

Frederick Memorial Hospital, Inc. And Subsidiaries

Consolidated Financial Report
June 30, 2006

McGladrey & Pullen
Certified Public Accountants

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McGladrey & Pullen

Certified Public Accountants

Independent Auditor's Report

To the Board of Directors
Frederick Memorial Hospital, Inc.
Frederick, Maryland

We have audited the accompanying consolidated balance sheets of Frederick Memorial Hospital, Inc. and Subsidiaries as of June 30, 2006 and 2005, and the related consolidated statements of operations, changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Hospital'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 of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Frederick Memorial Hospital, Inc. and Subsidiaries as of June 30, 2006 and 2005, and the results of their operations, changes in net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

McGladrey & Pullen, LLP

Baltimore, Maryland
September 1, 2006

Frederick Memorial Hospital, Inc. And Subsidiaries

**Consolidated Balance Sheets
June 30, 2006 And 2005**

Assets	2006	2005
Current Assets		
Cash and cash equivalents	\$ 12,606,506	\$ 15,526,026
Short-term investments	949,768	1,196,850
Net patient receivables	38,265,825	36,288,442
Other receivables	1,738,035	1,261,497
Inventory	4,040,941	3,915,679
Prepaid expenses	1,111,290	1,013,997
Assets limited as to use	13,760,868	4,490,348
Promises to give - donor restricted, net	1,448,793	1,625,441
Total current assets	73,922,026	65,318,280
Assets Limited as to Use	44,680,089	8,247,612
Donor Restricted Assets		
Promises to give, net	4,140,109	4,907,588
Investments	6,279,647	4,916,199
	10,419,756	9,823,787
Property, Plant and Equipment, net	182,632,569	169,485,705
Other Assets		
Long-term investments	27,795,908	44,072,291
Other investments	2,280,131	1,889,969
Debt issuance costs, net	3,545,860	2,884,300
Due from affiliates	43,941	138,530
Notes receivable	38,137	56,027
Intangible assets, net	1,624,780	1,672,955
	35,328,757	50,714,072
Total assets	\$ 346,983,197	\$ 303,589,456

See Notes to the Consolidated Financial Statements.

Liabilities and Net Assets	2006	2005
Current Liabilities		
Current maturities of long-term debt	\$ 11,669,433	\$ 2,146,452
Accounts payable	10,428,429	9,332,954
Accrued expenses	13,805,774	12,860,127
Accrued pension expense	2,500,000	1,800,000
Advances from third-party payors	5,785,291	5,816,470
Total current liabilities	44,188,927	31,956,003
Long-Term Liabilities, net of current portion		
Long-term debt	147,919,171	118,406,087
Interest rate swap contract	212,374	-
Accrued pension expense	1,337,376	417,150
Other	90,406	-
	149,559,327	118,823,237
Commitments and Contingencies		
Net Assets		
Unrestricted	141,366,394	141,360,988
Temporarily restricted	10,892,372	10,473,051
Permanently restricted	976,177	976,177
Total net assets	153,234,943	152,810,216
Total liabilities and net assets	\$ 346,983,197	\$ 303,589,456

Frederick Memorial Hospital, Inc. And Subsidiaries

**Consolidated Statements Of Operations
Years Ended June 30, 2006 And 2005**

	2006	2005
Unrestricted Revenues		
Net patient service revenue	\$ 234,874,764	\$ 219,274,556
Other operating revenues	9,102,841	8,897,770
Gifts, bequests and contributions	1,090,856	760,849
Net assets released from restrictions used for operations	267,397	107,571
Total revenues	245,335,858	229,040,746
Expenses		
Salaries and wages	100,346,460	95,237,651
Employee benefits	24,469,544	20,960,623
Professional fees	4,613,890	4,699,570
Cost of goods sold	39,397,358	36,339,754
Supplies	9,043,231	8,627,483
Contract services	21,247,864	16,336,095
Other	10,266,269	10,584,371
Utilities	3,495,338	2,881,345
Insurance	2,180,605	2,051,129
Depreciation and amortization	14,821,034	13,217,576
Interest	6,379,659	5,829,323
Provision for uncollectible accounts, net of recoveries; 2006, \$1,972,588; and 2005, \$1,905,472	8,860,437	8,863,479
Total expenses	245,121,689	225,628,399
Operating income	214,169	3,412,347
Other income (loss)		
Gain (loss) on sale of assets	(450,970)	21,015
Investment income	4,713,145	4,815,990
Change in fair value of interest rate swap contract	(212,374)	-
Loss on extinguishment of debt	(4,442,182)	-
Excess (deficiency) of revenues over expenses	(178,212)	8,249,352
Other changes in unrestricted net assets		
Additional minimum pension adjustment	(922,182)	(5,949,446)
Net unrealized depreciation of investments	(847,183)	(1,393,055)
Net assets released from restrictions used to purchase property, plant and equipment	1,952,983	11,688,165
Increase in unrestricted net assets	\$ 5,406	\$ 12,595,016

See Notes to the Consolidated Financial Statements.

Frederick Memorial Hospital, Inc. And Subsidiaries

**Consolidated Statements Of Changes In Net Assets
Years Ended June 30, 2006 And 2005**

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Net Assets, June 30, 2004	\$ 128,765,972	\$ 18,527,714	\$ 976,177	\$ 148,269,863
Increase in net assets	12,595,016	-	-	12,595,016
Assets released from restrictions	-	(11,795,736)	-	(11,795,736)
Restricted gifts, bequests and contributions	-	3,741,073	-	3,741,073
Change in net assets	12,595,016	(8,054,663)	-	4,540,353
Net Assets, June 30, 2005	141,360,988	10,473,051	976,177	152,810,216
Increase in net assets	5,406	-	-	5,406
Assets released from restrictions	-	(2,220,380)	-	(2,220,380)
Restricted gifts, bequests and contributions	-	2,639,701	-	2,639,701
Change in net assets	5,406	419,321	-	424,727
Net Assets, June 30, 2006	\$ 141,366,394	\$ 10,892,372	\$ 976,177	\$ 153,234,943

See Notes to the Consolidated Financial Statements.

Frederick Memorial Hospital, Inc. And Subsidiaries

Consolidated Statements Of Cash Flows
Years Ended June 30, 2006 And 2005

	2006	2005
Cash Flows From Operating Activities		
Change in net assets	\$ 424,727	\$ 4,540,353
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Provision for uncollectible accounts and contractual allowances	125,000	1,133,000
Provision for uncollectible promises to give	(236,864)	-
Net unrealized depreciation of investments	847,183	1,393,055
Net realized gain on sale of investments	(1,114,284)	(2,214,912)
Loss (gain) on disposal of assets	450,970	(21,015)
Depreciation	14,821,034	13,217,576
Loss on extinguishment of debt	4,442,182	-
Change in fair value of interest rate swap contract	212,374	-
Amortization of bond issue costs, original issue discount and intangible assets	356,374	347,652
Income from joint ventures	(349,546)	(218,727)
Restricted contributions	(2,639,701)	(3,741,073)
(Increase) decrease in assets:		
Patient and other receivables	(2,578,921)	(3,715,471)
Inventory	(125,262)	(322,604)
Prepaid expenses and other assets	(49,118)	5,281,980
Increase (decrease) in liabilities:		
Accounts payable	206,031	(158,958)
Accrued expenses	945,647	665,850
Accrued pension expense	1,620,226	2,217,150
Advances from third-party payors	(31,179)	697,732
Other long-term liabilities	90,406	-
Net cash provided by operating activities	17,417,279	19,101,588
Cash Flows From Investing Activities		
(Increase) decrease in funds held by trustee or authority	(45,702,997)	2,177,288
Purchases of property, plant and equipment	(27,529,424)	(39,142,115)
Net payments from (advances to) affiliates	94,589	(23,588)
Proceeds from sale of assets	-	27,577
Net investment in joint ventures	(15,000)	(20,000)
Proceeds from sale of investment in joint venture	-	400,000
Net repayment of notes receivable	17,890	29,289
Net proceeds from sale of short-term investments	247,082	1,021,216
Purchases of long-term and donor-restricted investments	(21,633,619)	(14,889,543)
Proceeds from sale of long-term and donor-restricted investments	36,813,655	36,748,268
Increase in other investments	(25,616)	(34,308)
Net cash used in investing activities	(57,733,440)	(13,705,916)

(Continued)

Frederick Memorial Hospital, Inc. And Subsidiaries

Consolidated Statements Of Cash Flows (Continued)
Years Ended June 30, 2006 And 2005

	2006	2005
Cash Flows From Financing Activities		
Principal payments on long-term debt	(37,455,821)	(1,921,057)
Proceeds from long-term debt	74,747,182	-
Debt issuance costs	(3,715,412)	(153,854)
Proceeds from restricted contributions	3,820,692	3,091,586
Net cash provided by financing activities	37,396,641	1,016,675
Net increase (decrease) in cash and cash equivalents	(2,919,520)	6,412,347
Cash and cash equivalents, beginning of year	15,526,026	9,113,679
Cash and cash equivalents, end of year	\$ 12,606,506	\$ 15,526,026
Supplemental Disclosure Of Cash Flow Information		
Interest paid, including capitalized interest of \$106,361 for 2006 and \$422,530 for 2005	\$ 7,299,154	\$ 6,289,338

Supplemental Disclosure Of Non-Cash Operating And Investing Activity

The Hospital capitalized construction costs of \$2,317,440 and \$1,427,996 which are included in accounts payable at June 30, 2006 and 2005, respectively.

See Notes to the Consolidated Financial Statements.

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 1. Nature of Activities and Significant Accounting Policies

Nature of activities: Frederick Memorial Hospital, Inc. (the "Hospital") is a not-for-profit hospital, exempt from Federal income taxes under Section 501(c)(3) of the Internal Revenue Code, located in Frederick, Maryland. The Hospital provides health care services primarily to residents of Frederick County.

A summary of the Hospital's significant accounting policies follows:

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. In 2005, the Hospital owned 100% of Frederick Surgical Services Corporation (FSSC). As of July 1, 2005, the outstanding shares of FSSC were contributed to FHSC.

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 delivered by the Hospital and operates the Kline Hospice House.

FHSC has four wholly-owned subsidiaries: Rosehill of Frederick, LLC, Mt. Airy Plaza, LLC, and Corporate Occupational Health Solutions, LLC, which are for-profit limited liability companies, and FSSC, all of which have been consolidated into FHSC in the accompanying financial statements.

In 2005, FSSC had a 99% interest in Frederick Surgical Center, LLC (FSC), with the remaining 1% interest owned by FHSC. In 2006, FSSC owned 100% of FSC.

All material intercompany balances and transactions have been eliminated.

Basis of accounting: The accompanying financial statements are presented in accordance with the accrual basis of accounting, whereby revenue is recognized when earned and expenses are recognized when incurred.

Basis of presentation: The financial statement presentation follows the recommendations of the Financial Accounting Standards Board in its Statement of Financial Accounting Standards (SFAS) No. 117, *Financial Statements of Not-for-Profit Organizations* and the *AICPA Audit and Accounting Guide for Health Care Organizations*. Under SFAS No. 117, the Hospital and HFC are required to report information regarding their financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets.

Unrestricted net assets represent contributions, gifts and grants which have no donor-imposed restrictions or which arise as a result of operations.

Temporarily restricted net assets represent contributions, gifts and grants which have donor-imposed limitations on their use for a specified time period or purpose.

Permanently restricted net assets represent contributions, gifts and grants that have been restricted by donors to be maintained by the Hospital in perpetuity.

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 1. Nature of Activities and Significant Accounting Policies (Continued)

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 and reported in the Statements of Operations as net assets released from restrictions. Donor restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying consolidated financial statements.

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.

Patient receivables: Patient receivables are carried on the basis of total patient charges. The allowances include estimates for accounts, which may ultimately prove uncollectible, and third party contractual and discount arrangements. Management determines the allowance for uncollectible accounts by identifying estimated third party contractual discounts and allowances and by using historical experience applied to an aging of accounts. Patient receivables are written off when deemed uncollectible. Recoveries of previously written off patient receivables are recorded when received.

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

Investments: Investments in equity securities with readily determinable fair market values and all investments in debt securities are measured at fair value. Investments in joint ventures are carried on the equity method. Other investments are carried at cost. Investment income or loss (including realized gains and losses on investments, and interest and dividends) is included in the change in unrestricted net assets unless the income or loss is restricted by the donor or law.

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, 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, plant and equipment: Land acquired prior to 1956 is carried at appraised value as of June 30, 1956. Land acquired subsequent to 1956 is carried at cost. Buildings and equipment are 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 Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 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.

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 1. Nature of Activities and Significant Accounting Policies (Continued)

Capitalized interest: Interest incurred on debt during the construction period has been capitalized as a component of construction in progress and is depreciated over the life of the related construction when placed in service.

Intangible assets: FSC follows the provisions of SFAS No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 requires that intangible assets that meet certain criteria be reported separately from goodwill. SFAS No. 142 prescribes a two-step process for impairment testing of goodwill, which is performed annually, as well as when an event triggering impairment may have occurred. The first step tests for impairment, while the second step, if necessary, measures the impairment. FSC has elected to perform its annual analysis during the fourth quarter of each fiscal year. Management has assessed the value of FSC's goodwill and has determined that no impairment exists at June 30, 2006 and 2005.

Intangible assets, other than goodwill, are amortized using the straight-line method over their estimated useful lives.

Debt issuance costs: Debt issuance costs related to the Series 1993, Series 2002 and Series 2006 MHHEFA bonds and the equipment note payable are being amortized over the life of the debt using the effective interest method. The unamortized issuance costs related to the Series 1993 bonds were written off in 2006 and are reported as a component of loss on extinguishment of debt.

Patient service revenue and allowances: Patient service revenue is accounted for at established rates on the accrual basis in the period in which the service is provided. Allowances to recognize third-party payor contractual arrangements and uncollectible accounts are accounted for on the accrual basis.

The Hospital has agreements with third-party payors that provide for payments to the Hospital for unregulated 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 are not finalized until subsequent to the period during which the services were rendered.

Excess of revenues over expenses: The Statements of Operations includes excess of revenues over expenses. Changes in unrestricted net assets which are excluded from excess of revenues over expenses, consistent with industry practice, include net unrealized appreciation (depreciation) of investments, additional minimum pension adjustment, permanent transfers of assets to and from affiliates for other than goods and services, and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets).

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.

The Hospital follows SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which requires that all derivative financial instruments be recognized in the financial statements at their fair value. 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 under SFAS No. 133. Changes in the fair value of the derivative financial instrument are recognized in the Statement of Operations as a component of other income.

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 1. Nature of Activities and Significant Accounting Policies (Continued)

The carrying value of the Hospital's derivative financial instrument approximates fair value. Since quoted market prices are not available for this financial instrument, the fair value is based on estimates using present value and other valuation techniques.

Estimates: The preparation of financial statements 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 in the June 30, 2005 financial statements have been reclassified to conform to the June 30, 2006 financial statement presentation. These reclassifications had no effect on change in net assets.

Note 2. Patient Receivables and Patient Service Revenue

Patient receivables consist of the following at June 30:

	2006	2005
Gross patient receivables	\$ 46,231,825	\$ 44,129,442
Less: Estimated uncollectible accounts and contractual allowances	7,966,000	7,841,000
Net patient receivables	<u>\$ 38,265,825</u>	<u>\$ 36,288,442</u>

Patient service revenue consists of the following for the years ended June 30, 2006 and 2005:

	2006	2005
Inpatient charges	\$ 125,786,701	\$ 120,135,370
Outpatient charges	161,556,001	140,951,138
	287,342,702	261,086,508
Less: Allowances, contractual and other	52,467,938	41,811,952
Net patient service revenue	<u>\$ 234,874,764</u>	<u>\$ 219,274,556</u>

Note 3. Assets Limited as to Use

A summary of assets which are limited as to use substantially for construction, renovation and debt service, consisting primarily of cash and government obligations at June 30, is as follows:

	2006	2005
Current:		
Debt Service Funds	\$ 4,357,338	\$ 4,365,283
Cash to defease Series 1993 Bonds	9,274,035	-
Equipment Escrow Account	129,495	125,065
	<u>\$ 13,760,868</u>	<u>\$ 4,490,348</u>
Noncurrent:		
Debt Service Reserve Funds	\$ 10,501,590	\$ 7,907,929
Construction Fund	32,178,693	-
Self Insurance Trusts (Note 16)	1,909,400	339,683
Deferred Compensation Trusts (Note 11)	90,406	-
	<u>\$ 44,680,089</u>	<u>\$ 8,247,612</u>

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 3. Assets Limited as to Use (Continued)

The Hospital established the Frederick Memorial Hospital Self-Insurance Trust as described in Note 16. The Trust funds are designated to pay professional liability claims, if any, related to a former insurance carrier of the Hospital that was liquidated.

Note 4. Promises to Give

As of June 30, 2006 and 2005, contributors to the Hospital and HFC have made written unconditional promises to give, with remaining balances totaling \$7,232,405 and \$9,742,396, respectively, on which management has established an allowance for uncollectible promises to give and a discount on promises to give which aggregate \$1,643,503 and \$3,209,367, respectively. Promises to give are discounted at a rate of 5%. Most promises to give are for capital projects, established mainly for property and equipment purchases, and are due as follows at June 30, 2006:

Less than one year	\$ 1,673,474
One to five years	3,639,328
More than five years	1,919,603
	<u>\$ 7,232,405</u>

Note 5. Investments

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

	2006	2005
Cash and money market funds	\$ 5,125	\$ 53,994
U.S. Government obligations	599,720	698,378
Collateralized mortgage securities/asset backed securities	344,923	444,478
	<u>\$ 949,768</u>	<u>\$ 1,196,850</u>

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:

	2006		2005	
	Cost	Fair Value	Cost	Fair Value
Cash and cash equivalents	\$ 4,262,083	\$ 4,262,083	\$ 3,750,873	\$ 3,750,873
Marketable equity securities	17,461,236	19,096,370	23,624,939	26,222,477
U.S. Government obligations	3,304,940	3,292,915	8,663,867	8,722,102
Corporate obligations	3,866,052	3,796,974	9,221,495	9,233,064
Mutual funds	2,948,603	3,627,213	1,037,168	1,059,974
	<u>\$ 31,842,914</u>	<u>\$ 34,075,555</u>	<u>\$ 46,298,342</u>	<u>\$ 48,988,490</u>

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 5. Investments (Continued)

Investments are allocated as follows at June 30:

	2006	2005
Investment allocation:		
Unrestricted long-term investments	\$ 27,795,908	\$ 44,072,291
Donor restricted investments	6,279,647	4,916,199
	<u>\$ 34,075,555</u>	<u>\$ 48,988,490</u>

Components of investment income, including income from short-term investments, for the years ended June 30, 2006 and 2005 are as follows:

	2006	2005
Unrestricted		
Net realized gains	\$ 1,114,284	\$ 2,214,912
Interest and dividends, net of investment expense	3,249,315	2,382,351
Income from joint ventures	349,546	218,727
	<u>\$ 4,713,145</u>	<u>\$ 4,815,990</u>

Note 6. Other Investments

Other investments consist of the following at June 30:

	Cost		Income	
	2006	2005	2006	2005
Joint Ventures	\$ 1,041,061	\$ 676,515	\$ 349,546	\$ 218,727
Cash Surrender Value of Life Insurance	1,239,070	1,213,454	25,616	34,308
	<u>\$ 2,280,131</u>	<u>\$ 1,889,969</u>	<u>\$ 375,162</u>	<u>\$ 253,035</u>

In 2006, the Hospital funded a 14.3% interest in an organization that operates a regional group purchasing arrangement. The Hospital's equity interest in this organization was \$15,000 at June 30, 2006.

In 2005, Corporate Occupational Health Solutions, LLC, funded a 25% interest in an organization that provides occupational health and wellness services in Carroll County, Maryland. Corporate Occupational Health Solutions, LLC's equity interest in this organization was \$23,397 and \$21,440 at June 30, 2006 and 2005, respectively.

In 2004, FHSC funded a 50% interest in a claims management organization. FHSC's equity interest in this organization was \$12,910 and \$26,557 at June 30, 2006 and 2005, respectively.

In May 2002, FHSC funded a 50% interest in an organization that owns, operates, and manages an open magnetic resonance imaging facility. FHSC's equity interest in this organization was \$284,048 and \$262,509 at June 30, 2006 and 2005, respectively.

In November 2000, FHSC funded a 33.33% interest in an organization that provides patient transportation services to Frederick and Washington counties. FHSC's equity interest in this organization was \$339,379 at June 30, 2006 and had no carrying value at June 30, 2005.

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 6. Other Investments (Continued)

In July 2000, FHSC funded a 50% interest in a preferred provider organization. FHSC's equity interest in this organization was \$32,078 and \$34,839 at June 30, 2006 and 2005, respectively.

The Hospital has a 50% interest in a nursing and rehabilitation center. The Hospital's interest in this corporation was \$(125,000) at June 30, 2006 and 2005.

In July 1999, the Hospital funded a 50% start-up interest in a limited liability company to build information systems infrastructure for medical providers in Frederick County, and to sell technology services to those providers. FHSC's membership interest in this joint venture was \$400 at June 30, 2006 and had no carrying value at June 30, 2005.

In March 1999, the Hospital funded a 50% interest in a limited liability company to provide outpatient behavioral health services. The Hospital's membership interest in this joint venture had no carrying value at June 30, 2006 and 2005.

In August 1993, the Hospital funded an interest in an organization that operates and manages healthcare group purchasing and other healthcare related programs for the benefit of its partners to assist in providing superior healthcare services in their communities. The Hospital's membership interest in this organization has averaged less than 1% and was \$456,849 at June 30, 2006 and 2005.

Note 7. Property, Plant and Equipment

Property, plant and equipment consist of the following at June 30:

	Estimated Useful Lives	2006	2005
Land	-	\$ 4,369,379	\$ 4,369,379
Land improvements	8 - 20 years	1,241,412	1,229,413
Buildings	20 - 40 years	145,804,614	135,818,955
Fixed equipment	10 - 20 years	15,417,342	15,098,213
Movable equipment	3 - 20 years	99,504,556	87,546,433
Leasehold improvements	5 - 20 years	13,113,275	11,544,161
		279,450,578	255,606,554
Less accumulated depreciation		111,413,930	97,505,754
		168,036,648	158,100,800
Construction in process, renovations, and deposits	-	14,595,921	11,384,905
		\$ 182,632,569	\$ 169,485,705

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 8. Intangible Assets

Intangible assets consist of the following at June 30:

Description	2006	2005
Goodwill	\$ 1,254,124	\$ 1,254,124
Intangible pension asset (Note 11)	370,656	418,831
	\$ 1,624,780	\$ 1,672,955

Note 9. Long-Term Debt

Long-term debt consists of the following as of June 30, 2006 and 2005:

	2006	2005
a) MHHEFA Series 1993 Bonds	\$ 10,485,000	\$ 45,251,708
b) MHHEFA Series 2002 Bonds	69,720,160	69,626,628
c) MHHEFA Series 2006A Bonds	37,141,907	-
d) MHHEFA Series 2006B Bonds	37,489,999	-
e) Equipment note payable	3,772,502	4,625,782
f) State of Maryland loan	108,524	235,258
g) Note payable - Emmitsburg	753,624	813,163
h) Note payable - FSC	116,888	-
	159,588,604	120,552,539
Less current maturities	11,669,433	2,146,452
	\$ 147,919,171	\$ 118,406,087

(a) Series 1993 MHHEFA Revenue Bonds

During 1994, the Hospital obtained a loan of \$55,060,000 in Maryland Health and Higher Educational Facility Authority (MHHEFA) Revenue Bonds, Frederick Memorial Hospital Issue, Series 1993. The MHHEFA Series 1993 Bonds were issued to refinance certain Frederick County loans and to finance and refinance costs of acquisition, construction, renovation and equipping certain Hospital facilities. The Series 1993 Bonds were net of an original issue discount of \$3,126,313, which was being amortized over the life of the bonds using the yield method. The unamortized balance of the original issue discount of \$1,534,003 was written off in 2006 in conjunction with the refunding of the series 1993 Bonds. Accumulated amortization was \$1,498,021 at June 30, 2005. The average annual interest rate on the bond loan is 5%. Interest is payable semi-annually on January 1 and July 1. In July 2006, the remaining balance of these bonds was paid in full.

In connection with the bond issuance, the Hospital was required to deposit as collateral, in a trustee Debt Service Reserve Fund, an amount equal to the maximum annual debt service on the Series 1993 Bonds of \$3,409,810.

The Series 1993 Bonds (other than those maturing on July 1, 2008 and July 1, 2013 aggregating \$10,485,000) maturing on or after July 1, 2004 were subject to redemption prior to maturity beginning on July 1, 2003 at the option of the Authority as outlined in the agreement dated November 12, 1993.

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 bond agreement contains certain financial covenants.

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 9. Long-Term Debt (Continued)

(b) Series 2002 MHHEFA Revenue Bonds

In August 2002, the Hospital obtained a loan of \$71,715,000 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 \$2,361,175 which is being amortized over the life of the bonds using the yield method. Accumulated amortization was \$366,335 and \$272,803 at June 30, 2006 and 2005, 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.

In connection with the bond issuance, the Hospital was required to deposit as collateral, in a trustee Debt Service Reserve Fund, an amount equal to the maximum annual debt service on the Series 2002 Bonds of \$4,058,000.

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.

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 Series 2006A and 2006B Bonds, the Series 1993 Bonds and the loan from the State of Maryland.

The bond agreement contains certain financial covenants.

(c) Series 2006A MHHEFA Revenue Bonds and

(d) Series 2006B MHHEFA Revenue Bonds

In June 2006, the Hospital obtained two loans totaling \$75,000,000 in MHHEFA Revenue Bonds, Frederick Memorial Hospital Issue, Series 2006A (\$37,325,000) and Series 2006B (\$37,675,000). The MHHEFA Series 2006 Bonds were issued to finance and refinance costs of construction, renovation and equipping certain Hospital facilities, as well as refunding the Series 1993 Bonds. The Series 2006 Bonds are net of original issue discounts of \$370,000 which are being amortized over the life of the bonds using the yield method. Accumulated amortization was \$1,906 at June 30, 2006. The bonds accrue interest at a variable rate (3.85% as of June 30, 2006). Interest is payable semiannually on each January 1 and July 1, through July 1, 2028 for the Series A bonds and through July 1, 2035 for the Series B bonds.

In connection with the bond issuance, the Hospital was required to deposit as collateral an additional \$2,747,000 in a trustee Debt Service Reserve Fund, for total funding in an amount equal to the maximum annual debt service on the Series 2006 Bonds, the Series 1993 Bonds and the Series 2002 Bonds.

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 2006A and 2006B Bonds are secured ratably with the Series 1993 and Series 2002 Bonds and the loan from the State of Maryland.

The bond agreement contains certain financial covenants.

e) Equipment Note Payable

In June 2004, the Hospital obtained a \$5,367,028 loan from GE Capital Public Finance, Inc. to finance the acquisition of certain equipment. The Hospital was required to place the loan proceeds into a trustee-held escrow account until all equipment was purchased. At June 30, 2006 and 2005, unexpended loan proceeds of \$129,495 and \$125,065, respectively, were held by the trustee in escrow. The note is payable in monthly installments of principal and interest of \$87,717 and is due on July 1, 2010. The note bears interest at 4.83% and is collateralized by certain property and equipment.

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 9. Long-Term Debt (Continued)

f) State of Maryland Loan

A loan agreement with the State of Maryland, dated April 27, 1967, for original borrowings of \$2,575,995 is secured on a parity basis with the MHHEFA Revenue Bonds. The loan is payable in annual installments of \$136,701 including interest of approximately 5%, through 2007.

g) 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 \$1,219,454. The notes are payable in monthly installments of principal and interest of \$10,200, bear interest at 8%, and are due December 31, 2014.

h) Note Payable – FSC

In 2006, FSC obtained a note payable to a bank to finance the purchase of medical equipment. The note is collateralized by the equipment, bears interest at 6.99% and is payable in equal monthly installments of \$2,498.

Debt service requirements on long-term debt, excluding the original issue discounts on the MHHEFA Bonds, are as follows:

Years Ending June 30:	Principal	Interest	Total
2007	\$ 11,669,433	\$ 8,963,720	\$ 20,633,153
2008	1,689,501	8,848,736	10,538,237
2009	1,869,534	8,735,213	10,604,747
2010	1,992,906	8,566,546	10,559,452
2011	1,995,307	8,459,833	10,455,140
Later Years	142,734,857	120,045,237	262,780,094
	<u>\$ 161,951,538</u>	<u>\$ 163,619,285</u>	<u>\$ 325,570,823</u>

Note 10. Interest Rate Swap Contract

In conjunction with the issuance of the Series 2006A and 2006B Bonds, the Hospital entered into an interest rate swap contract with a third party, on an original notional amount of \$75,000,000 until July 1, 2010, at which point the notional amount amortizes over the term of the underlying Series 2006 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) (3.55% as of June 30, 2006). Both the debt and the swap require payments be made or received semiannually, on January 1 and July 1. The fair value of the swap contract was a liability of \$212,374 at June 30, 2006.

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 11. Employee Benefit Plans

(a) The Hospital has a trustee, defined benefit pension plan covering substantially all of its employees. The Hospital's funding policy is to make a minimum annual contribution equal to net periodic pension cost for the Plan year.

In accordance with SFAS No. 87, the Hospital was required to recognize a minimum liability relating to the under-funded status of the plan, as of June 30, 2005. An under-funding results whenever the accumulated benefit obligation exceeds the fair value of the plan assets. An additional minimum liability adjustment is offset by an intangible asset to the extent that prior service costs have not been recognized. Unrecognized prior service costs of \$370,656 and \$418,831 were recorded as an intangible pension asset at June 30, 2006 and 2005, respectively. The remaining additional minimum liability adjustment is reflected as a component of other changes in unrestricted net assets on the Statements of Operations. The remaining adjustment was \$922,182 and \$5,949,446 for the years ended June 30, 2006 and 2005, respectively.

The Hospital uses a measurement date of March 31 for the Plan.

Obligation and Funded Status:

	2006	2005
Accumulated benefit obligation	\$ 49,531,666	\$ 43,848,966
Fair value of Plan assets	\$ 45,694,290	\$ 41,631,816
Projected benefit obligation	(53,381,869)	(47,460,210)
Funded status	(7,687,579)	(5,828,394)
Unrecognized net actuarial loss	11,463,145	10,398,352
Unrecognized prior service cost	(370,656)	(418,831)
Net amount recognized	\$ 3,404,910	\$ 4,151,127
Employer contributions	\$ 1,800,000	\$ -
Plan participants' contributions	\$ -	\$ -
Benefits paid	\$ 826,881	\$ 644,880

Amounts recognized in the financial statements consist of the following:

	2006	2005
Accrued benefit cost	\$ (3,837,376)	\$ (2,217,150)
Intangible asset (Note 8)	370,656	418,831
Additional minimum pension adjustment	(922,182)	(5,949,446)
Net pension expense	2,546,217	1,721,420

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 11. Employee Benefit Plans (Continued)

Assumptions: Weighted-average assumptions used to determine net periodic pension cost are as follows:

	2006	2005
Discount rate	6.00%	6.25%
Expected long-term rate of return on Plan assets	8.00%	8.00%
Rate of increase in compensation	4.00%	4.00%

Weighted-average assumptions used to determine benefit obligation are as follows:

	2006	2005
Discount rate	6.00%	6.00%
Rate of increase in compensation	4.00%	4.00%

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 chart below details ranges for the expected long-term returns for the asset classes in which the Plan currently invests:

Asset Class	Range of Expected Returns
U.S. Equity Securities	8% - 9%
Investment grade fixed income securities	4% - 6%

Plan Assets: The Plan's weighted-average asset allocations at March 31, 2006 and 2005, by asset category are as follows:

	2006	2005
Equity securities	56%	55%
Debt securities	44%	44%
Other	-	1%
	100%	100%

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
- 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 55% in domestic equities and 45% in investment-grade fixed income (debt) securities.

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 11. Employee Benefit Plans (Continued)

Contributions: The Hospital expects to contribute approximately \$2,500,000 to the Plan in the fiscal year ending June 30, 2007.

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

Years Ending June 30,	
2007	\$ 1,025,951
2008	1,174,373
2009	1,334,884
2010	1,509,204
2011	1,723,428
2012-2016	12,429,953

(b) The Hospital also has a tax-deferred annuity savings plan available to substantially all employees. The Hospital provides a 50% match of employee deferrals up to 4% of gross earnings. The Hospital match was \$1,069,246 and \$1,043,038 for 2006 and 2005, respectively.

(c) The Hospital is partially self-insured against employee medical claims. Plan expenses include claims paid and a provision for claims incurred but not reported. The program has an annual aggregate stop loss provision of \$250,000 per employee.

(d) 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 contributions to the plans were \$8,500 for the year ended June 30, 2006.

Note 12. Concentrations 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 whom 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:

	2006	2005
Medicare	19%	19%
Medicaid	12%	15%
Blue Cross	13%	18%
HMO's and PPO's	24%	20%
Commercial insurance and other third party payors	9%	11%
Patients	23%	17%
	<u>100%</u>	<u>100%</u>

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 13. Charity Care

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 gross patient service revenue. Charity care provided for the years ended June 30, 2006 and 2005 was \$2,866,553 and \$3,184,847, respectively.

Note 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:

	2006	2005
Health care services	\$ 144,661,140	\$ 134,465,055
General and administrative	100,460,549	91,163,344
	<u>\$ 245,121,689</u>	<u>\$ 225,628,399</u>

Note 15. Temporarily and Permanently Restricted Net Assets

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

	2006	2005
Health care services		
Buildings and equipment	\$ 10,092,081	\$ 9,754,357
Education programs	604,734	522,777
Research	195,917	195,917
	<u>\$ 10,892,732</u>	<u>\$ 10,473,051</u>

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

	2006	2005
General health care services (reported as operating income)	\$ 971,177	\$ 971,177
Specific health care services (reported as temporarily restricted income)	5,000	5,000
	<u>\$ 976,177</u>	<u>\$ 976,177</u>

During 2006 and 2005, net assets were released from donor restrictions by incurring expenses or capital expenditures satisfying the restricted purposes in the amounts of \$2,220,380 and \$11,795,736, respectively.

Note 16. Contingencies

There are several lawsuits pending in which the Hospital has been named as a defendant on allegations of malpractice. Attorneys for insurance companies and the Hospital are representing the Hospital. All claims are expected to be covered by the Hospital's insurance and all possible awards limited to such insurance coverage, except as described in the following paragraph.

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 16. Contingencies (Continued)

The Hospital was insured for professional liability with Pennsylvania Hospital Insurance Company (PHICO) during the coverage period from July 1, 1999 through June 30, 2001. The insurance was provided on the occurrence basis, so that claims filed subsequent to June 30, 2001 that occurred during the coverage period were covered by the PHICO policies. PHICO is being liquidated by the Pennsylvania Insurance Commissioner who set April 1, 2003 as the submission date for filing claims in the liquidation proceedings. Property & Casualty Insurance Guaranty Corporation (Guaranty Corporation) has assumed coverage obligations for claims incurred by PHICO during the coverage period and filed by the April 1, 2003 submission date. However, several malpractice claims have been filed against the Hospital, subsequent to the submission date, for events that occurred during the coverage period. Guaranty Corporation refused to assume PHICO's coverage obligations for these claims, asserting that the Hospital failed to present these claims by a statutory time limit. The Hospital filed a complaint against Guaranty Corporation seeking a declaration that requires Guaranty Corporation to assume PHICO's coverage obligation with respect to the claims filed after April 1, 2003. The Circuit Court ruled in favor of the Hospital. Guaranty Corporation appealed to the Court of Special Appeals, which affirmed the lower court ruling in the Hospital's favor by a decision on August 30, 2006, ordering Guaranty Corporation to cover the cases filed after April 1, 2003.

Guaranty Corporation has indicated it will file a petition for a writ of certiorari to the Court of Appeals. Unless the Court of Appeals both grants the writ of certiorari and reverses the Court of Special Appeals' decision, Guaranty Corporation will have to cover the contested cases.

The Hospital has established a self-insurance trust to set aside funds to cover future claims, if any, under the former PHICO policies with liability limits of \$100,000 per claim. The Hospital has asserted it is protected by the doctrine of charitable immunity for any liability over the limits of the self-insurance trust. The funded balance of the Trust was \$352,583 and \$339,683 at June 30, 2006 and 2005, respectively, which is included as Assets Limited as to Use on the Consolidated Balance Sheets.

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 self-insurance trust to set aside funds to cover future professional liability claims. The initial funding to the trust was \$1,500,000. Total disbursements from the fund for a covered loss by one or more persons as a result of any one occurrence shall not exceed \$1,000,000 and \$3,000,000 in the aggregate in any one fiscal year. Concurrently, the Hospital purchased excess "umbrella" coverage through a commercial carrier with a limit of \$10,000,000. The funded balance of the trust was \$1,556,817 at June 30, 2006 and is included as Assets Limited as to Use on the Consolidated Balance Sheets.

Note 17. Commitments

Capital Project: The Hospital initiated a major building and renovation project (the "Project") in 2000. The Hospital Board approved a revised budget of \$102.7 million in December 2003 to reflect change orders in excess of budgeted contingency related to unanticipated rock and Hospital driven design changes, and an additional \$3.7 million contingency for the remainder of the Project. The Hospital received a Certificate of Need from the Maryland Health Care Commission on June 21, 2001. The Project is being completed in distinct phases. Phase I of the Project, which was exempt from CON, included a new central energy plant and the relocation of the ICU into existing space and was substantially completed in May 2002 at a cost of \$10.9 million.

Phase II of the Project began in October 2001 and included the renovation and expansion of the emergency and perioperative services of the Hospital. In addition, a new main entrance and support space was constructed adjacent to the existing emergency room. Phase II was substantially complete at June 30, 2004. Phase III of the Project involved demolition of approximately 128,000 square feet of existing facilities and included construction of a new patient tower with all private rooms. This phase of the Project resulted in approximately 271,000 square feet of new space and approximately 113,000 square feet of renovated facilities. Phase III commenced in June 2003 and was substantially complete, with modifications as described below, at June 30, 2005.

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 17. Commitments (Continued)

During 2005, the Hospital approved a change to the remaining components of Phase III of the Project. As a result, Phase III was concluded and a new Phase IV was approved. The CON was amended and approved by the Maryland Health Care Commission in May 2005. The Project change will result in cost savings, 12,000 square feet of additional space and earlier completion of the overall Project compared to the previous Phase III plan. The Project is expected to be substantially completed in October 2006.

At June 30, 2006, the Hospital's remaining commitments under Project related construction contracts approximated \$7.3 million.

Operating leases: The Hospital and its subsidiaries lease facilities under 11 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 six operating leases, the last of which expires in February 2009.

Rent expense under all operating leases was \$4,386,729 and \$4,706,409 for 2006 and 2005, respectively.

Future minimum payments under operating leases are as follows:

Years Ending June 30:

2007	\$ 2,881,103
2008	2,000,036
2009	591,964
2010	214,781
2011	121,716
Thereafter	746,235
	<u>\$ 6,555,835</u>

Employment agreements: The Hospital has an employment agreement with its President, which includes provisions for salary and benefits.

The Hospital has employment agreements with 16 physicians as a result of its purchase of physician medical practices.

Unemployment compensation letter of credit: The Hospital has an irrevocable letter of credit from a bank for approximately \$940,000 to fund potential unemployment compensation claims through September 30, 2007.

Worker's compensation: The Hospital is self-insured against worker's compensation claims, up to \$250,000 per occurrence, and has excess insurance coverage of \$1,000,000 per occurrence. Expenses include claims paid and a provision for claims incurred but not reported.

Line of credit: FSC has a line of credit with a bank, at the bank's prime interest rate, which expires in November 2006. The maximum line is \$300,000 and it is collateralized by accounts receivable, inventory and all property and equipment. There was no balance on the line as of June 30, 2006 and 2005.

Frederick Memorial Hospital, Inc. And Subsidiaries

Notes To Consolidated Financial Statements

Note 18. 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.

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 both 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 approximately \$1,378,000 and \$1,104,000 for the years ended June 30, 2006 and 2005, respectively.