**(1,483)**	2,353
Inventories and other assets	**(12,742)**	1,604
Accounts payable and accrued liabilities	**(3,213)**	1,620
Accrued self-insured and other liabilities	**402**	(5,983)
Advances from third-party payors	**1,166**	(1,903)
Net cash provided by operating activities	**31,259**	29,960
Investing activities		
Purchase of investments	**(136,140)**	(126,724)
Proceeds from sales of investments	**132,453**	127,262
Purchase of property and equipment	**(18,194)**	(29,423)
Proceeds from disposal of assets	**30**	–
Change in assets limited as to use	**(7,108)**	(2,734)
Net cash used in investing activities	**(28,959)**	(31,619)
Financing activities		
Capital contribution from parent	**6,000**	–
Proceeds from restricted contributions and realized gains (losses) on restricted investments	**2,899**	(998)
Repayments of long-term debt	**(3,055)**	(2,931)
Net cash provided by (used in) financing activities	**5,844**	(3,929)
Net increase (decrease) in cash and cash equivalents	**8,144**	(5,588)
Cash and cash equivalents at beginning of year	**19,121**	24,709
Cash and cash equivalents at end of year	**$ 27,265**	$ 19,121

See accompanying notes.

1. Organization and Mission

Peninsula Regional Medical Center (the Hospital) is a not-for-profit, nonstock corporation founded in 1897 to serve the health care needs of its region. Primary service areas include the Maryland counties of Wicomico, Somerset and Worcester, south Delaware and the northern Eastern Shore of Virginia. The Hospital's mission is to improve the health care of the community by providing exceptional quality primary, secondary and selected tertiary health care services to patients in a competent and compassionate manner, designed to elicit a high degree of customer satisfaction. The Hospital provides services regardless of race, creed, sex, national origin, handicap or age. In May 2013, Delmarva Peninsula Insurance Company (DPIC) was formed as a wholly owned subsidiary of the Hospital. DPIC was formed as a captive insurer to provide professional and general liability insurance.

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

2. Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of the Hospital and its wholly owned subsidiary, Delmarva Peninsula Insurance Company (DPIC).

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual amounts could differ from those estimates.

2. Significant Accounting Policies (continued)

Fair Value of Financial Instruments

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

Cash and Cash Equivalents

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

Investments and Investment Income

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

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

The Hospital periodically evaluates whether any declines in the fair value of investments are other-than-temporary. This evaluation consists of a review of several factors, including but not limited to: length of time and extent that a security has been in an unrealized loss position; the existence of an event that would impair the issuer's future earnings potential; the near-term prospects for recovery of the market value of a security; and the intent and ability of the Hospital to hold the security until the market value recovers. Realized gains or losses are included in nonoperating (expense) income in the accompanying statements of operations. Declines in fair value below cost that are deemed to be other-than-temporary would be recorded as realized losses within nonoperating (expense) income. Based on its evaluation, the Hospital has recorded no other-than-temporary impairments for the years ended June 30, 2014 and 2013.

2. Significant Accounting Policies (continued)

Accounts Receivable and Contractual Allowances

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

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

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

Approximately 39% and 38%, respectively, of accounts receivable were due from the Medicare program as of June 30, 2014 and 2013, respectively.

The Medicare and Medicaid reimbursement programs represent a substantial portion of the Hospital's revenues. The Hospital's operations are subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement for patient services and Medicare and Medicaid fraud and abuse.

2. Significant Accounting Policies (continued)

Over the past several years, government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by health care providers. Violations of these laws and regulations could result in expulsion from government health care programs, together with the imposition of fines and penalties, as well as repayments for patient services previously billed. Compliance with fraud and abuse standards and other government regulations can be subject to future government review and interpretation. Also, future changes in federal and state reimbursement funding mechanisms and related government budgeting constraints could have an adverse effect on the Hospital.

Inventories

Inventories consist of supplies. Inventories of supplies are carried at lower of cost or market, using the first-in, first-out method.

Other Assets

Other assets includes an investment in a limited partnership, a prepaid pension asset, and a reinsurance receivable asset. The investment is accounted for under the equity method of accounting.

Assets Limited as to Use

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

Board-Designated Investments

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

2. Significant Accounting Policies (continued)

Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

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

Unamortized Financing Costs

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

Estimated Self-Insurance Liabilities and Workers' Compensation

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

Pension Benefits

Pension benefits are recorded in accordance with ASC No. 715, *Compensation – Retirement Benefits*, which requires the recognition of the funded status of pension plans within the accompanying balance sheets. As of June 30, 2014 the funded status of the pension plan has been recorded within other assets. As of June 30, 2013, the funded status of the pension plan has been recorded within other long-term liabilities.

(In Thousands)

2. Significant Accounting Policies (continued)

Temporarily and Permanently Restricted Net Assets

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

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

Net Patient Service Revenue

Net patient service revenue is reported at the estimated realizable amounts from patients, third-party payors and others for services rendered. During 2014 and 2013, approximately 48% and 48% of net patient service revenue was received under the Medicare program, 13% and 13% from CareFirst Blue Cross Blue Shield, 33% and 31% from contracts with other third parties, and 7% and 8% from other sources, respectively.

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

	Year Ended June 30	
	2014	**2013**
Gross patient service revenue	**$ 483,185**	$ 478,086
Revenue deductions:		
Charity care	**16,369**	22,153
Contractual and other allowances	**82,431**	80,655
Net patient service revenue	**384,385**	375,278
Less: Provision for bad debts	**14,313**	15,598
Net patient service revenue less bad debts	**$ 370,072**	$ 359,680

2. Significant Accounting Policies (continued)

The Hospital employs physicians in several hospital-based specialties. The Hospital bills for the services provided by these physicians. Net physician revenue is recognized when the services are provided and recorded at the estimated net realizable amount based on the contractual arrangements with third-party payors and the expected payments from the third-party payors and the patients. The difference between the billed charges and the estimated net realizable amounts are recorded as a reduction in physician revenue when the services are provided. For the years ended June 30, 2014 and 2013, the Hospital recorded $26,497 and $25,337 of net physician revenue, respectively. At June 30, 2014 and 2013, approximately $717 and $1,199, respectively, of net physician accounts receivable are included in accounts receivable in the accompanying balance sheets.

Patient accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectability of accounts receivable, the Hospital analyzes its past history and identifies trends for each of its major payer sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. Management regularly reviews data about these major payer sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts. For receivables associated with services provided to patients who have third-party coverage, the Hospital analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts, if necessary. For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the Hospital records a provision for bad debts in the period of service on the basis of its past experience. The difference between the standard rates (or the discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts. The Hospital has not changed its charity care or uninsured discount policies during fiscal years 2014 or 2013.

2. Significant Accounting Policies (continued)

Other Operating Revenue

The American Recovery and Reinvestment Act of 2009 provides for Medicare and Medicaid incentive payments for eligible hospitals and professionals that implement and achieve meaningful use of certified electronic health record (EHR) technology. For Medicare and Medicaid EHR incentive payments, the Hospital uses a gain contingency accounting method to recognize the revenues. Under this accounting policy, EHR incentive payments are recognized as revenue upon the completion of the meaningful use period and completion of the related 12-month cost report. Accordingly, the Hospital recognized approximately $3,905 of EHR revenues for the year ended June 30, 2014 and $4,606 for the year ended June 30, 2013. This is based on cost report data which is subject to audit by CMS or its intermediaries, and the amounts recognized are subject to change.

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

Charity Care

The Hospital provided care to patients who met certain criteria under its charity care policy, without charge or at amounts less than its approved rates. Because the Hospital did not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. The amounts written off as charity care for 2014 and 2013 were $12,957 and $17,833, respectively. These amounts represent direct and indirect charity care costs, which are calculated using the Hospital's cost to charge ratio. The state of Maryland rate system includes components within the rates to partially compensate hospitals for uncompensated care.

(In Thousands)

2. Significant Accounting Policies (continued)

Donor-Restricted Gifts

Unconditional promises to give cash and other assets to the Hospital are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted donations if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or the purpose of the restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statements of operations and changes in net assets as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying financial statements.

Investment Income

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

The components of investment income are as follows:

	Year Ended June 30	
	2014	**2013**
Interest and dividend income	**$ 3,687**	$ 3,643
Realized gains, net	**15,343**	8,084
Income earned on equity method investments	**2,679**	1,216
Other	**20**	267
Total	**$ 21,729**	$ 13,210

2. Significant Accounting Policies (continued)

Income Taxes

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

Performance Indicator

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

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2014-09 *Revenue from Contracts with Customers (Topic 606)*. This guidance is intended to improve and converge with international standards the financial reporting requirements for revenue from contracts with customers. It will be effective for fiscal year 2019 and early adoption is permitted beginning in fiscal year 2018. We have not yet determined the impact from adoption of this new accounting pronouncement on our financial statements.

(In Thousands)

3. Property and Equipment

A summary of property and equipment follows:

	Estimated Useful Lives	June 30 2014	June 30 2013
Land	–	**$ 10,636**	$ 10,636
Land improvements	20	**13,857**	13,857
Buildings and improvements	15 – 40	**205,008**	203,491
Fixed equipment	20	**34,115**	34,115
Movable equipment	7 – 10	**212,673**	203,715
		476,289	465,814
Less accumulated depreciation		**(289,015)**	(266,653)
		187,274	199,161
Construction in progress		**16,062**	8,682
Property and equipment, net		**$ 203,336**	$ 207,843

As of June 30, 2014, the Hospital was committed to building and equipment purchases totaling approximately $1,301.

4. Other Liabilities

The components of other liabilities are as follows:

	June 30 2014	June 30 2013
Long-term benefit obligation	**$ –**	$ 2,986
Self-insurance obligations	**13,819**	10,921
Other	**829**	437
Total	**$ 14,648**	$ 14,344

(In Thousands)

5. Long-Term Debt

Long-term debt consists of the following:	June 30	
	2014	**2013**
Maryland Health and Higher Educational Facilities Authority Revenue Bonds Series 2006:		
Serial bonds with interest rates ranging from 3.50% to 5.00% and effective rates ranging from 3.49% to 4.67% due in various annual amounts on July 1 of each year from 2007 through 2021 and 2027	**$ 27,810**	$ 30,850
5.00% term bonds with effective rate of 4.44% due July 1, 2026	**24,635**	24,635
5.00% term bonds with effective rate of 4.63% due July 1, 2036	**69,505**	69,505
Property acquisition note:		
5.50% due March 1 of each year from 2007 to 2015	**15**	30
	121,965	125,020
Less:		
Current portion of Maryland Health and Higher Educational Facilities Authority Series 2006 serial bonds	**3,170**	3,040
Property acquisition note	**15**	15
	118,780	121,965
Original issue premium	**2,737**	3,020
Long-term debt, less current portion	**$ 121,517**	$ 124,985

5. Long-Term Debt (continued)

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

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

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

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

On March 1, 2006, the Hospital entered into a promissory note for the acquisition of property in the amount of $135 ($15 outstanding at June 30, 2014). The interest rate is 5.50% with principal and interest due annually through 2015.

(In Thousands)

5. Long-Term Debt (continued)

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

2015	$ 3,185
2016	3,330
2017	3,495
2018	3,670
2019	3,855
2020 and thereafter	104,430
	$ 121,965

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

The fair market value of the Hospital's long-term debt outstanding as of June 30, 2014 and 2013 was $125,756 and $128,925, respectively.

Total interest paid for fiscal years 2014 and 2013 was $5,990 and $6,105, respectively.

6. Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes:

	June 30	
	2014	**2013**
Health care services:		
Capital purposes	**$ 15,044**	$ 12,988
Patient services	**4,324**	4,124
Educational purposes	**993**	887
	$ 20,361	$ 17,999

(In Thousands)

6. Temporarily and Permanently Restricted Net Assets (continued)

Permanently restricted net assets are restricted to:

	June 30 2014	June 30 2013
Investments to be held in perpetuity, the income from which is expendable to support health care services	**$ 8,093**	$ 8,083

The Foundation initiated a major fundraising campaign for capital funds during fiscal year 2005 to support the Hospital's capital plans that include expansion and modernization of facilities. The Foundation has raised approximately $14,629 as of June 30, 2014, which includes net pledges receivable present valued at approximately $988. There were two large donations that represent approximately 67% and 19%, respectively, of the net pledges receivable at year-end. The Foundation expects to receive payment of all pledges by 2025. Additionally, during 2011, the Foundation launched a fundraising campaign to support the Operating Room expansion. This campaign has raised $2,644 as of June 30, 2014 which includes net pledges receivable present valued at $513. Pledges receivable are included in assets limited as to use in the accompanying balance sheets.

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

2015	$ 627
2016 – 2019	741
2020 and thereafter	515
	1,883
Less:	
Impact of discounting of pledges receivable to net present value	158
Allowance for uncollectible pledges	224
Net pledges receivable, capital campaign	1,501
Other pledges receivable	2
Total pledges receivable	$ 1,503

(In Thousands)

7. Functional Expenses

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

	Year Ended June 30	
	2014	**2013**
Health care services	**$ 331,694**	$ 334,544
Management and general	**36,476**	34,715
Total	**$ 368,170**	$ 369,259

8. Malpractice Insurance Costs, Self-Insured Professional Liability and Workers Compensation

Effective July 1, 2013, Delmarva Peninsula Insurance Captive (DPIC) was formed in the Cayman Islands as a captive insurer to provide general and professional liability insurance. DPIC is a wholly-owned subsidiary of Peninsula Regional Medical Center. Effective July 1, 2013, under a loss portfolio transfer agreement ("LPT"), DPIC assumed the Medical Professional Liability ("MPL") and General Liability ("GL") coverage previously included under PRMC's self-insurance plan for incidents occurring between March 1, 1986, and June 30, 2013, for MPL and for occurrences between March 1, 2004 and June 30, 2013 for GL, on a claims occurrence basis. The policy provides MPL coverage limits varying from $1 million to $2 million each and every medical incident, with policy aggregates varying from $3 million to $8 million. The policy provides GL coverage limits of $1 million per occurrence and $3 million policy aggregates. This policy is retrospectively rated. DPIC is fully insured by commercial carriers in excess of the coverage limits discussed above up to $25 million per claim and in the aggregate. In the prior year the Hospital was self-insured, but it did not use a captive entity. As of June 30, 2014 and 2013, the accrued self-insured professional liability losses have been discounted at 0% for both years. As of June 30, 2014 and 2013, respectively, $12,503 and $10,170 have been reserved for professional liability loss contingencies, including excess coverage. A related reinsurance receivable of $3,664 and $0 has been recorded in Other Assets as of June 30, 2014 and June 30, 2013 respectively.

8. Malpractice Insurance Costs, Self-Insured Professional Liability and Workers Compensation (continued)

Effective July 1, 2013, DPIC provides excess umbrella liability coverage on a mature claims-made basis with a retroactive date of March 1, 2005. The excess medical professional liability tower follows form of the underlying primary MPL coverage providing a total of $25 million limits of liability. The umbrella liability coverage provides $25 million limits of liability excess of scheduled underlying coverages including the primary GL coverage. The excess umbrella liability coverage is 100% reinsured with Darwin for the first $10 million limit and OneBeacon for the second $15 million limit.

The Hospital is self-insured for workers' compensation up to an annual limit of $500 per occurrence. The Hospital carries an excess liability insurance policy for workers' compensation claims above this limit. As of June 30, 2014 and 2013, respectively, $3,600 and $3,104 have been reserved for workers' compensation loss contingencies.

9. Investments

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

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

(In Thousands)

9. Investments (continued)

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

	June 30	
	2014	**2013**
Investments:		
Cash and cash equivalents	**$ 12,924**	$ 12,589
U.S. treasury securities	**11,835**	9,637
Corporate bonds	**56,783**	44,463
Equity securities	**176,759**	142,649
Mortgage-backed securities	**23,914**	31,849
Other (including pledges receivable held at the Foundation)	**4,640**	3,070
Total	**$ 286,855**	$ 244,257

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

(In Thousands)

9. Investments (continued)

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

The following table shows the gross unrealized losses and fair value of the Hospital's investments with unrealized losses that are not deemed to be other than temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2014 and 2013:

	Fair Value < 1 year	Unrealized Losses < 1 year	Fair Value > 1 year	Unrealized Losses > 1 year	Total Unrealized Losses
June 30, 2014					
U.S. Treasury	**$ 829**	**$ 1**	**$ 8,153**	**$ 233**	**$ 234**
Mortgage-backed securities	**3,953**	**58**	**8,838**	**372**	**430**
Corporate bonds	**4,878**	**47**	**6,219**	**215**	**262**
Equity securities	**14,670**	**894**	**749**	**52**	**946**
Total investments	**$ 24,330**	**$ 1,000**	**$ 23,959**	**$ 872**	**$ 1,872**
June 30, 2013					
U.S. Treasury	$ 6,165	$ 112	$ 1,666	$ 35	$ 147
Mortgage-backed securities	12,405	303	3,788	161	464
Corporate bonds	21,863	679	1,675	91	770
Equity securities	15,176	1,047	1,680	112	1,159
Total investments	$ 55,609	$ 2,141	$ 8,809	$ 399	$ 2,540

10. Group Purchasing Organization Initial Public Offering

The Hospital has participated and owned equity in the Premier Limited Partnership (Premier) which has served as a group purchasing organization for many years. This participation provides purchasing contract rates and rebates the Hospital would not be able to obtain on its own. The Hospital accounts for its investment in Premier using the equity method of accounting.

During the year ended June 30, 2014, Premier restructured from a privately held company to a public company in an initial public offering (IPO) and several financial transactions have occurred with those holding equity in Premier before the IPO, including the Hospital. As a result, the Hospital received a cash payment of approximately $1.6 million in exchange for 16% of its previous ownership in Premier. In addition, in exchange for the extension of the group purchasing contract, the Hospital received partial ownership of the new public Company (the Class B units).

The Hospital recognized a gain of approximately $1.5 million on the sale of its 16% interest and that is presented in investment income in the accompanying financial statements. The Hospital received 337,447 Class B units that are earned in 7 separate tranches over an 85 month period ending October 31, 2020. The opportunity will exist in the future for these Class B units to be converted to the Premier public company stock. Prior to vesting, the Class B units may be transferred or sold with the approval of Premier. During the year ended June 30, 2014, the Hospital recognized approximately $1.0 million related to Tranche 1 of the Class B units. This amount is recorded as an investment on the accompanying balance sheet and was recognized as a reduction of supplies expense in the accompanying statement of operations as the value of the Class B shares is tied to the group purchasing contract and is considered a vendor incentive.

11. Fair Value Measurements

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

11. Fair Value Measurements (continued)

- Level 1 – Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Hospital has the ability to access.

- Level 2 – Inputs to the valuation methodology include:

  – Quoted prices for similar assets or liabilities in active markets;

  – Quoted prices for identical or similar assets or liabilities in inactive markets;

  – Inputs other than quoted prices that are observable for the asset or liability; and

  – Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

- Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

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

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

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

(In Thousands)

11. Fair Value Measurements (continued)

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

	Assets at Fair Value as of June 30, 2014			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets				
Cash and cash equivalents	**$ 12,924**	**$ –**	**$ –**	**$ 12,924**
U.S. treasury securities	**11,835**	**–**	**–**	**11,835**
Corporate bonds	**–**	**56,783**	**–**	**56,783**
Mortgage-backed securities	**–**	**23,914**	**–**	**23,914**
Equity securities	**176,759**	**–**	**–**	**176,759**
Other	**3,137**	**–**	**1,503**	**4,640**
Total assets	**$ 204,655**	**$ 80,697**	**$ 1,503**	**$ 286,855**

	Assets at Fair Value as of June 30, 2013			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets				
Cash and cash equivalents	$ 12,589	$ –	$ –	$ 12,589
U.S. treasury securities	9,637	–	–	9,637
Corporate bonds	–	44,463	–	44,463
Mortgage-backed securities	–	31,849	–	31,849
Equity securities	142,649	–	–	142,649
Other	1,035	–	2,035	3,070
Total assets	$ 165,910	$ 76,312	$ 2,035	$ 244,257

The fair values of securities are determined by third-party service providers utilizing various methods dependent upon the specific type of investment. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Where significant inputs, including benchmark yields, broker-dealer quotes, issuer spreads, bids, offers, the LIBOR curve and measures of volatility, are used by these third-party dealers or independent pricing services to determine fair values, the securities are classified within Level 2.

(In Thousands)

11. Fair Value Measurements (continued)

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

	Year Ended June 30	
	2014	**2013**
Pledges receivable		
Balance at July 1	**$ 2,035**	$ 2,326
New pledges	**–**	337
Collections on pledges	**(622)**	(682)
Write-off of pledges	**(4)**	(16)
Changes in reserves	**94**	70
Balance at June 30	**$ 1,503**	$ 2,035

12. Pension Plan

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

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

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

(In Thousands)

12. Pension Plan (continued)

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

The following provides a reconciliation of the changes in fair value of the Plan's assets and projected benefit obligations, and the Plan's funded status:

	2014	2013
Accumulated benefit obligation	**$ 99,255**	$ 97,810
Projected benefit obligation, beginning of year	**$ 107,740**	$ 101,641
Service cost	**4,941**	4,846
Interest cost	**4,177**	4,006
Actuarial loss	**4,642**	1,599
Settlements paid	**(14,200)**	(4,119)
Benefits paid	**(324)**	(233)
Projected benefit obligation, end of year	**106,976**	107,740
Fair value of plan assets, beginning of year	**104,754**	92,529
Actual gain on plan assets	**16,772**	10,577
Employer contributions	**6,000**	6,000
Settlements paid	**(14,200)**	(4,119)
Benefits paid	**(324)**	(233)
Fair value of plan assets, end of year	**113,002**	104,754
Fair value of plan assets greater than/(less than) projected benefit obligation	**$ 6,026**	$ (2,986)
Prepaid/(Accrued) pension cost recorded in the balance sheets	**$ 6,026**	$ (2,986)

(In Thousands)

12. Pension Plan (continued)

Components of net periodic benefit cost are as follows:

	Year Ended June 30 2014	2013
Service cost	**$ 4,942**	$ 4,844
Interest cost	**4,176**	4,006
Expected return on plan assets	**(6,998)**	(7,051)
Amortization of prior service credit	**(126)**	(126)
Recognized net actuarial loss	**3,225**	3,343
Partial plan settlement	**3,853**	–
Net periodic benefit cost	**$ 9,072**	$ 5,016

During the year ended June 30, 2014, a partial settlement of the Plan's defined benefit obligation was recognized. Since the settlement was more than minor, ASC 715 requires that a pro rata amount of the net loss in accumulated unrestricted net assets is charged to excess of unrestricted revenues and other support over expenses based on the proportion of the projected benefit obligation settled to the total projected benefit obligation. The settlement has been recognized and measured as of both April 30, 2014 (settlement date) and June 30, 2014. As of June 30, 2014, the Group determined that a settlement had occurred and recognized a loss of $3,853 that was recorded within Employee Benefits expense line item in the consolidated statements of operations and changes in net assets.
Net amount recognized in unrestricted net assets that have not been recognized in net periodic benefit cost are as follows:

	2014	2013
Net actuarial loss	**$ 26,828**	$ 39,038
Prior service credit	**(315)**	(441)
Total recognized in unrestricted net assets	**$ 26,513**	$ 38,597

The estimated net actuarial loss and prior service credit for the Plan that will be amortized from unrestricted net assets into net periodic benefit cost over the next fiscal year are $2,729 and ($126), respectively.

(In Thousands)

12. Pension Plan (continued)

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

	2014	2013
Projected benefit obligation		
Discount rate	**3.50%**	4.15%
Rates of increase in compensation levels:		
Age:		
<30	**5.00%**	5.00%
30<44	**4.00%**	4.00%
45=<	**3.00%**	3.00%
Net periodic benefit cost		
Discount rate	**3.60%**	4.00%
Expected long-term return on plan assets	**7.00%**	7.25%
Rate of increase in compensation levels:		
Age:		
<30	**5.00%**	5.00%
30<44	**4.00%**	4.00%
45=<	**3.00%**	3.00%

(In Thousands)

12. Pension Plan (continued)

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

	2014	**2013**	**Target Allocation**
Debt securities	**27%**	29%	25%–40%
Equity securities	**71**	68	45%–75%
Cash and cash equivalents	**2**	3	1%–10%
Total	**100%**	100%	

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

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

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

(In Thousands)

12. Pension Plan (continued)

The fair value of the Hospital's pension plan assets as of June 30, 2014 and June 30, 2013, by asset category (see Note 10, *Fair Value Measurements*, for a description of the asset categories) are as follows:

	June 30, 2014			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets				
Investments at fair value:				
Cash and cash equivalents	**$ 2,771**	**$ –**	**$ –**	**$ 2,771**
U.S. Treasuries	**6,281**	**–**	**–**	**6,281**
Mortgage-backed securities	**–**	**7,887**	**–**	**7,887**
Corporate debt securities	**–**	**15,865**	**–**	**15,865**
Publically traded equity securities	**79,848**	**–**	**–**	**79,848**
Other	**350**	**–**	**–**	**350**
Total investments	**$ 89,250**	**$ 23,752**	**$ –**	**$ 113,002**

	June 30, 2013			
	Level 1	**Level 2**	**Level 3**	**Total**
Assets				
Investments at fair value:				
Cash and cash equivalents	$ 3,318	$ –	$ –	$ 3,318
U.S. Treasuries	5,069	–	–	5,069
Mortgage-backed securities	–	7,161	–	7,161
Corporate debt securities	–	17,829	–	17,829
Publically traded equity securities	70,591	417	–	71,008
Other	369	–	–	369
Total investments	$ 79,347	$ 25,407	$ –	$ 104,754

(In Thousands)

12. Pension Plan (continued)

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

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

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

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

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

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

Cash Flows

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

2015	$ 9,082
2016	8,801
2017	8,669
2018	8,798
2019	8,998
2020 – 2024	42,278

12. Pension Plan (continued)

The Hospital intends to make voluntary contributions to the defined benefit pension plan for the year ending June 30, 2015. Since the plan is 106% funded as of June 30, 2014, there are no regulatory funding requirements for fiscal year 2015. Accordingly, the amount to be funded has not yet been determined.

13. Commitments and Contingencies

Agreement with the Office of Inspector General

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

Operating Leases

The Company leases certain of its operating facilities and equipment. These leases, which expire through 2028, generally require the Company to pay all maintenance, property tax and insurance costs.

(In Thousands)

13. Commitments and Contingencies (continued)

At June 30, 2014, aggregate amounts of future minimum payments under operating leases were as follows:

2015	$	2,029
2016		1,688
2017		1,484
2018		1,351
2019		1,222
2020 – Beyond		7,113

Rent expense is recognized on a straight-line basis over the terms of the leases. Rent expense was $1,915 and $2,161 for the years ended June 30, 2013 and 2014, respectively.

Other

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

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

The Hospital's revenues may be subject to adjustment as a result of examination by government agencies or contractors based upon differing interpretation of government regulations, medical diagnosis, charge coding, medical necessity, or other contract terms. The resolution of these matters, if any, often is not finalized until subsequent to the period during which the services were rendered. Section 302 of the Tax Relief and Health Care Act of 2006 authorized a permanent program involving the use of third-party recovery audit contractors (RACs) to identify Medicare overpayments and underpayments made to providers. We have established protocols to respond to RAC requests and payment denials. Payment recoveries resulting from RAC reviews are appealable through administrative and judicial processes, and we intend to pursue the reversal of adverse determinations where appropriate. In addition to overpayments

13. Commitments and Contingencies (continued)

that are not reversed on appeal, we will incur additional costs to respond to requests for records and pursue the reversal of payment denials. As of June 30, 2014 and 2013, the Hospital has recorded an estimated reserve regarding the Medicare overpayments. In the opinion of the Hospital's management, the ultimate settlement of this matter will not have a material adverse effect on the financial position of the Hospital.

As part of a national investigation, the Hospital is working on a data request by the Department of Justice (DOJ) regarding the Medicare programs coverage guidelines for the implantation of implantable cardioverter defibrillators (ICD's). As of June 30, 2014, no case or demand for payment has been initiated by DOJ or Centers for Medicare and Medicaid Services (CMS). The Hospital is currently in the process of preparing a response to the DOJ data request. The Hospital does not believe the settlement of this matter will have a material adverse effect on the entity's financial statements.

The Hospital filed self-disclosures to CMS, reporting technical violations of the self referral regulations (referred to as Stark). As of June 30, 2014, the Hospital does not believe the settlements of these issues will have a material adverse effect on the entity's financial statements.

14. Maryland Health Services Cost Review Commission

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

Through June 2014, the current rate of reimbursement for principally all inpatient services and certain other services to patients under the Medicare and Medicaid programs is based on an agreement between the Centers for Medicare and Medicaid Services and the Commission. This agreement is based upon a waiver from Medicare prospective payment system reimbursement principles granted to the State of Maryland under Section 1814(b) of the Social Security Act and will continue as long as the rate of increase for costs per hospital inpatient admission in Maryland is below the national average.

14. Maryland Health Services Cost Review Commission (continued)

Beginning fiscal year 2014, the Hospital entered into an agreement with the HSCRC to participate in the Global Budgeted Revenue (GBR) program. GBR methodology encourages hospitals to focus on population health strategies by establishing a fixed annual revenue cap for each GBR hospital. The agreement is evergreen in nature and covers both regulated inpatient and outpatient revenues.

Under GBR, hospital revenue is known at the beginning of each fiscal year. Annual Revenue is calculated from a base year and is adjusted annually for inflation, infrastructure requirements, population changes, performance in quality-based programs and changes in levels of uncompensated care. Revenue may also be adjusted annually for market levels and shifts of services to unregulated services.

As of January 2014, the Centers for Medicare and Medicaid Services approved a modernized waiver that will be in place as long as Maryland hospitals commit to achieving significant quality improvements, limits on all-payer per capita hospital growth and limits on annual Medicare per capita hospital cost growth to a rate lower than the national annual per capita growth rate.

The Commission's rate-setting methodology for hospital service centers consists of establishing an acceptable unit rate for defined inpatient and outpatient service centers within the hospital. The actual average unit charge for each service center is compared to the approved rate month and annually. Overcharges and undercharges due to either patient volume or price variances, adjusted for penalties where applicable, are applied to decrease (in the case of overcharges) or increase (in the case of undercharges) future approved rates on an annual basis. The Hospital overcharged by $336, as of June 30, 2014, which is within the allowable corridor as specified in the GBR Agreement.

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

14. Maryland Health Services Cost Review Commission (continued)

Previously, under the HSCRC rate-setting system, the Hospital's inpatient charges were subject to an inpatient charge per case target (the Charge Per Case Target). Under the charge per case target methodology, the Hospital monitored its average charge per case compared to HSCRC case mix adjusted targets on a monthly basis. The Charge Per Case (CPC) Target was adjusted annually for inflation, case mix changes, and other factors.

15. Subsequent Events

The Health System has evaluated subsequent events through September 19, 2014, the date the financial statements were issued.

Supplementary Information

Peninsula Regional Medical Center

Summary of Operations

(In Thousands)

	Year Ended June 30				
	2014	2013	2012	2011	2010
Gross patient revenue	**$ 483,185**	$ 478,086	$ 476,777	$ 457,035	$ 426,582
Deductions from revenue	**98,800**	102,808	98,742	76,983	58,173
Patient revenue net of deductions	**384,385**	375,278	378,035	380,052	368,409
Provision for bad debts	**14,313**	15,598	16,616	17,411	17,977
Net patient service revenue less provision for bad debts	**370,072**	359,680	361,419	362,641	350,432
Other operating revenue	**5,789**	6,444	2,360	2,357	2,059
	375,861	366,124	363,779	364,998	352,491
Operating expenses	**368,170**	369,259	357,545	349,451	345,461
Income (loss) from operations	**7,691**	(3,135)	6,234	15,547	7,030
Nonoperating income:					
Nonoperating income:	**21,729**	13,210	6,974	12,164	10,304
Basic swap income	**-**	644	2,629	3,128	1,753
	21,729	13,854	9,603	15,292	12,057
Excess of unrestricted revenue and debt support over expenses	**$ 29,420**	$ 10,719	$ 15,837	$ 30,839	$ 19,087

Peninsula Regional Medical Center

Gross Patient Revenue
(In Thousands)

	Year Ended June 30	
	2014	**2013**
Total gross patient revenue:		
Routine care:		
Daily hospital care	**$ 78,718**	$ 78,487
Daily hospital care – nursery	**4,269**	5,009
Emergency services	**22,626**	24,058
Admissions charge	**2,269**	2,312
	107,882	109,866
Ancillary services:		
Pathology and clinical laboratory	**37,717**	35,817
Operating room	**42,291**	38,968
Pharmacy	**61,603**	59,772
Ambulatory pharmacy	**1,535**	–
Radiology:		
Diagnostic	**5,444**	5,565
Nuclear medicine	**2,562**	2,661
Special procedures	**3,880**	4,088
Ultrasound lab	**3,868**	3,549
C/T scanning and magnetic resonance imaging	**9,267**	9,001
Vascular lab	**4,431**	4,130
Radiation oncology	**12,267**	14,111
Medical oncology	**7,730**	6,754
Respiratory care and pulmonary function	**9,954**	9,750
Blood bank	**1,862**	1,629
Medical and surgical supplies	**66,184**	65,384
Delivery service	**7,943**	7,854
Anesthesiology	**3,377**	3,170
Electrocardiogram	**604**	521
Cardiac laboratory	**13,215**	14,833
Intravenous solutions	**481**	548
Lithotripsy	**84**	81
Physical, speech and occupational therapy	**5,217**	5,427
Neurological diagnostics	**5,054**	5,117
Cardiac rehabiliation	**1,294**	1,180
Family practice, clinic and diagnostic centers	**27,773**	26,002
Specialty practices	**26,996**	24,400
Transactional care	**1,784**	8,442
Recovery care	**5,446**	5,518
Observation service	**5,438**	3,948
Mental Health PHP	**2**	–
	375,303	368,220
Gross patient revenue	**$ 483,185**	$ 478,086

Peninsula Regional Medical Center

Operating Expenses
(In Thousands)

	Year Ended June 30 2014	2013	Increase (Decrease)
Nursing services	**$ 95,246**	$ 97,591	$ (2,345)
Building and grounds	**13,056**	13,762	(706)
Laboratory	**13,108**	13,475	(367)
Materials management	**4,888**	6,154	(1,266)
Adminstration	**26,842**	29,564	(2,722)
Food services	**3,467**	4,101	(634)
Financial affairs and information systems	**20,630**	19,213	1,417
Respiratory services	**4,908**	5,420	(512)
Pharmacy	**38,843**	36,192	2,651
Radiology	**13,342**	13,952	(610)
Radiation oncology	**5,298**	5,334	(36)
Medical oncology	**6,947**	7,141	(194)
Physican services	**7,649**	6,923	726
Electrocardiology, neurological diagnostic, cardiac catheterization laboratory, family practice, lithotripsy, diagnostic, and breast care centers	**43,157**	42,254	903
Physical, speech and occupational therapy	**2,307**	3,223	(916)
Admitting and registration	**2,028**	2,373	(345)
Education and registration	**314**	1,368	(1,054)
Transitional care	**546**	2,321	(1,775)
Employee benefits, child care (exclusive of FICA)	**36,873**	30,739	6,134
Depreciation	**22,685**	22,008	677
Interest	**5,990**	6,105	(115)
Amortization of financing costs and deferred charge for retirement of debt	**46**	46	–
	$ 368,170	$ 369,259	$ (1,089)

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