Consolidated Financial Statements and Other Financial Information

Frederick Memorial Hospital, Inc. and Subsidiaries
Years Ended June 30, 2011 and 2010
With Report of Independent Auditors

Ernst & Young LLP

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Frederick Memorial Hospital, Inc. and Subsidiaries

Consolidated Financial Statements and Other Financial Information

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Report of Independent Auditors

The Board of Directors
Frederick Memorial Hospital, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Frederick Memorial Hospital, Inc. and Subsidiaries as of June 30, 2011 and 2010, 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 Frederick Memorial Hospital, Inc. and Subsidiaries' (the Company's) management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company at June 30, 2011 and 2010, and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Ernst & Young LLP

October 21, 2011

Frederick Memorial Hospital, Inc. and Subsidiaries

Consolidated Balance Sheets

(In Thousands)

	June 30 2011	June 30 2010
Assets		
Current assets:		
Cash and cash equivalents	**$ 27,295**	$ 34,805
Patient receivables, net	**45,977**	43,158
Other receivables	**1,155**	2,391
Inventory	**4,356**	4,156
Prepaid expenses	**2,446**	2,291
Assets limited as to use	**3,702**	2,841
Promises to give, net	**613**	711
Total current assets	**85,544**	90,353
Net property and equipment	**180,833**	181,666
Other assets:		
Assets limited as to use	**14,003**	11,091
Investments – donor restricted	**2,896**	2,552
Promises to give, net	**2,665**	2,402
Long-term investments	**105,795**	67,837
Other investments	**3,423**	4,190
Debt issuance costs, net	**1,694**	1,799
Other assets	**177**	320
Total other assets	**130,653**	90,191
Total assets	**$ 397,030**	$ 362,210

	June 30	
	2011	**2010**
Liabilities and net assets		
Current liabilities:		
Current maturities of long-term debt and capital lease obligations	**$ 3,732**	$ 1,568
Accounts payable	**14,500**	15,869
Accrued expenses	**21,553**	18,364
Advances from third-party payors	**8,178**	8,048
Other current liabilities	**2,987**	3,047
Total current liabilities	**50,950**	46,896
Long-term liabilities, net of current portion:		
Long-term debt and capital lease obligations	**142,567**	140,211
Interest rate swap contract	**9,715**	11,265
Accrued pension expense	**16,476**	22,416
Other long-term liabilities	**9,481**	6,605
Total long-term liabilities, net of current portion	**178,239**	180,497
Total liabilities	**229,189**	227,393
Net assets:		
Unrestricted	**161,667**	129,158
Temporarily restricted	**5,198**	4,683
Permanently restricted	**976**	976
Total net assets	**167,841**	134,817
Total liabilities and net assets	**$ 397,030**	$ 362,210

See accompanying notes.

Frederick Memorial Hospital, Inc. and Subsidiaries

Consolidated Statements of Operations
(In Thousands)

	Year Ended June 30	
	2011	**2010**
Unrestricted revenue and other support:		
Net patient service revenue	**$ 341,584**	$ 304,786
Other operating revenues	**9,831**	6,719
Gifts, bequests, and contributions	**2,294**	1,965
Net assets released from restriction used for operations	**368**	2,368
Total unrestricted revenue and other support	**354,077**	315,838
Operating expenses:		
Salaries and wages	**140,080**	128,402
Employee benefits	**35,401**	32,228
Professional fees	**11,768**	11,465
Cost of goods sold	**49,869**	45,060
Supplies	**10,740**	9,295
Contract services	**32,708**	28,928
Other	**11,996**	10,711
Utilities	**4,541**	4,390
Insurance	**4,737**	2,707
Depreciation and amortization	**19,304**	18,301
Interest	**4,665**	4,357
Provision for uncollectible accounts	**13,801**	12,821
Total operating expenses	**339,610**	308,665
Operating income	**14,467**	7,173
Other income (loss), net:		
Gain on sale of assets	**5**	14
Investment gain (loss), net	**3,893**	(1,802)
Change in unrealized gains on trading securities, net	**8,391**	8,414
Realized and unrealized losses on interest rate swap contract, net	**(1,068)**	(5,836)
Other non-operating income, net	**61**	291
Total other income, net	**11,282**	1,081
Excess of unrestricted revenue and other support over expenses	**25,749**	8,254
Other changes in unrestricted net assets:		
Pension adjustment	**6,504**	(7,037)
Released from restriction used to purchase capital	**256**	640
Increase in unrestricted net assets	**$ 32,509**	$ 1,857

See accompanying notes.

Frederick Memorial Hospital, Inc. and Subsidiaries

Consolidated Statements of Changes in Net Assets

(In Thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Net assets, June 30, 2009	$ 127,301	$ 6,148	$ 976	$ 134,425
Excess of unrestricted revenue and other support over expenses	8,254	–	–	8,254
Pension adjustment	(7,037)	–	–	(7,037)
Released from restriction used to purchase capital	640	–	–	640
Assets released from restrictions	–	(3,008)	–	(3,008)
Restricted gifts, bequests and contributions	–	1,543	–	1,543
Changes in net assets	1,857	(1,465)	–	392
Net assets, June 30, 2010	129,158	4,683	976	134,817
Excess of unrestricted revenue and other support over expenses	**25,749**	**–**	**–**	**25,749**
Pension adjustment	**6,504**	**–**	**–**	**6,504**
Released from restriction used to purchase capital	**256**		**–**	**256**
Assets released from restrictions	**–**	**624**	**–**	**624**
Restricted gifts, bequests and contributions	**–**	**(109)**	**–**	**(109)**
Changes in net assets	**32,509**	**515**	**–**	**33,024**
Net assets, June 30, 2011	**$ 161,667**	**$ 5,198**	**$ 976**	**$ 167,841**

See accompanying notes.

Frederick Memorial Hospital, Inc. and Subsidiaries

Consolidated Statements of Cash Flows
(In Thousands)

	Year Ended June 30	
	2011	**2010**
Cash flows provided by operating activities		
Change in net assets	**$ 33,024**	$ 392
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	**19,304**	18,301
Amortization of original issue discount and bond issue costs	**204**	194
Equity in (gains) losses of joint ventures	**384**	(362)
Change in other assets	**143**	–
Gain on sale of property and equipment	**(5)**	(14)
Gain on sale of joint venture	**(3,300)**	–
Investment in subsidiaries	**(620)**	–
Change in unrealized gains on trading securities, net	**(8,391)**	(8,414)
Proceeds from realized (gains) losses on investments – trading	**(1,338)**	4,039
Increase in investments – trading	**(28,573)**	(5,940)
Increase in assets limited as to use – trading, net	**(2,716)**	(140)
Proceeds from restricted contributions	**(624)**	(1,543)
Change in pledges receivable	**(165)**	1,582
Realized and unrealized losses on interest rate swap contract, net	**1,068**	5,836
Change in operating assets and liabilities:		
Receivables, patient and other	**(1,583)**	(3,698)
Inventories and other assets	**(355)**	717
Accounts payable	**(1,369)**	2,604
Accrued expenses	**3,189**	88
Accrued pension expense	**(5,940)**	9,109
Advances from third-party payors	**130**	843
Other short-term liabilities	**(60)**	(707)
Other long-term liabilities	**2,876**	1,836
Net cash provided by operating activities	**5,283**	24,723
Cash flows used in investing activities		
(Increase) decrease in assets limited as to use-non-trading, net	**(1,057)**	14
Realized losses on interest rate swap contract	**(2,620)**	(2,618)
Purchases of property and equipment	**(14,322)**	(20,726)
Proceeds from sale of assets	**2,445**	523
Proceeds from sale of joint venture	**4,000**	**–**
Other investing activities	**300**	1,102
Net cash used in investing activities	**(11,254)**	(21,705)
Cash flows from fundraising and financing activities		
Proceeds from restricted contributions	**624**	1,543
Repayments of long-term debt	**(2,163)**	(2,308)
Net cash used in fundraising and financing activities	**(1,539)**	(765)
Net (decrease) increase in cash and cash equivalents	**(7,510)**	2,253
Cash and cash equivalents at beginning of year	**34,805**	32,552
Cash and cash equivalents at end of year	**$ 27,295**	$ 34,805
Supplemental disclosures:		
New capital lease obligations	**$ 6,584**	$ –
Cash paid for interest	**$ 4,655**	$ 4,387

See accompanying notes.

1. Organization and Mission

Frederick Memorial Hospital, Inc. (the Hospital) is a not-for-profit hospital, exempt from federal income tax under Section 501(a) of the Internal Revenue Code (the Code) as an organization described in Section 501(c)(3) whereby only unrelated business income as defined by Section 512(a)(1) of the Code, is subject to Federal income tax. The Hospital is located in Frederick, Maryland, and provides health care services primarily to residents of Frederick County.

The Hospital and Hospice of Frederick County have received determination letters from the Internal Revenue Service (IRS) stating that they are exempt from federal income taxes under Section 501(c) of the Internal Revenue Code.

Frederick Health Services Corporation (FHSC) is subject to federal and state income taxes. No provision for income taxes has been recorded for 2011 and 2010 as FHSC does not have taxable income or current tax liabilities.

2. Significant Accounting Policies

Principles of Consolidation

The accompanying financial statements include the accounts and transactions of the Hospital, its for-profit, wholly-owned subsidiary, Frederick Health Services Corporation (FHSC); Emmitsburg Properties, LLC; Hospice of Frederick County, Inc.; and Frederick Memorial Hospital Self-Insurance Trust.

Hospice of Frederick County, Inc. (HFC) is an independent 501(c)(3) organization. HFC remains a separate entity, controlled by the Hospital, and operates as a fundraising organization for the benefit of hospice services and operates the Kline Hospice House.

FHSC has three wholly-owned subsidiaries: Rosehill of Frederick, LLC and Corporate Occupational Health Solutions, LLC, which are for-profit limited liability companies, and Frederick Surgical Services Corporation (FSSC), all of which have been consolidated into FHSC in the accompanying financial statements. The accompanying consolidated financial statements include the accounts of the Hospital and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

2. Significant Accounting Policies (continued)

On June 28, 2011 the Hospital Board of Directors approved a corporate restructuring which included the creation of a non-profit 501(c)3 Parent Corporation to be known as Frederick Regional Health System (FRHS). Additionally two additional non-profit entities were organized, Monocacy Insurance, LTD and Monocacy Health Partners, both of which will be 100% owned by FRHS. Monocacy Insurance, LTD is a Cayman Islands domiciled Single Parent captive to provide a flexible risk financing structure to meet the needs of FRHS. Monocacy Health Partners will serve as a physician enterprise, providing governance, management and support functions for employed physicians. Completion of this restructuring will occur during fiscal year 2012.

Donor-Restricted Gifts

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 to unrestricted net assets if restricted for capital or reported in the statements of operations as net assets released from restrictions if restricted for operating purposes. Donations received with no restrictions and donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying consolidated statements of operations as other operating revenues.

Cash and Cash Equivalents

Cash and cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less, excluding those cash and money market funds which are classified as short-term and long-term investments.

2. Significant Accounting Policies (continued)

Patient Receivables and Allowances

The Hospital'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. Accounts receivable from third-party payors have been adjusted to reflect the difference between charges and the estimated reimbursable amounts. Recoveries of previously written off patient receivables are recorded when received.

Inventory

Inventory is stated at the lower of cost or market. Cost is determined using the first-in, first-out (FIFO) method.

Cost of Goods Sold

Cost of goods sold consists primarily of drugs, medical supplies, and surgical implants used in the care and treatment of patients.

Investments and Assets Limited as to Use

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. Realized and unrealized investment return from all unrestricted investments and assets limited as to use is included in the consolidated statements of operations as part of nonoperating gains and losses. 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. Investments are classified as either current or noncurrent based on maturity dates and availability for current operations.

2. Significant Accounting Policies (continued)

Substantially all the Hospital's investment portfolio (excluding assets limited as to use) is classified as trading, with unrealized gains and losses included in excess of unrestricted revenue and other support over expenses. Certain trusteed assets that are included in assets limited as to use are classified as other-than-trading. These assets primarily consist of debt reserve funds and funds held under trust arrangements related to unreleased bond proceeds.

Investment Risk and Uncertainties

The Hospital invests in professionally managed portfolios that contain corporate bonds, United States Government obligations, municipal obligations, asset-backed securities, marketable equity securities, hedge funds, and money market funds. Such investments are exposed to various risks, such as interest rate, market, and credit. Due to the level of risk associated with such investments and the level of uncertainty related to changes in the value of such investments, it is at least reasonably possible that changes in risks in the near term would materially affect investment balances and the amounts reported in the financial statements.

Property and Equipment

Property and equipment is carried at historical cost. Items acquired by gift are recorded at fair value at the time of acquisition. Depreciation is provided on the straight-line method over the estimated useful lives of the depreciable assets. Leasehold improvements are amortized using the straight-line method over the shorter of the lease term, or the estimated useful lives of the assets.

Valuation of Long-Lived Assets

The Hospital accounts for the valuation of long-lived assets under *Accounting for the Impairment or Disposal of Long-Lived Assets.* This guidance requires that long-lived assets and certain identifiable intangible assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the long-lived asset is measured by a comparison of the carrying amount of the asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. Assets to be disposed of are reportable at the lower of the carrying amount or fair value, less costs to sell.

2. Significant Accounting Policies (continued)

Debt Issuance Costs

Debt issuance costs related to the Series 2002 and Series 2008 MHHEFA bonds and the equipment note payable are being amortized over the life of the debt using the effective interest method.

Patient Service Revenue and Allowances

The Hospital has agreements with third-party payors that provide for payments to the Hospital for patient services at amounts different from its established rates. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated adjustments under reimbursement agreements with third-party payors. Estimated adjustments are accrued in the period the related services are rendered and adjusted in future periods as final settlements are determined.

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.

Performance Indicator

The performance indicator is the excess of unrestricted revenue and other support over expenses. Changes in unrestricted net assets, consistent with industry practice, includes pension adjustments and net assets released from restriction for capital purposes.

Fair Value of Financial Instruments

The carrying amounts reported on the consolidated balance sheets for cash and cash equivalents, receivables, accounts payable, accrued expenses, and advances from third-party payors approximate their fair values. The fair value of the Hospital's notes receivable, revenue bond notes, and other long-term debt approximate the carrying amounts, based on loans with similar terms and average maturities.

2. Significant Accounting Policies (continued)

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 results could differ from those estimates.

Reclassification

Certain amounts from the prior year financial statements related to the interest rate swap contract as discussed in Note 11 have been reclassified in order to conform to the current year presentation. These reclassifications had no impact on revenues and gains in excess of expenses or net assets for the years ended June 30, 2011 and June 30, 2010.

Recent Accounting Pronouncements

In January 2010, the FASB issued ASC Accounting Standards Update (ASU) No. 2010-06 (ASU 2010-06), *Improving Disclosures about Fair Value Measurements*, which clarifies certain existing fair value measurement disclosure requirements of ASC Topic 820 – *Fair Value Measurements and Disclosures* 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. The adoption of this guidance did not have a significant impact on the Hospital's consolidated financial statements for the year ended June 30, 2011.

(Dollars in Thousands)

2. Significant Accounting Policies (continued)

In August 2010, the FASB issued ASU 2010-23, *Health Care Entities: Measuring Charity Care for Disclosure – a consensus of the FASB Emerging Issues Task Force,* which provides guidance on measuring charity care for disclosure purposes. This guidance requires that cost be used as the measurement basis for charity care disclosure purposes and that cost identified includes both the direct and indirect costs of providing charity care. Disclosure requirements include the method used to identify or determine such costs. This guidance is effective for the Hospital for the fiscal year ending June 30, 2012. The Hospital is currently evaluating the impact of this guidance on its consolidated financial statements.

In July 2011, the FASB issued ASU 2011-07, *Health Care Entities: Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities (a consensus of the FASB Emerging Issues Task Force),* which provides guidance on the presentation and disclosure of patient service revenue, provisions for bad debts, and the allowance for doubtful accounts for certain health care entities. This guidance changes the presentation of the statement of operations by reclassifying the provision for bad debts associated with patient service revenue from an operating expense to a deduction from patient service revenue (net of contractual allowances and discounts). Additionally, the guidance requires enhanced disclosures about the policies for recognizing revenue and assessing bad debts, as well as qualitative and quantitative information about changes in the allowance for doubtful accounts. This guidance is effective for the Hospital for the fiscal year ending June 30, 2013. The Hospital is currently evaluating the impact of this guidance on its consolidated financial statements.

3. Patient Receivables and Patient Service Revenue

Patient receivables consist of the following at June 30:

	2011	**2010**
Gross patient receivables	**$ 64,121**	$ 61,580
Less: estimated uncollectible accounts and contractual allowances	**18,144**	18,422
Net patient receivables	**$ 45,977**	$ 43,158

(Dollars in Thousands)

3. Patient Receivables and Patient Service Revenue (continued)

Patient service revenue consists of the following for the years ended June 30, 2011 and 2010:

	2011	2010
Inpatient charges	**$ 209,514**	$ 185,415
Outpatient charges	**210,770**	187,008
Gross charges	**420,284**	372,423
Less: Allowances, contractual and other	**78,700**	67,637
Net patient service revenue	**$ 341,584**	$ 304,786

The Hospital provides care to patients who meet certain criteria under its charity care policy. The Hospital charges at its established rates but waives all or a portion of reimbursement. Because the Hospital does not pursue collection of amounts determined to qualify as charity care, these revenues are not reported as net patient service revenue. Charity care provided for the years ended June 30, 2011 and 2010, was $7.5 million and $4.4 million respectively.

4. Other Receivables

In August 2010, the Hospital received a distribution of $594 from a settlement of an estate gift of which $300 was included in other receivables in the accompanying consolidated financial statements as of June 30, 2010.

5. Assets Limited as to Use

A summary of assets which are limited as to use substantially for debt service and self insurance at June 30 is as follows:

	2011	2010
Current:		
Principal and interest due – bonds	**$ 3,702**	$ 2,841
Noncurrent:		
Debt service reserve funds	**$ 6,474**	$ 6,499
Self insurance trusts	**6,984**	4,268
Deferred compensation trusts	**545**	324
	$ 14,003	$ 11,091

(Dollars in Thousands)

5. Assets Limited as to Use (continued)

The assets which are limited as to use consists of the following at June 30:

		2011		2010
Current:				
Cash and money market accounts	**$**	**3,413**	$	2,550
U.S. government obligations		**289**		291
	$	**3,702**	$	2,841
Noncurrent:				
Cash and money market accounts	**$**	**837**	$	698
U.S. government obligations		**6,037**		6,194
Corporate obligations		**83**		60
Equity securities		**455**		260
Mutual funds		**6,591**		3,879
	$	**14,003**	$	11,091

The noncurrent assets limited as to use mutual funds are primarily invested in cash and short-duration debt securities.

6. Promises to Give

Promises to give are discounted and are due as follows at June 30:

		2011		2010
Less than one year	**$**	**721**	$	838
One to five years		**2,226**		1,967
More than five years		**1,542**		1,441
		4,489		4,246
Less: discounting and allowance for uncollectible promises		**1,211**		1,133
Total promises to give, net		**3,278**		3,113
Less: current portion of promises to give, net		**613**		711
	$	**2,665**	$	2,402

(Dollars in Thousands)

6. Promises to Give (continued)

Promises to give include $649 related to charitable remainder trusts. This net amount represents the excess of the fair value of the related trust accounts over the net present value of the annuities to be paid out of the trust to the named beneficiaries over their estimated life expectancy.

7. Investments

Long-term investments represent unrestricted investments and unrestricted income earned on unrestricted, temporarily restricted, and permanently restricted investments.

Donor-restricted investments are designated by the donors for expenses relating to capital projects, replacement or improvement of existing assets, or to cover the cost of services rendered as charity care and other programs.

Long-term investments consist of the following at June 30:

	2011		**2010**	
	Cost	**Fair Value**	**Cost**	**Fair Value**
Cash and cash equivalents	**$ 8,811**	**$ 8,807**	$ 12,746	$ 12,746
U.S. government obligations	**4,758**	**4,768**	1,835	1,927
Corporate obligations	**3,668**	**3,759**	2,418	2,555
Mortgage-backed securities	**4,011**	**4,186**	3,481	3,713
Equity securities	**30,429**	**34,026**	20,050	18,547
Mutual funds	**38,768**	**40,799**	24,147	23,371
	90,445	**96,345**	64,677	62,859
Hedge funds	**11,500**	**12,346**	7,300	7,530
	$ 101,945	**$ 108,691**	$ 71,977	$ 70,389

(Dollars in Thousands)

7. Investments (continued)

The hedge fund is accounted for under the equity method of accounting. Valuation of this equity investment is primarily based on financial data supplied by the underlying investee fund. The Hospital has the ability to liquidate this investment on a quarterly basis. The Hospital must provide notice of intent to redeem it's shares 65 days prior to the redemption date. Ninety percent of the redemption value will be returned to the Hospital within 45 days of the redemption date, with the balance payable 30 days after the receipt of the fund's annual audited financial statements. Value may be based on historical cost, appraisals, or other estimates that require varying degrees of judgment.

Investments are allocated as follows at June 30:

	2011	2010
Investment allocation:		
Unrestricted long-term investments	**$ 105,795**	$ 67,837
Donor restricted investments	**2,896**	2,552
	$ 108,691	$ 70,389

Investment income (losses), including income from short-term investments, for the years ended June 30 are as follows:

	2011	2010
Unrestricted:		
Net realized gains (losses)	**$ 1,339**	$ (4,039)
Interest and dividends, net of investment expense	**2,170**	1,875
Income from joint ventures	**384**	362
	$ 3,893	$ (1,802)

Investment expense was $235 and $235 for the fiscal years ended June 30, 2011 and 2010, respectively.

(Dollars in Thousands)

7. Investments (continued)

Other investments consist of the following at June 30:

	Carrying Value		Income	
	2011	**2010**	**2011**	**2010**
Joint ventures	**$ 2,735**	$ 3,502	**$ 384**	$ 362
Cash surrender value of life insurance policy	**688**	688	**–**	5
	$ 3,423	$ 4,190	**$ 384**	$ 367

Investments in joint ventures accounted for using the equity method, unless otherwise noted, at June 30 are as follows:

	Entity	Interest %	2011	2010
Colonial Regional Alliance	FMH	14.3%	**$ 30**	$ 30
Carroll Occupational Health, LLC	FHSC	25.0%	**(21)**	(18)
Comp Claim Management, LLC	FHSC	50.0%	**3**	5
Open MRI of Frederick, LLC	FHSC	50.0%	**195**	245
Glade Valley Nursing and Rehabilitation Center, Inc.	FMH	50.0%	**69**	768
Premier Purchasing Partners (cost method)	FMH	<1.0%	**447**	447
Mt. Airy Health Services, LLC	FMH	50.0%	**434**	510
Mt. Airy Plaza, LLC	FHSC	50.0%	**(345)**	(343)
Mt. Airy Surgical Center LLC	FHSC	50.0%	**167**	167
Frederick Surgical Center, LLC	FHSC	36.0%	**1,756**	1,691
			$ 2,735	$ 3,502

In December 2010 Glade Valley Nursing and Rehabilitation, Inc. (Glade Valley) was sold to a third party. The Hospital owned 50% of Glade Valley and, as a result of the sale, recognized a $3,300 gain which is shown in the other operating revenue section of the accompanied financial statements. The remaining balance in the Glade Valley investment account represents an estimate of the Hospital's portion of remaining accounts receivable.

8. Fair Value Measurements

Assets and liabilities recorded at fair value in the consolidated balance sheets are categorized based upon the level of judgment associated with the inputs used to measure their fair value. FASB guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability (i.e., the "exit price") in an orderly transaction between market participants at the measurement date, emphasizing that fair value is market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, the FASB establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Level 1 and 2 of the hierarchy) and the reporting entity's own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy). The Level inputs, as defined by FASB guidance for fair value measurements and disclosures, are as follows:

- Level 1 – Inputs utilize unadjusted quoted prices in active markets for identical assets or liabilities that the Hospital has the ability to access at the measurement date.

- Level 2 – Inputs are inputs other than quoted prices included in Level 1 that are observable for the assets or liabilities, either directly or indirectly. Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the assets or liabilities (other than quoted prices), such as interest rates, foreign exchange rates, and yield curves that are observable at commonly quoted intervals.

- Level 3 – Inputs are unobservable inputs for the assets or liabilities, which are typically based on an entity's own assumptions, as there is little, if any, related market activity.

(Dollars in Thousands)

8. Fair Value Measurements (continued)

The determination of the fair value level within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Hospital's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the assets or liabilities. The following tables present the Hospital's assets and liabilities measured at fair value on a recurring basis, aggregated by the level in the fair value hierarchy within which those measurements fall, as of June 30, 2011 and June 30, 2010:

		Fair Value Measurements at Reporting Date Using		
	Fair Value at June 30, 2011	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Other Unobservable Inputs (Level 3)**
Assets				
Cash and cash equivalents	**$ 40,353**	**$ 40,353**	**$ –**	**$ –**
Equity securities	**34,480**	**34,480**	**–**	**–**
U.S. government obligations	**11,094**	**–**	**11,094**	**–**
Corporate and other bonds	**3,843**	**–**	**3,843**	**–**
Mutual funds	**47,390**	**47,390**	**–**	**–**
Mortgage-backed securities	**4,186**	**–**	**4,186**	**–**
Contributions receivable	**3,278**	**–**	**–**	**3,278**
Total assets	**$ 144,624**	**$ 122,223**	**$ 19,123**	**$ 3,278**
Liabilities				
Interest rate swap liability	**$ (9,715)**	**$ –**	**$ (9,715)**	**$ –**
Total liabilities	**$ (9,715)**	**$ –**	**$ (9,715)**	**$ –**

(Dollars in Thousands)

8. Fair Value Measurements (continued)

		Fair Value Measurements at Reporting Date Using		
	Fair Value at June 30, 2010	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Other Unobservable Inputs (Level 3)**
Assets				
Cash and cash equivalents	$ 50,799	$ 50,799	$ –	$ –
Equity securities	18,807	18,807	–	–
U.S. government obligations	8,413	–	8,413	–
Corporate and other bonds	2,615	–	2,615	–
Mutual Funds	27,250	27,250	–	–
Mortgage-backed securities	3,713	–	3,713	–
Contributions receivable	3,113	–	–	3,113
Total assets	$ 114,710	$ 96,856	$ 14,741	$ 3,113
Liabilities				
Interest rate swap liability	$ (11,265)	$ –	$ (11,265)	$ –
Total liabilities	$ (11,265)	$ –	$ (11,265)	$ –

The fair value of the Hospital's trading securities is 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.

Assets utilizing Level 1 inputs include exchange-traded equity securities and equity and fixed income mutual funds. Assets and liabilities utilizing Level 2 inputs include U.S. government securities, corporate bonds, mortgage-backed securities, and interest rate swaps. Assets utilizing Level 3 inputs are contributions receivable.

(Dollars in Thousands)

8. Fair Value Measurements (continued)

Interest Rate Swap

The Hospital entered into an interest rate swap agreement in conjunction with the issuance of variable rate bonds. The swap contract is valued using models based on readily observable market parameters for all substantial terms of the contract. The fair value of the swap agreement is included as interest rate swap contract in the accompanying balance sheets. The fair value calculation at June 30, 2011, includes a credit valuation adjustment (CVA) as required by the FASB. At June 30, 2011, the valuation of the interest rate swap agreement liability position was reduced by $918 when applying the CVA. The change in the fair value of the swap agreement is included in excess (deficiency) of unrestricted revenue and other support over expenses, as the swap is not designated as an effective hedge. Credit exposure associated with non-performance by the counterparty to the derivative instrument is generally limited to the uncollateralized fair value of the asset related to instruments recognized in the balance sheets.

Assets utilizing Level 3 inputs are contributions receivable. Contributions receivable are recorded net of allowance for uncollectible pledges and discounted to net present value. The present value of estimated future cash flows using a discount rate commensurate with the risks involved is an appropriate measure of fair value for unconditional promises to give cash and is considered Level 3.

The following table provides a reconciliation of the beginning and ending balances of items measured at fair value on a recurring basis in the table above that used significant unobservable inputs (Level 3):

	Contributions Receivable	Total
Balance at June 30, 2009	$ 4,695	$ 4,695
Purchases, issuances and settlements	(1,582)	(1,582)
Balance at June 30, 2010	3,113	3,113
Purchases, issuances and settlements	**165**	**165**
Balance at June 30, 2011	**$ 3,278**	**$ 3,278**

(Dollars in Thousands)

9. Property and Equipment

Property and equipment consist of the following at June 30:

	Estimated Useful Lives	2011	2010
Land	–	**$ 3,765**	$ 3,765
Land improvements	8 – 20 years	**1,249**	1,249
Buildings	20 – 40 years	**180,300**	176,601
Fixed equipment	10 – 20 years	**16,343**	16,338
Movable equipment	3 – 20 years	**148,265**	133,826
Leasehold improvements	5 – 20 years	**19,160**	18,815
		369,082	350,594
Less accumulated depreciation		**190,138**	171,073
		178,944	179,521
Construction in process, renovations, and deposits	–	**1,889**	2,145
		$ 180,833	$ 181,666

Construction-in-progress consists of 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.

The net book value of assets under capital lease arrangements totaled $6,669 and $1,487 as of June 30, 2011 and 2010, respectively. Depreciation expense related to assets under capital lease arrangements was $1,404 and $525 for the fiscal years ended June 30, 2011 and 2010, respectively.

(Dollars in Thousands)

10. Long-Term Debt

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

	2011	2010
MHHEFA Series 2002 Bonds	**$ 66,983**	$ 67,733
MHHEFA Series 2008 Bonds	**71,944**	72,035
Note payable – Emmitsburg	**373**	461
Capital lease obligations	**6,999**	1,550
	146,299	141,779
Less current maturities	**3,732**	1,568
	$ 142,567	$ 140,211

Series 2008 MHHEFA Revenue Bonds

In July 2008, the Hospital advance refunded its Series 2006 MHHEFA Revenue Bonds (auction rate securities) totaling $75,000 in part through the issuance of Series 2008 MHHEFA Revenue Bonds (Series 2008 Bonds) in the amount of $72,160. The Series 2008 Bonds are variable rate demand bonds. The bond insurance securing the Series 2006 Bonds was terminated. The general terms of the original $75,000 interest rate swap contract remained in place. However, due to the lower principal amount on the new issuance, a portion of the swap was terminated ($2,840) and a partial termination fee was incurred of approximately $218. A loss on extinguishment of debt of $2,370 was recognized as a result of the write-off of unamortized deferred financing cost and original issue discounts. In conjunction with the issuance of the Series 2008 Bonds, the Hospital secured a three-year letter of credit with a bank covering the entire bond issue. The letter of credit was amended on June 25, 2010, with terms for tender advances of the greater of LIBOR +2.75% or 4.00% for the first 90 days, and the greater of LIBOR +3.25% or 4.00% for days 91-366. Tender advances are due 366 days after initial draw. The new termination date of the letter of credit is July 8, 2013.

10. Long-Term Debt (continued)

The Series 2008 MHHEFA Revenue Bonds are net of original issue discounts of $144 which are being amortized over the life of the bonds using the yield method. Accumulated amortization was $28 at June 30, 2011. During the year ended June 30, 2011, the interest rate on these variable rate demand bonds has varied from 0.10% – 0.35%. Interest is payable monthly through July 1, 2035. The fair value of the Series 2008 MHHEFA Revenue Bonds is estimated based on the quoted market prices for the same or similar issues. As of June 30, 2011, the carrying value of the MHHEFA Series 2008 Bonds approximates fair value. Under the provisions of the bond agreement, the Hospital has granted to the Authority a security interest in all receipts now owned and hereafter acquired. The Series 2008 Bonds are secured ratably with the Series 2002 Bonds.

There is no debt service reserve requirement associated with the Series 2008 Bonds.

The bond agreement contains certain financial covenants.

Series 2002 MHHEFA Revenue Bonds

In August 2002, the Hospital obtained a loan of $71,715 in MHHEFA Revenue Bonds, Frederick Memorial Hospital Issue, Series 2002. The MHHEFA Series 2002 Bonds were issued to finance and refinance costs of construction, renovation, and equipping certain Hospital facilities. The Series 2002 Bonds are net of an original issue discount of $2,361 which is being amortized over the life of the bonds using the yield method. Accumulated amortization was $824 and $734 at June 30, 2011 and 2010, respectively. The annual interest rate on the bond loan ranges between 3.25% and 5.125%. Interest is payable semiannually on each January 1 and July 1, through July 1, 2035.

After refunding the Series 2006 Bonds and the issuance of Series 2008 Bonds, the debt service reserve requirement for the Series 2002 Bonds is $6,208.

Series 2002 Bonds maturing on or after July 1, 2012 are subject to redemption or purchase prior to maturity, beginning on July 1, 2012, at the option of the Authority at the principal amount of the Series 2002 Bonds to be redeemed plus accrued interest thereon to the date set for redemption.

(Dollars in Thousands)

10. Long-Term Debt (continued)

Under the provisions of the bond agreement, the Hospital has granted to the Authority a security interest in all receipts now owned and hereafter acquired. The Series 2002 Bonds are secured ratably with the 2008 Bonds. The fair value of the Series 2002 MHHEFA Revenue Bonds is estimated based on the quoted market prices for the same or similar issues. As of June 30, 2011, the fair value of the MHHEFA Series 2002 Bonds is estimated as $68,520.

The bond agreement contains certain financial covenants.

Note Payable – Emmitsburg

In December 1994, the Hospital acquired a 100% interest in Emmitsburg Properties, LLC and subsequently conveyed a 1% interest in the limited liability company to FHSC. In accordance with the terms of the purchase agreement, the Hospital executed two notes payable to the former owners aggregating $1,219. The notes are payable in monthly installments of principal and interest of $10, bear interest at 8%, and are due December 31, 2014.

Capital Lease Obligations

During the fiscal year ended June 30, 2011, the Hospital entered into certain capital lease obligations to secure major medical diagnostic equipment. Future payments under these obligations are as follows:

Years ending June 30:	
2012	$ 2,013
2013	1,778
2014	1,670
2015	1,443
2016	724
Total payments	7,628
Less: interest payments	629
Total lease obligations, principal	6,999
Less: current portion	1,761
Long-term obligations under capital leases	$ 5,238

(Dollars in Thousands)

10. Long-Term Debt (continued)

Debt service requirements on long-term debt and capital lease obligations, excluding the original issue discounts on the MHHEFA Bonds at June 30, 2011 and 2010, of $1,653 and $1,752, respectively, are as follows:

	Principal
Years ending June 30:	
2012	$ 3,732
2013	3,648
2014	3,702
2015	5,222
2016	4,638
Thereafter	127,010
	$ 147,952

11. Interest Rate Swap Contract

In conjunction with the issuance of the Series 2008 Bonds, the Hospital modified its interest rate swap contract with a third party to a notional amount of $72,160 until July 1, 2010, at which point the notional amount amortizes over the term of the underlying Series 2008 Bonds, with a final maturity of July 1, 2035. The Hospital is exposed to credit loss in the event of nonperformance by the counterparty to the interest rate swap contract. However, the Hospital does not anticipate nonperformance by the counterparty. Under the swap contract, the Hospital pays interest at a fixed rate of 3.804% and receives interest at a variable rate equal to 67% of the one-month London Interbank Offered Rate (LIBOR) (0.1856% as of June 30, 2011). The swap contract requires payments to be made or received monthly. The fair value of the swap contract was a liability of $9,715 and $11,265 at June 30, 2011 and 2010, respectively.

The Hospital accrued net payments under its interest rate swap program of $2,620 and $2,618 during fiscal years 2011 and 2010, respectively. These amounts are included within realized and unrealized loss on interest rate swap contract, net in the consolidated statements of operations and investing activities in the statement of cash flows.

11. Interest Rate Swap Contract (continued)

The Hospital records their derivatives as assets or liabilities at fair value. A derivative is typically defined as an instrument whose value is "derived" from an underlying instrument, index or rate, has a notional amount, requires little or no initial investment, and can be net settled. The Hospital participates in an interest rate swap contract that is considered a derivative financial instrument.

The interest rate swap contract is not designated as an effective cash flow hedge. The Hospital's objectives of entering into the interest rate swap contract include limiting or hedging variable interest rate payments, to achieve lower overall borrowing costs than a comparable unhedged fixed rate borrowing, to alter the pattern of debt service payments, and to improve asset/liability matching. Changes in the fair value of the derivative financial instrument are recognized in the consolidated statements of as a component of other loss. The carrying value of the Hospital's derivative financial instrument approximates fair value. The interest rate swap contract is valued using models based on readily observable market parameters for all substantial terms of the contract.

Credit exposure associated with non-performance by the counterparties to derivative instruments is generally limited to the uncollateralized fair value of the asset related to instruments recognized in the consolidated balance sheets. The Hospital attempts to mitigate the risk of non-performance by selecting counterparties with high credit ratings and monitoring their creditworthiness.

Our derivative agreements do not contain any credit support provisions that require us to post collateral if there are declines in the derivative value or our credit rating.

	Fair Value	
Balance Sheet Location	**2011**	**2010**
Asset derivatives		
Derivatives not designated as hedging instruments:		
Interest rate contracts	**$ –**	$ –
Liability derivatives		
Long-term liabilities	**$ 9,715**	$ 11,265
Total derivatives not designated as hedging instruments	**$ 9,715**	$ 11,265

(Dollars in Thousands)

11. Interest Rate Swap Contract (continued)

A summary of the effect of the non-hedging derivatives on the Hospital's income statement for the year ended June 30, 2011, is as follows:

Type of Non-Hedging Derivatives	Income Statement Location of Loss Recognized	Derivative Loss Recognized
Interest rate swap contract – realized losses	Other loss	**$ (2,620)**
Interest rate swap contract – unrealized gains	Other income	**1,552**
Total		**$ (1,068)**

A summary of the effect of the non-hedging derivatives on the Hospital's income statement for the year ended June 30, 2010, is as follows:

Type of Non-Hedging Derivatives	Income Statement Location of Loss Recognized	Derivative Loss Recognized
Interest rate swap contract – realized losses	Other loss	$ (2,618)
Interest rate swap contract – unrealized losses	Other loss	(3,218)
Total		$ (5,836)

12. Employee Benefit Plans

The Hospital has a trusteed, defined benefit pension plan that covers substantially all employees. The Hospital's funding policy is to make a minimum annual contribution equal to net periodic pension cost for the Plan year as determined by its actuary. The Hospital uses a measurement date of June 30 to determine plan assets and benefit obligations. Effective June 30, 2007, the Hospital approved a curtailment of the Plan. The curtailment is such that participants will no longer accrue benefits under the Plan and no new participants will be accepted. Current participant accounts will not receive any service credits beyond June 30, 2007; however, the Hospital will make annual contributions to the plan in accordance with actuarially determined amounts to meet future accumulated benefit obligations under the frozen plan. Effective July 1, 2007, a modified defined contribution plan (403b) was implemented as described below.

Effective January 1, 2011 the Plan was amended, as required by SFAS No. 87, by changing the prior plan balance interest crediting rate from 8.5% to 4.5% resulting in a $643 reduction to the projected benefit obligation at June 30, 2012.

12. Employee Benefit Plans (continued)

The following provides a reconciliation of the changes in fair value of the Plan's assets and projected benefit obligations, and the Plan's funded status based on a June 30, 2011 and 2010, measurement date:

	2011	2010
	(In Thousands)	
Accumulated benefit obligation	**$ 73,238**	$ 72,489
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	**72,489**	58,978
Service cost	**374**	293
Interest cost	**3,939**	3,782
Plan Amendment	**(643)**	–
Actuarial loss (gain)	**(1,389)**	10,858
Benefits paid	**(1,532)**	(1,422)
Projected benefit obligation at end of year	**73,238**	72,489
Change in plan assets:		
Fair value of plan assets at beginning of year	**50,073**	45,671
Actual return on plan assets	**6,247**	5,742
Employer contribution	**1,974**	82
Benefits paid	**(1,532)**	(1,422)
Fair value of plan assets at end of year	**56,762**	50,073
Funded status	**(16,476)**	(22,416)
Net amount recognized	**$ (16,476)**	$ (22,416)

(Dollars in Thousands)

12. Employee Benefit Plans (continued)

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

	June 30	
	2011	**2010**
Net actuarial loss	**$ 19,442**	$ 25,177
Prior service cost	**443**	1,212
Total recognized in unrestricted net assets	**$ 19,885**	$ 26,389

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

	June 30	
	2011	**2010**
Discount rate	**5.60%**	5.50%
Rate of compensation increase	**n/a**	n/a

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

	Year Ended June 30	
	2011	**2010**
Discount rate	**5.50%**	6.50%
Expected return on plan assets	**7.00%**	7.00%
Rate of compensation increase	**n/a**	n/a

(Dollars in Thousands)

12. Employee Benefit Plans (continued)

Net periodic pension cost included the following components:

	2011	2010
Service cost	**$ 373**	$ 293
Interest cost	**3,939**	3,782
Expected return on plan assets	**(3,550)**	(3,142)
Amortization of prior service cost	**127**	127
Recognized net actuarial loss	**1,649**	1,094
Net periodic pension cost	**$ 2,538**	$ 2,154

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, 2012, is $1,137.

The Hospital determines the expected long-term rate of return on Plan assets by taking into consideration the historical returns of various asset classes and the types of investments the Plan is expected to hold.

The defined benefit pension plan asset allocation as of the measurement date presented as a percentage of total plan assets were as follows:

	2011	2010
Equity securities	**25.0%**	29.5%
Debt securities	**55.9**	55.9
Cash	**2.1**	1.8
Hedge funds	**17.0**	12.8
Total	**100.0%**	100.0%

The Plan assets are recorded at fair value and are categorized based upon the level of judgment associated with the inputs used to measure their fair value.

12. Employee Benefit Plans (continued)

FASB guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability (i.e., the "exit price") in an orderly transaction between market participants at the measurement date, emphasizing that fair value is market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, the FASB establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Level 1 and 2 of the hierarchy) and the reporting entity's own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy). The Level inputs, as defined by FASB guidance for fair value measurements and disclosures, are as follows:

- Level 1 – Inputs utilize unadjusted quoted prices in active markets for identical assets or liabilities that the Hospital has the ability to access at the measurement date.

- Level 2 – Inputs are inputs other than quoted prices included in Level 1 that are observable for the assets or liabilities, either directly or indirectly. Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the assets or liabilities (other than quoted prices), such as interest rates, foreign exchange rates, and yield curves that are observable at commonly quoted intervals.

- Level 3 – Inputs are unobservable inputs for the assets or liabilities, which are typically based on an entity's own assumptions, as there is little, if any, related market activity.

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

(Dollars in Thousands)

12. Employee Benefit Plans (continued)

The Hospital's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the assets or liabilities. The following tables present the Plan's assets and liabilities measured at fair value on a recurring basis, aggregated by the level in the fair value hierarchy within which those measurements fall, as of June 30, 2011 and June 30, 2010:

		Fair Value Measurements at Reporting Date Using		
	Fair Value at June 30, 2011	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Other Unobservable Inputs (Level 3)**
Assets				
Cash and cash equivalents	**$ 1,220**	**$ 1,220**	**$ –**	**$ –**
Equity securities	**14,163**	**14,163**	**–**	**–**
Fixed income mutual funds	**31,744**	**31,744**	**–**	**–**
Hedge funds	**9,635**	**–**	**–**	**9,635**
Total assets	**$ 56,762**	**$ 47,127**	**$ –**	**$ 9,635**

		Fair Value Measurements at Reporting Date Using		
	Fair Value at June 30, 2010	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Other Unobservable Inputs (Level 3)**
Assets				
Cash and cash equivalents	$ 875	$ 875	$ –	$ –
Equity securities	14,769	14,769	–	–
Fixed income mutual funds	28,023	28,023	–	–
Hedge Funds	6,406	–	–	6,406
Total assets	$ 50,073	$ 43,667	$ –	$ 6,406

(Dollars in Thousands)

12. Employee Benefit Plans (continued)

The following table provides a reconciliation of the beginning and ending balances of items measured at fair value on a recurring basis in the table above that used significant unobservable inputs (Level 3):

	Hedge Funds	Total
Balance at June 30, 2009	$ –	$ –
Purchases, issuances and settlements	6,406	6,406
Balance at June 30, 2010	6,406	6,406
Purchases, issuances and settlements	**3,229**	**3,229**
Balance at June 30, 2011	**$ 9,635**	**$ 9,635**

The fair value of the Plan's trading securities is 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. Assets utilizing Level 1 inputs include exchange-traded equity securities and equity and fixed income mutual funds. Assets utilizing Level 3 inputs are hedge funds.

The hedge fund is accounted for at fair value which has been estimated using the net asset value per share of the fund as of June 30, 2011. The Plan has the ability to liquidate this investment on a quarterly basis. The Plan must provide notice of intent to redeem its shares 65 days prior to the redemption date. Ninety percent of the redemption value will be returned to the Plan within 45 days of the redemption date, with the balance payable 30 days after the receipt of the fund's annual audited financial statements.

Assets of the Plan are invested in a manner consistent with fiduciary standards of the Employees Retirement Income Security Act of 1974 (ERISA); namely, (a) the safeguards and diversity to which a prudent investor would adhere must be present, and (b) all transactions undertaken on behalf of the Plan must be for the sole interest of Plan participants and beneficiaries, to provide benefits in a prudent manner. Investment objectives of the Plan also include:

- Achieve an annualized total return that equals or exceeds the actuarial target
- Preserve the value of the Plan's assets

(Dollars in Thousands)

12. Employee Benefit Plans (continued)

- Diversify assets sufficiently, and, in accordance with modern portfolio theory, avoid large specific risks (losses) and minimize the volatility of the portfolio

- Provide sufficient liquidity to plan benefit payment outflows and meet the Plan's requirements

The strategic target asset allocation for the Plan is 24% in equities, 59% in debt securities, and 17% in other investments.

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

2012	$ 1,926
2013	2,152
2014	2,403
2015	2,626
2016	2,843
2017 – 2021	18,353

The Hospital also has a tax-deferred annuity savings (403b) plan available to substantially all employees. In conjunction with the curtailment of the defined benefit pension plan, the Hospital modified the 403b plan effective July 1, 2007. Under the terms of the modified plan, every eligible employee receives a base contribution of 2.5% of earnings. The Hospital will match 50% – 70% on employee contributions up to 5% of employee earnings depending on years of service. In addition, certain employees are eligible for transition credits based on age and years of service to the Hospital. The Hospital's contribution for base matching and transition credits totaled $4,787 and $5,478 for fiscal years 2011 and 2010, respectively.

The Hospital is partially self-insured against employee medical claims. Plan expenses include claims paid and a provision for claims incurred but not reported. As of June 30, 2011 and 2010, the Hospital has recorded a liability for claims incurred but not reported of $1,600 and $1,250, respectively. The program has an annual aggregate stop loss provision of $350 per employee.

(Dollars in Thousands)

12. Employee Benefit Plans (continued)

In December 2005, the Hospital adopted two non-qualified deferred compensation plans with an effective date of December 15, 2004, for certain members of executive management. Under the plans, participating employees may contribute amounts from their compensation to the plan and may receive a discretionary employer contribution. Employees are fully vested in all employee contributions to the plans. Vesting in employer contributions occurs in accordance with the underlying plan documents. All assets of the plans are held in separate trusts. Total Hospital contributions to the plans were $220 and $211 for the years ended June 30, 2011 and 2010, respectively.

13. Concentration of Credit Risk

The Hospital, HFC, FSSC, and FHSC have funds on deposit with financial institutions in excess of amounts insured by the Federal Deposit Insurance Corporation. The Hospital grants credit without collateral to its patients, most of who are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors (in percentages) at June 30 was as follows:

	2011	2010
Medicare	**21%**	22%
Medicaid	**10**	13
Blue Cross	**18**	16
HMOs and PPOs	**19**	17
Commercial insurance and other third-party payors	**6**	6
Patients	**26**	26
	100%	100%

(Dollars in Thousands)

14. Functional Expenses

The Hospital and its subsidiaries provide general health care services to residents within its geographic location. Expenses related to providing these services are as follows:

	2011	2010
Health care services	**$ 304,010**	$ 278,165
General and administrative	**35,600**	30,500
	$ 339,610	$ 308,665

15. Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes or periods at June 30:

	2011	2010
Health care services:		
Buildings and equipment	**$ 1,849**	$ 1,240
Restricted by time only	**2,470**	2,240
Education programs	**574**	667
Indigent care and research	**305**	536
	$ 5,198	$ 4,683

Permanently restricted net assets consist of investments to be held in perpetuity, the income from which is expendable for:

	2011	2010
General health care services (reported as operating income)	**$ 971**	$ 971
Specific health care services (reported as temporarily restricted income)	**5**	5
	$ 976	$ 976

During 2011 and 2010, net assets were released from donor restrictions by incurring expenses or capital expenditures satisfying the restricted purposes in the amounts of $624 and $3,008, respectively.

16. Contingencies

The Hospital has been named as a defendant 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 Hospital's ultimate liability under all current legal proceedings will not have a material adverse effect on their consolidated financial position or results of operations.

The Hospital was insured for professional liability under an occurrence basis policy through June 30, 2005. Effective July 1, 2005, the Hospital established a new irrevocable self-insurance trust to set aside funds to cover future professional liability claims. The initial funding to the trust was $1,500. Total disbursements from the fund for a covered loss by one or more persons as a result of any one occurrence shall not exceed $1,000 and $3,000 in the aggregate in any one fiscal year. Concurrently, the Hospital purchased excess "umbrella" coverage through a commercial carrier with a per-occurrence and aggregate limit of $10,000 per policy period. The funded balance of the trust was $6,984 and $4,268 at June 30, 2011 and 2010, respectively, and is included as assets limited as to use on the consolidated balance sheets.

There are known claims and incidents that could result in the assertion of additional claims, as well as claims from unknown incidents that could be asserted arising from services provided to patients. The Hospital maintains reserves, in the amount of $6,733 and $4,807 at June 30, 2011 and 2010, respectively, to cover estimated costs incurred within the self-insured period. The Hospital employs 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.

(Dollars in Thousands)

17. Commitments

Operating Leases

The Hospital and its subsidiaries lease facilities under various operating leases, the last of which expires in November 2015. The Hospital has various options to renew the leases. The Hospital also leases equipment under various operating leases. Rent expense under all operating leases was $4,953 and $4,808 for 2011 and 2010, respectively. Future minimum payments under non-cancelable operating leases are as follows:

Years ending June 30:		
2012	$	3,049
2013		1,889
2014		1,480
2015		1,399
2016		1,235
Thereafter		17,411
	$	26,463

Workers' Compensation

The Hospital is self-insured against worker's compensation claims, up to $500 per occurrence, and has excess insurance coverage of $1,000 per occurrence. Expenses include claims paid and a provision for claims incurred but not reported.

Supply Chain Management Agreement

The Hospital has a master service agreement with a vendor to provide supply chain management functions. This agreement contains certain purchase volume commitments.

Letter of Credit

The Hospital has a letter of credit issued by a lending institution in the amount of $1,246. This letter of credit is renewed on an annual basis and is required by the State of Maryland as collateral for unemployment benefits.

18. Regulatory Environment

Medicare and Medicaid

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.

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.

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 Hospital, has not been determined.

State of Maryland Health Services Cost Review Commission

Rates charged by Maryland hospitals are subject to review and certification by the State of Maryland Health Services Cost Review Commission (HSCRC). Maryland hospitals are not permitted to charge for regulated services, defined as services provided on the Hospital's campus or Hospital based services, at rates other than those approved by the HSCRC.

18. Regulatory Environment (continued)

In April 1999, the HSCRC implemented a rate methodology for inpatient hospital services. Under this methodology, a target average charge per case is established annually for each hospital based on past actual charges, case mix indices, and other annual adjustments. The actual average charge per case is compared with the target average charge per case and to the extent that the actual average is above or below the target, the variance plus applicable penalties will increase or decrease the approved target for the succeeding fiscal year.

The HSCRC's rate setting methodology for service centers that provide either inpatient and outpatient services, or only outpatient services, establishes an acceptable unit rate for each inpatient and outpatient center. The actual average unit charge for each service center is compared to the approved rate monthly. Variances due to volume or price plus applicable penalties are applied to decrease or increase approved rates for the succeeding fiscal year.

The timing of the HSCRC's rate adjustments in any given year could result in an increase or decrease in the succeeding year's rates due to the variances and penalties described above. The Hospital accrues revenue based on actual charges for services to patients in the year in which the services are performed.

The HSCRC established an uncompensated care fund whereby certain hospitals are required to contribute to the fund to help cover the costs associated with uncompensated care for all Maryland hospitals equitably. The Hospital's contribution to the fund was $4,004 and $3,173 for the years ended June 30, 2011 and 2010, respectively.

Beginning in fiscal year 2011, the HSCRC implemented the Charge Per Visit (CPV) methodology for certain outpatient services. Using fiscal year 2010 as the base period, the actual average 2011 CPV is compared with the base period target. Similar to the CPC target, the CPV target is adjusted annually for inflation, case mix changes and other factors. The outpatient services that are excluded from the CPV methodology are reimbursed on approved HSCRC charges.

19. Subsequent Events

The Hospital has evaluated subsequent events for the year ended June 30, 2011 through October 21, 2011, the date these financial statements were issued.

No other significant subsequent events were noted that would require recognition or disclosure at this time.

Other Financial Information

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Report of Independent Auditors

The Board of Directors
Frederick Memorial Hospital, Inc. and Subsidiaries

Our audit was conducted for the purpose of forming an opinion on the June 30, 2011, consolidated financial statements taken as a whole. The accompanying consolidating schedules are presented for purposes of additional analysis and are 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, 2011, consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the June 30, 2011, consolidated financial statements taken as whole.

Ernst & Young LLP

October 21, 2011

Frederick Memorial Hospital, Inc. and Subsidiaries

Consolidating Balance Sheet

(In Thousands)

June 30, 2011

	Frederick Memorial Hospital Inc.	Hospice of Frederick County, Inc.	Emmitsburg Properties, LLC	Frederick Health Services Corporation	Elimination	Consolidated
Assets						
Current assets:						
Cash and cash equivalents	$ 25,834	$ 443	$ –	$ 1,018	$ –	$ 27,295
Patient receivables, net	44,666	25	–	1,286	–	45,977
Other receivables	1,361	–	–	44	(250)	1,155
Inventory	4,356	–	–	–	–	4,356
Prepaid expenses	2,358	2	–	86	–	2,446
Assets limited as to use	3,702	–	–	–	–	3,702
Promises to give, net	613	–	–	–	–	613
Total current assets	82,890	470	–	2,434	(250)	85,544
Net property and equipment	174,734	981	–	5,118	–	180,833
Other assets:						
Assets limited as to use	14,003	–	–	–	–	14,003
Investments – donor restricted	2,896	–	–	–	–	2,896
Promises to give, net	2,665	–	–	–	–	2,665
Long-term investments	101,639	1,484	2,672	–	–	105,795
Other investments	19,105	–	–	1,756	(17,438)	3,423
Debt issuance costs, net	1,694	–	–	–	–	1,694
Other assets	3,878	–	–	–	(3,701)	177
Total other assets	145,880	1,484	2,672	1,756	(21,139)	130,653
Total assets	$ 403,504	$ 2,935	$ 2,672	$ 9,308	$ (21,389)	$ 397,030

Frederick Memorial Hospital, Inc. and Subsidiaries

Consolidating Balance Sheet (continued)

(In Thousands)

	Frederick Memorial Hospital Inc.	Hospice of Frederick County, Inc.	Emmitsburg Properties, LLC	Frederick Health Services Corporation	Elimination	Consolidated
Liabilities and net assets						
Current liabilities:						
Current maturities of long-term debt and capital lease obligations	$ 3,732	$ –	$ –	$ –	$ –	$ 3,732
Accounts payable	14,453	90	–	408	(451)	14,500
Accrued expenses	20,863	–	–	690	–	21,553
Advances from third-party payors	8,178	–	–	–	–	8,178
Loans payable, affiliates	75	–	–	3,440	(3,515)	–
Other current liabilities	2,987	–	–	–	–	2,987
Total current liabilities	50,288	90	–	4,538	(3,966)	50,950
Long-term liabilities, net of current portion:						
Long-term debt and capital lease obligations	142,567	–	–	–	–	142,567
Interest rate swap contract	9,715	–	–	–	–	9,715
Accrued pension expense	16,476	–	–	–	–	16,476
Other long-term liabilities	9,481	–	–	–	–	9,481
Total long-term liabilities, net of current portion	178,239	–	–	–	–	178,239
Total liabilities	228,527	90	–	4,538	(3,966)	229,189
Net assets:						
Unrestricted	168,803	2,845	2,672	4,770	(17,423)	161,667
Temporarily restricted	5,198	–	–	–	–	5,198
Permanently restricted	976	–	–	–	–	976
Total net assets	174,977	2,845	2,672	4,770	(17,423)	167,841
Total liabilities and net assets	$ 403,504	$ 2,935	$ 2,672	$ 9,308	$ (21,389)	397,030

Frederick Memorial Hospital, Inc. and Subsidiaries

Consolidating Statement of Operations and Changes in Net Assets
(In Thousands)

Year Ended June 30, 2011

	Frederick Memorial Hospital Inc.	Hospice of Frederick County, Inc.	Emmitsburg Properties, LLC	Frederick Health Services Corporation	Elimination	Consolidated
Unrestricted revenue and other support:						
Net patient service revenue	$ 337,537	$ 227	$ –	$ 4,099	$ (279)	$ 341,584
Other operating revenues	7,272	–	–	4,742	(2,183)	9,831
Gifts, bequests, and contributions	1,608	686	–	–	–	2,294
Net assets released from restriction used for operations	368	–	–	–	–	368
Total unrestricted revenue and other support:	346,785	913	–	8,841	(2,462)	354,077
Operating expenses:						
Salaries and wages	135,205	–	–	4,921	(46)	140,080
Employee benefits	34,454	–	–	983	(36)	35,401
Professional fees	11,733	1	–	64	(30)	11,768
Cost of goods sold	49,193	1	–	675	–	49,869
Supplies	10,649	91	–	–	–	10,740
Contract services	33,463	662	–	381	(1,798)	32,708
Other	11,369	164	–	1,015	(552)	11,996
Utilities	4,438	17	–	86	–	4,541
Insurance	4,625	–	–	112	–	4,737
Depreciation and amortization	18,839	77	–	388	–	19,304
Interest	4,667	–	–	113	(115)	4,665
Provision for uncollectible accounts	13,783	–	–	18	–	13,801
Total operating expenses	332,418	1,013	–	8,756	(2,577)	339,610
Operating income (loss)	14,367	(100)	–	85	115	14,467

Frederick Memorial Hospital, Inc. and Subsidiaries

Consolidating Statement of Operations and Changes in Net Assets (continued)

(In Thousands)

	Frederick Memorial Hospital Inc.	Hospice of Frederick County, Inc.	Emmitsburg Properties, LLC	Frederick Health Services Corporation	Elimination	Consolidated
Other income (loss), net:						
Gain on sale of assets	$ 5	$ –	$ –	$ –	$ –	$ 5
Investment (loss) income, net	3,778	67	138	25	(115)	3,893
Change in unrealized gains on trading securities, net	7,907	191	293	–	–	8,391
Realized and unrealized losses on interest rate swap contract, net	(1,068)	–	–	–	–	(1,068)
Other non-operating income	305	–	–	(244)	–	61
Total other income (loss)	10,927	258	431	(219)	(115)	11,282
Excess (deficiency) of unrestricted revenue and other support over expenses	25,294	158	431	(134)	–	25,749
Other changes in unrestricted net assets:						
Pension adjustment	6,504	–	–	–	–	6,504
Released from restriction used to purchase capital	256	–	–	–	–	256
Increase (decrease) in unrestricted net assets	$ 32,054	$ 158	$ 431	$ (134)	$ –	$ 32,509

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