# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-K/A
## (Amendment No. 1)

**(Mark One)**

☑ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended December 31, 2011**

**or**

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**Commission file number 001-32559**

# Medical Properties Trust, Inc.
## MPT Operating Partnership, L.P.

**(Exact Name of Registrant as Specified in Its Charter)**

| | |
|---|---|
| **Maryland**<br>**Delaware**<br>**(State or Other Jurisdiction of Incorporation or Organization)** | **20-0191742**<br>**20-0242069**<br>**(IRS Employer Identification No.)** |
| **1000 Urban Center Drive, Suite 501**<br>**Birmingham, AL**<br>**(Address of Principal Executive Offices)** | **35242**<br>**(Zip Code)** |

**(205) 969-3755**
**(Registrant's telephone number, including area code)**

**Securities registered pursuant to Section 12(b) of the Act:**

| Title of Each Class | Name of Each Exchange on Which Registered |
|---|---|
| Common Stock, par value $0.001 per share of Medical Properties Trust, Inc. | New York Stock Exchange |

**Securities registered pursuant to Section 12(g) of the Act:**
**None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☑ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☑

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☑ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☑ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment of this Form 10-K. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

| | | | | |
|---|---|---|---|---|
| Large accelerated filer (Medical Properties Trust Inc. only) | ☑ | | Accelerated filer | ☐ |
| Non-accelerated filer (MPT Operating Partnership, L.P. only) | ☑ | (Do not check if a smaller reporting company) | Smaller reporting company | ☐ |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ☐ No ☑

As of June 30, 2011, the aggregate market value of the 111,712,079 shares of common stock, par value $0.001 per share ("Common Stock"), held by non-affiliates of the registrant was $1,284,688,909 based upon the last reported sale price of $11.50 on the New York Stock Exchange. For purposes of the foregoing calculation only, all directors and executive officers of the registrant have been deemed affiliates.

As of February 22, 2012, 135,275,389 shares of Medical Properties Trust, Inc. Common Stock were outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's definitive Proxy Statement for the Annual Meeting of Stockholders to be held on May 17, 2012 are incorporated by reference into Items 10 through 14 of Part III, of this Annual Report on Form 10-K.

[Table of Contents](#)

# MEDICAL PROPERTIES TRUST, INC.
# MPT OPERATNIG PARTNERSHIP, L.P.
# AMENDMENT NO. 1 TO ANNUAL REPORT ON FORM 10-K
# FOR THE FISCAL YEAR ENDED DECEMBER 31, 2011

This Amendment No. 1 to the Annual Report on Form 10-K for the fiscal year ended December 31, 2011 of Medical Properties Trust, Inc. and MPT Operating Partnership, L.P. is filed for the sole purpose of adding the consolidated financial statements of Prime Healthcare Services, Inc. and Subsidiaries ("Prime") as Exhibit 99.1. At December 31, 2011, our properties leased to Prime were significant to our total assets. Since these properties are leased to Prime under long-term, triple-net leases that transfer substantially all operating costs to Prime, financial information about Prime may be relevant to investors. The audited financial statements of Prime for the years ended December 31, 2011 and 2010 are attached to this report as Exhibit 99.1. Refer to our 2010 Form 10-K/A filed on April 12, 2011 for the audited financial statements of Prime for the years ended December 31, 2010 and 2009. These financial statements were provided to us by Prime and Medical Properties Trust, Inc. did not participate in their preparation or review. Accordingly, Item 15 of Part IV has also been amended to reflect the filing of these exhibits.

Other than as expressly set forth above, this Amendment does not, and does not purport to, update or restate the information in any other Item of the originally filed annual report.

**TABLE OF CONTENTS**

## PART IV

**ITEM 15.** ***Exhibits and Financial Statement Schedules***

**(a) Financial Statements and Financial Statement Schedules**

The financial statements and financial statement schedules were previously filed with the Annual Report on Form 10-K for the fiscal year ended December 31, 2011, filed on February 29, 2012.

**(b) Exhibits**

| Exhibit Number | Exhibit Title |
|---|---|
| 3.1(1) | Registrant's Second Articles of Amendment and Restatement |
| 3.2(2) | Articles of Amendment of Registrant's Second Articles of Amendment and Restatement |
| 3.3(3) | Registrant's Second Amended and Restated Bylaws |
| 4.1(1) | Form of Common Stock Certificate |
| 4.2(4) | Indenture, dated July 14, 2006, among Registrant, MPT Operating Partnership, L.P. and the Wilmington Trust Company, as trustee |
| 4.3(13) | Indenture, dated as of March 26, 2008, among MPT Operating Partnership, L.P., as Issuer, Medical Properties Trust, Inc., as Guarantor, and Wilmington Trust Company, as Trustee. |
| 4.4(9) | Indenture, dated as of April 26, 2011, Medical Properties Trust, Inc., MPT Operating Partnership, L.P., MPT Finance Corporation, the Subsidiary Guarantors and Wilmington Trust Company, as Trustee. |
| 10.1(11) | Second Amended and Restated Agreement of Limited Partnership of MPT Operating Partnership, L.P. |
| 10.2(6) | Amended and Restated 2004 Equity Incentive Plan |
| 10.3(7) | Form of Stock Option Award |
| 10.4(7) | Form of Restricted Stock Award |
| 10.5(7) | Form of Deferred Stock Unit Award |
| 10.6(1) | Employment Agreement between Registrant and Edward K. Aldag, Jr., dated September 10, 2003 |
| 10.7(1) | First Amendment to Employment Agreement between Registrant and Edward K. Aldag, Jr., dated March 8, 2004 |
| 10.8(1) | Employment Agreement between Registrant and R. Steven Hamner, dated September 10, 2003 |
| 10.9 | Not used |
| 10.10(1) | Employment Agreement between Registrant and Emmett E. McLean, dated September 10, 2003 |
| 10.12(1) | Form of Indemnification Agreement between Registrant and executive officers and directors |
| 10.13(11) | Form of Medical Properties Trust, Inc. 2007 Multi-Year Incentive Plan Award Agreement (LTIP Units) |
| 10.14(11) | Form of Medical Properties Trust, Inc. 2007 Multi-Year Incentive Plan Award Agreement (Restricted Shares) |
| 10.17(16) | Second Amendment to Employment Agreement between Registrant and Edward K. Aldag, Jr., dated September 29, 2006 |
| 10.18(16) | First Amendment to Employment Agreement between Registrant and R. Steven Hamner, dated September 29, 2006 |
| 10.19(16) | First Amendment to Employment Agreement between Registrant and Emmett E. McLean, dated September 29, 2006 |
| 10.21(8) | Second Amended and Restated 2004 Equity Incentive Plan |
| 10.22(17) | Second Amendment to Employment Agreement between Registrant and William G. McKenzie, dated February 27, 2009 |
| 10.25(17) | Second Amendment to Employment Agreement between Registrant and Emmett E. McLean, dated January 1, 2008 |
| 10.26(17) | Third Amendment to Employment Agreement between Registrant and Emmett E. McLean, dated January 1, 2009 |
| 10.27(17) | Second Amendment to Employment Agreement between Registrant and Richard S. Hamner, dated January 1, 2008 |
| 10.28(17) | Third Amendment to Employment Agreement between Registrant and R. Steven Hamner, dated January 1, 2009 |
| 10.29(17) | Third Amendment to Employment Agreement between Registrant and Edward K. Aldag, Jr., dated January 1, 2008 |
| 10.30(17) | Fourth Amendment to Employment Agreement between Registrant and Edward K. Aldag, Jr., dated January 1, 2009 |
| 10.31(17) | Third Amendment to Employment Agreement between Registrant and William G. McKenzie, dated January 1, 2008 |
| 10.32(17) | Fourth Amendment to Employment Agreement between Registrant and William G. McKenzie, dated January 1, 2009 |
| 10.34(9) | Amended and Restated Revolving Credit and Term Loan Agreement, dated as of April 26, 2011, among Medical Properties Trust, Inc., MPT Operating Partnership, L.P., KeyBank National Association as syndication agent, and JPMorgan Chase Bank, N.A., as administrative agent |
| 12.1(19) | Statement re Computation of Ratios |
| 21.1(19) | Subsidiaries of Registrant |

| Exhibit Number | Exhibit Title |
|---|---|
| 23.1(19) | Consent of PricewaterhouseCoopers LLP |
| 31.1(21) | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. (Medical Properties Trust, Inc.) |
| 31.2(21) | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. (Medical Properties Trust, Inc.) |
| 31.3(21) | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. (MPT Operating Partnership, L.P.) |
| 31.4(21) | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. (MPT Operating Partnership, L.P.) |
| 32.1(19) | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(b) under the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (Medical Properties Trust, Inc.) |
| 32.2(19) | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(b) under the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (MPT Operating Partnership, L.P.) |
| 99.1(20)(21) | Consolidated Financial Statements of Prime Healthcare Services, Inc. as of December 31, 2011 and 2010 |
| | The following materials from Medical Properties Trust, Inc.'s and MPT Operating Partnership, L.P.'s Annual Report on Form 10-K for the year ended December 31, 2011 formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income; (iii) the Consolidated Statements of Equity, (iv) the Consolidated Statements of Cash Flows; and (v) related notes to these financial statements. |

| | |
|---|---|
| Exhibit 101.INS | XBRL Instance Document |
| Exhibit 101.SCH | XBRL Taxonomy Extension Schema Document |
| Exhibit 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| Exhibit 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| Exhibit 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| Exhibit 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

(1) Incorporated by reference to Registrant's Registration Statement on Form S-11 filed with the Commission on October 26, 2004, as amended (File No. 333-119957).
(2) Incorporated by reference to Registrant's current report on Form 8-K, filed with the Commission on November 24, 2009.
(3) Incorporated by reference to Registrant's quarterly report on Form 10-Q for the quarter ended September 30, 2005, filed with the Commission on November 10, 2005.
(4) Incorporated by reference to Registrant's current report on Form 8-K, filed with the Commission on July 20, 2006.
(5) Incorporated by reference to Registrant's current report on Form 8-K, filed with the Commission on November 13, 2006.
(6) Incorporated by reference to Registrant's definitive proxy statement on Schedule 14A, filed with the Commission on September 13, 2005.
(7) Incorporated by reference to Registrant's current report on Form 8-K, filed with the Commission on October 18, 2005.
(8) Incorporated by reference to Registrant's definitive proxy statement on Schedule 14A, filed with the Commission on April 14, 2007.
(9) Incorporated by reference to Registrant's current report on Form 8-K, filed with the Commission on May 2, 2011.
(10) Incorporated by reference to Registrant's quarterly report on Form 10-Q for the quarter ended September 30, 2007, filed with the Commission on November 9, 2007.
(11) Incorporated by reference to Registrant's current report on Form 8-K, filed with the Commission on August 6, 2007.
(12) Incorporated by reference to Registrant's current report on Form 8-K, filed with the Commission on August 15, 2007.
(13) Incorporated by reference to Registrant's current report on Form 8-K, filed with the Commission on March 26, 2008.
(14) Incorporated by reference to Registrant's quarterly report on Form 10-Q for the quarter ended March 31, 2008, filed with the Commission on May 9, 2008.
(15) Incorporated by reference to Registrant's quarterly report on Form 10-Q for the quarter ended June 30, 2008, filed with the Commission on August 8, 2008.

(16) Incorporated by reference to Registrant's annual report on Form 10-K/A for the period ended December 31, 2007, filed with the Commission on July 11, 2008.

(17) Incorporated by reference to Registrant's annual report on Form 10-K for the period ended December 31, 2008, filed with the Commission on March 13, 2009.

(18) Incorporated by reference to Registrant's current report on Form 8-K, filed with the Commission on June 11, 2010.

(19) Previously filed as an exhibit to Registrant's Annual Report on form 10-K, filed with the Commission on February 29, 2012.

(20) Since affiliates of Prime Healthcare Services, Inc. lease a significant amount of our total assets under triple net leases, the financial status of Prime may be considered relevant to investors. Prime's most recently available audited consolidated financial statements (as of and for the years ended December 31, 2011 and 2010) are attached as Exhibit 99.1 to this Amendment No. 1 to the Annual Report on Form 10-K. Refer to our 2010 Form 10-K/A filed on April 12, 2011 for the audited financial statements of Prime for the years ended December 31, 2010 and 2009. We have not participated in the preparation of Prime's financial statements nor do we have the right to dictate the form of any financial statements provided to us by Prime.

(21) Included in this Form 10-K/A.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

MEDICAL PROPERTIES TRUST, INC.

By: /s/ R. Steven Hamner
R. Steven Hamner
Executive Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

MPT OPERATING PARTNERSHIP, L.P.

By: /s/ R. Steven Hamner
R. Steven Hamner
Executive Vice President and Chief Financial Officer of the sole member of the general partner of
MPT Operating Partnership, L.P.
(Principal Financial and Accounting Officer)

Date: May 10, 2012

## INDEX TO EXHIBITS

| Exhibit Number | Exhibit Title |
|---|---|
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. (Medical Properties Trust, Inc.) |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. (Medical Properties Trust, Inc.) |
| 31.3 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. (MPT Operating Partnership, L.P.) |
| 31.4 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. (MPT Operating Partnership, L.P.) |
| 99.1 | Consolidated Financial Statements of Prime Healthcare Services, Inc. as of December 31, 2011 and 2010 |

**Exhibit 31.1**

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO RULE 13a-14(a) UNDER THE SECURITIES EXCHANGE ACT OF 1934

I, Edward K. Aldag, Jr., certify that:

1) I have reviewed this annual report on Form 10-K/A of Medical Properties Trust, Inc.

2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3) Based on my knowledge, the other financial information included in this report is fairly presented in all material respects as of, and for, the periods presented in this report.

Date: May 10, 2012

/s/ Edward K. Aldag, Jr.
Edward K. Aldag, Jr.
Chairman, President and Chief Executive Officer

**Exhibit 31.2**

CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO RULE 13a-14(a) UNDER THE SECURITIES EXCHANGE ACT OF 1934

I, R. Steven Hamner, certify that:

1) I have reviewed this annual report on Form 10-K/A of Medical Properties Trust, Inc.

2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3) Based on my knowledge, the other financial information included in this report is fairly presented in all material respects as of, and for, the periods presented in this report.

Date: May 10, 2012

/s/ R. Steven Hamner

R. Steven Hamner
Executive Vice President and Chief Financial Officer

**Exhibit 31.3**

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO RULE 13a-14(a) UNDER THE SECURITIES EXCHANGE ACT OF 1934

I, Edward K. Aldag, Jr., certify that:

1) I have reviewed this annual report on Form 10-K/A of MPT Operating Partnership, L.P.

2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3) Based on my knowledge, the other financial information included in this report is fairly presented in all material respects as of, and for, the periods presented in this report.

Date: May 10, 2012

/s/ Edward K. Aldag, Jr.
Edward K. Aldag, Jr.
Chairman, President and Chief Executive Officer
of the Sole Member of the General Partner of
MPT Operating Partnership, L.P.

**Exhibit 31.4**

CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO RULE 13a-14(a) UNDER THE SECURITIES EXCHANGE ACT OF 1934

I, R. Steven Hamner, certify that:

1) I have reviewed this annual report on Form 10-K/A of MPT Operating Partnership, L.P.

2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3) Based on my knowledge, the other financial information included in this report is fairly presented in all material respects as of, and for, the periods presented in this report.

Date: May 10, 2012

/s/ R. Steven Hamner

R. Steven Hamner
Executive Vice President and Chief Financial Officer
of the Sole Member of the General Partner of
MPT Operating Partnership, L.P.

Report of Independent Auditors
and Consolidated Financial Statements for

Prime Healthcare Services, Inc.
and Subsidiaries

December 31, 2011 and 2010

MOSS-ADAMS LLP

Certified Public Accountants | Business Consultants

*Acumen. Agility. Answers.*

**CONTENTS**

**REPORT OF INDEPENDENT AUDITORS**

Board of Directors
Prime Healthcare Services, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Prime Healthcare Services, Inc. and Subsidiaries (the "Company") as of December 31, 2011 and 2010, and the related consolidated statements of income, stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of Prime Healthcare Services, Inc. and Subsidiaries' management. Our responsibility is to express an opinion on these consolidated 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 audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatements. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Prime Healthcare Services, Inc. and Subsidiaries, as of December 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Moss Adams LLP

Irvine, California
May 1, 2012

## ASSETS

| | DECEMBER 31, 2011 | DECEMBER 31, 2010 |
|---|---|---|
| CURRENT ASSETS | | |
| Cash and cash equivalents* | $ 57,298,258 | $ 77,159,641 |
| Patient accounts receivable, net of allowance for doubtful accounts of $68,492,000 in 2011 and $75,513,000 in 2010* | 194,209,929 | 211,501,164 |
| Related party receivables* | 2,355,218 | 3,609,270 |
| Notes receivable* | 9,099,880 | 2,000,000 |
| Estimated third-party payor settlements | 52,577,251 | 64,966,506 |
| Supplies inventory* | 8,031,867 | 6,032,663 |
| Prepaid expenses and other current assets* | 81,256,259 | 68,781,353 |
| Total current assets | 404,828,662 | 434,050,597 |
| PROPERTY AND EQUIPMENT, net of accumulated depreciation and amortization* | 339,313,402 | 262,620,741 |
| INSURANCE CLAIMS AND RESERVES RECOVERABLE | 66,030,896 | 64,164,484 |
| GOODWILL | 14,536,634 | 13,707,803 |
| OTHER ASSETS* | 17,152,965 | 21,700,654 |
| | $841,862,559 | $796,244,279 |

* *Account balances contain assets of the consolidated variable interest entities that can only be used to settle obligations of the variable interest entities (see Note 2) as of December 31, 2011 and 2010, respectively: Cash and cash equivalents $6,346,505 and $21,996,733; Patient accounts receivable, net of allowance for doubtful accounts $5,306,603 and $4,880,065; Notes receivable $20,000 and $2,000,000; Supplies inventory $73,580 and $63,740; Prepaid expenses and other current assets $4,074,359 and $4,006,534; Property and Equipment $64,756,779 and $9,414,390; and Other assets $225,275 and $0.*

See accompanying notes.

## LIABILITIES AND STOCKHOLDERS' EQUITY

| | DECEMBER 31, 2011 | DECEMBER 31, 2010 |
|---|---|---|
| CURRENT LIABILITIES | | |
| Accounts payable* | $ 43,395,656 | $ 41,586,501 |
| Accrued expenses* | 70,942,735 | 71,504,856 |
| Medical claims payable* | 2,111,513 | 5,135,213 |
| Current portion of capital leases | 9,811,202 | 6,161,122 |
| Current portion of long-term debt* | 23,164,358 | 11,014,600 |
| Total current liabilities | 149,425,464 | 135,402,292 |
| LONG-TERM LIABILITIES | | |
| Sale lease-back liability | 138,000,000 | 68,000,000 |
| Insurance claims liabilities and reserves | 66,030,896 | 64,164,484 |
| Interest rate swap | 8,782,334 | 6,439,555 |
| Capital leases, net of current portion | 11,283,972 | 7,328,405 |
| Long-term debt, net of current portion* | 216,947,849 | 250,986,875 |
| Total long-term liabilities | 441,045,051 | 396,919,319 |
| STOCKHOLDERS' EQUITY | | |
| Common stock, $0.01 par value, 3,000 shares authorized, 30 shares issued and outstanding | 1 | 1 |
| Additional paid in capital | 2,999 | 2,999 |
| Retained earnings | 148,698,005 | 114,674,021 |
| Non-controlling interest | 102,691,039 | 149,245,647 |
| Total stockholders' equity | 251,392,044 | 263,922,668 |
| | $841,862,559 | $796,244,279 |

* *Account balances contain liabilities of consolidated variable interest entities for which creditors do not have recourse to the general credit of the Company (see Note 2) as of December 31, 2011 and 2010, respectively: Accounts payable $3,047,577 and $2,890,547; Accrued expenses $4,985,455 and $5,040,296; Medical claims payable $236,886 and $867,461; and Long term liabilities $4,381,471 and $5,036,012.*

 See accompanying notes.

**CONSOLIDATED STATEMENTS OF INCOME**

| | YEARS ENDED DECEMBER 31, 2011 | 2010 |
|---|---|---|
| REVENUE | | |
| Net patient service revenue (net of contractual allowances and discounts) | $1,451,478,874 | $1,556,186,337 |
| Provision for bad debts | 262,448,130 | 264,700,480 |
| Net patient service revenue less provision for bad debts | 1,189,030,744 | 1,291,485,857 |
| Premium revenue | 27,400,681 | 24,322,191 |
| Other revenue | 44,874,855 | 12,774,685 |
| | 1,261,306,280 | 1,328,582,733 |
| OPERATING EXPENSES | | |
| Compensation and employee benefits | 589,817,249 | 540,880,458 |
| General and administrative | 121,730,935 | 198,632,643 |
| Supplies | 144,703,586 | 131,197,337 |
| Professional services | 115,120,232 | 103,057,965 |
| Rent and lease | 51,051,406 | 53,407,075 |
| Depreciation and amortization | 35,333,531 | 29,418,170 |
| Medical claims | 8,484,053 | 2,851,257 |
| | 1,066,240,992 | 1,059,444,905 |
| INCOME FROM OPERATIONS | 195,065,288 | 269,137,828 |
| GAIN FROM ACQUISITION | 4,608,751 | 13,272,876 |
| INTEREST EXPENSE, net | (39,789,039) | (31,917,551) |
| INCOME BEFORE PROVISION FOR INCOME TAXES | 159,885,000 | 250,493,153 |
| INCOME TAX PROVISION | 2,967,872 | 2,671,612 |
| INCOME BEFORE ALLOCATION TO NON-CONTROLLING INTEREST | 156,917,128 | 247,821,541 |
| ALLOCATION OF INCOME TO NON-CONTROLLING INTEREST | (66,887,635) | (141,244,753) |
| CONTROLLING INTEREST IN NET INCOME | $ 90,029,493 | $ 106,576,788 |

See accompanying notes.

**PRIME HEALTHCARE SERVICES, INC.**
**AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

| | Shares | Common Stock | Additional Paid in Capital | Retained Earnings | Non-controlling Interest | Total |
|---|---|---|---|---|---|---|
| BALANCE, December 31, 2009 | 30 | $ 1 | $ 2,999 | $ 55,258,421 | $ 107,295,136 | $ 162,556,557 |
| Contributions from stockholder | — | — | — | — | 2,410,000 | 2,410,000 |
| Distribution of Montclair Hospital Medical Center (see Note 4) | — | — | — | (47,161,188) | — | (47,161,188) |
| Cash distributions | — | — | — | — | (101,704,242) | (101,704,242) |
| Controlling interest in net income | — | — | — | 106,576,788 | — | 106,576,788 |
| Non-controlling interest in net income | — | — | — | — | 141,244,753 | 141,244,753 |
| BALANCE, December 31, 2010 | 30 | 1 | 2,999 | 114,674,021 | 149,245,647 | 263,922,668 |
| Contributions from stockholder | — | — | — | — | 1,000,000 | 1,000,000 |
| Distribution of Sherman Oaks Hospital (see Note 4) | — | — | — | (56,005,509) | — | (56,005,509) |
| Acquisition of Harlingen Medical Center (see Note 4) | — | — | — | — | 21,238,222 | 21,238,222 |
| Cash distributions | — | — | — | — | (135,680,465) | (135,680,465) |
| Controlling interest in net income | — | — | — | 90,029,493 | — | 90,029,493 |
| Non-controlling interest in net income | — | — | — | — | 66,887,635 | 66,887,635 |
| BALANCE, December 31, 2011 | 30 | $ 1 | $ 2,999 | $148,698,005 | $ 102,691,039 | $ 251,392,044 |



See accompanying notes.

| | YEARS ENDED DECEMBER 31, 2011 | 2010 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Income before allocation to non-controlling interest | $ 156,917,128 | $ 247,821,541 |
| Adjustments to reconcile controlling interest in net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 35,333,531 | 29,418,170 |
| Gain on sale of assets | (1,117,468) | (134,165) |
| Provision for doubtful accounts | 262,448,130 | 264,700,480 |
| Gain on acquisition | (4,608,751) | (13,272,876) |
| Change in interest rate swap | 1,652,507 | 2,138,505 |
| Changes in assets and liabilities net of acquisitions/dispositions: | | |
| Patient accounts receivable | (252,455,684) | (277,399,304) |
| Supplies inventory | 156,536 | (94,785) |
| Prepaid expenses and other current assets | (16,217,765) | (4,070,723) |
| Other assets | 3,689,088 | (1,225,103) |
| Related party receivables/payables | 1,237,182 | (2,811,165) |
| Accounts payable | 2,605,398 | (1,805,096) |
| Accrued expenses | (12,319,968) | (5,580,082) |
| Medical claims payable | (3,023,700) | (259,114) |
| Estimated third-party payor settlements | 11,729,816 | (62,157,789) |
| Net cash provided by operating activities | 186,025,980 | 175,268,494 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Purchase of property and equipment | (35,917,844) | (21,811,864) |
| Proceeds from sale of property and equipment | 1,416,943 | 939,353 |
| Cash paid for acquisitions, net of cash acquired | (48,073,448) | (51,893,403) |
| Advances on related party notes receivable | (4,853,801) | — |
| Repayments on notes receivable | 2,000,000 | — |
| Advances on notes receivable | (4,246,079) | (2,000,000) |
| Net cash used in investing activities | (89,674,229) | (74,765,914) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Payments of loan issuance costs | — | (9,305,395) |
| Proceeds from long-term debt borrowing | — | 232,066,959 |
| Lease buyout of Sherman Oaks Hospital facility | (20,004,282) | — |
| Lease buyout of Montclair Hospital Medical Center facility | — | (20,041,610) |
| Proceeds from borrowings on sale lease-back | 70,000,000 | — |
| Repayments of sale lease-back borrowings | — | (75,000,000) |
| Borrowings on lines of credit | 333,408,345 | 320,831,871 |
| Repayments on lines of credit | (322,380,004) | (373,554,707) |
| Payments on long term debt | (32,917,609) | (29,939,175) |
| Payments on capital lease obligations | (7,501,994) | (11,502,536) |
| Contributions from stockholder | 1,000,000 | 2,410,000 |
| Cash distributions | (135,680,465) | (101,704,242) |
| Cash distribution of Sherman Oaks Hospital | (2,137,125) | — |
| Cash distribution of Montclair Hospital Medical Center | — | (3,607,305) |
| Net cash used in financing activities | (116,213,134) | (69,346,140) |
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | (19,861,383) | 31,156,440 |
| CASH AND CASH EQUIVALENTS, beginning of year | 77,159,641 | 46,003,201 |
| CASH AND CASH EQUIVALENTS, end of year | $ 57,298,258 | $ 77,159,641 |

See accompanying notes.

## PRIME HEALTHCARE SERVICES, INC.
## AND SUBSIDIARIES
## CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

### SUPPLEMENTAL CASH FLOW INFORMATION

| | YEARS ENDED DECEMBER 31, | |
|---|---|---|
| | 2011 | 2010 |
| Cash paid during the year for: | | |
| Interest | $32,284,845 | $28,821,662 |
| Income taxes | $ 2,967,872 | $ 1,713,000 |

### SUPPLEMENTAL DISCLOSURE OF NON CASH INVESTING AND FINANCING ACTIVITIES

| | | |
|---|---|---|
| Capital lease obligations incurred for the acquisition of property and equipment | $15,107,641 | $ 3,476,529 |
| Non-cash distribution of Montclair Hospital Medical Center assets (see Note 4) | $ — | $43,553,883 |
| Non-cash distribution of Sherman Oaks Hospital assets (see Note 4) | $53,868,384 | $ — |



See accompanying notes.

**Note 1 - Nature of Business**

Prime Healthcare Services, Inc. and Subsidiaries (the "Company" or "PHSI") is a Delaware corporation that incorporated on March 27, 2000.

The Company operates 13 acute care hospitals with 2,448 licensed beds located in various communities throughout California and Texas. The Company's operations also include four medical groups and other operations related to its hospital business. The Company operates the following acute care hospitals:

| Hospital | Licensed Beds | Location |
|---|---|---|
| Desert Valley Hospital | 83 | Victorville, CA |
| Chino Valley Medical Center | 126 | Chino, CA |
| Sherman Oaks Hospital* | 153 | Sherman Oaks, CA |
| Huntington Beach Hospital | 131 | Huntington Beach, CA |
| La Palma Intercommunity Hospital | 141 | La Palma, CA |
| West Anaheim Medical Center | 219 | Anaheim, CA |
| Paradise Valley Hospital | 301 | National City, CA |
| Centinela Hospital Medical Center | 370 | Inglewood, CA |
| Garden Grove Hospital Medical Center | 167 | Garden Grove, CA |
| San Dimas Community Hospital | 93 | San Dimas, CA |
| Shasta Regional Medical Center | 246 | Redding, CA |
| Alvarado Hospital | 306 | San Diego, CA |
| Harlingen Medical Center | 112 | Harlingen, TX |

* As of December 31, 2011, Sherman Oaks Hospital was distributed by the Company, on behalf of the controlling stockholder, who contributed Sherman Oaks Hospital to Prime Healthcare Services Foundation, Inc. (see Note 4)

**Note 2 - Organization and Summary of Significant Accounting Policies**

**Basis of consolidation** - The consolidated financial statements include the accounts of the Company, the wholly owned hospital subsidiaries as described in Note 1 and the following other wholly owned subsidiaries:

Prime Healthcare Services Alvarado Hospital, LLC
Bio-Med Services, Inc.
Prime Healthcare Services Los Angeles, LLC

**Note 2 - Organization and Summary of Significant Accounting Policies (continued)**

**Basis of consolidation (continued)** - The Company has a variable interest in the following entities as defined by Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 810, for which PHSI is the primary beneficiary of these variable interest entities:

Medical groups:

Desert Valley Medical Group, Inc.
Sherman Oaks Medical Group Management, Inc.
Paradise Valley Medical Group, Inc.
Shasta Regional Medical Group, Inc.

Other entities:

Prime Healthcare Management, Inc.
Prime Healthcare Management - Garden Grove, Inc.
Prime Healthcare Management - San Dimas, Inc.
Prime Healthcare Management - Encino, Inc.
Prime Healthcare Management - Shasta, Inc.
Hospital Business Service, Inc.
Prime Healthcare Air Transport LLC
International Aircraft Investments LLC
HMC Realty, LLC (see Note 4)

The Company has determined that the medical groups are variable interest entities due to the equity interest holder's lack of ability to exercise control. The Company has determined that the other entities are variable interest entities due to a lack of sufficient equity at risk. The Company has also determined it is the primary beneficiary of the medical groups and other entities because the Company has the power to direct activities that most significantly impact the economic performance of these entities. Accordingly, the Company has consolidated these entities into PHSI.

The equity of the variable interest entities have been reflected as a non-controlling interest as of December 31, 2011 and 2010. The consolidation of these entities does not change any legal ownership, and does not change the assets or the liabilities and equity of PHSI as a stand-alone entity. Total assets of these variable interest entities were approximately $82,196,000 and $42,361,000 as of December 31, 2011 and 2010, respectively. Total liabilities of these variable interest entities were approximately $12,651,000 and $13,834,000 as of December 31, 2011 and 2010, respectively. With the exception of HMC Realty, LLC, these entities provide management services for the Company, as well as providing health care services through the medical groups for which total revenues were approximately $55,219,000 and $33,379,000 for the years ended December 31, 2011 and 2010, respectively. HMC Realty, LLC is a real estate partnership which owns the land and hospital building leased to and operated by Harlingen Medical Center. The Company owns a 36.06 percent interest in HMC Realty, LLC and through Prime Healthcare Management, Inc. a security interest in the real estate owned by HMC Realty, LLC. All intercompany accounts and transactions have been eliminated upon consolidation.

**Note 2 - Organization and Summary of Significant Accounting Policies (continued)**

**Net patient service revenue** - Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. In some cases, reimbursement is based on formulas which cannot be determined until cost reports are filed and audited or otherwise settled by the various programs.

**Premium revenue and medical claims expense** - The Company has agreements with various Health Maintenance Organizations (“HMO”) to provide medical services to enrollees. Under these agreements, the Company receives monthly capitation revenue based on the number of each HMO’s enrollees, regardless of services actually performed by the Company. Premium revenue under HMO contracts is recognized during the period in which the Company is obligated to provide services. Certain HMO contracts also contain shared-risk provisions whereby the Company can earn additional incentive revenue or incur penalties based upon the utilization of inpatient hospital services by assigned HMO enrollees. The Company records shared-risk revenue and expenses based upon inpatient utilization on an estimated basis. Differences between estimated shared-risk revenue or expenses and actual amounts are recorded upon final settlement with each HMO. Amounts due to unaffiliated health care providers for out of network claims are recognized as incurred. The amounts recorded are based upon projections of historical developments. Such projections are adjusted and estimates changed when developments of claims information are warranted. There was no significant impact to the 2011 and 2010 operating results due to changes in this estimate.

**Supplies inventory** - Supplies inventory is stated at cost, determined by the average cost method, which is not in excess of market.

**Property and equipment** - Property and equipment is stated at cost, net of depreciation and amortization. Depreciation and amortization is computed using the straight-line method over the estimated useful lives of the assets, which range from three to forty years. Amortization of leasehold improvements is computed over the lesser of the lease term and the estimated useful lives of the assets and is included in depreciation and amortization expense.

**Asset retirement obligations** - The Company recognizes the fair value of a liability for legal obligations associated with asset retirements in the period in which it is incurred if a reasonable estimate of the fair value of the obligation can be made. When the liability is initially recorded, the Company capitalizes the cost of the asset retirement obligation by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost associated with the retirement obligation is depreciated over the useful life of the related asset. Upon settlement of the obligation, any difference between the cost to settle the asset retirement obligation and the liability recorded is recognized as a gain or loss in the Consolidated Statements of Income.

**Note 2 - Organization and Summary of Significant Accounting Policies (continued)**

**Use of estimates** - The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Income taxes** - PHSI, Desert Valley Hospital, Chino Valley Medical Center, and Bio-Med Services, Inc. are Sub chapter S Corporations. In addition, Desert Valley Hospital, Chino Valley Medical Center and Bio-Med Services, Inc. are qualified Q subs of PHSI and are included in the PHSI S corporation income tax return for the years ended December 31, 2011 and 2010. In lieu of corporate income taxes, the stockholders of PHSI will be taxed on their proportionate share of their respective net income as defined by the Internal Revenue Code. Alvarado Hospital, Prime Healthcare Services Alvarado Hospital, LLC, Huntington Beach Hospital, La Palma Intercommunity Hospital, West Anaheim Medical Center, Sherman Oaks Hospital, Paradise Valley Hospital, Centinela Hospital Medical Center, Garden Grove Hospital Medical Center, San Dimas Community Hospital, Shasta Regional Medical Center, and Prime Healthcare Services Los Angeles, LLC, are single member limited liability corporations. Their taxable income and loss is included in the PHSI S corporation income tax return for the years ended December 31, 2011 and 2010. Harlingen Medical Center is a limited liability partnership and is not subject to income taxes. The partners separately account for their share of pro-rata income or loss. PHSI is subject to state franchise taxes and limited liability company fees. PHSI disburses funds necessary to satisfy the stockholders’ income tax liabilities.

The following non-controlling entities, Desert Valley Medical Group, Inc., Prime Healthcare Management, Inc., Sherman Oaks Medical Group Management, Inc., Paradise Valley Medical Group, Inc., Hospital Business Service, Inc., Prime Healthcare Management - Garden Grove, Inc., Prime Healthcare Management - San Dimas, Inc., Prime Healthcare Management - Encino, Inc., Shasta Regional Medical Group, Inc., and Prime Healthcare Management - Shasta, Inc., have elected to be taxed under the provision of subchapter S of the Internal Revenue Code and state law. Under these provisions, the entities do not pay corporate income taxes on their taxable income. However, the entities are subject to California franchise taxes. In addition, the stockholders’ of the entities are liable for individual federal and state income taxes on taxable income. The Company disburses funds necessary to satisfy the stockholders’ tax liability. HMC Realty, LLC is a limited liability corporation and not subject to income taxes. The shareholders separately account for their share of pro-rata income or loss.

**Cash and cash equivalents** - The Company considers all highly liquid investments with an original maturity of three months or less when purchased to be cash equivalents.

**Note 2 - Organization and Summary of Significant Accounting Policies (continued)**

**Goodwill** - Management evaluates goodwill, at a minimum, on an annual basis and whenever events and changes in circumstances suggest that the carrying amount may not be recoverable. Impairment of goodwill is tested at the reporting unit level by comparing the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit. The fair value of the reporting units are estimated using a combination of the income or discounted cash flow approach and market approach, which uses comparable data. If the carrying amount of the reporting unit exceeds fair value, goodwill is considered impaired and a second step is performed to measure the amount of impairment loss, if any.

For the years ended December 31, 2011 and 2010, the management of the Company determined that an impairment did not exist. However, if estimates or the related assumptions change in the future, the Company may be required to record impairment charges to reduce the carrying amount of this asset.

**Fair value of financial instruments** - The Company's consolidated balance sheets include the following financial instruments: cash and cash equivalents, patient accounts receivable, notes receivable, accounts payable and accrued liabilities, and long-term liabilities. The Company considers the carrying amounts of current assets and liabilities in the consolidated balance sheets to approximate the fair value of these financial instruments and their expected realization. The carrying amount of notes receivable and long-term debt approximated their fair value, based on current market rates of instruments of the same risks and maturities.

**Deferred loan issuance costs** - Deferred loan issuance costs are amortized over the term of the loan (see Note 8).

**Charity care** - The Company provides care to patients who lack financial resources and are deemed to be medically indigent based on criteria established under the Company's charity care policy. This care is provided without charge or at amounts less than its established rates. Because the Company does not pursue collection of amounts determined to qualify as charity care, such amounts are not reported as revenue. The Company maintains records to identify and monitor the level of charity care provided. These records include the amount of direct and indirect costs for services and supplies furnished under its charity care policy. The direct and indirect costs related to this care totaled approximately $18,261,000 and $20,619,000 in 2011 and 2010, respectively. Direct and indirect costs for providing charity care are estimated by calculating a ratio of cost to gross charges and then multiplying that ratio by the gross uncompensated charges associated with providing care to charity patients. In addition, the Company provides services to other medically indigent patients under various state Medicaid programs. Such programs pay amounts that are less than the cost of the services provided to the recipients.

**Bad debt expense** - Effective December 31, 2011, management adopted ASU 2011-07, "Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities," which requires health care entities to present the provision for doubtful accounts relating to patient service revenue as a deduction from patient service revenue in the statements of operations rather than as an operating expense. All periods presented have been reclassified in accordance with the provisions of ASU 2011-07.

**Note 2 - Organization and Summary of Significant Accounting Policies (continued)**

**Allowance for Contractual Adjustments and Doubtful Accounts** - The Company's patient accounts receivable are reduced by allowances for contractual adjustments and doubtful accounts. In evaluating the collectibility of patient accounts receivable, the Company analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowances for both contractual adjustments and doubtful accounts and provision for bad debts. Management regularly reviews data about these major payor sources of revenue in evaluating the sufficiency of these allowances. For receivables associated with services provided to patients who have third-party coverage, the Company analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts, if necessary (for example, for expected uncollectible deductibles and copayments on accounts for which the third-party payor has not yet paid, or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely). For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the Company records a provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

The Company's allowance for doubtful accounts decreased from 7.7 percent of gross patient accounts receivable at December 31, 2010 to 6.8 percent of gross patient accounts receivable at December 31, 2011. In addition, the Company's writeoffs were approximately $266,378,000 and $267,740,000 for the years ended December 31, 2011 and 2010. The Company has not changed its charity care or uninsured discount policies during 2011 or 2010.

**Insurance claims** - In August 2010, Accounting Standards Update ("ASU") 2010-24 "Presentation of Insurance Claims and Related Insurance Recoveries" was released which provides further guidance on accounting by health care entities for medical malpractice claims and similar liabilities and their related anticipated insurance recoveries. The ASU specifies that a health care entity should not net insurance recoveries against a related claim liability. ASU 2010-24 becomes effective for all periods beginning after December 15, 2010. The adoption increased total assets and liabilities at December 31, 2011 and 2010 by $66,031,000 and $64,164,000, respectively. The early adoption had no impact on PHSI's operating results for the years ended December 31, 2011 and 2010.

**Reclassification** - Certain prior year amounts were reclassified to conform to the current year presentation. There was no change in reported net income or stockholders' equity related to these reclassifications.

**Note 2 - Organization and Summary of Significant Accounting Policies (continued)**

**Subsequent events** - Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are available to be issued. The Company recognizes in the consolidated financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing the consolidated financial statements. The Company's consolidated financial statements do not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date and before consolidated financial statements are available to be issued. The Company has evaluated subsequent events through May 1, 2012, which is the date the consolidated financial statements were available to be issued.

**Note 3 - Net Patient Service Revenue**

The Company has arrangements with third-party payors that provide for payments to the Company at amounts different from its established rates. A summary of the payment arrangements with major third-party payors are as follows:

**Medicare** - Inpatient acute-care services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Medicare reimburses the Company for covered outpatient services rendered to Medicare beneficiaries by way of an outpatient prospective payment system based on ambulatory payment classifications. The Company's classification of patients under the Medicare program and the appropriateness of their admissions are subject to an independent review.

Inpatient non-acute services, certain outpatient services, medical education costs, and defined capital costs related to Medicare beneficiaries are paid based, in part, on a cost reimbursement methodology. The Company is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports and audits thereof by the Medicare fiscal intermediary. The estimated amounts due to or from the program are reviewed and adjusted annually based on the status of such audits and any subsequent appeals. Differences between final settlements and amounts accrued in previous years are reported as adjustments to net patient service revenue in the year examination is substantially completed. These differences increased net patient service revenue by approximately $1,672,000 and $23,016,000 for the years ended December 31, 2011 and 2010, respectively. The Company does not believe that there are significant credit risks associated with this government agency.

**Note 3 - Net Patient Service Revenue (continued)**

**Medi-Cal** - Inpatient services rendered to Medi-Cal program beneficiaries are reimbursed under both contracted and non-contracted payment arrangements. Contracted hospitals are reimbursed at a prospectively determined negotiated per diem rate. Non-contracted hospitals are reimbursed using a cost reimbursement methodology. Interim payments are based on a cost to charge ratio with final settlement determined after submission of annual cost reports and audits thereof by the Department of Health Care Services (“DHCS”). The estimated amounts due to or from DHCS are reviewed and adjusted annually based on the status of such audits and any subsequent appeals. Differences between final settlements and amounts accrued in previous years are reported as adjustments to net patient service revenue in the year examination is substantially complete.

**Commercial Insurance, Health Maintenance Organizations, and Preferred Provider Organizations** - The Company has also entered into agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payment to the Company under these agreements includes prospectively determined rates per discharge, discounts from established charges and prospectively determined daily rates.

**Other** - The Company also provides its services to patients enrolled in programs of commercial insurance carriers, health maintenance organizations and preferred provider organizations under which the Company does not have agreements. The Company recognizes revenue for these patients based on its usual customary rates for these services adjusted for historical trends in the Company’s reimbursement for similar services.

Laws and regulations governing the third party payor arrangements are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

**Note 4 - Acquisitions and Dispositions**

During 2011 and 2010, the Company entered into the following acquisitions and dispositions. All acquisitions have been accounted for using the purchase method of accounting. Operating results for each of the acquisitions have been included in the accompanying consolidated financial statements from the date of acquisition. Operating results for the dispositions have been included in the accompanying consolidated financial statements through the date of disposition.

**Note 4 - Acquisitions and Dispositions (continued)**

Effective December 31, 2010, the Company distributed the ownership interest of Montclair Hospital Medical Center to Prime Healthcare Services Foundation, Inc. on behalf of its controlling stockholder. The following table summarizes the components of assets distributed:

| | |
|---|---|
| Cash and cash equivalents | $ 3,607,305 |
| Patient accounts receivable, net of allowance | 7,736,639 |
| Supplies inventory | 191,487 |
| Prepaid expenses and other current assets | 5,874,314 |
| Property and equipment | 25,635,844 |
| Estimated third-party payor settlements | 4,115,599 |
| | $47,161,188 |

In conjunction with the distribution of Montclair Hospital Medical Center, all of Montclair Hospital Medical Center’s liabilities were assumed by PHSI.

Effective December 31, 2011, the Company distributed the ownership interest of Sherman Oaks Hospital to Prime Healthcare Services Foundation, Inc. on behalf of its controlling stockholder. The following table summarizes the components of assets distributed:

| | |
|---|---|
| Cash and cash equivalents | $ 2,137,125 |
| Patient accounts receivable, net of allowance | 16,694,375 |
| Related party receivables | 16,870 |
| Estimated third-party payor settlements | 907,135 |
| Supplies inventory | 380,515 |
| Prepaid expenses and other current assets | 4,120,018 |
| Property and equipment | 31,749,471 |
| | $56,005,509 |

In conjunction with the distribution of Sherman Oaks Hospital, all of Sherman Oaks Hospital’s liabilities were assumed by PHSI.

**Note 4 - Acquisitions and Dispositions (continued)**

On November 17, 2010, the Company entered into an asset purchase agreement with Plymouth Health Investments LLC and a membership interest purchase agreement with Plymouth Health LLC. The business acquired is a provider of general acute care services, consistent with the Company's strategic growth plan. Pursuant to the agreements, the Company acquired all of the outstanding equity interests and certain real estate from Plymouth Health Investments, LLC, collectively Alvarado Hospital. The Company paid $55,000,000 in cash up front and an additional $1,200,000 subsequent to closing to reimburse the prior owners for their portion of the California Hospital Fee Program for a total of $56,200,000. The following table presents the allocation of the aggregate purchase price:

| | Allocation at November 17, 2010 |
|---|---|
| Cash and equivalents | $ 4,335,774 |
| Accounts receivable | 16,671,359 |
| Prepaids and other current assets | 2,400,752 |
| Supplies inventory | 982,977 |
| Land | 4,200,000 |
| Building and land improvements | 50,153,593 |
| Equipment and software | 13,303,960 |
| Liabilities | (22,546,362) |
| Gain on purchase | (13,272,876) |
| Net cash consideration | $ 56,229,177 |

In December 1, 2011 the Company acquired 34.82 percent equity interest in Harlingen Medical Center for total cash consideration of $7,000,000. The Company also acquired a 36.06 percent interest in HMC Realty, LLC the lessor of the hospital facility operated by Harlingen Medical Center for $2,000,000. In conjunction with the purchase of the interest in HMC Realty, LLC, Prime Healthcare Management, Inc. (see Note 2) purchased the outstanding notes payable secured by the Hospital Facility from GE Capital for $36,432,090. On December 15, 2011 the Company acquired an additional equity interest of 33.08 percent for cash consideration of $8,500,000. The total equity interest of 67.90 percent held by the Company constitutes control of Harlingen Medical Center as of December 15, 2011. The purchase of the outstanding notes payable and the 36.06 percent equity interest of HMC Realty, LLC constitutes control under ASC 810 (see Note 2).

**Note 4 - Acquisitions and Dispositions (continued)**

The following table presents the allocation of the aggregate purchase price:

| | Allocation at December 15, 2011 |
|---|---|
| Cash and equivalents | $ 5,858,642 |
| Accounts receivable | 9,200,000 |
| Third party settlements | 238,384 |
| Prepaids and other current assets | 573,058 |
| Supplies inventory | 2,536,254 |
| Building and land improvements | 57,000,000 |
| Equipment and software | 12,884,000 |
| Construction in progress | 602,937 |
| Other assets | 1,009,561 |
| Goodwill | 828,831 |
| Liabilities | (10,952,604) |
| Gain from acquisition | (4,608,751) |
| Non-controlling interest | (21,238,222) |
| Net cash consideration | $ 53,932,090 |

The operating results of Harlingen Medical Center and HMC Realty, LLC from the date of acquisition (December 15, 2011) through December 31, 2011 are not material.

**Note 5 - Concentration of Credit Risk**

Financial instruments which potentially subject the Company to significant concentrations of credit risk consist primarily of cash. The Company maintains cash in bank deposit accounts at high credit quality financial institutions. The balances, at times, may exceed federally insured limits. Management monitors the financial condition of these institutions on an ongoing basis and does not believe any significant credit risk exists as of December 31, 2011.

**Note 5 - Concentration of Credit Risk (continued)**

Patient accounts receivable at December 31, 2011 and 2010 are comprised of the following: government programs, primarily Medicare 30% and 31%; respectively, Medi-Cal 28% and 29%, respectively; healthcare maintenance and preferred provider organizations (managed care programs) 13% and 15%, respectively; and private pay and commercial insurance patients 29% and 25%, respectively. Management believes there is no credit risks associated with receivables from government programs. Receivables from managed care programs and others are from various payors who are subject to differing economic conditions and do not represent concentrated risks to the Company. Management continually monitors and adjusts the reserves associated with receivables, and does not require collateral. Normal estimation differences between subsequent cash collections on patent accounts receivable and net patient accounts receivable estimated in the prior year are reported as adjustments to net patient service revenue in the current period. These differences decreased net patient service revenue by approximately $34,194,000 and $1,500,000 for the years ended December 31, 2011 and 2010, respectively.

**Note 6 - Property and Equipment**

Property and equipment consist of the following at December 31:

| | 2011 | 2010 |
|---|---|---|
| Land | $ 42,715,973 | $ 42,612,568 |
| Buildings | 177,555,175 | 111,255,273 |
| Building improvements | 9,270,294 | 21,992,507 |
| Equipment | 197,782,080 | 176,221,157 |
| Construction in progress (estimated cost to complete at December 31, 2011 and 2010 is approximately $49,343,000 and $15,812,000, respectively) | 23,037,141 | 7,557,968 |
| | 450,360,663 | 359,639,473 |
| Accumulated depreciation and amortization | (111,047,261) | (97,018,732) |
| | $ 339,313,402 | $262,620,741 |

Gross property and equipment includes approximately $35,493,000 and $35,160,000 of equipment under capital lease arrangements as of December 31, 2011 and 2010, respectively. Related accumulated amortization totaled approximately $20,058,000 and $23,811,000 as of December 31, 2011 and 2010, respectively.

**Note 7 - Notes Receivable**

On various dates in 2011, the Company entered into three separate participation agreements in which Healthcare Finance Group, LLC assigned certain equipment loans receivable and security agreements to the Company that were due from Christ Hospital in exchange for $4,600,000. The loans accrue interest at LIBOR plus 4.13%. As of December 31, 2011 the amount owed to the Company by Christ Hospital was approximately $4,600,000.

On November 11, 2011 the Company entered into a sales and assignment agreement with Midcap Financial, LLC to acquire the rights, title, and privileges to certain notes receivable and credit agreements owed by Hawaii Medical Center for approximately $5,076,000. The reassigned note receivables had an aggregate maximum revolving principal of $29,000,000. The notes bear interest at a rate of 8% per year. For the year ended December 31, 2011 the amount owed to the Company by Hawaii Medical Center was approximately $4,226,000. The balance on the note was repaid in January 2012.

**Note 8 - Long-Term Debt**

During 2010, the Company entered into a credit agreement including Term Loan A and Term Loan B with Royal Bank of Canada (“RBC”). A portion of the total proceeds of $232,000,000 from Term Loan A and Term Loan B was used to pay off existing bank debt for various amounts totaling $130,400,000. Approximately $9,500,000 of deferred loan issuance costs were incurred relating to this credit agreement and are amortized over the term of the loans. The balance is included within other assets.

The Company’s Term Loan A and Term Loan B are subject to certain financial covenants including 1) interest expense coverage ratio of not less than 3.00 to 1.00; 2) total leverage ratio not to exceed 2.75 to 1.00 through September 30, 2012, 2.50 to 1.00 through September 30, 2014, and 2.25 to 1.00 thereafter; 3) minimum liquidity of at least $30,000,000; and 4) capital expenditures not exceeding the amount of $35,000,000 per fiscal year.

Long-term debt consists of the following as of December 31:

| | 2011 | 2010 |
|---|---|---|
| Term A Loan with Royal Bank of Canada, secured by all assets of the Company, payable in quarterly installments ranging from $900,000 to $3,600,000 with final payment on maturity of $45 million, plus interest at LIBOR (greater of 2% or average British Bankers Association Interest Settlement Rate) plus 4.25% on Eurodollar Loans or 3.25% on Alternate Base Rate Loans (6.25% at December 31, 2011) per annum, maturing in 2014. PHSI is required to maintain certain financial and non financial covenants relating to this loan. | $56,994,425 | $69,300,000 |

**Note 8 - Long-Term Debt (continued)**

| | 2011 | 2010 |
|---|---|---|
| Term B Loan with Royal Bank of Canada, secured by all assets of the Company, payable in quarterly installments of $400,000 plus interest at interest at LIBOR (greater of 2% or average British Bankers Association Interest Settlement Rate) plus 5.25% on Eurodollar Loans or 4.25% on Alternate Base Rate Loans (7.25% at December 31, 2011) per annum, maturing in 2015. PHSI is required to maintain certain financial and non financial covenants relating to this loan. | $139,555,575 | $158,800,000 |
| Term loan with Siemens Financial Services, secured by certain equipment of Prime Healthcare Air Transport LLC, payable in monthly installments of approximately $75,000 including interest at a fixed rate of 6.77% per annum, maturing in 2017. | 4,252,549 | 4,837,895 |
| Bank note payable, secured by certain real estate of Desert Valley Medical Group, bearing interest at 5.75% per annum, payable in monthly payments of $1,258, maturing in August 2024. | 128,923 | 135,853 |
| Note payable, secured by a vehicle, bearing interest at 3.90% per annum, payable in monthly payments of $1,131, maturing in July 2015. This note payable was paid off and closed in May 2011. | — | 62,264 |
| Note payable with Medical Properties Trust secured by certain property and equipment and lease deposits of Paradise Valley Hospital, bearing a fixed interest rate of 9.75% per annum as of December 31, 2011. Interest only payments due monthly, principal balance due at maturity on May 6, 2022. | 25,000,000 | 25,000,000 |
| Lines of credit with Healthcare Finance Group (“HFG”), secured by accounts receivable of Huntington Beach Hospital, La Palma Intercommunity Hospital and West Anaheim Medical Center, interest payable monthly at an annual rate of the greater of 2.75% or LIBOR + 3.50% (5.5% at December 31, 2011), maturing in November 2012. Under the terms of the agreements, the respective hospitals are required to maintain financial and non-financial covenants. At December 31, 2011, approximately $2,288,000, $1,700,000, and $3,848,000, respectively, were available under these lines. | 8,164,154 | 2,073,629 |

**Note 8 - Long-Term Debt (continued)**

| | 2011 | 2010 |
|---|---|---|
| Line of credit with HFG, secured by accounts receivable and inventory of Sherman Oaks Hospital, interest payable monthly at an annual rate of the greater for 2.75% or LIBOR + 3.00% (5.50% at December 31, 2010), maturing in February 2013. SOH is required to maintain certain financial and non-financial covenants at year end. This line of credit was repaid and closed in December 2011. | $ — | $ 516,231 |
| Line of credit with HFG, secured by accounts receivable and inventory of Chino Valley Medical Center, interest payable monthly at an annual rate of the greater of 2.75% or LIBOR + 2.50% (5.25% at December 31, 2011), maturing on April 30, 2012. Chino Valley Medical Center is required to maintain certain financial and non-financial covenants at year end. At December 31, 2011, approximately $4,697,000 was available under this line. | 3,303,163 | 500,000 |
| Line of credit with HFG, secured by accounts receivable and inventory of Paradise Valley Hospital, interest payable monthly at an annual rate of the greater for 2.75% or Libor + 2.50% (5.25% at December 31, 2011), maturing in December 2012. Paradise Valley Hospital is required to maintain certain financial & non-financial covenants at year end. At December 31, 2011, approximately $7,287,000 was available under this line. | 2,713,418 | 775,603 |
| | 240,112,207 | 262,001,475 |
| Less current portion | (23,164,358) | (11,014,600) |
| | $216,947,849 | $250,986,875 |

**Note 8 - Long-Term Debt (continued)**

Aggregate annual principal maturities of long-term debt for the five years subsequent to December 31, 2011 and thereafter, are as follows:

| Years ending December 31, | |
|---|---|
| 2012 | $ 23,164,358 |
| 2013 | 14,877,813 |
| 2014 | 39,969,487 |
| 2015 | 135,531,181 |
| 2016 | 829,657 |
| Thereafter | 25,739,711 |
| | $240,112,207 |

The lines of credit contain lockbox requirements and subjective acceleration clauses, therefore all amounts have been classified as current within the liabilities section of the consolidated balance sheet. The Company has other financial covenants with its other lenders.

**Note 9 - Interest Rate Swap**

In conjunction with the RBC Term B Loan, the Company entered into an interest rate swap and floor agreement with a commercial bank. The swap agreement serves to convert the underlying variable interest rates of the Term Loans. The swap has not been designated as an effective cash flow hedge for accounting purposes, therefore changes in the fair value of the swap are recorded as interest expense.

ASC 820-10 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants and the measurement date. ASC 820-10 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value: Level 1 - Quoted prices in active markets for identical assets or liabilities; Level 2 - Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

**Note 9 - Interest Rate Swap (continued)**

Interest rate swaps are valued using observable inputs, such as quotations received from the counterparty, dealers or brokers, whenever available and considered reliable. In instances where models are used, the value of the interest rate swap depends upon the contractual terms of, and specific risks inherent in, the instrument as well as the availability and reliability of observable inputs. Such inputs include market prices for reference securities, yield curves, credit curves, measures of volatility, prepayment rates, assumptions for nonperformance risk, and correlations of such inputs. The interest rate swap arrangements have inputs which can generally be corroborated by market data and are therefore classified within level 2. The fair value of the interest rate swap liability of approximately ($8,782,000] and ($6,440,000] and interest rate floor asset of $4,991,000 and $4,301,000 are included within long term liabilities and other assets, respectively, at December 31, 2011 and December 31, 2010, respectively. The net change in value of approximately $1,653,000 and $2,139,000 is included within interest expense for the years ended December 31, 2011 and December 31, 2010, respectively.

**Note 10 - Leases**

In May 2007, in connection with the acquisition of certain assets, Paradise Valley Hospital (PVH) sold the real estate and related hospital building acquired to a health care real estate investment trust (“the REIT”). As part of the sale, PVH leased back the real estate and hospital building (“leased property”) in a lease agreement which expires in May 2022. PVH has an option to extend the term of the lease for three additional five year periods. After ten years, or at the end of the lease term, PVH has the option to purchase the leased property for $23,000,000. If at the end of the lease term, including renewal terms, PVH does not exercise its option to purchase the leased property; PVH must pay the lessor a lease make up payment equal to the difference between the then fair market value of the leased property and $23,000,000. Due to the guarantee included in the lease, this transaction was recognized as a finance obligation. The proceeds of $23,000,000 were recorded as a sales lease-back liability on the consolidated balance sheets. The lease provides for a monthly base rent of $173,000 for the leased property, which is adjusted annually based on the change in the consumer price index.

**Note 10 - Leases (continued)**

In November 2007, in connection with the acquisition of certain assets, Centinela Hospital Medical Center sold the real estate and related hospital building acquired to the REIT. As part of the sale, Centinela Hospital Medical Center leased back the real estate and hospital building (“leased property”] in a lease agreement which expires in November 2022. Centinela Hospital Medical Center has an option to extend the term of the lease for three additional five year periods. After ten years, or at the end of the lease term, Centinela Hospital Medical Center has the option to purchase the leased property for $75,000,000. If at the end of the lease term, including renewal terms, Centinela Hospital Medical Center does not exercise its option to purchase the leased property; Centinela Hospital Medical Center must pay the lessor a lease make up payment equal to the difference between the then fair market value of the leased property and $75,000,000. Due to the guarantee included in the lease, this transaction was recognized as a finance obligation. The proceeds of $75,000,000 were recorded as a sales lease-back liability on the consolidated balance sheet The lease provides for a monthly base rent of $563,000 for the leased property, which is adjusted annually based on the change in the consumer price index. During 2010, in connection with the RBC refinancing transaction, the $75,000,000 was paid off and the lease was terminated.

In November 2008, in connection with the acquisition of certain assets, San Dimas Community Hospital sold the real estate and related hospital and medical office buildings acquired to the REIT. As part of the sale, San Dimas Community Hospital leased back the hospital and related land as well as the medical office buildings and the related land (“leased property”) which expires in November 2018. San Dimas Community Hospital has options to extend the terms of the leases for three additional five year periods. After ten years, or at the end of the lease term, San Dimas Community Hospital has the option to purchase the leased property for $13,000,000 for the hospital and related land and $7,000,000 for the medical office buildings and related land. If at the end of the lease term, including renewal terms, San Dimas Community Hospital does not exercise its option to purchase the leased property, San Dimas Community Hospital must pay to the lessor a lease make up payment equal to the difference between the then fair market value of the leased property and $13,000,000 and $7,000,000, for the hospital and medical office buildings, respectively. Due to the guarantee included in the lease, this transaction was recognized as a finance obligation. The proceeds of $13,000,000 and $7,000,000 were recorded as sale lease-back liabilities on the consolidated balance sheet. The lease provides for a monthly base rent of $114,000 and $61,000 for the hospital and related land and the medical office buildings and the related land, respectively, which is adjusted annually based on the change in the consumer price index.

**Note 10 - Leases (continued)**

In November 2008, in connection with the acquisition of certain assets, Garden Grove Hospital Medical Center sold the real estate and related hospital and medical office buildings acquired from Tenet to the REIT. As part of the sale, Garden Grove Hospital Medical Center leased back the hospital and related land as well as the medical office building and the related land ("leased property"] in a lease agreement which expires in November 2018. Garden Grove Hospital Medical Center has options to extend the terms of the leases for three additional five year periods. After ten years, or at the end of the lease term, Garden Grove Hospital Medical Center has the option to purchase the leased property for $16,250,000 for the hospital and related land and $8,750,000 for the medical office buildings and related land. If at the end of the lease term, including renewal terms, Garden Grove Hospital Medical Center does not exercise its option to purchase the leased property, Garden Grove Hospital Medical Center must pay to the lessor a lease make up payment equal to the difference between the then fair market value of the leased property and $16,250,000 and $8,750,000, respectively. Due to the guarantee included in the lease, this transaction was recognized as a finance obligation. The proceeds of $16,250,000 and $8,750,000 were recorded as sale lease-back liabilities on the consolidated balance sheet. The lease provides for a monthly base rent of $142,000 and $77,000 for the hospital and related land and the medical office building and the related land, respectively, which is adjusted annually based on the change in the consumer price index.

In February 2011, the Company agreed to sell the land and buildings acquired in the November 2010 Alvarado Hospital acquisition to the REIT. As part of the sale, Alvarado Hospital leased back the hospital and related land in a lease agreement which expires in February 2021. Alvarado Hospital has options to extend the terms of the lease for three additional five year periods. After ten years, or at the end of the lease term, Alvarado Hospital has the option to purchase the leased property for $70,000,000 for the hospital and related land. If at the end of the lease term, including renewal terms, Alvarado Hospital does not exercise its option to purchase the leased property, Alvarado Hospital must pay to the lessor a lease make up payment equal to the difference between the then fair market value of the leased property and $70,000,000. Due to the guarantee included in the lease, this transaction was recognized as a finance obligation. The proceeds of $70,000,000 will be recorded as a sale lease-back liability on the consolidated balance sheet. The lease provides for monthly base rent of approximately $607,000, which is adjusted annually based on the change in the consumer price index.

**Note 10 - Leases (continued)**

The Company's sales lease back liabilities consist of the following:

| Hospital | December 31, 2011 | December 31, 2010 |
|---|---|---|
| Paradise Valley Hospital | $ 23,000,000 | $23,000,000 |
| Alvarado Hospital | 70,000,000 | — |
| San Dimas Community Hospital | 13,000,000 | 13,000,000 |
| San Dimas Medical Office Building | 7,000,000 | 7,000,000 |
| Garden Grove Hospital Medical Center | 16,250,000 | 16,250,000 |
| Garden Grove Medical Office Building | 8,750,000 | 8,750,000 |
| | $138,000,000 | $68,000,000 |

The Company leases certain equipment under various non-cancelable operating and capital lease arrangements. Capital leases bear interest at rates ranging from 4.0% - 8.2%.

On February 12, 2007, the Company entered into a lease agreement with Prime A Investment LLC ("Prime A"), a related party under common ownership, to lease Desert Valley Hospital's hospital building and land. The initial lease term is 180 months (15 years). The lease provides for a monthly base rent of $525,000, which is adjusted annually based on the greater of 2% or the consumer price index. On December 28, 2009, Desert Valley Hospital and Prime A entered into an agreement with MPT to borrow up to $20 million to fund a hospital expansion project. Desert Valley Hospital makes monthly interest payments at the stated rate of 10.67% of the outstanding balance.

On March 1, 2007, the Company entered into a lease agreement with Prime A to lease Chino Valley Medical Center's hospital building and land. The initial lease term is 180 months (15 years). The lease provided for an initial monthly base rent of $375,000, which is adjusted annually based on the greater of 2% or the consumer price index. On January 1, 2009, the lease was amended to include an additional $300,000 per month in base rent.

In addition to the hospitals owned through the sale leaseback transactions and the related party leases for Desert Valley Hospital and Chino Valley Medical Center's hospital buildings, the Company also leases the hospital properties and related other medical office buildings for Huntington Beach Hospital, La Palma Intercommunity Hospital, West Anaheim Medical Center, and Shasta Regional Medical Center from the REIT. The significant terms of the leases are as follows:

The Huntington Beach Hospital facility lease expires in November 2021. The lease provides for monthly rent payments of approximately $99,000 at inception, which is adjusted annually based on the consumer price index.

**Note 10 - Leases (continued)**

The La Palma Intercommunity Hospital facility lease expires in November 2021. The lease provides for monthly rent payments of approximately $99,000 at inception, which is adjusted annually based on the consumer price index.

The West Anaheim Medical Center facility lease expires in November 2021. The lease provides for monthly rent payments of approximately $198,000 at inception, which is adjusted annually based on the consumer price index.

The Shasta Regional Medical Center facilities lease expires in November 2017. The lease provides for no rent for the first six months of the lease and monthly rent payments thereafter of approximately $486,000, which is adjusted annually based on the consumer price index.

Lease expense, consisting primarily of building rent and equipment leases, amounted to approximately $48,929,000 and $53,680,000 for the years ended December 31, 2011 and 2010 respectively.

Future minimum lease payments under non-cancelable operating leases (with initial or remaining lease terms in excess of one year] and future minimum capital lease payments as of December 31, 2011, are:

| Years ending December 31, | Capital Leases | Operating Lease Commitments | Sale Leaseback Commitments |
|---|---|---|---|
| 2012 | $10,567,895 | $ 42,942,681 | $ 14,690,121 |
| 2013 | 5,503,071 | 40,368,383 | 14,983,923 |
| 2014 | 3,416,112 | 38,974,460 | 15,283,601 |
| 2015 | 3,145,720 | 37,923,017 | 15,589,273 |
| 2016 | 219,568 | 38,128,301 | 15,901,059 |
| Thereafter | — | 176,097,559 | 206,945,528 |
| Total minimum payments | 22,852,366 | $374,434,401 | 283,393,505 |
| Less amounts representing interest | (1,757,192) | | (145,393,505) |
| | 21,095,174 | | 138,000,000 |
| Less current portion | (9,811,202) | | — |
| | $11,283,972 | | $ 138,000,000 |

**Note 11 - Professional Liability, Workers' Compensation, Healthcare and Earthquake Insurance**

Desert Valley Insurance, LTD. ("DVIL") and the Hartford Insurance Company provides professional liability, workers' compensation, healthcare and earthquake insurance coverage to the Company. DVIL is affiliated with the Company through common ownership. Under the terms of the agreement DVIL is obligated to insure each workers' compensation claim up to a maximum of $1,000,000 per claim. Losses in excess of $1,000,000 per claim are insured by the Hartford Insurance Company.

The Company also entered into an agreement with DVIL to provide medical malpractice liability insurance on a claims-made basis. Under this policy, insurance premiums cover only those claims actually reported during the policy term. Should the claims made policy not be renewed or replaced with equivalent insurance, claims related to occurrences during the policy term but reported subsequent to the policy's termination may be uninsured. Under the current policy, the medical groups of PHSI are covered up to a $1,000,000 per claim and $3,000,000 general aggregate limit with no amount deductible. The hospitals of PHSI are covered up to a $3,000,000 per claim and $15,000,000 general aggregate limit with no amount deductible. Excess losses up to an additional $7,000,000 per incident and $14,000,000 general aggregate will be insured by CNA Insurance Company. The Company renewed its claims made policy with DVIL for the next policy year ending December 31, 2012, under the same terms.

The Company also entered into an agreement with DVIL to provide earthquake and flood insurance. Under this policy insurance premiums cover only those claims which occurred during the policy term. Should the claims made policy not be renewed, or replaced with equivalent insurance, claims related to occurrences during the policy term but reported subsequent to the policy's termination may be uninsured under the current policy. The company is covered up to $30,000,000 per occurrence and in the aggregate subject to a five percent deductible. The company renewed its policy through June 2012.

The Company began a medical insurance program with DVIL for healthcare coverage for employees effective January 1, 2010. The Company has renewed this policy through December 31, 2012. Under the terms of the agreement, DVIL is obligated to insure each employee medical claim subject to a deductible of $500 per claim. Claims are adjudicated by an independent third party administrator.

Accounting principles generally accepted in the United States of America require that a health care facility recognize the estimated costs of malpractice claims in the period of the incident of malpractice, if it is reasonably possible that liabilities may be incurred and losses can be reasonably estimated. The Company recognized an estimated liability based upon its claims experience to cover the Company's potential exposure to incurred but unreported claims. The claim reserve is based on the best data available to the Company; however, the estimate is subject to a significant degree of inherent variability.

**Note 11 - Professional Liability, and Workers' Compensation, Healthcare and Earthquake Insurance (continued)**

The estimate is continually monitored and reviewed, and as the reserve is adjusted, the difference is reflected in current operations. While the ultimate amount of professional liability is dependent on future developments, management is of the opinion that the associated liabilities recognized in the accompanying consolidated financial statements is adequate to cover such claims. Management is aware of no potential professional liability claims whose settlement, if any, would have a material adverse effect on the Company's consolidated financial position.

The Company has evaluated whether they are required to consolidate DVIL in accordance with ASC 810 as of December 31, 2011, and has determined that DVIL is not a variable interest entity and the Company is not the primary beneficiary of DVIL. The Company is not exposed to the risk that it may be required to subsidize the losses, if any of DVIL. DVIL provides workers compensation, hospital and medical professional and general liability insurance. DVIL had total assets of approximately $188,000,000 and $193,000,000 as of December 31, 2011 and 2010, respectively. DVIL had total admitted assets of approximately $180,000,000 and $185,000,000 and total equity of approximately $32,000,000 and $35,000,000 as of December 31, 2011 and 2010, respectively.

**Note 12 - Related Party Transactions**

Notes receivable from related parties as of December 31:

| | 2011 | 2010 |
|---|---|---|
| Receivable from DVIL, related to expenses incurred in excess of deductibles and over-payment of health insurance premiums | $2,294,613 | $3,387,798 |
| Various | 60,605 | 221,472 |
| | $2,355,218 | $3,609,270 |

**Note 12 - Related Party Transactions (continued)**

The Company entered into agreements with DVIL to provide workers’ compensation and earthquake insurance coverage and commercial malpractice liability insurance on a claims-made basis (see Note 11). Effective January 1, 2010, the Company entered into an agreement with DVIL to provide healthcare insurance for employees (see Note 11). Insurance premiums paid to DVIL totaled $64,071,000 and $106,686,000 for the years ended December 31, 2011 and 2010, respectively. The Company receives reimbursement from DVIL for workers’ compensation insurance deductibles paid on behalf of DVIL. As of December 31, 2011 and 2010, the Company has recorded a prepaid insurance expense of approximately $24,875,000 and $23,631,000, respectively related to workers’ compensation and malpractice, and approximately $33,820,000 and $37,444,000, respectively, for healthcare coverage being provided by DVIL in future years.

The Company leases certain office buildings and parking facilities from Prime A (see Note 10). The leases are for five year terms. Rent expense incurred under these leases was approximately $1,960,000 and $6,184,000 for the years ended December 31, 2011 and 2010, respectively.

During 2007, the Company entered into agreements with Prime A to lease the hospital buildings and land at Desert Valley Hospital and Chino Valley Medical Center. The leases are for 15-year terms (see Note 10). Rent payments made under these leases totaled approximately $18,912,000 and $14,260,000 for the years ended December 31, 2011 and 2010, respectively.

During 2006 and through February 11, 2007, Desert Valley Hospital leased its facilities under a non- cancelable 15 year operating lease with Medical Properties Trust (“MPT”). On February 12, 2007, as provided by the lease agreement, the Desert Valley Hospital exercised its option to purchase the facility. Prime A Investments, LLC, an entity under common control, purchased the building for $28,000,000 which was based on a formula contained in the lease agreement with MPT. The purchase was financed by a first trust deed mortgage with MPT. The mortgage bears interest at 9% per annum and has an outstanding balance of $70,000,000 as of December 31, 2011. As additional security for the first trust deed mortgage, Desert Valley Hospital is listed as the co-borrower with Prime A. The first trust deed mortgage is not secured by any assets of Desert Valley Hospital. Management has a reasonable basis to believe that the fair market value of the real estate and building are sufficient to satisfy the first trust deed mortgage in the event of default and accordingly the likelihood of Desert Valley Hospital being required to satisfy the first trust deed mortgage is remote. As a result, the liability associated with the first trust deed mortgage was not recorded as a liability of PHSI in the consolidated financial statements as of December 31, 2011 and 2010.

**Note 12 - Related Party Transactions (continued)**

On December 28, 2009, Desert Valley Hospital and Prime A Investments, LLC, as co-borrowers, entered into a promissory note with MPT in the amount of $20,000,000 to fund the expansion of Desert Valley Hospital's facilities. The promissory note bears interest at 10.67% per annum and has an outstanding balance of $20,000,000 as of December 31, 2011. The first trust deed mortgage is not secured by any assets of Desert Valley Hospital. Management has a reasonable basis to believe that the fair market value of the hospital building expansion is sufficient to satisfy the promissory note in the event of default and accordingly the likelihood of Desert Valley Hospital being required to satisfy the promissory note is remote. As a result, the liability associated with the first trust deed mortgage was not recorded as a liability of PHSI in the consolidated financial statements as of December 31, 2011 and 2010.

During 2006 and through February 28, 2007, Chino Valley Medical Center leased its facilities under a non-cancelable 15-year operating lease with Medical Properties Trust ("MPT"). On March 1, 2007, as provided by the lease agreement, Chino Valley Medical Center exercised its option to purchase the facility. Prime A Investments, LLC, an entity under common control, purchased the building for $21,000,000 which was based on a formula contained in the lease agreement with MPT. The purchase was financed by a first trust deed mortgage with MPT. The mortgage bears interest at 9.73% per annum and has an outstanding balance of $50,000,000 as of December 31, 2011. As additional security for the first trust deed mortgage Chino Valley Medical Center is listed as the co-borrower with Prime A. The first trust deed mortgage is not secured by any assets of Chino Valley Medical Center. Management has a reasonable basis to believe that the fair market value of the real estate and building are sufficient to satisfy the first trust deed mortgage in the event of default and accordingly the likelihood of Chino Valley Medical Center being required to satisfy the first trust deed mortgage is remote. As a result, the liability associated with the first trust deed mortgage was not recorded as a liability of PHSI in the consolidated financial statements as of December 31, 2011 and 2010.

**Note 13 - Retirement Savings Plan**

The Company has a defined contribution pension plan covering substantially all of its employees. The Company's contribution to the plan is at the Company's discretion but limited to the maximum amount deductible for federal income tax purposes under the applicable Internal Revenue Code. During the years ended December 31, 2011 and 2010, the Company made contributions of $4,535,000 and $3,910,000, respectively, to the plan.

**Note 14 - Contingencies**

The Company is aware of certain asserted and unasserted legal claims arising in the normal course of business. While the outcomes cannot be determined at this time, it is management's opinion that the liability, if any, from these actions will not have a material adverse effect on the Company's financial position.

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time. These laws and regulations include, but are not limited to, accreditation, licensure, and government health care program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. 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 exclusion from government health care program participation, together with the imposition of significant fines and penalties, as well as significant repayment for past reimbursement for patient services received. While the Company is subject to similar regulatory review, there are no reviews currently underway and management believes that the outcome of any potential regulatory review will not have a material adverse effect on the Company's financial position.

Management believes that the Company is in compliance with government laws and regulations related to fraud and abuse and other applicable areas. Compliance with such laws and regulations can be subject to future governmental review and interpretation, as well as regulatory actions unknown or unasserted at this time.

**Note 15 - Legislation**

The Health Insurance Portability and Accountability Act ("HIPAA") was enacted on August 21, 1996, to assure health insurance portability, reduce health care fraud and abuse, guarantee security and privacy of health information and enforce standards for health information. Organizations were required to be in compliance with certain HIPAA privacy provisions beginning April 2003. Organizations are subject to significant fines and penalties if found not to be compliant with the provisions outlined in the regulations. Management believes that the Company is in compliance with HIPAA.

**Note 16 - Revenue from Governmental Programs**

**Hospital fee program** - The California Hospital Fee Program (the “Program”] was signed into law by the Governor of California and became effective on January 1, 2010. Amending legislation, to conform to changes requested by the Centers for Medicare and Medicaid Services (“CMS”] during the approval process, was signed into law on September 8, 2010 by the Governor of California. The Program required a “hospital fee” or “Quality Assurance Fee” (“QA Fee”) to be paid by certain hospitals to a State fund established to accumulate the assessed QA Fees and receive matching federal funds. QA Fees and corresponding matching federal funds are then paid to participating hospitals in two supplemental payment methodologies, a fee-for-service methodology and a managed care plan methodology.

CMS approved California’s State Plan Amendment and Waiver as of October 7, 2010 allowing the State to implement the QA Fee and the fee-for-service Supplemental Payment methodology of the legislation. Final approval of the program was effective December 30, 2010, and expense and revenue was recognized for retroactive periods in this period.

The period covered by the Program included a substantial retroactive federal matching component, including all or a portion of the 2008-2009 and 2009-2010 federal fiscal years. The QA Fee assessment and fee-for-service Supplemental Payments for approved periods were assessed and paid in installments through December 2010.

On May 2011, a Six-Month Hospital Fee Program covering the period January 1, 2011 through June 30, 2011 was initiated by the Department of Health Care Services (DHCS). CMS granted approval of the Fee- For-Service portion on December 2, 2011 and subsequently approved the Managed Care component on December 29, 2011. The QA Fee assessment and fee-for-service Supplemental Payments for the approved were assessed and paid in three installments with the first QA Fee assessment occurring on May 16, 2011 and the first corresponding fee-for-service Supplement Payment occurring on May 31, 2011. The second and third QA Fee assessment occurred on June 27, 2011 and August 29, 2011 respectively.

Based on formulas contained in the legislation as well as modeling done by the California Hospital Association, the Company recognized approximately $54,718,000 and $42,655,000 in revenue and $42,486,000 and $30,358,000 in General and Administrative expense related to the program for the years ended December 31, 2011 and December 31, 2010, respectively The Company has recorded a receivable of approximately $13,207,000 and $16,667,000 included within Estimated Third-Party Payor Settlements at December 31, 2011 and December 31, 2010, respectively.

**“Meaningful Use” incentives** - The American Recovery and Reinvestment Act of 2009 (ARRA) established incentive payments under the Medicare and Medi-Cal programs for certain professionals and hospitals that meaningfully use certified electronic health record (HER) technology. The Medicare incentive payments will be paid out to qualifying hospitals over four consecutive years on a transitional schedule. To qualify for Medicare incentives, hospitals and physicians must meet EHR “meaningful use” criteria that become more stringent over three stages that have yet to be finalized by the Centers for Medicare and Medicaid (CMS).

**Note 16 - Revenue from Governmental Programs (continued)**

Medicaid programs and payment schedules vary from state to state. The Medi-Cal programs requires hospitals to register for the program prior to 2016, to engage in efforts to adopt, implement or upgrade certified EHR technology in order to qualify for the initial year of participation, and to demonstrate meaningful use of certified EHR technology in order to qualify for payment for up to three additional years.

For the year ended December 31, 2011, the Company recorded $0 related to the Medicare program and $10,199,309 related to the Medi-Cal program in the consolidated statement of income, included in the other revenue line item. These incentives have been recognized following the grant accounting model, recognizing income ratably over the applicable reporting period as management becomes reasonably assured of meeting the required criteria. Subsequent changes to these estimates will be recognized in the consolidated statement of income in the period in which additional information is available. Such estimates are subject to audit by the federal government or its designee.

**Note 17 - Labor Relations**

**Centinela Hospital Medical Center** - SEIU-UHW represents approximately 800 employees at Centinela Hospital Medical Center and the California Nurses Association ("CNA"] represents approximately 400 registered nurses at Centinela Hospital Medical Center. The collective bargaining agreement with SEIU-UHW terminated on December 31, 2009 and efforts to negotiate the terms of a new collective bargaining agreement have been unsuccessful to date. The collective bargaining agreement with CNA terminated on or about March 31, 2010 subject to certain agreed upon extensions which are no longer in effect. Subject to certain exceptions, the terms and conditions of employment as of the date on which the collective bargaining agreements terminated remain in place until such time that new agreements are reached.

**Garden Grove Hospital Medical Center** - SEIU-UHW represents approximately 400 employees at Garden Grove Hospital Medical Center and the United Nurses Association of California ("UNAC"] represents approximately 250 registered nurses at Garden Grove Hospital Medical Center. The collective bargaining agreement with SEIU-UHW terminated on March 31, 2011. Subject to certain exceptions, the terms and conditions of employment as of the date on which the collective bargaining agreement with SEIU terminated remain in place until such time that a new agreement is reached. The collective bargaining agreement with UNAC remains in place until such time as an arbitrator issues a ruling on the terms of a new agreement.

**Alvarado Hospital** - CNA represents approximately 200 registered nurses at Alvarado Hospital. Although the term of the collective agreement expired on February 28, 2011, the collective bargaining agreement with CNA remains in place subject to either party's right to terminate the agreement by providing advance written notice of its intent to terminate the agreement. In March 2012, a new four- year agreement was signed with CNA.

**Note 17 - Labor Relations (continued)**

**Shasta Regional Medical Center** - Shasta Regional Medical Center received a petition from more than 50% of the 140 employees represented by SEIU-UHW indicating that they no longer wished to be represented by SEIU-UHW. Based on this petition, Shasta Regional Medical Center unilaterally withdrew recognition of SEIU-UHW on January 5, 2011.

**Note 18 - Subsequent Events**

On February 22, 2012, PHSI acquired substantially all of the assets of Roxborough Memorial Hospital (RMH] from Solis Healthcare in exchange for cash consideration of $23,500,000. RMH is a 140 licensed bed acute care hospital located in the suburbs of Philadelphia, Pennsylvania. The acquisition is consistent with the Company’s strategic growth plans.