Consolidated Financial Statements and Other Financial Information

Anne Arundel Health System, Inc. and Subsidiaries
Years Ended June 30, 2010 and 2009
With Report of Independent Auditors

Ernst & Young LLP

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Contents

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Report of Independent Auditors

Board of Trustees of
Anne Arundel Health System, Inc.

We have audited the accompanying consolidated balance sheets of Anne Arundel Health System, Inc. (a Maryland not-for-profit corporation) and subsidiaries as of June 30, 2010 and 2009, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of Anne Arundel Health System, Inc. and subsidiaries' (the Group's) management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Cottage Insurance Company, Ltd., a wholly-owned subsidiary, which statements reflect total assets of $31,308,000 and $23,924,000 as of June 30, 2010 and 2009, respectively, and net income (loss) after elimination of intercompany revenues of $215,000 and $(2,947,000), respectively, for the years then ended. 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 Cottage Insurance Company, Ltd., 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. We were not engaged to perform an audit of the Group's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our 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 Anne Arundel Health System, Inc. and subsidiaries as of June 30, 2010 and 2009, and the consolidated results of their operations, changes in net assets, and cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

October 6, 2010

Anne Arundel Health System, Inc. and Subsidiaries

Consolidated Balance Sheets

	June 30	
	2010	**2009**
Assets		
Current assets:		
Cash and cash equivalents	**$ 37,366,000**	$ 34,139,000
Short-term investments	**3,425,000**	5,363,000
Current portion of assets whose use is limited	**6,623,000**	7,278,000
Patient receivables, less allowance for uncollectible accounts of $11,183,000 and $10,721,000, respectively	**55,887,000**	42,159,000
Current portion of pledges receivable, net	**4,736,000**	4,503,000
Inventories	**7,894,000**	6,454,000
Prepaid expenses and other current assets	**5,842,000**	6,824,000
Total current assets	**121,773,000**	106,720,000
Property and equipment	**663,217,000**	567,504,000
Less: accumulated depreciation and amortization	**(197,431,000)**	(171,429,000)
Net property and equipment	**465,786,000**	396,075,000
Other assets:		
Investments	**174,616,000**	152,033,000
Investments in joint ventures	**1,664,000**	1,426,000
Pledges receivable, net of current portion and net of allowance for uncollectible pledges of $806,000 and $866,000, respectively	**10,573,000**	11,279,000
Assets whose use is limited	**116,311,000**	156,249,000
Deferred debt issue costs, net of accumulated amortization of $1,632,000 and $1,975,000, respectively	**8,104,000**	9,108,000
Restricted collateral for interest rate swap contracts	**41,819,000**	35,176,000
Other assets	**11,725,000**	8,231,000
Total assets	**$ 952,371,000**	$ 876,297,000

	June 30	
	2010	**2009**
Liabilities and net assets		
Current liabilities:		
Accounts payable	**$ 24,378,000**	$ 24,865,000
Accrued salaries, wages and benefits	**22,499,000**	21,786,000
Other accrued expenses	**22,732,000**	15,157,000
Current portion of long-term debt and capital lease obligations	**4,190,000**	4,333,000
Advances from third-party payors	**14,813,000**	11,528,000
Total current liabilities	**88,612,000**	77,669,000
Long-term debt and capital lease obligations, less current portion and unamortized original issue discount	**437,471,000**	420,189,000
Interest rate swap contracts	**47,510,000**	36,299,000
Accrued pension liability	**32,148,000**	26,417,000
Other long-term liabilities	**19,808,000**	14,741,000
Total liabilities	**625,549,000**	575,315,000
Net assets:		
Unrestricted	**298,384,000**	268,812,000
Temporarily restricted	**16,690,000**	20,558,000
Permanently restricted	**11,748,000**	11,612,000
Total net assets	**326,822,000**	300,982,000
Total liabilities and net assets	**$ 952,371,000**	$ 876,297,000

See accompanying notes.

Anne Arundel Health System, Inc. and Subsidiaries

Consolidated Statements of Operations and Changes in Net Assets

	Year Ended June 30	
	2010	**2009**
Operating revenue:		
Net patient service revenue	**$ 455,275,000**	$ 415,062,000
Other operating revenue	**20,502,000**	19,512,000
Total operating revenue	**475,777,000**	434,574,000
Operating expenses:		
Salaries and wages	**191,331,000**	166,417,000
Employee benefits	**34,623,000**	41,961,000
Medical supplies and drugs	**92,583,000**	82,086,000
Purchased services	**77,645,000**	69,129,000
Professional fees	**9,075,000**	8,975,000
Depreciation and amortization	**27,294,000**	22,685,000
Interest	**13,115,000**	10,965,000
Provision for bad debts	**19,252,000**	16,969,000
Total operating expenses	**464,918,000**	419,187,000
Operating income	**10,859,000**	15,387,000
Other income (loss):		
Investment income, net	**7,831,000**	6,902,000
Income from joint ventures and other, net	**1,232,000**	1,139,000
Loss on extinguishment of debt	**(1,967,000)**	–
Change in unrealized gains (losses) on trading securities, net	**19,835,000**	(33,235,000)
Fair value adjustments for interest rate swap contracts	**(10,385,000)**	(17,810,000)
Total other income (loss), net	**16,546,000**	(43,004,000)
Revenues and gains in excess of (less than) expenses	**$ 27,405,000**	$ (27,617,000)

Anne Arundel Health System, Inc. and Subsidiaries

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

	Year Ended June 30	
	2010	**2009**
Unrestricted net assets		
Revenues and gains in excess of (less than) expenses	**$ 27,405,000**	$ (27,617,000)
Pension liability adjustment	**(10,185,000)**	(12,643,000)
Net assets released from restrictions used for purchase of property and equipment	**11,927,000**	10,584,000
Transfers and other, net	**425,000**	1,883,000
Increase (decrease) in unrestricted net assets	**29,572,000**	(27,793,000)
Temporarily restricted net assets		
Contributions and pledges	**8,966,000**	12,088,000
Change in net unrealized gains and losses on investments	**1,163,000**	(2,586,000)
Temporarily restricted investment income	**325,000**	525,000
Net assets released from restrictions	**(14,556,000)**	(11,581,000)
Transfers and other, net	**234,000**	(505,000)
Decrease in temporarily restricted net assets	**(3,868,000)**	(2,059,000)
Permanently restricted net assets		
Contributions for endowment funds	**233,000**	23,000
Transfers of interest income and other, net	**(97,000)**	(136,000)
Increase (decrease) in permanently restricted net assets	**136,000**	(113,000)
Increase (decrease) in net assets	**25,840,000**	(29,965,000)
Net assets at beginning of year	**300,982,000**	330,947,000
Net assets at end of year	**$ 326,822,000**	$ 300,982,000

See accompanying notes.

Anne Arundel Health System, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

	Year Ended June 30	
	2010	**2009**
Operating activities		
Increase (decrease) in net assets	**$ 25,840,000**	$ (29,965,000)
Adjustments to reconcile increase (decrease) in net assets to net cash provided by operating activities:		
Change in net unrealized (gains) and losses on investments	**(20,998,000)**	35,821,000
Fair value adjustments for interest rate swap contracts	**10,385,000**	17,810,000
Pension liability adjustment	**10,185,000**	12,643,000
Equity in earnings of joint ventures and other	**(536,000)**	(522,000)
Distributions received from joint ventures	**298,000**	555,000
Restricted contributions and pledges, net	**(9,201,000)**	(12,111,000)
Loss on extinguishment of debt	**1,967,000**	–
Depreciation and amortization	**27,294,000**	22,685,000
Restricted investment income	**(325,000)**	(525,000)
Decrease in investments – trading	**354,000**	11,579,000
Increase in assets whose use is limited, net – trading	**(7,504,000)**	(7,029,000)
Net change in operating assets and liabilities	**(4,849,000)**	4,036,000
Net cash provided by operating activities	**32,910,000**	54,977,000
Investing activities		
Purchases of property and equipment	**(94,264,000)**	(106,193,000)
Acquisition of OSMC	**(2,316,000)**	–
Decrease (increase) in assets whose use is limited–other– than–trading	**48,097,000**	(110,012,000)
Change in collateralization of interest rate swaps	**(6,643,000)**	(35,176,000)
Net cash used in investing activities	**(55,126,000)**	(251,381,000)
Financing and fundraising activities		
Net proceeds from issuance of Series 2009 Revenue Bonds	**–**	175,183,000
Net proceeds from issuance of Series 2010 Revenue Bonds	**83,903,000**	–
Net proceeds from term loan	**–**	55,000,000
Draws on construction loans	**11,627,000**	19,848,000
Draws on line of credit	**3,010,000**	–
Repayments of long-term debt	**(4,206,000)**	(3,582,000)
Repayment of line of credit	**(3,010,000)**	(42,502,000)
Repayment of dedicated funding program	**(15,000,000)**	–
Extinguishment of Series 2004B Revenue Bonds	**(59,350,000)**	–
Payments for deferred financing costs	**(1,525,000)**	(4,558,000)
Restricted contributions received and other	**9,669,000**	7,754,000
Restricted income received	**325,000**	525,000
Net cash provided by financing and fundraising activities	**25,443,000**	207,668,000
Net increase in cash and cash equivalents	**3,227,000**	11,264,000
Cash and cash equivalents at beginning of year	**34,139,000**	22,875,000
Cash and cash equivalents at end of year	**$ 37,366,000**	$ 34,139,000

Anne Arundel Health System, Inc. and Subsidiaries

Consolidated Statements of Cash Flows (continued)

	Year Ended June 30	
	2010	**2009**
Changes in operating assets and liabilities		
(Increase) decrease in operating assets:		
Patient receivables, net	**$ (13,728,000)**	$ 2,193,000
Inventories	**(1,348,000)**	(526,000)
Prepaid expenses and other	**982,000**	(265,000)
Other assets	**(954,000)**	(1,194,000)
	(15,048,000)	208,000
Increase (decrease) in operating liabilities:		
Accounts payable	**(487,000)**	(2,565,000)
Accrued salaries, wages and benefits	**713,000**	2,154,000
Other accrued expenses	**7,575,000**	4,682,000
Advances from third-party payors	**3,285,000**	987,000
Other long-term liabilities	**(887,000)**	(1,430,000)
	10,199,000	3,828,000
Net change in operating assets and liabilities	**$ (4,849,000)**	$ 4,036,000
Supplemental disclosures		
Cash paid for interest	**$ 22,712,000**	$ 16,284,000
Net proceeds from capital lease	**$ –**	$ 4,927,000

See accompanying notes.

1. Organization and Basis of Presentation

Anne Arundel Health System, Inc. (the Parent or the System) is a Maryland not-for-profit corporation. The Parent has the following wholly owned subsidiaries: Anne Arundel Medical Center, Inc. (the Hospital) and its subsidiaries, Anne Arundel Health Care Services, Inc. (HCS), and Anne Arundel General Treatment Services, Inc. (GTS); Anne Arundel Medical Center Foundation, Inc. (the Foundation); Anne Arundel Health Care Enterprises, Inc. (HCE); Physician Enterprise, LLC (PE) and its subsidiaries, Anne Arundel Physician Group, LLC (AAPG) and Orthopedic Physicians of Annapolis (OPA); Anne Arundel Real Estate Holding Company, Inc. (the Real Estate Company) and its subsidiaries, Pavilion Park, Inc. (PPI), Annapolis Exchange, LLC, & Blue Building, LLC; Anne Arundel Health System Research Institute, Inc. (RI); and Cottage Insurance Company, Ltd. (Cottage). PE was organized in April 2009, and operates as a not-for-profit provider of physician, diagnostic, therapeutic, and other health care services, while also providing support to AAPG and OPA, which also provide such services. OPA was acquired in July 2009 (see Note 15). The accompanying consolidated financial statements include the accounts of the Parent and its wholly owned subsidiaries (collectively, the Group). All significant intercompany accounts and transactions have been eliminated in consolidation.

The Real Estate Company and PPI own an interest in Kent Island Medical Arts, LLC (KIMA), a limited liability company that owns and operates a medical office building. PPI is the managing member of KIMA and has substantive participation rights in KIMA. The financial statements of KIMA are consolidated in the accompanying consolidated financial statements.

2. Summary of Significant Accounting Policies

Cash and Cash Equivalents

Cash and cash equivalents include cash held in checking and savings accounts, money market accounts, and short-term certificates of deposit with original maturities of 90 days or less. Cash balances, and collateral held by a counterparty, are principally uninsured and are subject to normal credit risks. At June 30, 2010 and 2009, and at various times during the year, the System maintained cash-in-bank balances in excess of the $250,000 general deposit federally insured limits.

2. Summary of Significant Accounting Policies (continued)

Derivative Instruments

On April 25, 2003, the Hospital entered into two interest rate swap derivative contracts to reduce the risk of changing interest rates. On January 27, 2004, the Hospital entered into an additional interest rate swap derivative contract for similar purposes. On May 10, 2006, the Hospital entered into a forward variable to fixed interest rate swap agreement with an effective date of November 1, 2008. This contract was also entered into in an effort to reduce the risk of variable interest rate debt and has a term through July 1, 2048. Under Accounting Standards Codification (ASC) 815, *Derivatives and Hedging*, the Hospital has recognized its derivative instruments as either assets or liabilities in the consolidated balance sheets at fair value. As these derivative instruments are not designated as hedges, the unrealized gain or loss on these contracts has been recognized in the accompanying consolidated statements of operations and changes in net assets as fair value adjustments for interest rate swap contracts. The fair values of the derivative instruments are determined under the provisions of ASC 820, *Fair Value Measurements and Disclosures* (ASC 820), which was adopted on July 1, 2008. The impact of applying the provisions of ASC 820 was to decrease the net derivative liability by $1,198,000 and $766,000 as of June 30, 2010 and 2009, respectively.

A summary of the Hospital's derivative instruments and related activity at June 30, 2010 and 2009 and for the years then ended is as follows:

	2010	
Description of Derivative Instrument	**Fair Value Asset (Liability)**	**Change in Unrealized Gain/(Loss)**
Variable-to-variable interest rate swap contract	**$ (355,000)**	**$ 250,000**
Fixed-to-variable interest rate swap contract	**2,232,000**	**826,000**
Variable-to-fixed interest rate swap contract	**(47,155,000)**	**(11,461,000)**
	$ (45,278,000)	**$ (10,385,000)**

2. Summary of Significant Accounting Policies (continued)

	2009	
Description of Derivative Instrument	**Fair Value Asset (Liability)**	**Change in Unrealized Gain/(Loss)**
Variable-to-variable interest rate swap contract	$ (605,000)	$ (1,121,000)
Fixed-to-variable interest rate swap contract	1,406,000	1,544,000
Variable-to-fixed interest rate swap contract	–	354,000
Variable-to-fixed interest rate swap contract	(35,694,000)	(18,587,000)
	$ (34,893,000)	$ (17,810,000)

At June 30, 2010 and 2009, the net termination value (i.e., mark to market value) of the derivative instruments totaled $46,476,000 and $35,659,000, respectively.

The Hospital may be exposed to credit loss in the event of nonperformance by the other party to the interest rate swap agreements, the risk of which is reflected in the fair value of the instruments under ASC 820. However, the Hospital does not anticipate nonperformance by the counterparty.

During fiscal 2010, the Hospital paid net payments under its interest rate swap program of $5,501,000. In fiscal 2009, the Hospital paid net payments under its interest rate swap program of $4,340,000. These amounts are included as increases to interest expense in the accompanying consolidated statements of operations and changes in net assets.

Under the derivative contracts, the Hospital must transfer collateral for the benefit of the counterparty to the extent that the termination values exceed certain limits. The Hospital's collateral requirement for the benefit of the counterparty was approximately $41,819,000 and $35,176,000 at June 30, 2010 and 2009, respectively, for the derivatives. The ongoing mark to market values and resulting collateral requirements of the Hospital's interest rate swap contracts are subject to variability based on market factors (primarily changes in interest rates). Collateral requirements under these interest rate swap contracts are excluded from unrestricted cash and investments for purposes of determining the System's compliance with its liquidity covenants under its Maryland Health and Higher Educational Facilities Authority (MHHEFA) revenue bond agreements and its derivative agreements. Collateral amounts are included in noncurrent assets in the accompanying consolidated balance sheets. The collateral requirement as of October 1, 2010 was $50,607,000.

2. Summary of Significant Accounting Policies (continued)

Assets Whose Use is Limited and Investments

Assets whose use is limited are principally comprised of certain funds established to be held and invested by a trustee. These funds are related to the issuance of the Hospital's Revenue Bonds, investments held at Cottage, and certain permanently restricted endowment assets.

The fair values of individual investments are based on quoted market prices of individual securities or investments or estimated amounts using quoted market prices of similar investments. Investment income from all unrestricted investments is included in the consolidated statements of operations and changes in net assets as part of other income.

Investment income (loss) on investments of temporarily and permanently restricted assets is added to or deducted from the appropriate restricted fund balance if the income is restricted. The cost of securities sold is based on the specific-identification method.

All investment balances are principally uninsured and subject to normal credit risk. Investments are classified as either current or noncurrent based on maturity dates and availability for current operations. Investments included in noncurrent other assets consist of board-designated investment funds of $173,194,000 and $150,800,000 as of June 30, 2010 and 2009, respectively. Based on the System's investment policy, such amounts could be liquidated, at the discretion of the Board, to satisfy short-term requirements.

Substantially all investments, other than borrowed funds required to be expended on capital projects, are classified as trading securities, with unrealized gains and losses included in revenues and gains in excess of (less than) expenses.

Borrowed funds required to be expended on capital projects are classified as other-than-trading and are included in assets whose use is limited.

Patient Receivables and Allowances

The Group's policy is to write off all patient accounts that have been identified as uncollectible. An allowance for doubtful accounts is recorded for accounts not yet written off that are anticipated to become uncollectible in future periods.

Insurance coverage and credit information are obtained from patients when available. No collateral is obtained for accounts receivable.

2. Summary of Significant Accounting Policies (continued)

Accounts receivable from third-party payors have been adjusted to reflect the difference between charges and the estimated reimbursable amounts.

Inventories

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

Property and Equipment

Property and equipment are stated at cost. Depreciation and amortization, including amortization of assets recorded under capital leases, are recorded on the straight-line method over the estimated useful lives of the assets.

The following is a summary of property and equipment, stated at cost:

	Estimated Useful Lives	June 30 2010	2009
Land	–	**$ 13,151,000**	$ 13,151,000
Land improvements	20 years	**10,436,000**	6,585,000
Buildings and improvements	20-40 years	**298,674,000**	228,261,000
Fixed equipment	5-20 years	**6,687,000**	6,686,000
Leasehold improvements	5-10 years	**37,362,000**	23,185,000
Movable equipment	7-10 years	**132,727,000**	124,822,000
Computers and software	3-5 years	**44,410,000**	36,248,000
Construction-in-progress	–	**119,770,000**	128,566,000
		$ 663,217,000	$ 567,504,000

Construction-in-progress consists of direct costs associated with the construction of a new nine story patient care tower scheduled to open in fiscal 2011, parking garages, certain leasehold improvements, and hospital department renovations. As these projects are completed, the related assets are transferred out of construction-in-progress and into the appropriate asset category and are depreciated over the applicable useful lives. Interest on debt is capitalized in accordance with ASC 835, *Interest,* throughout the year as part of costs for the constructed assets. The amount of net capitalized interest recorded by the Group during fiscal 2010 and 2009 was $8,520,000 and $5,319,000, respectively.

2. Summary of Significant Accounting Policies (continued)

Investments in Joint Ventures

HCE maintains a 25% equity interest in Shipley's Imaging, LLC, an imaging center. HCE also maintains a 31% equity interest in Nighttime Pediatrics and Adult Care Too, LLC, an after hours urgent care center for children and adults. HCE also maintains a 25% interest in Fresenius Anne Arundel Dialysis Services, LLC, an outpatient dialysis center. These investments are accounted for using the equity method of accounting.

Deferred Debt Issuance Costs

Administrative, legal, financing, underwriting discount and other miscellaneous expenses that were incurred in connection with debt financings were deferred and are being amortized over the lives of the bond issues using the effective interest method. The amortization expense of deferred debt issue costs was $515,000 and $338,000 for the years ended June 30, 2010 and 2009, respectively.

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the Group has been limited by donors to a specific time period or purpose. Substantially all temporarily restricted net assets in the accompanying consolidated financial statements are restricted to fund certain Hospital capital additions and operating programs. Permanently restricted net assets have been restricted by donors to be maintained in perpetuity. The income from these funds is expendable to support health care services.

Net Patient Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered. This includes regulatory discounts allowed to Blue Cross, Medicare, Medicaid, and other third-party payors and charity care.

The Group provides charity care to patients who meet certain criteria established under its charity care guidelines. Because members of the Group do not pursue the collection of amounts determined to qualify as charity care, they are not reported as revenue. The amount of charity care provided by the Group during 2010 and 2009 was $5,610,000 and $4,872,000, respectively, measured at established rates.

2. Summary of Significant Accounting Policies (continued)

A substantial amount of the Group's revenues are received from health maintenance organizations and other managed care payors. Managed care payors generally use case management activities to control hospital utilization. These payors also have the ability to select health care providers offering the most cost-effective care. Management does not believe that the Group 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, and as a result of 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.

Donations and Bequests

Unconditional promises to give cash and other assets 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 support 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 purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets in the consolidated statements of operations and changes in net assets. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the consolidated financial statements. Contributions that are unrestricted are reflected as other income in the consolidated statements of operations and changes in net assets. Pledges receivable are discounted using rates between 0.3% and 4.0%.

Revenues and Gains in Excess of (Less than) Expenses

The consolidated statements of operations and changes in net assets include revenues and gains in excess of (less than) expenses. Changes in unrestricted net assets that are excluded from revenues and gains in excess of (less than) expenses, consistent with industry practice, include contributions received and used for additions of long-lived assets and certain changes in pension liabilities.

2. Summary of Significant Accounting Policies (continued)

Income Tax Status

The Parent, the Hospital, the Foundation, HCS, GTS, and RI have received determination letters from the Internal Revenue Service (IRS) stating that they are exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code. The Real Estate Company has received a determination letter from the IRS stating that it is exempt from federal income taxes under Section 501(c)(2) of the Internal Revenue Code. PE's application for exemption is currently in process with the IRS.

HCE and PPI are subject to federal and state income taxes. No provision for income taxes has been recorded for fiscal 2010 and 2009, as these companies and PE do not have taxable income or current tax liabilities. Deferred tax assets (consisting principally of net operating loss carryforwards) are not significant and are not considered to be realizable, given the operations of these entities.

Certain limited liability companies within the consolidated group are not subject to income taxes. Taxable income or loss is passed through to and reportable by the members individually.

Under the Cayman Islands Tax Concessions Law (Revised), the Governor-in-Cabinet issued an undertaking to Cottage on November 29, 2005 exempting it from all local income, profit or capital gains taxes. The undertaking has been issued for a period of 20 years and, at the present time, no such taxes are levied in the Cayman Islands. Accordingly, no provision for taxes is made in these consolidated financial statements.

Under the requirements of ASC 740, *Income Taxes*, tax-exempt organizations could be required to record an obligation as the result of a tax position they have historically taken on various tax exposure items. The Group has determined that it does not have any uncertain tax positions through June 30, 2010.

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 as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Summary of Significant Accounting Policies (continued)

Recent Accounting Pronouncements

In December 2008, the FASB issued additional authoritative guidance regarding an employer’s disclosures about postretirement benefit plan assets, currently included in ASC Topic 715, *Compensation – Retirement Benefits* (formerly FSP FAS 132(R)-1). This guidance requires disclosure about the major classes of postretirement benefit plan assets, including a description of the inputs and valuation techniques used to measure those assets and the designation of such assets by level; how investment allocation decisions are made; the effect of fair value measurements using significant unobservable inputs on changes in plan assets for the period; and significant concentrations of risk within plan assets. See Note 8 for these additional disclosures for the year ended June 30, 2010. The adoption of this guidance did not have a significant impact on the Group’s consolidated financial statements for the year ended June 30, 2010.

In April 2009, the FASB issued Statement of Financial Accounting Standards No. 164, *Not-for-Profit Entities: Mergers and Acquisitions—Including an amendment of FASB Statement No. 142* (codified under ASC 958, *Not-for-Profit Entities*), which establishes accounting for mergers of not-for-profit entities and for acquisitions by not-for-profit entities. SFAS No. 164 also amends SFAS No. 142, *Goodwill and Other Intangible Assets*, to make it fully applicable to not-for-profit entities. SFAS No. 164 is effective for financial statements issued for fiscal years beginning on or after December 15, 2009. The Group is currently evaluating the impact that this pronouncement will have on its consolidated financial statements.

In June 2009, the FASB issued SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)* (codified under ASC 810, *Consolidation*) and requires an enterprise to perform an analysis to determine whether the enterprise’s variable interest or interests give it a controlling financial interest in a variable interest entity. The FASB also issued an amendment which modifies the accounting and disclosure requirements for the consolidation of variable interest entities, or VIEs, under ASC 810-10. This amendment requires an enterprise to perform a qualitative analysis when determining whether or not it must consolidate a VIE. The amendment also requires an enterprise to continuously reassess whether it must consolidate a VIE. Additionally, the amendment requires enhanced disclosures about an enterprise’s involvement with VIEs and any significant change in risk exposure due to that involvement, as well as how its involvement with VIEs impacts the enterprise’s financial statements. Finally, an enterprise will be required to disclose significant judgments and assumptions used to determine whether or not to consolidate a

2. Summary of Significant Accounting Policies (continued)

VIE. SFAS No 167 and the amendment are effective for financial statements issued for fiscal years beginning on or after November 15, 2009. The Group is currently evaluating the impact that these pronouncements will have on its consolidated financial statements.

In January 2010, the FASB issued ASC Accounting Standards Update (ASU) No. 2010-06 (ASU 2010-06), which guidance clarifies certain existing fair value measurement disclosure requirements of ASC Topic 820 (formerly SFAS No. 157) and also requires additional fair value measurement disclosures. Specifically, ASU 2010-06 clarifies that assets and liabilities must be leveled by major class of asset or liability, and provides guidance regarding the identification of such major classes. Additionally, disclosures are required about valuation techniques and the inputs to those techniques, for those assets or liabilities designated as Level 2 or Level 3 instruments. Disclosures regarding transfers between Level 1 and Level 2 assets and liabilities are required, as well as a deeper level of disaggregation of activity within existing rollforwards of the fair value of Level 3 assets and liabilities. See Note 5 for these additional fair value measurement disclosure requirements for the year ended June 30, 2010, excluding the additional requirements related to Level 3 rollforward activity, which are not required to be adopted until the Group's fiscal year ended June 30, 2012. The adoption of this guidance did not have a significant impact on the Group's consolidated financial statements for the fiscal year ended June 30, 2010.

3. Regulatory Environment

Medicare and Medicaid

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

3. Regulatory Environment (continued)

In 1983, Congress approved a Medicare prospective payment plan for most inpatient services as part of the Social Security Amendment Act of 1983. Hospitals in Maryland are currently exempt from these federal reimbursement regulations under a special waiver. The waiver currently in effect is subject to renewal based upon criteria defined in the federal law. Under these payment arrangements with Medicare, a retroactive adjustment could occur if certain performance standards are not attained by all hospitals on a statewide basis. The impact, if any, of any retroactive adjustment of the Medicare prospective payment system, should hospitals in Maryland become subject to such system, on future operations of the Group, has not been determined.

HSCRC

The Hospital's rate structure for all hospital-based services is subject to review and approval by the Maryland Health Services Cost Review Commission (HSCRC). Under the HSCRC rate-setting system, the Hospital's inpatient charges are subject to an inpatient charge per case target (the Charge Per Case Target). The Charge Per Case Target is adjusted annually for inflation, case mix changes and other factors.

Under the charge per case target methodology, the Hospital monitors its average charge per case compared to HSCRC case mix adjusted targets on a monthly basis. Also, under the Commission's rate methodology for certain outpatient services, a target average Charge Per Visit was established in fiscal 2010 for the Hospital based on 2010 actual charges and case mix indices. The actual average 2011 Charge Per Visit will be compared with the 2010 target average Charge Per Visit and to the extent that the actual average exceeds or is less than the target, the Hospital's future rates may be prospectively adjusted.

The Hospital's policy is to recognize revenue based on actual charges for services to patients in the year in which the services are performed. The Hospital's revenues may be subject to adjustment as a result of examination by government agencies or contractors, and as a result of 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.

4. Investments

Investments, consisting of assets whose use is limited and other, are stated at fair value. Borrowed funds which are required to be expended on specified capital projects under MHHEFA revenue bond agreements are classified as "other-than-trading". All other investments and assets whose use is limited are classified as trading securities.

	June 30	
	2010	**2009**
Assets whose use is limited:		
Endowment assets:		
Cash and cash equivalents	**$ 1,056,000**	$ 1,740,000
Equity mutual funds	**7,126,000**	6,293,000
Fixed income mutual funds	**4,220,000**	3,732,000
	12,402,000	11,765,000
Amounts held by trustee:		
Cash and cash equivalents	**10,180,000**	13,130,000
U.S. Government obligations	**76,394,000**	120,813,000
	86,574,000	133,943,000
Amounts held by Cottage Insurance Company, Ltd., a captive insurance subsidiary:		
Cash and cash equivalents	**2,730,000**	2,349,000
Equity mutual funds	**6,372,000**	6,116,000
Fixed income mutual funds	**14,856,000**	9,354,000
	23,958,000	17,819,000
Total assets whose use is limited	**122,934,000**	163,527,000
Less current portion	**6,623,000**	7,278,000
	$ 116,311,000	$ 156,249,000

4. Investments (continued)

	June 30	
	2010	**2009**
Amounts held by counterparty as collateral for interest rate swap:		
Cash and cash equivalents	**$ 41,819,000**	$ 35,176,000
	$ 41,819,000	$ 35,176,000
Amounts held by trustee are broken down as follows:		
Bond indenture	**$ 86,574,000**	$ 133,943,000
Other investments:		
Cash and cash equivalents	**$ 3,456,000**	$ 5,465,000
Equity mutual funds	**82,220,000**	68,903,000
Fixed income mutual funds	**92,365,000**	83,028,000
	178,041,000	157,396,000
Less short-term investments	**3,425,000**	5,363,000
Investments	**$ 174,616,000**	$ 152,033,000

Investment income, net of investment fees, and gains (losses) for assets whose use is limited and other investments are comprised of the following:

	June 30	
	2010	**2009**
Income:		
Interest income, net	**$ 5,907,000**	$ 5,991,000
Realized gains, net	**1,924,000**	911,000
	$ 7,831,000	$ 6,902,000
Change in unrealized gains (losses) on trading securities, net	**$ 19,835,000**	$ (33,235,000)

5. Fair Value Measurements

ASC 820, *Fair Value Measurements and Disclosures* (formerly SFAS No. 157), defines fair value, establishes a framework for measuring fair value in accordance with U.S. generally accepted accounting principles, and expands disclosures about fair value measurements. The System adopted the provisions of ASC 820 for its financial assets and liabilities on July 1, 2008 and for its nonfinancial assets and liabilities on July 1, 2009 (see Note 13).

ASC 820 requires that the fair value of derivative contracts include adjustments related to the credit risks of both parties associated with the derivative transactions. The fair value of the Group's derivative contracts reflected in the accompanying consolidated financial statements include adjustments related to the credit risks of the parties to the transactions.

ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: *Level 1* – defined as observable inputs such as quoted prices in active markets; *Level 2* – defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and *Level 3* – defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

The following tables present the fair value hierarchy for the Group's financial assets and liabilities measured at fair value on a recurring basis at June 30, 2010 and 2009:

		Quoted Prices in Active Markets for Identical Assets	**Significant Other Observable Inputs**	**Significant Unobservable Inputs**
June 30, 2010	**Total**	**Level 1**	**Level 2**	**Level 3**
Assets:				
Cash and cash equivalents	**$ 37,366,000**	**$ 31,354,000**	**$ 6,012,000**	**$ –**
Trading securities and other assets whose use is limited	**300,974,000**	**196,110,000**	**104,864,000**	**–**
Collateral for interest rate swap:				
Cash and cash equivalents	**41,819,000**	**41,819,000**	**–**	**–**
Derivative instruments	**2,232,000**	**–**	**2,232,000**	**–**
Total assets	**$ 382,391,000**	**$ 269,283,000**	**$ 113,108,000**	**$ –**
Liabilities:				
Derivative instruments	**$ (47,510,000)**	**$ –**	**$ (47,510,000)**	**$ –**
Total liabilities	**$ (47,510,000)**	**$ –**	**$ (47,510,000)**	**$ –**

5. Fair Value Measurements (continued)

June 30, 2009	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets:				
Cash and cash equivalents	$ 34,139,000	$ 28,135,000	$ 6,004,000	$ –
Trading securities and other assets whose use is limited	320,923,000	175,086,000	130,367,000	15,470,000
Collateral for interest rate swap:				
Cash and cash equivalents	35,176,000	35,176,000	–	–
Derivative instruments	1,406,000	–	1,406,000	–
Total assets	$ 391,644,000	$ 238,397,000	$ 137,777,000	$ 15,470,000
Liabilities:				
Derivative instruments	$ (36,299,000)	$ –	$ (36,299,000)	$ –
Total liabilities	$ (36,299,000)	$ –	$ (36,299,000)	$ –

The Group's Level 1 securities primarily consist of U.S. Treasury securities, exchange-traded mutual funds and cash. The Group determines the estimated fair value for its Level 1 securities using quoted (unadjusted) prices for identical assets or liabilities in active markets.

The Group's Level 2 securities primarily consist of U.S. government sponsored entities bonds and money market funds. The Group determines the estimated fair value for these Level 2 securities using the following methods: quoted prices for similar assets/liabilities in active markets, quoted prices for identical or similar assets in non-active markets (few transactions, limited information, non-current prices, high variability over time), inputs other than quoted prices that are observable for the asset/liability (e.g., interest rates, yield curves volatilities, default rates, etc.), and inputs that are derived principally from or corroborated by other observable market data.

The Group's Level 2 securities also consist of derivative instruments, which are reported using valuation models commonly used for derivatives. Valuation models require a variety of inputs, including contractual terms, market fixed prices, inputs from forward price yield curves, notional quantities, measures of volatility and correlations of such inputs.

5. Fair Value Measurements (continued)

Investments classified within Level 3 have significant unobservable inputs, as they trade infrequently or not at all. Level 3 instruments include non-exchange traded funds which are typically valued utilizing the net asset valuations provided by the underlying private investment companies or their administrators. Fund management considers subscription and redemption rights, including any restrictions on the disposition of the interest in its determination of fair value.

The classification of a financial instrument within Level 3 (all previously held at Cottage) is based upon the significance of the unobservable inputs to the overall fair value measurement. The following table includes a rollforward of the amounts for the year ended June 30, 2010 for financial instruments measured at fair value on a recurring basis classified within Level 3.

	Fair Value Measurements Using Level 3 Inputs			
	Balance June 30, 2009	**Net Purchases/ Sales/ Transfers**	**Gains/(Losses) Included in Performance Indicator**	**Balance June 30, 2010**
Assets:				
Trading securities	$ 15,470,000	$ (15,470,000)	$ –	$ –
Total	$ 15,470,000	$ (15,470,000)	$ –	$ –

During the year ended June 30, 2010, the FASB issued an update to its accounting standard for investments in certain entities that calculate net asset value (NAV) per share. If a reporting entity has the ability to redeem its investment with the investee at the NAV per share (or its equivalent) at the measurement date, the fair value measurement of the investment shall be categorized as a Level 2 fair value measurement. Because the Group can redeem its shares in its non-exchange traded fixed income and equity mutual fund investments at the NAV per share at the measurement date, these investments have been transferred from Level 3 to Level 2 fair value measurement during the year ended June 30, 2010.

6. Long-Term Debt and Lines of Credit

Long-term debt consists of the following:

	Interest Rate	Maturity Dates	June 30 2010	June 30 2009
Maryland Health and Higher Educational Facilities Authority Revenue Bonds – Series 2010	3.0 – 5.0%	2011 – 2040	**$ 85,410,000**	$ –
Maryland Health and Higher Educational Facilities Authority Revenue Bonds – Series 2009A	4.0 – 6.75%	2013 – 2040	**120,000,000**	120,000,000
Maryland Health and Higher Educational Facilities Authority Revenue Bonds – Series 2009B	Variable	2041 – 2044	**60,000,000**	60,000,000
Maryland Health and Higher Educational Facilities Authority Revenue Bonds – Series 2004A	2.0 – 5.0%	2006 – 2035	**22,995,000**	23,530,000
Maryland Health and Higher Educational Facilities Authority Revenue Bonds – Series 2004B	Variable (Auction rate)	2006 – 2035	**–**	60,325,000
Maryland Health and Higher Educational Facilities Authority Revenue Bonds – Series 1998	4.2 – 5.25%	2003 – 2033	**61,785,000**	63,090,000
Maryland Health and Higher Educational Facilities Authority Dedicated Funding Program	Variable	2006 – 2011	**–**	15,000,000
2008 term loan from a bank	Variable	2018	**55,000,000**	55,000,000
Kent Island term loan from a bank	Variable	2015	**8,836,000**	6,966,000
2008 construction loan from a bank	Variable	2018	**29,441,000**	19,848,000
			443,467,000	423,759,000
Less current portion of long-term debt			**2,900,000**	3,106,000
Less unamortized original issue discount			**6,553,000**	5,212,000
Long-term debt			**$ 434,014,000**	$ 415,441,000

These debt instruments are secured by the receipts of the Hospital and substantially all of the property and equipment of the consolidated group.

6. Long-Term Debt and Lines of Credit (continued)

Principal payments due under all debt instruments as of June 30, 2010 are as follows:

2011	$ 2,900,000
2012	5,962,000
2013	6,362,000
2014	6,377,000
2015	14,041,000
Thereafter	407,825,000
	$ 443,467,000

Series 2010 Revenue Bonds

In February 2010, the Hospital entered into a loan agreement with MHHEFA for the issuance of $85,410,000 of Series 2010 Revenue Bonds (referred to as the 2010 Bonds). The proceeds of the 2010 Bonds were used to repay the Series 2004B Bonds and Dedicated Financing previously provided by the Authority and are being used to finance the expansion of the parking garage for the Hospital's acute care pavilion. The 2010 Bonds provide for annual principal payments each July 1, from 2011 through 2040. Interest is payable semi-annually on each July 1 and January 1, beginning July 1, 2010. The 2010 Bonds bear stated interest at rates of 3.00% to 5.00%, and were issued at an original issue discount of $1,507,000. The effective annual interest rate for the 2010 Bonds was 4.36% for the year ended June 30, 2010.

The provisions of the 2010 Bonds, together with the 2009 Bonds, 2004 Bonds and the 1998 Bonds, require the Parent and subsidiaries to comply with certain covenants on an annual basis, including a debt service coverage requirement, a debt to capitalization requirement and a liquidity requirement.

Series 2009 Revenue Bonds

In January 2009, the Hospital entered into a loan agreement with MHHEFA for the issuance of $120,000,000 Series 2009A Revenue Bonds (the 2009A Bonds) and in February 2009, $60,000,000 Series 2009B Revenue Bonds (the 2009B Bonds) (collectively referred to as the 2009 Bonds). The proceeds of the 2009 Bonds are being used to finance a portion of the costs of construction of an eight-story patient care building, two new parking garages and certain costs relating to the issuance. The 2009A Bonds provide for annual principal payments each July 1,

6. Long-Term Debt and Lines of Credit (continued)

from 2012 through 2039. Interest is payable semi-annually on each July 1 and January 1, beginning July 1, 2009. The 2009B Bonds provide for annual principal payments each July 1, from 2040 through 2043. Interest is payable semi-annually on each July 1 and January 1, beginning July 1, 2009. The 2009A Bonds bear stated interest at rates of 4.00% to 6.75%. The 2009A Bonds were issued at an original issue discount of $4,817,000. The effective annual interest rate for the 2009A Bonds was 6.57% for the years ended June 30, 2010 and 2009. The 2009B Bonds bear interest at variable rates, as set forth in the loan agreement. The maximum interest rate is 12% for the 2009B Bonds. The effective annual interest rates for the 2009B Bonds for the years ended June 30, 2010 and 2009 were 0.28% and 0.47%, respectively. The principal and interest payments on the Series 2009B Bonds are secured by a letter of credit equal to the original principal of the bonds plus an amount equal to 35 days' interest thereon, calculated at the maximum rate. The current letter of credit expires in February 2012. Under certain circumstances, the Hospital would need to fully redeem the 2009B bonds upon expiration of the letter of credit, unless a conforming replacement letter of credit was secured prior to such expiration. The Hospital, the Parent and HCS are members of the obligated group for the 2009 Bonds.

Series 2004 Revenue Bonds

In February 2004, the Hospital entered into a loan agreement with MHHEFA for the issuance of $25,570,000 Series 2004A Revenue Bonds (the 2004A Bonds), $64,250,000 Series 2004B Revenue Bonds (the 2004B Bonds) and $49,425,000 Series 2004C Revenue Bonds (the 2004C Bonds) (collectively referred to as the 2004 Bonds). The proceeds of the 2004A and 2004B Bonds were used to finance and refinance the costs of acquisition, construction, renovation and equipping of the 2004 Project; to repay certain debt; to fund debt service reserve requirements; and to pay certain other costs relating to the issuance. The 2004 Project included renovations to the Hospital's Cancer Center together with new furnishings and equipment, acquisition of 21 acres of land and acquisition and installation of capital equipment and furnishings. Concurrent with the issuance of the 2004 Bonds, the Parent and HCS became members of the obligated group for the 2004 Bonds and the 1998 Bonds.

On the date of issuance, the Hospital loaned $49,425,000 from the Series C Bonds to the Real Estate Company. The Real Estate Company used the funds to repay existing commercial debt obligations. The remaining proceeds of the Series C Bonds were used to create a debt service reserve fund and finance certain issuance costs. In April 2008, the 2004C Bonds were extinguished through an advance refunding financed by line of credit proceeds (as further discussed below).

6. Long-Term Debt and Lines of Credit (continued)

In February 2010, the 2004B Bonds were extinguished through an advance refunding financed by proceeds from the 2010 Bonds. The remaining unamortized deferred financing costs and premium totaling $1,967,000 were written off upon extinguishment of the 2004B Bonds and recorded as a loss on extinguishment of debt in the accompanying consolidated statements of operations and changes in net assets for the year ended June 30, 2010.

The 2004A Bonds provide for annual principal payments each July 1, from 2005 through 2034. Interest is payable semiannually on each July 1 and January 1. The effective interest rates for the 2004A Bonds for the years ended June 30, 2010 and 2009 were 4.39% and 4.34%, respectively.

Series 1998 Revenue Bonds

In August 1998, the Hospital and its subsidiaries entered into a loan agreement with MHHEFA for the issuance of $69,840,000 of Series 1998 Revenue Bonds (the 1998 Bonds). The proceeds were used to finance the acquisition, construction and equipping of a new replacement hospital, the renovation and equipping of certain existing facilities, the purchase of capital equipment and the payment of certain other costs relating to the issuance.

The 1998 Bonds provide for annual principal payments each July 1, from 2002 through 2032. Interest is payable semiannually on each July 1 and January 1. The effective interest rate was approximately 5.16% and 5.15% for fiscal 2010 and 2009, respectively.

In connection with the issuance of the 2010 Bonds, 2009 Bonds, the 2004 Bonds and the 1998 Bonds (collectively, the Bonds), certain funds were established to be held and invested by a trustee:

- Amounts deposited in the Debt Service Funds are to be used to satisfy the Bonds' semiannual interest and annual principal payment requirements. Interest earnings on these funds are accumulated therein to reduce future payments by the Group.

- Prescribed amounts deposited in the Debt Service Reserve Funds are to be used to fund debt payments in the later years of the Bonds.

- Amounts deposited in the Construction Fund are to be used to pay approved costs of the capital projects financed by the 2009 and 2010 Bonds.

6. Long-Term Debt and Lines of Credit (continued)

- Amounts deposited in the Capitalized Interest Fund represent borrowings able to be used to fund certain interest costs during the construction period relating to the capital projects financed by the 2009 and 2010 Bonds.

The related balances are included in assets whose use is limited and consist of the following:

	June 30	
	2010	**2009**
Debt service funds	**$ 18,141,000**	$ 4,938,000
Debt service reserve funds	**20,785,000**	18,993,000
Construction fund and capitalized interest fund	**47,648,000**	110,012,000
	$ 86,574,000	$ 133,943,000

Bank Line of Credit and Term Loan

The Hospital maintains a line of credit with a bank. Under the agreement with the bank, which is reviewed for renewal on January 31 of each year, the Hospital has available credit of up to $15,000,000. Interest on any borrowings accrues at the 30-day London Interbank Offered Rate (LIBOR) plus 1.0%.

On October 23, 2008, the Real Estate Company secured a term loan in the amount of $55,000,000 with a bank. The proceeds from the term loan were used to refinance the $42,502,000 line of credit proceeds and fund certain construction costs related to a medical office building. The loan bears interest at a variable rate, based on the LIBOR Market Index Rate plus 1.25%. The term loan has a final maturity of November 5, 2018. The effective annual interest rates for the years ended June 30, 2010 and 2009 were 1.53% and 2.08%, respectively.

2008 Construction Loan

On October 23, 2008, the Real Estate Company entered into a construction loan in the amount of $30,000,000 with a bank to fund the construction of a medical office building. The loan was issued under the same loan agreement as the term loan discussed in the immediately preceding paragraph. The debt is secured by the medical office building. Interest only is due during the

6. Long-Term Debt and Lines of Credit (continued)

construction period at a rate equal to the LIBOR Market Index Rate plus 1.25%. The loan converts to a term loan after the completion of construction. The term loan has a final maturity of November 5, 2018. As of June 30, 2010, the Real Estate Company had drawn down $29,441,000 on the loan. The effective annual interest rates for the years ended June 30, 2010 and 2009 were 1.40% and 2.08%, respectively.

Dedicated Funding Program

In January 2006, the Hospital entered into a master lease agreement with MHHEFA whereby the Hospital can draw up to $15,000,000 for the purpose of completing various hospital renovations. The interest on this debt is variable, based upon the USD – BMA Municipal Swap Index and is payable semiannually beginning on July 1, 2006. During the years ended June 30, 2010 and 2009, $129,000 and $382,000, respectively, in interest expense was recognized related to this debt. The effective average interest rate was approximately 0.9% and 2.5% for fiscal 2010 and 2009, respectively. All amounts advanced were paid with proceeds from the 2010 Bonds. As of June 30, 2009, the Hospital had drawn down $15,000,000 of the loan.

Kent Island Term Loan

In August 2007, KIMA entered into a construction loan agreement with a bank in the amount of $9,000,000. The proceeds were used to construct a medical office building. The debt is secured by the medical office building. Interest only was due during the construction period at a rate of the 30-day LIBOR rate plus 1.0%. The loan converted to a term loan after the completion of construction. The term loan has a final maturity of June 2015, with payments, including principal and interest, to be made over the remaining life of the loan. As of June 30, 2010, KIMA had drawn down $8,836,000 of the loan.

7. Capital Lease Obligations

The Group has entered into capital lease agreements for certain medical equipment and software at a cost of $8,257,000 as of June 30, 2010 and 2009. Accumulated amortization on these assets was $2,324,000 and $1,593,000 as of June 30, 2010 and 2009, respectively. Future payments under these capital lease obligations are as follows:

2011	$ 1,495,000
2012	1,443,000
2013	1,164,000
2014	991,000
2015	83,000
Total payments	5,176,000
Less amount deemed to represent interest	429,000
	4,747,000
Less current portion	1,290,000
	$ 3,457,000

8. Pension Plan and Thrift Plan

The Hospital has a qualified noncontributory, defined benefit pension plan that covers substantially all employees. The Group's policy is to fund pension costs as determined by its actuary. Adopted by the Board of Trustees on June 11, 2009 and effective September 1, 2009, the Hospital amended the plan to freeze future benefit accruals, and participants have not earned any additional benefits under the Plan since that date. However, subsequent to September 1, 2009, participants have continued to vest in benefits they have earned through September 1, 2009. The frozen benefit balance for the participants will only accrue interest credits until the participants' benefit commencement dates. A curtailment loss of $935,000 was reported as of June 30, 2009 for the recognition of previously unrecognized prior service costs due to the plan freeze. Balances below as of June 30, 2010 reflect the impact of the plan freeze effective September 1, 2009.

FASB ASC 715, *Compensation – Retirement Benefits,* requires the Group to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its pension plan on its consolidated balance sheet, with a corresponding adjustment to unrestricted net assets. The pension liability adjustment to unrestricted net assets represents the change in net unrecognized actuarial losses, and unrecognized prior service costs

8. Pension Plan and Thrift Plan (continued)

which have not yet been recognized as part of revenues and gains in excess of (less than) expenses. These amounts are subsequently recognized as net periodic pension cost pursuant to the Group's historical accounting policy for amortizing such amounts.

The reconciliation of the beginning and ending balances of the projected benefit obligation and the fair value of plan assets for the years ended June 30, 2010 and 2009 and the accumulated benefit obligation at June 30, 2010 and 2009 is as follows:

	June 30	
	2010	**2009**
Accumulated benefit obligation	**$ 97,422,000**	$ 83,215,000
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	**$ 83,215,000**	$ 76,004,000
Service cost	**815,000**	3,718,000
Interest cost	**5,309,000**	4,960,000
Amendments (curtailment)	**–**	(12,641,000)
Actuarial loss	**11,528,000**	13,614,000
Benefits paid	**(3,445,000)**	(2,440,000)
Projected benefit obligation at end of year	**97,422,000**	83,215,000
Change in plan assets:		
Fair value of plan assets at beginning of year	**56,798,000**	60,469,000
Actual return on plan assets	**6,559,000**	(8,531,000)
Employer contribution	**5,362,000**	7,300,000
Benefits paid	**(3,445,000)**	(2,440,000)
Fair value of plan assets at end of year	**65,274,000**	56,798,000
Net liability recognized	**$ (32,148,000)**	$ (26,417,000)

8. Pension Plan and Thrift Plan (continued)

	June 30	
	2010	**2009**
Net amounts recognized in the consolidated balance sheets consist of		
Accrued pension costs	**$ (32,148,000)**	$ (26,417,000)
Amounts recognized in accumulated unrestricted net assets consist of		
Net actuarial loss	**$ 41,040,000**	$ 30,818,000

The following table sets forth the weighted-average assumptions used to determine benefit obligations:

	June 30	
	2010	**2009**
Discount rate	**5.60%**	6.25%
Rate of compensation increase	**N/A**	5.00

The following table sets forth the weighted-average assumptions used to determine net periodic benefit cost:

	Year Ended June 30	
	2010	**2009**
Discount rate	**6.25%**	6.75%
Expected return on plan assets	**8.00**	8.00
Rate of compensation increase	**N/A**	4.50

8. Pension Plan and Thrift Plan (continued)

Net periodic pension cost included the following components:

	June 30	
	2010	**2009**
Service cost	**$ 815,000**	$ 3,718,000
Interest cost	**5,309,000**	4,960,000
Expected return on plan assets	**(5,771,000)**	(5,107,000)
Amortization of prior service cost	**37,000**	222,000
Recognized net actuarial loss	**518,000**	811,000
Curtailment loss due to plan freeze	**–**	935,000
Net periodic benefit cost	**$ 908,000**	$ 5,539,000

The estimated net loss that is expected to be amortized from other changes in unrestricted net assets into net periodic benefit cost for the year ending June 30, 2011 is $581,000.

The Hospital's defined benefit plan invests in a diversified mix of traditional asset classes. Investments in certain types of U.S. equity securities and fixed income securities are made to maximize long-term results while recognizing the need for adequate liquidity to meet on-going benefit and administrative obligations. Risk tolerance of unexpected investment and actuarial outcomes is continually evaluated by understanding the pension plan's liability characteristics. Equity investments are used primarily to increase overall plan returns. Debt securities provide diversification benefits and liability hedging attributes that are desirable, especially in falling interest rate environments.

The Hospital's target asset allocation percentages as of June 30, 2010 were as follows: 30% large cap domestic stocks, 10% mid-cap domestic stocks, 10% small cap domestic stocks, 10% international stocks, 35% U.S. investment grade bonds, and 5% high-yield bonds.

8. Pension Plan and Thrift Plan (continued)

The following tables present the fair value hierarchy of assets of the defined benefit pension plan at June 30, 2010 and 2009, respectively:

June 30, 2010	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets:				
Cash and cash equivalents	**$ 8,540,000**	**$ 83,000**	**$ 8,457,000**	**$ –**
Mutual funds:				
Equity	**24,907,000**	**24,907,000**	**–**	**–**
Corporate bonds	**3,059,000**	**3,059,000**	**–**	**–**
Government bonds	**22,901,000**	**22,901,000**	**–**	**–**
International equity	**5,867,000**	**5,867,000**	**–**	**–**
Total	**$ 65,274,000**	**$ 56,817,000**	**$ 8,457,000**	**$ –**

June 30, 2009	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Assets:				
Cash and cash equivalents	$ 7,178,000	$ 120,000	$ 7,058,000	$ –
Mutual funds:				
Equity	21,763,000	21,763,000	–	–
Corporate bonds	2,574,000	2,574,000	–	–
Government bonds	20,163,000	20,163,000	–	–
International equity	5,120,000	5,120,000	–	–
Total	$ 56,798,000	$ 49,740,000	$ 7,058,000	$ –

8. Pension Plan and Thrift Plan (continued)

Level 1 securities primarily consist of exchange-traded mutual funds. Level 2 securities primarily consist of money market funds. Methods consistent with those discussed in Note 5 are used to estimate the fair values of these securities.

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 considered the target rates of return for the future, which have historically not changed.

The Hospital does not have any regulatory contribution requirements for 2010; however, the Hospital currently intends to make voluntary contributions to the defined benefit pension plan of $4,000,000 in fiscal 2011.

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

2011	$ 6,325,000
2012	5,562,000
2013	6,404,000
2014	6,983,000
2015	6,527,000
2016 – 2020	31,332,611

In addition to the noncontributory, defined benefit pension plan, the Hospital also offers an employee thrift plan. Participation in the plan is voluntary. Substantially all full-time employees of the Hospital are eligible to participate. Employees may elect to contribute a minimum of 1% of compensation, and a maximum amount as determined by Sections 403(b) and 415 of the Internal Revenue Code. Any employee making contributions to the plan is entitled to a Hospital contribution that will match the employee contribution at the rate of 50% to 75%, depending on the number of years of service, up to a maximum of 4% of qualified compensation. The Hospital temporarily suspended matching contributions during fiscal 2010. Matching contributions under this thrift plan were $1,784,000 in fiscal 2009.

9. Concentrations of Credit Risk

Certain members of the Group grant credit without collateral to their patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors was as follows:

	June 30	
	2010	**2009**
Medicare	**30%**	28%
Medicaid	**9**	8
Blue Cross	**22**	20
Health maintenance organizations	**21**	25
Commercial and other	**11**	11
Patients	**7**	8
	100%	100%

10. Malpractice Insurance Costs and Self-Insured Professional Liability

Until August 1, 1998, the Group maintained insurance coverage for general and professional liability claims on a claims-made basis. The professional liability coverage included a per-case deductible of $250,000, up to a maximum out-of-pocket amount of $750,000 annually. Effective August 1, 1998, the Group changed its professional liability coverage to a full coverage claims-made policy with no annual deductibles. This policy included tail coverage for claims incurred prior to August 1, 1998, but reported subsequently. Effective August 1, 2002, the Group changed its professional liability coverage back to a claims-made policy with a per-case deductible of $250,000, up to a maximum out-of-pocket amount of $750,000 annually. Also, the Group did not purchase tail coverage for claims incurred prior to August 1, 2002 not yet reported.

Effective March 1, 2004, the Group changed its professional liability coverage to a self-insurance trust with annual exposure limits of $2,000,000 per claim and $11,000,000 in aggregate. The Group carried an excess liability insurance policy for claims above these limits.

10. Malpractice Insurance Costs and Self-Insured Professional Liability (continued)

Effective July 1, 2005, Cottage was formed as a captive insurer to provide professional liability insurance for the Group. Cottage is a wholly owned subsidiary of the System which was formed in the Cayman Islands. The primary layer of professional and general liability insurance coverage is self-insured through Cottage and the secondary layer is fully reinsured through a commercial carrier.

For the period July 1, 2005 to June 30, 2009, Cottage issued claims-made policies covering hospital professional liability (including employed physicians) and on an occurrence basis, comprehensive general liability risks of the Parent and certain affiliates. Policy limits were $2,000,000 per claim with a $9,000,000 policy aggregate. Effective July 1, 2005, Cottage assumed existing liabilities from the System's self-insured trust discussed above on a claims made basis. Effective July 1, 2009, Cottage issued a claims-made policy providing $2,000,000 per claim hospital professional liability coverage and $1,000,000 per claim comprehensive general liability coverage, subject to a consolidated annual aggregate limit of $10,000,000.

For the period July 1, 2005 to June 30, 2008, Cottage also issued an excess umbrella coverage policy (covering hospital professional liability) with limits of $20,000,000 per claim and in the policy aggregate. For claims reported on and subsequent to July 1, 2008, the coverage limit provided is $30,000,000 per claim and in the policy aggregate. These excess limits are excess of the primary policy, and the umbrella policies are 100% reinsured with third-party commercial reinsurers.

As of June 30, 2010 and 2009, the balance for outstanding claims reserves recorded at Cottage is $18,694,000 and $16,366,000, respectively. The remaining tail liability for claims incurred but not reported is $6,520,000 and $4,821,000 as of June 30, 2010 and 2009. $5,169,000 of the 2010 liability is recorded at the Hospital, with the remainder recorded at PE. The 2009 balance in its entirety was recorded at the Hospital. The Group has employed an independent actuary to estimate the ultimate settlement of such claims. In management's opinion, the amounts recorded provide an adequate reserve for loss contingencies. However, changes in circumstances affecting professional liability claims could cause these estimates to change by material amounts in the short term.

11. Commitments and Contingencies

Operating Leases

Various members of the Group have operating leases for storage space, equipment and offices. During 2010 and 2009, rent expense on these leases was approximately $6,760,000 and $5,369,000, respectively. Future minimum annual rental payments under noncancelable operating leases, which expire through 2019, are as follows:

2011	$ 6,853,000
2012	5,735,000
2013	4,582,000
2014	3,921,000
2015	3,023,000
Thereafter	6,216,000
	$ 30,330,000

Contracted Construction Commitments

Members of the Group have future construction commitments with outside contractors for various projects totaling $33,177,000 and $76,837,000 as of June 30, 2010 and 2009, respectively.

Contingencies

Members of the Group have been named as defendants in various legal proceedings arising from the performance of their normal activities. In the opinion of management, after consultation with legal counsel and after consideration of applicable insurance, the amount of the Group's ultimate liability under all current legal proceedings will not have a material adverse effect on its consolidated financial position or results of operations.

12. Functional Expenses

Members of the Group provide general health care services to residents within their service area. Expenses related to providing these services are as follows:

	2010	**2009**
Health care services	**$ 384,872,000**	$ 355,975,000
General and administrative	**80,046,000**	63,212,000
	$ 464,918,000	$ 419,187,000

13. Fair Value of Financial Instruments

The carrying amounts of cash and cash equivalents, patient receivables, prepaid expenses and other current assets, accounts payable, accrued salaries, wages and benefits, other accrued expenses and advances from third-party payors approximate fair value, given the short-term nature of these financial instruments and/or their methods of valuation. The following methods and assumptions were used by the Group in estimating the fair value of other financial instruments:

Investments and Assets Whose Use Is Limited

Fair values are based on quoted market prices, if available, or estimated using quoted market prices for similar securities.

Pledges Receivable

The Group estimates that the carrying value of pledges receivable approximates fair value, given the discount rates applied.

Long-Term Debt

Fair values of the Group’s fixed rate long-term debt are established using discounted cash flow analyses, based on the Group’s current incremental borrowing rates for similar types of borrowing arrangements. The carrying amount of the Group’s variable rate long-term debt approximates fair value. The estimated fair value of all long-term debt at June 30, 2010 and 2009 was approximately $458,648,000 and $434,544,000, respectively.

14. Temporarily Restricted Net Assets

At June 30, 2010 and 2009, temporarily restricted net assets are restricted for use, as follows:

	2010	2009
Hospital capital additions	**$ 16,002,000**	$ 20,551,000
Hospital operating programs	**688,000**	7,000
	$ 16,690,000	$ 20,558,000

15. Acquisition

In July 2009, HCE purchased assets and assumed certain liabilities from Orthopaedic and Sports Medicine Center, L.L.C. (OSMC) for $2,316,000, resulting in the formation of the OPA entity, which is recorded under PE on the Group's consolidated financial statements (see Note 1). OSMC was comprised of 15 physicians whom are now employed by the System. The assets purchased were medical and office equipment and tenant improvements. The assumed liabilities were associated with tail coverage for the physicians' professional liability insurance, the build out of the office locations, and the purchase of a billing system and certain other liabilities. In addition to the professional services, the System acquired the ancillary services of OSMC which include physical therapy, radiology imaging, and orthotics. In connection with this acquisition, approximately $1.5 million of goodwill was recognized and included in other assets on the consolidated balance sheet.

16. Subsequent Events

The Group has evaluated the impact of subsequent events through October 6, 2010, representing the date at which the consolidated financial statements were issued.

Other Financial Information

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Report of Independent Auditors on Other Financial Information

Board of Trustees of
Anne Arundel Health System, Inc.

Our audit was conducted for the purpose of forming an opinion on the June 30, 2010 consolidated financial statements taken as a whole. The June 30, 2010 supplementary consolidating information is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information has been subjected to the auditing procedures applied in our audit of the June 30, 2010 consolidated financial statements and, in our opinion, based on our audit and the report of other auditors, is fairly stated in all material respects in relation to the June 30, 2010 consolidated financial statements taken as a whole.

Ernst & Young LLP

October 6, 2010

Anne Arundel Health System, Inc. and Subsidiaries

Supplementary Consolidating Balance Sheet

June 30, 2010

	Anne Arundel Health System, Inc.	Anne Arundel Medical Center, Inc. and Subsidiaries	Anne Arundel Health Care Enterprises, Inc.	Anne Arundel Real Estate Holding Company, Inc. and Subsidiaries	Cottage Insurance Company, Ltd.	AAHS Research Institute, Inc.	Physician Enterprise, LLC	Anne Arundel Medical Center Foundation, Inc.	Consolidating and Eliminating Entries: Cottage Insurance Company, Ltd.	Consolidating and Eliminating Entries: Other Subsidiaries		Consolidated
Assets												
Current assets:												
Cash and cash equivalents	$ 162,000	$ 34,577,000	$ 3,000	$ 1,535,000	$ –	$ 14,000	$ 195,000	$ 880,000	$ –	$ –		$ 37,366,000
Short-term investments	–	2,077,000	–	–	–	–	–	1,348,000	–	–		3,425,000
Current portion of assets whose use is limited	–	3,893,000	–	–	2,730,000	–	–	–	–	–		6,623,000
Patient receivables, net	–	53,472,000	–	–	–	–	2,415,000	–	–	–		55,887,000
Current portion of pledges receivable, net	–		–	–	–	–	–	4,736,000	–	–		4,736,000
Inventories	–	7,806,000	88,000	–	–	–	–	–	–	–		7,894,000
Prepaid expenses and other current assets	–	24,811,000	1,402,000	1,066,000	40,000	101,000	2,000	15,000	–	(21,595,000)	(1) (4)	5,842,000
Total current assets	162,000	126,636,000	1,493,000	2,601,000	2,770,000	115,000	2,612,000	6,979,000	–	(21,595,000)		121,773,000
Property and equipment	–	507,829,000	8,283,000	146,751,000	–	107,000	–	247,000	–	–		663,217,000
Less: accumulated depreciation and amortization	–	(169,162,000)	(3,232,000)	(24,732,000)	–	(99,000)	–	(206,000)	–	–		(197,431,000)
Net property and equipment	–	338,667,000	5,051,000	122,019,000	–	8,000	–	41,000	–	–		465,786,000
Other assets:												
Investments	–	173,194,000	–	–	–	–	–	1,422,000	–	–		174,616,000
Investments in joint ventures	–	–	1,664,000	–	–	–	–	–	–	–		1,664,000
Pledges receivable, net	–	–	–	–	–	–	–	10,573,000	–	–		10,573,000
Assets whose use is limited	–	83,314,000	–	–	21,228,000	–	–	11,769,000	–	–		116,311,000
Deferred debt issue costs, net	–	7,624,000	–	480,000	–	–	–	–	–	–		8,104,000
Beneficial interest in net assets of Anne Arundel Medical Center Foundation, Inc.	–	28,849,000	–	–	–	–	–	–	–	(28,849,000)	(7)	–
Restricted collateral for interest rate swap contracts	–	41,819,000	–	–	–	–	–	–	–	–		41,819,000
Investment in subsidiaries and other assets	326,662,000	37,539,000	–	130,000	7,310,000	–	1,224,000	306,000	–	(361,446,000)		11,725,000
Total assets	$ 326,824,000	$ 837,642,000	$ 8,208,000	$ 125,230,000	$ 31,308,000	$ 123,000	$ 3,836,000	$ 31,090,000	$ –	$(411,890,000)	(2)(4)	$ 952,371,000

Anne Arundel Health System, Inc. and Subsidiaries

Supplementary Consolidating Balance Sheet (continued)

June 30, 2010

	Anne Arundel Health System, Inc.	Anne Arundel Medical Center, Inc. and Subsidiaries	Anne Arundel Health Care Enterprises, Inc.	Anne Arundel Real Estate Holding Company, Inc. and Subsidiaries	Cottage Insurance Company, Ltd.	AAHS Research Institute, Inc.	Physician Enterprise, LLC	Anne Arundel Medical Center Foundation, Inc.	Consolidating and Eliminating Entries: Cottage Insurance Company, Ltd.	Consolidating and Eliminating Entries: Other Subsidiaries		Consolidated
Liabilities and net assets												
Current liabilities:												
Accounts payable	$ –	$ 22,853,000	$ 7,821,000	$ 728,000	$ 64,000	$ 2,596,000	$ 9,798,000	$ 1,593,000	$ –	$ (21,075,000)	(1)	$ 24,378,000
Accrued salaries, wages and benefits	–	19,012,000	658,000	–	–	–	2,829,000	–	–	–		22,499,000
Other accrued expenses	–	18,148,000	2,000	534,000	3,400,000	–	–	648,000	–	–		22,732,000
Current portion of long-term debt and capital lease obligations	–	3,210,000	–	1,500,000	–	–	–	–	–	(520,000)	(1)	4,190,000
Advances from third-party payors	–	14,813,000	–	–	–	–	–	–	–	–		14,813,000
Total current liabilities	–	78,036,000	8,481,000	2,762,000	3,464,000	2,596,000	12,627,000	2,241,000	–	(21,595,000)		88,612,000
Long-term debt and capital lease obligations, less current portion and unamortized original issue discount	–	345,175,000	–	99,054,000	–	–	–	–	–	(6,758,000)	(4)	437,471,000
Interest rate swap contracts	–	47,510,000	–	–	–	–	–	–	–	–		47,510,000
Accrued pension liability	–	32,148,000	–	–	–	–	–	–	–	–		32,148,000
Other long-term liabilities	–	3,239,000	–	28,026,000	15,056,000	–	1,513,000	–	–	(28,026,000)	(4)	19,808,000
Total liabilities	–	506,108,000	8,481,000	129,842,000	18,520,000	2,596,000	14,140,000	2,241,000	–	(56,379,000)		625,549,000
Net assets:												
Unrestricted	298,386,000	303,096,000	(273,000)	(4,612,000)	12,788,000	(2,473,000)	(10,304,000)	1,027,000	–	(299,251,000)		298,384,000
Temporarily restricted	16,690,000	16,690,000	–	–	–	–	–	16,690,000	–	(33,380,000)		16,690,000
Permanently restricted	11,748,000	11,748,000	–	–	–	–	–	11,132,000	–	(22,880,000)	(2)(7)	11,748,000
Total net assets	326,824,000	331,534,000	(273,000)	(4,612,000)	12,788,000	(2,473,000)	(10,304,000)	28,849,000	–	(355,511,000)		326,822,000
Total liabilities and net assets	$ 326,824,000	$ 837,642,000	$ 8,208,000	$ 125,230,000	$ 31,308,000	$ 123,000	$ 3,836,000	$ 31,090,000	$ –	$(411,890,000)		$ 952,371,000

Anne Arundel Health System, Inc. and Subsidiaries

Supplementary Consolidating Schedule of Revenues, Expenses, Gains and Losses

Year Ended June 30, 2010

	Anne Arundel Health System, Inc.	Anne Arundel Medical Center, Inc. and Subsidiaries	Anne Arundel Health Care Enterprises, Inc.	Anne Arundel Real Estate Holding Company, Inc. and Subsidiaries	Cottage Insurance Company, Ltd.	AAHS Research Institute, Inc.	Physician Enterprise, LLC	Anne Arundel Medical Center Foundation, Inc.	Consolidating and Eliminating Entries: Cottage Insurance Company, Ltd.	Consolidating and Eliminating Entries: Other Subsidiaries	Consolidated
Operating revenue:											
Net patient service revenue	$ –	$420,763,000	$ –	$ –	$ –	$ –	$ 34,512,000	$ –	$ –	$ –	$455,275,000
Other operating revenue	1,123,000	8,859,000	5,404,000	14,148,000	4,885,000	382,000	863,000	–	(4,885,000) (6)	(10,277,000) (3) (6)	20,502,000
Total operating revenue	1,123,000	429,622,000	5,404,000	14,148,000	4,885,000	382,000	35,375,000	–	(4,885,000)	(10,277,000)	475,777,000
Operating expenses:											
Salaries and wages	–	163,670,000	2,462,000	–	–	1,061,000	25,198,000	704,000	–	(1,764,000) (3)	191,331,000
Employee benefits	–	31,546,000	503,000	–	–	255,000	2,574,000	169,000	–	(424,000) (3)	34,623,000
Medical supplies and drugs	–	90,442,000	77,000	4,000	–	18,000	2,030,000	12,000	–	–	92,583,000
Purchased services	1,154,000	64,460,000	2,792,000	8,523,000	2,847,000	337,000	9,457,000	935,000	(4,885,000) (6)	(7,975,000) (3)	77,645,000
Professional fees	–	9,061,000	–	–	–	14,000	–	–	–	–	9,075,000
Depreciation and amortization	–	20,892,000	920,000	5,161,000	–	26,000	292,000	3,000	–	–	27,294,000
Interest	–	11,846,000	–	1,383,000	–	–	–	–	–	(114,000) (6)	13,115,000
Provision for bad debts	–	17,961,000	–	–	–	–	1,291,000	–	–	–	19,252,000
Total operating expenses	1,154,000	409,878,000	6,754,000	15,071,000	2,847,000	1,711,000	40,842,000	1,823,000	(4,885,000)	(10,277,000)	464,918,000
Operating (loss) income	(31,000)	19,744,000	(1,350,000)	(923,000)	2,038,000	(1,329,000)	(5,467,000)	(1,823,000)	–	–	10,859,000
Other income (loss):											
Investment income, net	–	6,134,000	–	18,000	1,652,000	–	–	27,000	–	–	7,831,000
Income from joint ventures and other, net	27,433,000	781,000	451,000	–	–	–	–	–	–	(27,433,000) (5)	1,232,000
Loss on extinguishment of debt	–	(1,967,000)	–	–	–	–	–	–	–	–	(1,967,000)
Change in unrealized gains on trading securities, net	–	18,321,000	–	–	1,410,000	–	–	104,000	–	–	19,835,000
Fair value adjustments for interest rate swap contracts	–	(10,385,000)	–	–	–	–	–	–	–	–	(10,385,000)
Total other income, net	27,433,000	12,884,000	451,000	18,000	3,062,000	–	–	131,000	–	(27,433,000)	16,546,000
Revenues and gains in excess of (less than) expenses	$ 27,402,000	$ 32,628,000	$ (899,000)	$ (905,000)	$ 5,100,000	$ (1,329,000)	$ (5,467,000)	$ (1,692,000)	$ –	$ (27,433,000)	$ 27,405,000

Anne Arundel Medical Center, Inc. and Subsidiaries

Supplementary Consolidating Balance Sheet

June 30, 2010

	Anne Arundel Medical Center, Inc.	Anne Arundel Health Care Services, Inc.	Anne Arundel General Treatment Services, Inc.	Consolidating and Eliminating Entries		Consolidated
Assets						
Current assets:						
Cash and cash equivalents	$ 15,771,000	$ 18,805,000	$ 1,000	$ –		$ 34,577,000
Short-term investments	2,077,000	–	–	–		2,077,000
Current portion of assets whose use is limited	3,893,000	–	–	–		3,893,000
Patient receivables, net	50,238,000	2,735,000	499,000	–		53,472,000
Inventories	7,806,000	–	–	–		7,806,000
Due from affiliates, net	21,442,000	8,687,000	–	(9,057,000)	(1)	21,072,000
Prepaid expenses and other current assets	3,597,000	137,000	5,000	–		3,739,000
Total current assets	104,824,000	30,364,000	505,000	(9,057,000)		126,636,000
Property and equipment	479,634,000	22,719,000	5,476,000	–		507,829,000
Less: accumulated depreciation and amortization	(148,950,000)	(17,496,000)	(2,716,000)	–		(169,162,000)
Net property and equipment	330,684,000	5,223,000	2,760,000	–		338,667,000
Other assets:						
Investments	173,194,000	–	–	–		173,194,000
Assets whose use is limited	83,314,000	–	–	–		83,314,000
Deferred debt issue costs, net	7,624,000	–	–	–		7,624,000
Beneficial interest in net assets of Anne Arundel Medical Center Foundation, Inc.	28,849,000	–	–	–		28,849,000
Notes receivable from affiliate	7,278,000	–	–	–		7,278,000
Restricted collateral for interest rate swap contracts	41,819,000	–	–	–		41,819,000
Investments in subsidiaries and other assets, net	67,153,000	1,000	–	(36,893,000)	(2)	30,261,000
Total assets	$ 844,739,000	$ 35,588,000	$ 3,265,000	$ (45,950,000)		$ 837,642,000

Anne Arundel Medical Center, Inc. and Subsidiaries

Supplementary Consolidating Balance Sheet (continued)

June 30, 2010

	Anne Arundel Medical Center, Inc.	Anne Arundel Health Care Services, Inc.	Anne Arundel General Treatment Services, Inc.	Consolidating and Eliminating Entries		Consolidated
Liabilities and net assets						
Current liabilities:						
Accounts payable	$ 21,262,000	$ 1,570,000	$ 21,000	$ –		$ 22,853,000
Accrued salaries, wages and benefits	19,012,000	–	–	–		19,012,000
Other accrued expenses	18,148,000	–	–	–		18,148,000
Current portion of long-term debt and capital lease obligations	3,210,000	–	–	–		3,210,000
Intercompany payables	8,687,000	–	370,000	(9,057,000)	(1)	–
Advances from third-party payors	14,813,000	–	–	–		14,813,000
Total current liabilities	85,132,000	1,570,000	391,000	(9,057,000)		78,036,000
Long-term debt and capital lease obligations, less current portion and unamortized original issue discount	345,175,000	–	–	–		345,175,000
Interest rate swap contracts	47,510,000	–	–	–		47,510,000
Accrued pension liability	32,148,000	–	–	–		32,148,000
Other long-term liabilities	3,239,000	–	–	–		3,239,000
Total liabilities	513,204,000	1,570,000	391,000	(9,057,000)		506,108,000
Net assets:						
Unrestricted	303,097,000	34,018,000	2,874,000	(36,893,000)	(2)	303,096,000
Temporarily restricted	16,690,000	–	–	–		16,690,000
Permanently restricted	11,748,000	–	–	–		11,748,000
Total net assets	331,535,000	34,018,000	2,874,000	(36,893,000)		331,534,000
Total liabilities and net assets	$ 844,739,000	$ 35,588,000	$ 3,265,000	$ (45,950,000)		$ 837,642,000

Anne Arundel Medical Center, Inc. and Subsidiaries

Supplementary Consolidating Schedule of Revenues, Expenses, Gains and Losses

Year Ended June 30, 2010

	Anne Arundel Medical Center, Inc.	Anne Arundel Health Care Services, Inc.	Anne Arundel General Treatment Services, Inc.	Consolidating and Eliminating Entries		Consolidated
Operating revenue:						
Net patient service revenue	$ 388,624,000	$ 27,561,000	$ 4,578,000	$ –		$ 420,763,000
Other operating revenue	18,647,000	18,000	21,000	(9,827,000)	(3)	8,859,000
Total operating revenue	407,271,000	27,579,000	4,599,000	(9,827,000)		429,622,000
Operating expenses:						
Salaries and wages	163,670,000	4,620,000	2,883,000	(7,503,000)	(3)	163,670,000
Employee benefits	31,546,000	1,109,000	692,000	(1,801,000)	(3)	31,546,000
Medical supplies and drugs	89,165,000	1,060,000	276,000	(59,000)	(3)	90,442,000
Purchased services	58,189,000	6,051,000	684,000	(464,000)	(3)	64,460,000
Professional fees	3,126,000	5,874,000	61,000	–		9,061,000
Depreciation and amortization	18,569,000	2,170,000	153,000	–		20,892,000
Interest	11,846,000	–	–	–		11,846,000
Provision for bad debts	15,769,000	2,017,000	175,000	–		17,961,000
Total operating expenses	391,880,000	22,901,000	4,924,000	(9,827,000)		409,878,000
Operating income (loss)	15,391,000	4,678,000	(325,000)	–		19,744,000
Other income (loss):						
Investment income, net	6,126,000	8,000	–	–		6,134,000
Income from joint venture and other, net	5,142,000	–	1,000	(4,362,000)	(5)	781,000
Loss on extinguishment of debt	(1,967,000)	–	–	–		(1,967,000)
Change in unrealized gains on trading securities, net	18,321,000	–	–	–		18,321,000
Fair value adjustments for interest rate swap contracts	(10,385,000)	–	–	–		(10,385,000)
Total other income, net	17,237,000	8,000	1,000	(4,362,000)		12,884,000
Revenues and gains in excess of (less than) expenses	$ 32,628,000	$ 4,686,000	$ (324,000)	$ (4,362,000)		$ 32,628,000

Anne Arundel Health System, Inc. and Subsidiaries

Supplementary Description of Consolidating and Eliminating Entries

1. To eliminate intercompany payables/receivables.

2. To eliminate investment in subsidiaries and related net asset accounts.

3. To eliminate intercompany income/expense generated from management fees, staffing contracts, captive insurance premiums, and operating leases.

4. To eliminate intercompany notes.

5. To eliminate income of wholly owned subsidiaries.

6. To eliminate intercompany revenue/expense for interest and other miscellaneous transactions.

7. To eliminate the Hospital's beneficial interest in Anne Arundel Medical Center Foundation, Inc.

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