



FINANCIAL STATEMENTS

Southern Maryland Hospital, Inc.  
Period From January 1, 2012 Through December 9, 2012 and  
Year Ended December 31, 2011  
With Report of Independent Auditors

Ernst & Young LLP

 **ERNST & YOUNG**

Southern Maryland Hospital, Inc.

Financial Statements

Period From January 1, 2012 Through December 9, 2012 and  
Year Ended December 31, 2011

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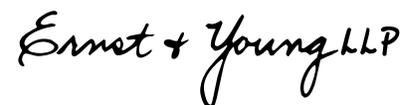
## Report of Independent Auditors

Stockholders  
Southern Maryland Hospital, Inc.

We have audited the accompanying balance sheets of Southern Maryland Hospital, Inc. (a Maryland Corporation) as of December 9, 2012 and December 31, 2011, and the related statements of revenues and expenses, changes in stockholders' equity, and cash flows for the period from January 1, 2012 through December 9, 2012 and the year ended December 31, 2011. These financial statements are the responsibility of the Corporation'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 Corporation'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 Corporation'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 financial position of Southern Maryland Hospital, Inc. at December 9, 2012 and December 31, 2011, and the results of its operations and its cash flows for the period from January 1, 2012 through December 9, 2012 and the year ended December 31, 2011 in conformity with U.S. generally accepted accounting principles

A handwritten signature in black ink that reads 'Ernst & Young LLP'.

April 8, 2013

Southern Maryland Hospital, Inc.

Balance Sheets

	<b>December 9, 2012</b>	<b>December 31, 2011</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 6,108,600	\$ 570,800
Accounts receivable, less allowance for uncollectible accounts of \$12,940,200 and \$22,422,100, respectively	34,485,000	45,168,600
Prepaid expenses and other assets	1,221,800	20,419,000
Inventories	4,235,400	3,364,800
Total current assets	<u>46,050,800</u>	<u>69,523,200</u>
Advances to related parties, net	—	1,456,000
Insurance recovery receivable	2,756,300	1,411,200
Restricted long term assets	19,975,000	—
Property and equipment:		
Buildings and land	19,639,200	18,615,200
Furniture, fixtures and minor equipment	19,472,000	19,262,500
Major movable equipment	32,906,900	33,325,800
Leasehold improvements	13,109,700	11,786,000
Construction in progress	9,694,100	4,666,700
	<u>94,821,900</u>	<u>87,656,200</u>
Less accumulated depreciation and amortization	<u>(51,852,300)</u>	<u>(49,375,300)</u>
Property and equipment, net	42,969,600	38,280,900
Total assets	<u><u>\$ 111,751,700</u></u>	<u><u>\$ 110,671,300</u></u>

Southern Maryland Hospital, Inc.

Balance Sheets

	<b>December 9, 2012</b>	<b>December 31, 2011</b>
<b>Liabilities and stockholders' equity</b>		
Current liabilities:		
Short term borrowings	\$           –	\$     630,000
Short term debt	–	4,600,000
Accounts payable	<b>10,668,700</b>	1,129,900
Accrued salaries, wages and employee benefits	<b>10,107,800</b>	7,272,800
Current portion of capital lease obligations	<b>1,026,300</b>	1,417,000
Advances from third-party payors	<b>10,542,900</b>	8,846,000
Other accrued liabilities	<b>4,042,900</b>	4,960,200
Total current liabilities	<b>36,388,600</b>	28,855,900
Noncurrent liabilities:		
Capital lease obligations, less current portion	<b>13,048,000</b>	14,042,900
Estimated professional liability	<b>9,723,000</b>	7,607,900
Long term note payable	–	6,400,000
Advances from related parties	<b>6,503,100</b>	–
Total noncurrent liabilities	<b>29,274,100</b>	28,050,800
Total liabilities	<b>65,662,700</b>	56,906,700
Stockholders' equity:		
Common stock, no par value, 10,000 shares authorized; 100 shares issued and outstanding	<b>100</b>	100
Additional paid-in capital	<b>9,943,500</b>	9,943,500
Retained earnings	<b>36,145,400</b>	43,821,000
Total stockholders' equity	<b>46,089,000</b>	53,764,600
Total liabilities and stockholders' equity	<b>\$ 111,751,700</b>	\$ 110,671,300

*See accompanying notes.*

Southern Maryland Hospital, Inc.

Statements of Revenues and Expenses

	<b>Period From January 1, 2012 Through December 9, 2012</b>	<b>Year Ended December 31, 2011</b>
<b>Operating revenues</b>		
Net patient service revenue	\$ 216,507,100	\$ 231,025,600
Net physician revenue	7,553,000	7,912,900
Other operating revenue	897,600	913,600
Total operating revenues	<u>224,957,700</u>	<u>239,852,100</u>
<b>Operating expenses</b>		
Salaries, wages and employee benefits	105,363,300	103,072,200
Drugs, hospital supplies and other expenses	61,816,200	56,055,700
Purchased services	35,682,300	35,384,400
Physician expenses	10,905,200	12,094,500
Depreciation and amortization	5,111,800	5,965,800
Interest	1,579,800	1,483,400
Provision for bad debts	11,548,700	16,887,500
Total operating expenses	<u>232,007,300</u>	<u>230,943,500</u>
(Loss) income from operations	(7,049,600)	8,908,600
Nonoperating (losses) gains	(154,400)	27,600
Net (loss) income with no income taxes provided	<u>\$ (7,204,000)</u>	<u>\$ 8,936,200</u>
<b>Pro forma amounts if the corporation, rather than the stockholders, paid income taxes (unaudited)</b>		
Net (loss) income with no income taxes provided	\$ (7,204,000)	\$ 8,936,200
Benefit (provision) for income taxes (at statutory tax rate)	2,521,400	(3,127,680)
Pro forma net (loss) income (unaudited)	<u>\$ (4,682,600)</u>	<u>\$ 5,808,520</u>

*See accompanying notes.*

Southern Maryland Hospital, Inc.

Statements of Changes in Stockholders' Equity

	<b>Common Stock</b>	<b>Additional Paid-in Capital</b>	<b>Retained Earnings</b>	<b>Total</b>
Balance at December 31, 2010	\$ 100	\$ 9,943,500	\$ 35,442,600	\$ 45,386,200
Net income with no income taxes provided	–	–	8,936,200	8,936,200
Distributions to stockholders, net	–	–	(557,800)	(557,800)
Balance at December 31, 2011	100	9,943,500	43,821,000	53,764,600
Net loss with no income taxes provided	–	–	(7,204,000)	(7,204,000)
Distributions to stockholders, net	–	–	(471,600)	(471,600)
Balance at December 9, 2012	<b>\$ 100</b>	<b>\$ 9,943,500</b>	<b>\$ 36,145,400</b>	<b>\$ 46,089,000</b>

*See accompanying notes.*

# Southern Maryland Hospital, Inc.

## Statements of Cash Flows

	<b>Period From January 1, 2012 Through December 9, 2012</b>	<b>Year Ended December 31, 2011</b>
<b>Operating activities</b>		
Net (loss) income with no income taxes provided	\$ (7,204,000)	\$ 8,936,200
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss on disposal of property and equipment	287,200	15,600
Depreciation and amortization	5,111,800	5,965,800
Changes in operating assets and liabilities, net	22,958,600	(3,444,700)
Net cash provided by operating activities	<b>21,153,600</b>	<b>11,472,900</b>
<b>Investing activities</b>		
Purchases of property and equipment, net	(10,087,700)	(12,205,800)
Net cash used in investing activities	<b>(10,087,700)</b>	<b>(12,205,800)</b>
<b>Financing activities</b>		
(Payment) issuance of note payable	(8,000,000)	8,000,000
Short term (repayments) borrowings	(630,000)	630,000
Borrowing on line of credit	-	3,000,000
Payments on line of credit	(3,000,000)	(3,000,000)
Payments of capital lease obligations	(1,385,600)	(4,131,900)
Distributions to stockholders, net	(471,600)	(557,800)
Changes in advances from related parties, net	7,959,100	(3,932,800)
Net cash (used in) provided by financing activities	<b>(5,528,100)</b>	<b>7,500</b>
Changes in cash and cash equivalents	5,537,800	(725,400)
Cash and cash equivalents, at beginning of year	570,800	1,296,200
Cash and cash equivalents, at end of year	<b>\$ 6,108,600</b>	<b>\$ 570,800</b>
<b>Changes in operating assets and liabilities</b>		
Changes in accounts receivable, net	\$ 10,683,600	\$ (8,774,000)
Changes in prepaid expenses and other	19,197,200	3,085,600
Changes in inventories	(870,600)	584,000
Changes in insurance company receivable	(1,345,100)	(1,411,200)
Changes in restricted long term assets	(19,975,000)	-
Changes in accounts payable	9,538,800	304,700
Changes in accrued salaries, wages and employee benefits	2,835,000	1,506,800
Changes in advances from third-party payors	1,696,900	797,400
Changes in other accrued liabilities	(917,300)	(652,300)
Changes in estimated professional liability	2,115,100	1,114,300
Changes in operating assets and liabilities, net	<b>\$ 22,958,600</b>	<b>\$ (3,444,700)</b>
<b>Supplemental disclosure of cash flow information</b>		
Cash paid for interest	<b>\$ 1,579,800</b>	<b>\$ 1,483,400</b>
<b>Supplemental disclosure of noncash investing and financing activities</b>		
Equipment and buildings acquired under capital leases	<b>\$ -</b>	<b>\$ 1,740,900</b>

*See accompanying notes.*

# Southern Maryland Hospital, Inc.

## Notes to Financial Statements

December 9, 2012

### **1. Organization**

Southern Maryland Hospital, Inc. (the Corporation), is a subchapter "S" corporation that operates an acute care hospital in Clinton, Maryland (suburban area in southern Maryland, east of Washington, D.C.). The Corporation is a full-service, regional healthcare facility that provides a complete range of inpatient, outpatient and community services for the residents of southern Maryland. The Corporation also operates a hospital-based sub-acute care unit. The Corporation is a resource center seeking to prevent illness and promote health through education and screening. The Corporation's mission is to assist the residents of southern Maryland in attaining the highest possible level of physical and mental healthcare, and thereby improve the quality of life in the community. During calendar year 2012, the majority owner of the Corporation transferred his entire ownership of the Corporation and the Partnership to members of his immediate family.

Effective December 10, 2012, the Corporation sold the operations of the regional healthcare facility which included substantially all of its underlying assets including all property, real, personal, or mixed, pertaining to, or otherwise held in connection with the operation of the business to Medstar Health, Inc. Sold assets include substantially all of the net accounts receivable balance, prepaid expenses and other current assets, inventories, and property and equipment. Cash and cash equivalents, insurance recovery receivables, and restricted long term assets were not sold. Transferred liabilities include accounts payable, accrued PTO, advances from third-party payors, substantially all current other accrued liabilities and capital lease obligations. Accrued salaries, wages and employee benefits (excluding accrued PTO), estimated professional liability, advances from related parties, and certain contingent liabilities disclosed in Note 8 were not assumed by Medstar Health, Inc. Funds received in consideration for the asset purchase agreement will be distributed to the stockholders of the Corporation. Medstar Health, Inc. intends to continue to operate the facility as an acute care hospital. The Corporation will remain active to settle professional liability claims for incidents prior to December 10, 2012, settle related party advances, and collect receivables not sold to Medstar Health, Inc.

During the current period, two matters were identified which understated prior year revenues and overstated prior year expenses in the amounts of \$518,500 and \$647,000, respectively. These matters were corrected in the current period. This correction resulted in a decrease to the 2012 loss from operations in the amount of \$1,165,500. We do not believe these matters to be material to the financial statements.

## Southern Maryland Hospital, Inc.

### Notes to Financial Statements (continued)

#### **2. Summary of Significant Accounting Policies**

##### **Comparability**

Due to the sale of assets as of December 10, 2012, these financial statements present the operations of the Corporation for the period from January 1, 2012 through December 9, 2012. The prior year audited figures are as of December 31, 2011 and the year then ended and have not been adjusted for comparability purposes. Any references to 2012 in the footnotes relates to the period from January 1, 2012 through December 9, 2012.

##### **New Accounting Pronouncements**

In July 2011, the FASB issued 2011-7, *Presentation and Disclosure of Patient Service Revenue, Provisions for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*. ASU 2011-7 requires healthcare organizations to present their provisions for doubtful accounts related to patient service revenue as a deduction from revenue, similar to contractual discounts. In addition, all healthcare organizations will be required to provide certain disclosures designed to help users understand how contractual discounts and bad debts affect recorded revenue in both interim and annual financial statements. For nonpublic entities, the amendments are effective for the first annual period ended after December 15, 2012. Due to these financial statements being prepared for a period from January 1, 2012 through December 9, 2012, management has not adopted this guidance.

##### **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 amount of assets and liabilities and disclosures 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.

##### **Fair Value of Financial Instruments**

The carrying amounts of financial instruments, including cash, accounts receivable, prepaid expenses and other assets, due to/from related parties, line of credit, short term borrowings, accounts payable, accrued salaries, wages and employee benefits, advances from third-party payors and other accrued liabilities approximate fair value, given the short-term nature of these financial instruments.

## Southern Maryland Hospital, Inc.

### Notes to Financial Statements (continued)

#### **2. Summary of Significant Accounting Policies (continued)**

##### **Cash and Cash Equivalents and Short-term Borrowings**

Cash and cash equivalents include amounts invested in accounts which are readily convertible to cash. Investments with original maturities of three months or less when purchased are classified as cash and cash equivalents.

##### **Accounts Receivable and Contractual Allowances**

The Corporation provides services to patients in southern Maryland, the majority of whom are covered by third-party health insurance. The Corporation bills the insurer directly for services provided. Insurance coverage and credit information is obtained from patients upon admission, when available. The Corporation's policy is to perform in-house collection procedures for approximately 120 days. A determination is made at that time as to what additional collection efforts to pursue. A provision for uncollectible accounts is recorded for amounts not yet written off, which are expected to become uncollectible.

The major payors routinely review patient billings and deny payment for certain charges as medically unnecessary or as performed without appropriate preauthorization. Accounts receivable from these third-party payors have been adjusted to reflect the difference between charges and the estimated reimbursable amounts.

Approximately 23% and 27% of accounts receivable were due from the Medicare program at December 9, 2012 and December 31, 2011, respectively. Approximately 7% and 11% of accounts receivable were due from CareFirst at December 9, 2012 and December 31, 2011, respectively.

##### **Prepaid Expenses and Other Assets**

At December 9, 2012 and December 31, 2011, the Corporation has prepaid expenses and other assets of \$1,221,800 and \$20,419,000, respectively, which relates to various purchased services and supplies. For the year ended December 31, 2011 included in these balances are amounts prepaid to related parties (see Note 4). At December 9, 2012 all prepaid expenses were with unrelated third parties.

##### **Inventories**

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

Southern Maryland Hospital, Inc.

Notes to Financial Statements (continued)

**2. Summary of Significant Accounting Policies (continued)**

**Property and Equipment**

Buildings and land under capital leases, furniture, fixtures and minor equipment, major movable equipment and leasehold improvements are recorded at cost and depreciated and amortized using the straight-line method over the lesser of the estimated useful lives of the assets or the terms of these leases as follows:

Buildings and land under capital leases	3 to 30 years
Furniture, fixtures and minor equipment	3 to 20 years
Major movable equipment	5 to 20 years
Leasehold improvements	5 to 25 years

For purposes of determining these lives, it is assumed that the operating lease for the main hospital building whose term currently expires in 2016 will be extended at least through the lives of the leasehold improvements and other related capital leases.

**Short Term Debt, Long Term Note Payable, Line of Credit and Letters of Credit**

For the year ended December 31, 2011 the Corporation had a \$3,000,000 line of credit with a bank which had an indefinite maturity. Borrowings bore interest at the bank's prime interest rate, as defined, which was 3.25% at December 31, 2011. As of December 31, 2011, the balance outstanding was \$3,000,000. Amounts outstanding under the line of credit as of December 31, 2011 were repaid in January 2012 and no amounts are outstanding as of December 9, 2012.

On December 21, 2011 the Corporation executed an \$8,000,000 Term Loan Agreement with Suntrust Bank. The loan bore interest at 3.23% per annum, with 59 consecutive monthly installments of \$144,700 ending on December 21, 2016. All amounts outstanding as of December 31, 2011 were repaid prior to December 9, 2012.

As of December 31, 2011 the Corporation was obligated under a \$9,630,000 letter of credit from Suntrust bank related to its professional liability insurance coverage (see Note 7). The letter of credit has been closed as of December 9, 2012. As of December 9, 2012 the Company held a Certificate of Deposit to satisfy its requirements to the professional liability insurer (see Note 2 – Restricted long term assets).

## Southern Maryland Hospital, Inc.

### Notes to Financial Statements (continued)

#### **2. Summary of Significant Accounting Policies (continued)**

##### **Restricted Long Term Assets**

Included within restricted long term assets is \$10,000,000 held as cash within an irrevocable trust established to cover future professional liability losses with an incident date preceding December 10, 2012. In addition, the Corporation held \$9,630,000 at December 9, 2012 in a certificate of deposit as a substitute for the letter of credit previously held with Suntrust bank to satisfy requirements of the Corporation's professional liability insurer (see Note 7). Also included within restricted long term assets is a \$345,000 certificate of deposit intended to cover any future workers compensation claims with an incident date preceding December 10, 2012. These certificates of deposit are recorded within the accompany balance sheet at fair value. The fair value of these assets are equivalent to the cash on deposit with the financial institution at December 9, 2012.

##### **Net Patient Service Revenue**

Net patient service revenue is reported at the estimated realizable amounts from patients, third-party payors and others for services rendered. A significant portion of the Corporation's patient service revenue is reimbursed through Medicare and Medicaid. Reimbursements by these third-party payors are based upon the Corporation's approved billing rates less a 6% discount. Contractual discounts and certain denials of payment for services rendered are recorded as reductions of net patient service revenue.

Patient service revenue reimbursed through these programs has been recorded at the net realizable amount in the accompanying statements of revenues and expenses. All other payors reimburse the Corporation at the Corporation's standard rates, adjusted for certain prompt pay discounts, which do not exceed 2%.

Southern Maryland Hospital, Inc.

Notes to Financial Statements (continued)

**2. Summary of Significant Accounting Policies (continued)**

The Corporation's principal sources of net patient service revenue may be summarized as follows:

	<b>Period From January 1, 2012 Through December 9, 2012</b>	<b>Year Ended December 31, 2011</b>
Medicare	<b>39%</b>	40%
Commercial Insurers (including Health Maintenance Organizations (HMO))	<b>18</b>	17
Blue Cross	<b>16</b>	16
Medicaid (including Medicaid HMO)	<b>17</b>	17
Other	<b>10</b>	10
	<b>100%</b>	100%

A substantial amount of the Corporation'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 Corporation has undue exposure to any managed care payor.

The provision for bad debts is based upon management's assessment of historical and expected net collections considering economic conditions, trends in health care coverage and other collection indicators. During the year, management assesses the adequacy of the allowance for uncollectible accounts based upon historical write-off experience by payor category. The results of this review are then utilized in the determination of the provision for bad debts to establish an appropriate allowance for uncollectible receivables.

## Southern Maryland Hospital, Inc.

### Notes to Financial Statements (continued)

#### **2. Summary of Significant Accounting Policies (continued)**

##### **Net Physician Revenue**

The Corporation employs physicians in several hospital-based specialties including anesthesia, obstetrics, psychiatrics and intensive care. The Corporation bills for the services provided by these physicians. The net physician revenue is recognized when the services are provided and recorded at the estimated net realizable value based on the contractual arrangements with third-party payors and the expected payments from the third-party payors and the patients. The differences between the billed charges and the estimated net realizable value are recorded as a reduction in physician revenue when the services are provided. As of December 9, 2012 and December 31, 2011, approximately \$1,832,300 and \$1,651,600, respectively, of net physician accounts receivable are included in accounts receivable in the accompanying balance sheets.

##### **Charity Care**

The Corporation provided care to patients who met certain criteria under its charity care policy, without charge or at amounts less than its approved rates. Because the Corporation did not pursue collection of amounts determined to qualify as charity care, they are not reported as net patient service revenue in the accompanying statements of revenues and expenses. The amounts written off as charity care for the period from January 1, 2012 through December 9, 2012 and the year ended December 31, 2011 were \$2,178,500 and \$1,390,700, respectively. These amounts represent direct and indirect charity care costs, which are calculated by taking the gross revenue related to the charity care services and reducing it by the company's profit margin, which is calculated by taking net income with no income taxes provided and dividing by total gross patient revenue. The state of Maryland rate system includes components within the rates to partially compensate hospitals for uncompensated care.

##### **Income Taxes**

The Corporation has elected to be taxed as a Subchapter "S" corporation for federal and state income tax purposes, reporting corporate taxable income or loss on the stockholders' individual income tax returns. The unaudited pro forma provision for income taxes in the accompanying statements of revenues and expenses reflects an amount equal to the provision or benefit for income taxes on the Corporation's net income or loss at corporate statutory income tax rates that would have been recognized by the Corporation had the "S" election not been in effect.

## Southern Maryland Hospital, Inc.

### Notes to Financial Statements (continued)

#### **3. Health Care Regulation**

##### **Health Services Cost Review Commission**

The Corporation's rate structure for most 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 Corporation'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 Corporation monitors its average charge per case compared to HSCRC case mix adjusted targets on a monthly basis.

The current rate of reimbursement for principally all inpatient services and certain other services to patients under the Medicare and Medicaid programs is based on an agreement between the Centers for Medicare and Medicaid Services and the HSCRC. This agreement is based upon a waiver from the Medicare prospective payment system reimbursement principles granted to the State of Maryland under Section 1814(b) of the Social Security Act and will continue as long as all third-party payors elect to be reimbursed in Maryland under this agreement and the rate of increase for costs per hospital inpatient admission in Maryland is below the national average. Management expects this agreement will remain in effect at least through June 30, 2013.

The HSCRC's rate-setting methodology for hospital service centers that provide both inpatient and outpatient services or only outpatient services consists of establishing an acceptable unit rate for defined inpatient and outpatient service centers within the hospital. The actual average unit charge for each service center is compared to the approved rate monthly and annually. Over charges and under charges due to price variances, plus penalties where applicable, are applied to decrease (in the case of overcharges or increase in the case of undercharges) future approved rates on an annual basis.

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

## Southern Maryland Hospital, Inc.

### Notes to Financial Statements (continued)

#### **3. Health Care Regulation (continued)**

As of December 9, 2012, the Corporation's actual average charge per case was less than the HSCRC's target average charge per case. In addition, as of December 9, 2012, the Corporation's actual average outpatient unit charges were less than the approved charges. The net amount undercharged by the Corporation was \$3.0 million at December 9, 2012. As of December 31, 2011, the net amount overcharged by the Corporation was \$1.5 million which was adjusted through lower rates in 2012.

#### **Other**

The Medicare and Medicaid reimbursement programs represent a substantial portion of the Corporation's revenues and its operations are subject to the 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.

The health care industry is 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 and reimbursement for patient services. Recently, 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 such laws and 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 Corporation.

#### **4. Related-Party Transactions**

##### **Capital Leases**

From July 1, 1979, through June 30, 2011, the Corporation leased its land, buildings and certain fixed and movable equipment under a 32-year lease (the original lease) from Southern Maryland Hospital Center, LP (the Partnership), a related party. Management negotiated a five-year extension of the lease (the renewal lease) with the Partnership following the expiration of the original lease on June 30, 2011. The original lease was accounted for as a capital lease and was

## Southern Maryland Hospital, Inc.

### Notes to Financial Statements (continued)

#### 4. Related-Party Transactions (continued)

capitalized at \$24,972,000, which was the fair market value of the property as determined by independent appraisal at the inception of the original lease. For the year ended December 31, 2011 original lease payments under the main building lease were \$6,027,200. For the period from January 1, 2012 through December 9, 2012 and the six months ended December 31, 2011 the operating lease payments under the main building lease were \$11,653,600 and \$6,027,200. Based on the CPI Housing Index, rentals increased 2.2% and 1.9% during 2012 and 2011, respectively, related to changes in utility costs, property taxes and changes in the market value of the property. The lease renewal has been classified as an operating lease.

The Corporation leases additional space, known as C-corridor, from a related party that was capitalized in 1983 at \$225,000, with annual lease payments of \$58,200, as adjusted for escalation of costs. This lease was recapitalized in 2006 for renovations associated with cardiac services at \$1,125,700, with lease payments of \$106,300 for the period from January 1, 2012 through December 9, 2012.

In 1996, the Corporation began leasing warehouse space, which was capitalized at \$594,600, with lease payments of \$56,500 for the period from January 1, 2012 through December 9, 2012. This lease is with the Partnership and it will expire in 2026. In addition to this original lease, this space was renovated and effective November 2010, the Corporation began leasing the newly renovated space, known as 2-North, from the Partnership under an additional new capital lease, which was capitalized at \$1,925,400, with annual lease payments of \$183,400 for the period from January 1, 2012 through December 9, 2012. This lease expires in 2025.

Effective July 1, 1996, the Corporation began leasing two additional building spaces for the sub-acute unit under capital leases which were capitalized at \$3,567,100, and \$134,100, with lease payments of \$375,400, and \$14,100 for the period from January 1, 2012 through December 9, 2012. These leases are with the Partnership and expire in 2016.

The Corporation leases building space, known as bed tower II, housing women's services, support services, and storage space which was capitalized for \$8,456,000, with lease payments of \$873,300 for the period from January 1, 2012 through December 9, 2012. The leases are with the Partnership and expire in 2026.

Effective July 1, 1998, the Corporation began leasing additional parking lots, known as employee parking, from the Partnership. The lease was capitalized at \$1,670,000, with lease payments of \$202,600 for the period from January 1, 2012 through December 9, 2012. This lease expires in 2013.

## Southern Maryland Hospital, Inc.

### Notes to Financial Statements (continued)

#### **4. Related-Party Transactions (continued)**

Effective October 1, 2003, the Corporation began leasing additional building space for the emergency room from the Partnership under a capital lease, which was capitalized at \$1,989,200, with lease payments of \$180,900 for the period from January 1, 2012 through December 9, 2012. This lease expires in 2023.

Effective March 2011, the Corporation began leasing newly constructed space for a sleep lab from the Partnership under a capital lease, which was capitalized at \$1,740,900, with lease payments of \$165,900 for the period from January 1, 2012 through December 9, 2012. This lease expires in 2026.

Included in the accompanying statements of revenues and expenses for the period from January 1, 2012 through December 9, 2012 and the year ended December 31, 2011 are \$1,196,500 and \$1,436,000, respectively, of interest expense and \$1,121,000 and \$5,742,000, respectively, of executory costs related to the above capital leases. The decrease is primarily driven by the change of the building lease from a capital lease to an operating lease as of June 30, 2011 as discussed above.

Since these capital lease obligations were entered into with the Partnership, which is a related party, the fair value of these obligations is not readily determinable.

#### **Operating Leases**

As mentioned above, the building and land lease with the Partnership became an operating lease on July 1, 2011. Rental payments for the period from January 1, 2012 through December 9, 2012 were \$11,653,500. Rental payments for the six month period ended December 31, 2011 were \$6,027,200.

The Corporation rents several office suites in a professional building and a warehouse known as Butler II, owned by a stockholder of the Corporation. The total rental payments for the period from January 1, 2012 through December 9, 2012 and for the year ended December 31, 2011 were \$182,200 and \$180,800, respectively. The annual rental payments under these operating leases are commensurate with those charged to other tenants of the professional building.

## Southern Maryland Hospital, Inc.

### Notes to Financial Statements (continued)

#### **4. Related-Party Transactions (continued)**

##### **Other Transactions**

Several stockholders of the Corporation are the sole owners of several companies, which provided administrative, financial, data processing and certain operational services to the Corporation during 2012 and 2011. Charges for these services are covered by a management fee of 10% of the Corporation's gross patient service revenue during 2012 and 2011.

For the year ended December 31, 2011 the Corporation prepaid amounts for rental payments, leases, administrative and financial services to related parties in the amount of \$9,140,600 which is included in prepaid expenses and other assets in the accompanying balance sheet. No such pre-payments were made for the period from January 1, 2012 through December 9, 2012.

The Corporation uses a nursing agency owned by a former stockholder of the Corporation to staff temporary nursing positions. Total nursing fees paid (which approximated local market rates) to the nursing agency for the period from January 1, 2012 through December 9, 2012 and for the year ended December 31, 2011 were \$877,900 and \$1,477,900, respectively.

The Corporation uses Professional Billing Inc. (PBI) owned by a former stockholder of the Corporation, to process its physician billings. Total PBI service fees paid for the period from January 1, 2012 through December 9, 2012 and for the year ended December 31, 2011 were \$904,500 and \$1,168,200, respectively.

The Corporation uses Chesapeake Receivables Management, owned by an executive of the Corporation, to provide collection services. Total service fees paid for the period from January 1, 2012 through December 9, 2012 and for the year ended December 31, 2011 were \$821,200 and \$516,500, respectively.

Advances from related parties as of December 9, 2012 and advances to related parties as of December 31, 2011 represent net amounts payable and receivable, respectively, from the Partnership and other entities owned by the stockholders of the Corporation for funds advanced by or owed to the Corporation.

## Southern Maryland Hospital, Inc.

### Notes to Financial Statements (continued)

#### 4. Related-Party Transactions (continued)

##### Guarantee of Partnership Debt

In December 2010, the Corporation became a guarantor for a new \$4,000,000 term loan that the Partnership obtained from a bank. The term loan matures in December 2017 and carries an annual variable interest rate of LIBOR plus 2.18%. The proceeds of the term loan were used by the Partnership to finance the construction of two new facilities that have been leased by the Corporation under long-term capital leases. The term loan was fully paid by the Partnership prior to December 9, 2012.

#### 5. Lease Commitments

##### Capital Leases

The Corporation has capitalized land, buildings, and fixed and movable equipment leases with a basis of \$27,323,900 and \$27,323,900 and accumulated amortization of \$18,160,800 and \$17,221,600 as of December 9, 2012 and December 31, 2011, respectively under capital leases. Amortization of assets recorded under capital leases is included with depreciation expense in the accompanying statements of revenues and expenses.

Future minimum lease payments under these capital leases, as of December 9, 2012, are as follows:

2013	\$ 3,402,400
2014	3,216,200
2015	3,202,400
2016	2,931,300
2017	2,586,900
Thereafter	<u>20,143,600</u>
Total	35,482,800
Less – amount representing executory costs (such as supply and service contracts, property taxes, heat, light, power, rent escalation and profit, included in total minimum lease payments)	<u>(12,635,300)</u>
Net minimum lease payments	22,847,500
Less – amount representing interest	<u>(8,773,200)</u>
Present value of future minimum lease payments	<u>\$ 14,074,300</u>

Southern Maryland Hospital, Inc.

Notes to Financial Statements (continued)

**5. Lease Commitments (continued)**

Included in total present value of future minimum lease payments are amounts due to related parties. As of December 9, 2012, such amounts were \$14,042,400.

**Operating Leases**

The building and land lease with the Partnership became an operating lease on July 1, 2011. Rental payments for the period from January 1, 2012 through December 9, 2012, and six-months ended December 31, 2011 were \$11,653,500, and \$6,027,200 respectively.

All amounts included in future minimum rental payments are amounts due to related parties. As of December 9, 2012, such amounts were \$43,542,600. Rental expense for the period from January 1, 2012 through December 9, 2012 and for the year ended December 31, 2011 was \$11,923,100 and \$6,474,100, respectively. The increase in rent expense is primarily driven by the change of the building lease from a capital lease to an operating lease as of June 30, 2011 as discussed above.

Future minimum lease payments under these operating leases, as of December 9, 2012, are as follows:

2013	\$ 12,335,600
2014	12,335,900
2015	12,336,300
2016	6,534,800
Total	<u>\$ 43,542,600</u>

**6. Defined Contribution Plan**

In 2012 and 2011, the Corporation maintained a defined contribution 401(k) plan covering substantially all employees who have completed at least 500 hours of service within the first six consecutive months of employment. Eligible employees may contribute a percentage of their salary in any taxable year not to exceed a dollar limit, which is set by law.

The Corporation's contributions vest 20% each year after completing one year of service until they are fully vested after six years of service. In connection with the asset purchase agreement, participants became fully vested in the Corporation's contributions. The Corporation contributed approximately \$899,500 and \$910,100, respectively, for the period from January 1, 2012 through December 9, 2012 and the year ended December 31, 2011.

## Southern Maryland Hospital, Inc.

### Notes to Financial Statements (continued)

#### **7. Insurance**

The Corporation participates in the Maryland Hospital Association Workers' Compensation Self-Insurance Group (the Group). Under this agreement, the Corporation pays monthly premiums based on estimated payroll costs. Total premiums for the period January 1, 2012 through December 9, 2012 and the year ended December 31, 2011 were \$1,315,700 and \$718,900, respectively. In 2012, the Corporation received a dividend of \$380,900 related to 2012 and prior-year premiums paid, which was applied against the 2012 gross premium expense of \$1,315,700, reducing it to \$934,800. In 2011, the Corporation received a dividend of \$514,300 related to 2011 and prior-year premiums paid, which was applied against the 2011 gross premium expense of \$718,900, reducing it to \$204,600.

The Corporation has a claims-made policy for its professional liability insurance coverage and its general liability coverage. The Corporation renewed its general and professional liability policies through November 16, 2012 and extended the policies through December 9, 2012. Claims not submitted under this policy will be covered under the tail insurance policy discussed below.

During 2001, the Corporation's former insurance carrier filed for bankruptcy protection and coverage was replaced with another carrier on November 16, 2001. As a result, the former insurance carrier may not be able to provide coverage for incidents that were reported but not paid up to the termination date of its policy. The State of Maryland established the Property and Casualty Insurance Guarantee Corporation, which covers up to \$300,000 per incident, less a \$100 deductible for claims that would have been covered by the bankrupt insurer, subject to the review and approval of the administrators of this fund. As of December 9, 2012 and December 31, 2011, management of the Corporation does not believe that the Corporation has exposure for claims reported to its former carrier that may not be covered under its policy or covered by the State of Maryland Property and Casualty Insurance Guarantee Corporation. Therefore, the Corporation has not recorded estimates for any such exposures as of December 9, 2012 and December 31, 2011.

For the period from November 16, 2004 through November 15, 2005, the Corporation's professional liability coverage was subject to a deductible of \$250,000 per incident and a \$750,000 annual maximum. For the periods from November 16, 2005 through November 15, 2009, the annual maximum was changed to \$2,500,000. For the period from November 16, 2009 through December 9, 2012, the deductible was increased to \$500,000 per case with no annual maximum.

## Southern Maryland Hospital, Inc.

### Notes to Financial Statements (continued)

#### **7. Insurance (continued)**

During the period ended December 9, 2012, the Corporation purchased a tail insurance policy for an unlimited term for \$7,000,000 which is included within drugs, hospital supplies and other expenses within the accompanying statement of revenues and expenses. The tail insurance policy covers incidents occurring November 28, 1986 through December 9, 2012 for which a claim or potential claim was not reported as of December 9, 2012. The tail insurance policy is subject to a deductible of \$1,000,000 per incident limited to \$15,000,000. The policy has an aggregate limit of \$25,000,000.

As of December 9, 2012 and December 31, 2011, the Corporation has estimated its exposures related to deductibles and incurred but not reported (IBNR) claims based on an undiscounted actuarial analysis of the outstanding known claims and IBNR claims and discussion with legal counsel. As of December 9, 2012 and December 31, 2011, \$9.7 million and \$7.6 million are included in estimated professional liability in the accompanying balance sheets.

In accordance with ASU 2010-24 “Health Care Entities—Presentation of Insurance Claims and Related Insurance Recoveries” the Corporation has included within “Insurance recovery receivable” in the accompanying Balance Sheets anticipated amounts due from insurance providers of \$2.8 million and \$1.4 million as of December 9, 2012 and December 31, 2011, respectively. There is no allowance applied to these receivable amounts as we believe the amounts are fully collectible.

#### **8. Commitments and Contingencies**

There are several lawsuits pending in which the Corporation has been named as a defendant. In the opinion of the Corporation’s management, after consultation with legal counsel, the amount of liability, if any, not covered by insurance will not have a material adverse impact on the Corporation’s financial position. The Corporation has estimated its exposures related to deductibles and incurred but not reported claims based on an undiscounted actuarial analysis of the outstanding known claims incurred but not reported claims as discussed at Note 7.

The Corporation’s revenues may be subject to adjustment as a result of examination by government agencies or contractors based upon differing interpretation of government regulations, medical diagnosis, charge coding, medical necessity, or other contract terms. The resolution of these matters, if any, often is not finalized until subsequent to the period during which the services were rendered. Section 302 of the Tax Relief and Health Care Act of 2006 authorized a permanent program involving the use of third-party recovery audit contractors (RACs) to identify Medicare overpayments and underpayments made to providers. The Corporation has established protocols

## Southern Maryland Hospital, Inc.

### Notes to Financial Statements (continued)

#### **8. Commitments and Contingencies (continued)**

to respond to RAC requests and payment denials. Payment recoveries resulting from RAC reviews are appealable through administrative and judicial processes, and the Corporation intends to pursue the reversal of adverse determinations where appropriate. In addition to overpayments that are not reversed on appeal, the Corporation will incur additional costs to respond to requests for records and pursue the reversal of payment denials. As of December 9, 2012 no amount has been accrued as a loss is not considered probable. Any possible loss is not estimable as of the date of these financial statements.

On October 24, 2012 and March 4, 2013, the Corporation filed self disclosures to The Centers for Medicare and Medicaid Services (CMS), reporting technical violations of the self referral regulations (referred to as Stark). As of December 9, 2012, the Corporation's management, after consultation with legal counsel, is not able to determine the likelihood or amount of the potential loss in this matter and therefore has not accrued any liability in the accompanying financial statements. The ultimate liability in this matter, if any, may be material to the accompanying financial statements.

#### **9. Subsequent Events**

Effective December 10, 2012 the Corporation sold the operations of the regional healthcare facility which included substantially all of its underlying assets including all property, real, personal, or mixed, pertaining to, or otherwise held in connection with the operation of the business to Medstar Health, Inc. Sold assets include substantially all of the net accounts receivable balance, prepaid expenses and other current assets, inventories, and property and equipment. Cash and cash equivalents insurance recovery receivables, and restricted long term assets were not sold. Transferred liabilities include accounts payable, accrued PTO, advances from third-party payors, substantially all current other accrued liabilities and capital lease obligations. Accrued salaries, wages and employee benefits (excluding accrued PTO), estimated professional liability, advances from related parties, and certain contingent liabilities disclosed in Note 8 were not assumed by Medstar Health, Inc. Funds received in consideration for the asset purchase agreement will be distributed to the stockholders of the Corporation. The Corporation evaluated the impact of subsequent events through April 8, 2013, representing the date at which the financial statements were available to be issued, and noted no other subsequent events that required disclosure.

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