

Financial Statements and Report of
Independent Certified Public Accountants

Bayhealth Medical Center, Inc.

June 30, 2017 and 2016

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Report of Independent Certified Public Accountants

Board of Directors
Bayhealth Medical Center, Inc.

We have audited the accompanying financial statements of Bayhealth Medical Center, Inc. (the Medical Center), which comprise the balance sheets as of June 30, 2017 and 2016, and the related statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the financial statements.

Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Bayhealth Medical Center, Inc. as of June 30, 2017 and 2016, and the results of its operations and changes in net assets and its cash flows for the years then ended, in accordance with accounting principles generally accepted in the United States of America.

Grant Thornton LLP

Philadelphia, Pennsylvania

September 27, 2017

Bayhealth Medical Center, Inc.

BALANCE SHEETS

June 30,

	<u>2017</u>	<u>2016</u>
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 26,267,030	\$ 43,904,846
Assets limited as to use, held by trustees	4,771,060	4,800,020
Patient accounts receivable, less allowance for uncollectibles of \$40,238,000 in 2017 and \$28,693,000 in 2016	61,532,615	59,875,577
Supplies	14,165,392	11,431,988
Prepaid expenses and other assets	<u>9,659,384</u>	<u>10,808,562</u>
Total current assets	116,395,481	130,820,993
Assets limited as to use		
Internally designated	249,260,861	255,257,055
Held by trustees	<u>12,407,469</u>	<u>11,379,479</u>
	261,668,330	266,636,534
Other investments	337,671,681	306,025,165
Prepaid expenses and other assets	8,111,050	5,094,250
Property and equipment, net	396,058,936	341,881,622
Beneficial interest in net assets of Bayhealth Foundation	16,499,669	13,751,289
Beneficial interest in perpetual trusts	<u>6,407,165</u>	<u>6,007,066</u>
TOTAL	<u>\$ 1,142,812,312</u>	<u>\$ 1,070,216,919</u>
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable and other accrued expenses	\$ 41,431,099	\$ 45,620,193
Construction and retainage payable	7,626,150	-
Accrued salaries, wages and benefits	42,883,956	49,209,447
Current portion of long-term debt	3,810,000	3,685,000
Accrued interest payable	3,183,702	3,188,876
Estimated settlements due to third-party payors	<u>10,298,827</u>	<u>12,263,451</u>
Total current liabilities	109,233,734	113,966,967
Construction and retainage payable	577,259	238,322
Interest rate swap	1,149,966	1,957,420
Accrued postretirement benefit costs	73,428,139	77,331,815
Estimated professional liability costs	9,873,205	10,976,750
Estimated workers' compensation costs	4,281,869	4,676,568
Long-term debt, net of current portion	<u>186,361,263</u>	<u>190,053,925</u>
Total liabilities	<u>384,905,435</u>	<u>399,201,767</u>
NET ASSETS		
Unrestricted	738,400,415	657,674,292
Temporarily restricted	13,099,297	7,333,794
Permanently restricted	<u>6,407,165</u>	<u>6,007,066</u>
Total net assets	<u>757,906,877</u>	<u>671,015,152</u>
TOTAL	<u>\$ 1,142,812,312</u>	<u>\$ 1,070,216,919</u>

The accompanying notes are an integral part of these statements.

STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS

For the year ended June 30,

	<u>2017</u>	<u>2016</u>
UNRESTRICTED NET ASSETS		
Revenues		
Net patient service revenue	\$ 606,456,958	\$ 583,783,128
Less: provision for bad debts	<u>(38,883,840)</u>	<u>(30,096,015)</u>
Net patient service revenue less provision for bad debts	567,573,118	553,687,113
Other revenue	<u>16,139,578</u>	<u>16,452,519</u>
Total revenues	583,712,696	570,139,632
Expenses		
Salaries and benefits	320,072,070	316,942,895
Supplies and other expenses	183,542,407	180,063,791
Interest	5,862,677	7,545,547
Depreciation and amortization	<u>37,034,037</u>	<u>29,204,562</u>
Total expenses	<u>546,511,191</u>	<u>533,756,795</u>
Operating income	37,201,505	36,382,837
Other		
Investment return, net	41,188,889	(3,430,529)
Change in fair value of interest rate swap	807,454	47,779
Change in beneficial interest in net assets of Bayhealth Foundation	(23,283)	(1,315,240)
Other, net	<u>304,983</u>	<u>400,176</u>
Total other	<u>42,278,043</u>	<u>(4,297,814)</u>
Excess of revenues over expenses	79,479,548	32,085,023
OTHER CHANGES IN UNRESTRICTED NET ASSETS		
Transfers from affiliate - Bayhealth Development Corp.	-	1,000,000
Other changes in benefit obligations	<u>1,246,575</u>	<u>(16,152,262)</u>
Increase in unrestricted net assets	<u>80,726,123</u>	<u>16,932,761</u>
TEMPORARILY RESTRICTED NET ASSETS		
Other	(2,580)	(1,797)
Change in beneficial interest in net assets of Bayhealth Foundation	<u>5,768,083</u>	<u>2,755,743</u>
Increase in temporarily restricted net assets	<u>5,765,503</u>	<u>2,753,946</u>
PERMANENTLY RESTRICTED NET ASSETS		
Change in beneficial interest in perpetual trusts	<u>400,099</u>	<u>(377,571)</u>
Increase (decrease) in permanently restricted net assets	<u>400,099</u>	<u>(377,571)</u>
INCREASE IN NET ASSETS	86,891,725	19,309,136
NET ASSETS, beginning of year	<u>671,015,152</u>	<u>651,706,016</u>
NET ASSETS, end of year	<u>\$ 757,906,877</u>	<u>\$ 671,015,152</u>

The accompanying notes are an integral part of these statements.

Bayhealth Medical Center, Inc.

STATEMENTS OF CASH FLOWS

For the year ended June 30,

	<u>2017</u>	<u>2016</u>
OPERATING ACTIVITIES		
Increase in net assets	\$ 86,891,725	\$ 19,309,136
Adjustments to reconcile increase in net assets to net cash provided by operating activities		
Other changes in benefit obligations	(1,246,575)	16,152,262
Change in fair value of interest rate swap	(807,454)	(47,779)
Net realized and unrealized (gains) losses on investments	(30,524,791)	14,370,976
Depreciation and amortization	37,034,037	29,204,562
Provision for bad debts	38,883,840	30,096,015
Change in beneficial interest in perpetual trusts	(400,099)	377,571
Change in beneficial interest in net assets of Bayhealth Foundation	(5,748,380)	(1,440,504)
Transfers from affiliate - Bayhealth Development Corp.	-	(1,000,000)
Changes in assets and liabilities		
Patient accounts receivable - net	(40,540,878)	(18,792,033)
Supplies	(2,733,404)	(545,937)
Prepaid expenses and other assets	151,380	(1,686,078)
Accounts payable and other accrued expenses	(3,759,591)	11,186,809
Accrued salaries, wages and benefits	(6,525,491)	4,129,177
Accrued interest payable	(5,174)	(16,897)
Estimated settlements due to third-party payors	(1,964,624)	1,263,423
Accrued postretirement benefit costs	(2,457,101)	(1,940,339)
Estimated professional liability costs	(1,407,531)	(1,295,187)
Estimated workers' compensation costs	(520,218)	48,384
	<u>64,319,671</u>	<u>99,373,561</u>
Net cash provided by operating activities before trading securities		
Change in investments - trading securities	<u>3,846,479</u>	<u>(18,308,417)</u>
Net cash provided by operating activities	<u>68,166,150</u>	<u>81,065,144</u>
INVESTING ACTIVITIES		
Capital expenditures, net	(83,128,926)	(66,024,957)
Distribution from Bayhealth Foundation	3,000,000	3,000,000
Investment unconsolidated joint ventures	(2,019,000)	-
Change in investments - other than trading securities	<u>28,960</u>	<u>25,520</u>
Net cash used in investing activities	<u>(82,118,966)</u>	<u>(62,999,437)</u>
FINANCING ACTIVITIES		
Transfers from affiliate - Bayhealth Development Corp.	-	1,000,000
Repayment of long-term debt	<u>(3,685,000)</u>	<u>(3,848,730)</u>
Net cash used in financing activities	<u>(3,685,000)</u>	<u>(2,848,730)</u>
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(17,637,816)	15,216,977
CASH AND CASH EQUIVALENTS - beginning of year	<u>43,904,846</u>	<u>28,687,869</u>
CASH AND CASH EQUIVALENTS - end of year	<u>\$ 26,267,030</u>	<u>\$ 43,904,846</u>
SUPPLEMENTAL CASH FLOW INFORMATION		
Cash paid for interest, net of amounts capitalized	<u>\$ 5,867,851</u>	<u>\$ 7,562,444</u>
SUPPLEMENTAL NONCASH INVESTING ACTIVITIES		
Increase (decrease) in accrual for the purchase of property and equipment	<u>\$ 7,965,088</u>	<u>\$ (887,193)</u>

The accompanying notes are an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS

June 30, 2017 and 2016

NOTE A - DESCRIPTION OF ORGANIZATION

Organization

Bayhealth Medical Center, Inc. (the Medical Center) is a not-for-profit, tax-exempt corporation under the control of its parent, Bayhealth, Inc., a not-for-profit Delaware corporation whose primary activities are to provide development and planning support to the Medical Center's two acute care hospitals: Kent General Hospital, Dover, Delaware, and Milford Memorial Hospital, Milford, Delaware. The Medical Center's primary service area includes Kent and portions of Sussex Counties in Delaware. Other entities affiliated with the Medical Center through common control by Bayhealth, Inc. are Bayhealth Foundation (the Foundation) and Bayhealth Development Corporation.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant management estimates and assumptions relate to the determination of allowance for doubtful accounts and contractual allowances for patient accounts receivable, estimated settlements with third-party payors, fair value of the interest rate swap, useful lives of property and equipment, actuarial estimates for the postretirement benefit plans, professional liability and workers' compensation costs, the assets retirement obligation and the reported fair values of certain of the Medical Center's assets and liabilities. Actual results could differ from those estimates.

2. Fair Value of Financial Instruments

Financial instruments consist of cash equivalents, patient accounts receivable, investments and assets limited as to use, beneficial interest in perpetual trusts, accounts payable and accrued expenses, interest rate swap agreements and long-term debt. The carrying amounts reported in the balance sheets for cash equivalents, patient accounts receivable, investments and assets limited as to use, beneficial interest in perpetual trusts, accounts payable and accrued expenses and the interest rate swap agreement approximate fair value. Management's estimate of the fair value of other financial instruments is described elsewhere in the notes to the financial statements.

3. Cash and Cash Equivalents

Cash and cash equivalents include short-term investments purchased with original maturities of three months or less and are stated at fair value.

The Medical Center routinely invests its surplus funds in repurchase agreements and money market funds. These funds generally are collateralized by, or invested in, highly liquid U.S. Government and agency obligations.

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

4. Allowance for Doubtful Accounts

The Medical Center provides an allowance for doubtful accounts for estimated losses resulting from the unwillingness or inability of patients to make payments for services. The allowance is determined by analyzing specific accounts and historical data and trends. Patient accounts receivable are charged off against the allowance for doubtful accounts when management determines that recovery is unlikely and the Medical Center ceases collection efforts.

In evaluating the collectability of accounts receivable, the Medical Center analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. Management reviews data about these major payor sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts. For receivables associated with services provided to patients who have third-party coverage, the Medical Center 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). For receivables associated with self-pay patients, the Medical Center records a significant provision for bad debts 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 billed rates and the amounts actually collected after all reasonable internal collection efforts have been exhausted is charged off against the allowance for doubtful accounts. During 2017 the allowance for doubtful accounts increased \$11,545,000 and 40%, due to an increase in overall volume and an increase in older self-pay balances for deductibles and co-insurance. These self-pay accounts were provided for in contractual allowances in prior years.

5. Supplies

Supplies are stated at the lower of cost or market. Cost is determined by using the first-in, first-out method of accounting.

6. Investments and Assets Limited as to Use

Investments in debt and equity securities are measured at fair value based on quoted market prices, if available, or estimated quoted market prices for similar securities. The Medical Center's investments are designated as trading securities, except for assets limited as to use under bond indentures - held by trustee, which are considered other-than-trading securities.

Investment income includes dividend and interest income; realized gains and losses and unrealized gains and losses on trading securities are included in other income as a component of excess of revenues over expenses unless such earnings are subject to donor-imposed restrictions; and unrealized gains and losses on other-than-trading securities are recorded as other changes in unrestricted net assets. Realized gains and losses for all investments are determined by the average cost method.

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Assets limited as to use include internally designated assets set aside by the Board of Directors (the Board) for future capital improvements, over which the Board retains control and may at its discretion subsequently use for other purposes, assets held by trustees under bond indenture agreements and assets held by a trustee under a malpractice funding arrangement. Amounts required to meet current liabilities have been classified as current assets in the accompanying balance sheets.

Investment securities, in general, are exposed to various risks, such as interest rate, credit and overall market volatility. Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such change could materially affect the amounts reported in the financial statements.

7. Beneficial Interest in Perpetual Trusts

The Medical Center is an irrevocable income beneficiary of certain perpetual trusts administered by independent trustees. Because the trusts are perpetual and the original corpus cannot be violated, these funds are reported at fair value based on the Medical Center's interest in the trusts, as permanently restricted net assets.

8. Property and Equipment

Property and equipment acquisitions are recorded at cost. Donated assets are recorded at their fair value at the date of donation. Depreciation is provided over the estimated useful life of each class of depreciable assets and is computed using the straight-line method. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. Interest in the amount of \$1,559,049 was capitalized for the year ended June 30, 2017.

Expenditures for renewals and improvements are charged to the property accounts. Replacements, maintenance and repairs that do not improve or extend the life of the respective assets are expensed when incurred. The Medical Center removes the cost and the related accumulated depreciation from the accounts for assets sold or retired, and resulting gains or losses are included in the accompanying statements of operations and changes in net assets.

Gifts of long-lived assets such as land, building or equipment are reported as unrestricted support, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and unspent gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

9. Deferred Financing Costs

Deferred financing costs are amortized over the life of the related bond issue. The accumulated amortization totaled \$813,933 and \$707,971 at June 30, 2017 and 2016, respectively.

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

10. Derivative Financial Instruments

The Medical Center recognizes all derivative financial instruments in the balance sheets at fair value. Management has determined that the interest rate swap agreement does not qualify as a hedge for financial reporting purposes. Consequently, the change in the fair value of the Medical Center's interest rate swap agreement is included in other income as a component of excess of revenues over expenses in the statements of operations and changes in net assets.

The interest rate swap agreement is used by the Medical Center to manage interest rate exposures and to hedge the changes in cash flows on variable rate revenue bonds. Derivative financial instruments involve, to a varying degree, elements of market and credit risk. The market risk associated with these instruments resulting from interest rate movements is expected to offset the market risk of the liability being hedged.

11. Estimated Professional Liability Costs

The reserve for estimated medical malpractice claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported.

12. Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the Medical Center has been limited by donors to a specific time period or purpose and amounted to \$44,065 and \$50,225 as of June 30, 2017 and 2016, respectively. In addition, a portion of the beneficial interest in the net assets of Bayhealth Foundation is included in temporarily restricted net assets based on the donors' intention. The temporarily restricted net assets are primarily restricted for capital acquisitions.

Permanently restricted net assets represent the Medical Center's beneficial interest in perpetual trusts. Income received from these trusts is unrestricted.

13. Excess of Revenues over Expenses

The statements of operations and changes in net assets include the excess of revenues over expenses. Changes in unrestricted net assets that are excluded from the excess of revenues over expenses, consistent with industry practice, are permanent transfers with affiliates and other changes in benefit obligations.

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

14. Donor-Restricted Gifts

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received, which is then treated as cost. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires - that is, when a stipulated time restriction ends or purpose restriction is accomplished - temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statements of operations and changes in net assets as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions, including amounts received and held by Bayhealth Foundation for the benefit of the Medical Center in the accompanying financial statements.

15. Net Patient Service Revenue

The Medical Center has agreements with third-party payors that provide for payments to the Medical Center at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges and per diem payments. 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 due to future audits, reviews and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, or investigations.

16. Electronic Health Records Incentives

The American Recovery and Reinvestment Act of 2009 provides for Medicare and Medicaid incentive payments for eligible hospitals and professionals that implement and achieve meaningful use of certified electronic health record (EHR) technology. For Medicare and Medicaid EHR incentive payments, the Medical Center utilizes a grant accounting model to recognize revenue. Under this accounting policy, EHR incentive payments are recognized as revenue when attestation that the EHR meaningful use criteria for the required period of time is demonstrated. Accordingly, the Medical Center recognized \$1,014,049 and \$2,259,771 of EHR revenue for the years ended June 30, 2017 and 2016, respectively. These amounts are included in other revenue on the statements of operations and changes in net assets.

The Medical Center's attestation of compliance with the meaningful use criteria is subject to audit by the federal government or its designee. Additionally, Medicare EHR incentive payments received are subject to retrospective adjustment.

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

17. Charity Care and Community Service

The Medical Center provides services to patients who meet the criteria of its charity service policy without charge or at amounts less than its established rates. Criteria for charity care include the patient's family income and net worth. Because the Medical Center does not pursue collection of amounts determined to qualify as charity care, they are not reported as net revenue.

The Medical Center maintains records to identify and monitor the level of charity care and community service it provides. These records include the amount of charges foregone based on established rates for services and supplies furnished under its charity care and community service policies and the number of patients receiving services under these policies. The Medical Center provided approximately \$7,744,000 and \$8,453,000 for the years ended June 30, 2017 and 2016, respectively, of charity care at full cost including direct and indirect costs, based on the actual charity population using a cost accounting system.

Additionally, the Medical Center provides a wide range of community services to the general public. These include but are not limited to the following: free health screenings for breast cancer, prostate cancer, skin cancer, diabetes, high blood pressure, high blood cholesterol, hearing loss and glaucoma; free educational programs on a variety of health care topics; health fairs and demonstrations; and networking and coordination of services for the needy, elderly, and disabled. These community services are offered at the Medical Center and at schools, businesses, and other locations throughout the Medical Center's service area.

The Medical Center also participates in the Medicaid program, which makes payment for services provided to financially needy patients at rates which are less than the established charges for such services.

18. Tax Status

The Medical Center is a Delaware nonprofit corporation and is exempt from federal income taxes pursuant to Section 501(c)(3) of the Internal Revenue Code.

The Medical Center follows the accounting guidance for uncertainties in income tax positions, which requires that a tax position be recognized or derecognized based on a "more likely than not" threshold. This applies to positions taken or expected to be taken in a tax return. The Medical Center does not believe its financial statements include any material uncertain tax positions. At June 30, 2017, the Medical Center's tax years ended June 30, 2014 through 2017 for the federal tax jurisdiction remain open.

19. Recently Adopted Accounting Pronouncement

During 2017, the Medical Center implemented Accounting Standards Update (ASU) 2015-03, *Simplifying the Presentation of Debt Issuance Costs*. This standard requires all costs incurred to issue debt be presented in the balance sheet as a direct deduction from the carrying value of the associate debt liability. As a result of the implementation of ASU 2015-03, deferred financing costs were presented as a direct reduction to long-term debt in the amount of \$1,885,781 and \$1,991,743 as of June 30, 2017 and 2016, respectively.

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

20. Pending Accounting Pronouncement

In May 2014, the Financial Accounting Standards Board (FASB) issued ASU 2014-09, *Revenue from Contracts with Customers*, to clarify the principles for recognizing revenue and to improve financial reporting by creating common revenue recognition guidance for U.S. GAAP and International Financial Reporting Standards. The core principle of the new guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for these goods and services. This standard is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early application is not permitted. An entity will apply the amendments in this update using either a full retrospective application, which applies the standard to each prior period presented, or under the modified retrospective application, in which an entity recognizes the cumulative effect of initially applying the new standard as an adjustment to the opening balance sheet of retained earnings at the date of initial application. Revenue in periods presented before that date will continue to be reported under guidance in effect before the change. Currently, the American Institute of Certified Public Accountants Healthcare Revenue Recognition Task Force is interpreting this standard and its effects on the health care industry.

In February 2016, the FASB issued ASU 2016-02, *Leases*, which requires that most leased assets be recognized on the balance sheet as assets and liabilities for the rights and obligations created by these leases. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018. Early application is permitted. An entity is required to apply the amendments in the standard under the modified retrospective transition approach. This approach includes a number of optional practical expedients, which are described in the final standard. Under these practical expedients, an organization will continue to account for leases that commence before the effective date in accordance with current U.S. GAAP, unless the lease is modified. However, lessees are required to recognize on the balance sheet leased assets and liabilities for operating leases at each reporting date.

In August 2016, the FASB issued ASU 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*. This standard intends to make certain improvements to the current reporting requirements for not-for-profit entities including: (1) the presentation for two classes of net assets at the end of the period, rather than the currently required three classes, as well as the annual change in each of the two classes; (2) the removal of the requirement to present or disclose the indirect method (reconciliation) when using the direct method for the statement of cash flows; and (3) the requirement to provide various enhanced disclosures relating to various not-for-profit specific topics. The new standard is effective for annual financial statements beginning after December 15, 2017.

In March 2017, the FASB issued ASU 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. This standard intends to make changes to employers that sponsor defined benefit pension and/or other postretirement benefit plans present the net periodic benefit cost in the income statement. Employers will present the service cost component of net periodic benefit cost in the same income statement line item(s) as other employee compensation costs arising from services rendered during the period. Only the service cost component will be eligible for capitalization in assets. Employers will present the other components of the net periodic benefit cost separately from the line item(s) that include(s) the service cost and outside of any subtotal of operating income, if one is presented. The new standard is effective for annual financial statements after December 15, 2017. Early application is permitted.

The Medical Center has not determined the impact of these new standards at this time.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE C - NET PATIENT SERVICE REVENUE

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

Medicare and Medicaid - Inpatient acute care services provided to Medicare and Medicaid 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. The Medical Center is reimbursed for certain cost-reimbursable items at a tentative rate, with final settlement determined after submission of annual cost reports by the Medical Center and audits thereof by Medicare. Medicare reimburses for most outpatient services on the Outpatient Prospective Payment System (OPPS). Medicaid outpatient services are paid based on a fee schedule. The Medical Center's Medicare cost reports have been audited and finalized by the Medicare fiscal intermediary through June 30, 2015 with the exception of the 2005 for Kent General Hospital and the 2007, 2009 and 2015 for Milford Memorial Hospital.

Blue Cross of Delaware - Inpatient and outpatient services rendered to Blue Cross subscribers are reimbursed primarily on a discount from established charge basis.

Net revenue from the Medicare and Medicaid programs accounted for approximately 35% and 20%, and 35% and 15%, respectively, of the Medical Center's net patient service revenue for the years ended June 30, 2017 and 2016, respectively. Laws and regulations governing the Medicare and Medicaid programs 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. For the years ended June 30, 2017 and 2016, net patient service revenue reflects net increases (decreases) of approximately \$3,268,000 and \$(665,000), respectively, due to final settlements or estimate changes.

The Medical Center has also entered into payment agreements with certain commercial insurance carriers, HMOs and preferred provider organizations. The basis for payment to the Medical Center under these agreements is primarily on a discount from established charges but also includes prospectively determined daily rates and prospectively determined fee schedules.

For uninsured patients who do not qualify for charity care, the Medical Center recognizes revenue based on established rates, subject to certain discounts as determined by the Medical Center. An estimated provision for bad debts is recorded that results in net patient service revenue being reported at the net amount expected to be received. The Medical Center has determined that patient service revenue is primarily recorded prior to assessing the patient's ability to pay and, as such, the entire provision for bad debts related to patient revenue is recorded as a deduction from patient service revenue in the accompanying statements of operations and changes in net assets.

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE C - NET PATIENT SERVICE REVENUE - Continued

Patient service revenue for both years ended June 30, 2017 and 2016, net of contractual allowances and discounts (but before the provision for bad debts), recognized in the period from these major payor sources based on primary insurance designation, is as follows:

	<u>Third-Party Payors</u>	<u>Self-Pay</u>	<u>Total All Payors</u>
Patient service revenue (net of contractual allowances and discounts)	93%	7%	<u>100%</u>

Deductibles and copayments under third-party payment programs within the third-party payor amount above are patients' responsibility, and the Medical Center considers these amounts in its determination of the provision for bad debts based on collection experience.

NOTE D - ASSETS LIMITED AS TO USE AND OTHER INVESTMENTS

Assets Limited as to Use

As of June 30, assets limited as to use consisted of:

	<u>2017</u>	<u>2016</u>
Internally designated		
Cash and cash equivalents	\$ 35,790,118	\$ 46,709,933
Government securities and corporate bonds	149,139,515	143,207,814
Equity securities	63,617,964	64,610,108
Accrued interest receivable	<u>713,264</u>	<u>729,200</u>
	<u>\$ 249,260,861</u>	<u>\$ 255,257,055</u>
Held by trustees		
Under bond indenture agreements		
Cash and cash equivalents	<u>\$ 5,031,091</u>	<u>\$ 5,000,051</u>
Under malpractice funding arrangement		
Cash and cash equivalents	920,199	844,142
Government securities and corporate bonds	4,464,974	4,330,683
Equity securities	<u>6,762,265</u>	<u>6,004,623</u>
	<u>12,147,438</u>	<u>11,179,448</u>
Total held by trustees	17,178,529	16,179,499
Less amounts required for current liabilities	<u>(4,771,060)</u>	<u>(4,800,020)</u>
	<u>\$ 12,407,469</u>	<u>\$ 11,379,479</u>

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE D - ASSETS LIMITED AS TO USE AND OTHER INVESTMENTS - Continued

Other Investments

Other investments at June 30, consisted of:

	<u>2017</u>	<u>2016</u>
Cash and cash equivalents	\$ 19,546,276	\$ 26,740,526
Government securities and corporate bonds	52,109,097	52,765,896
Equity securities	265,676,413	226,180,125
Accrued interest receivable	<u>339,895</u>	<u>338,618</u>
	<u>\$ 337,671,681</u>	<u>\$ 306,025,165</u>

Investment Return

The following schedule summarizes the Medical Center's investment return on assets limited as to use and other investments in other income on the statements of operations and changes in net assets for the years ended June 30:

	<u>2017</u>	<u>2016</u>
Investment return, net		
Interest and dividend income	\$ 12,503,291	\$ 12,390,638
Net realized gains on sales of securities	15,635,717	7,146,147
Change in net unrealized gains and losses on trading securities	14,889,074	(21,517,123)
Investment fees	<u>(1,839,193)</u>	<u>(1,450,191)</u>
	<u>\$ 41,188,889</u>	<u>\$ (3,430,529)</u>

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE E - PROPERTY AND EQUIPMENT

Property and equipment at June 30, consisted of:

	Estimated useful lives	<u>2017</u>	<u>2016</u>
Land		\$ 23,250,934	\$ 23,250,934
Land improvements	2 to 25 years	3,451,928	3,451,928
Buildings and improvements	5 to 40 years	273,669,972	274,843,736
Major movable and fixed equipment	3 to 20 years	<u>329,595,710</u>	<u>279,863,472</u>
		629,968,544	581,410,070
Construction in progress		<u>98,555,635</u>	<u>60,967,902</u>
		728,524,179	642,377,972
Less accumulated depreciation and amortization		<u>(332,465,243)</u>	<u>(300,496,350)</u>
		<u>\$ 396,058,936</u>	<u>\$ 341,881,622</u>

Depreciation and amortization expense for the years ended June 30, 2017 and 2016 totaled \$36,916,700 and \$29,087,224, respectively.

The Medical Center has a commitment for the construction of the Milford Memorial replacement hospital for \$227,389,293 as of June 30, 2017. The replacement hospital is currently under construction and is to be funded primarily through internally designated funds and is targeted to be completed by January 1, 2019.

NOTE F - LONG-TERM DEBT

Long-term debt as of June 30, consisted of:

	<u>2017</u>	<u>2016</u>
Project Revenue Bonds, Series 2009A, net of unamortized discount of \$647,956 and \$659,332 at June 30, 2017 and 2016, respectively	\$ 128,022,044	\$ 129,820,668
Variable Rate Refunding Revenue Bonds, Series 2012	<u>64,035,000</u>	<u>65,910,000</u>
	192,057,044	195,730,668
Less: Unamortized deferred financing costs, net	(1,885,781)	(1,991,743)
Current portion of long-term debt	<u>(3,810,000)</u>	<u>(3,685,000)</u>
	<u>\$ 186,361,263</u>	<u>\$ 190,053,925</u>

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE F - LONG-TERM DEBT - Continued

Fair Value

The Medical Center uses quoted market prices in estimating the fair value of the revenue bonds. The fair value of the Medical Center's long-term debt was \$198,841,000 and \$209,460,000 at June 30, 2017 and 2016, respectively.

Bonds

Series 2009A Bonds

In October 2009, the Medical Center entered into a financing arrangement with the Delaware Health Facilities Authority (the Authority) to issue \$138,490,000 Revenue Bonds, Bayhealth Medical Center Project, Series 2009A (Series 2009A). The Series 2009A bonds proceeds were used to extinguish the Series 1999 bonds and finance construction projects and renovations to the Medical Center.

The Series 2009A bonds include serial bonds bearing interest at rates ranging from 3.50% to 5.00%, with maturities annually through July 1, 2024, with principal payment ranging from \$250,000 to \$2,515,000. Term bonds, bearing interest at rates ranging from 4.50% to 5.00%, with maturities occurring on July 1, 2026 through July 1, 2044, are subject to mandatory sinking fund (principal) payments beginning July 1, 2025, ranging from \$1,170,000 to \$12,215,000 as set forth in the bond indenture agreements. The Series 2009A interest is payable semiannually on each January 1 and July 1.

Series 2012 Bonds

In June 2012, the Medical Center replaced the \$37,865,000 Variable Rate Refunding Revenue Bonds, Bayhealth Medical Center Project, Series 2009B (Series 2009B); and \$37,865,000 Variable Rate Refunding Revenue Bonds, Bayhealth Medical Center Project, Series 2009C (Series 2009C) with Series 2012 \$72,250,000 Variable Rate Refunding Bonds (Series 2012), that are Direct Bank Purchase Bonds with a national bank.

The Series 2012 bonds have annual sinking fund (principal) payments through July 1, 2039 ranging from \$1,940,000 to \$3,835,000 and bear interest based on a daily LIBOR rate (as defined) (1.29% and 0.90% at June 30, 2017 and 2016, respectively), payable monthly until July 1, 2019, at which time the Direct Bank Purchase Agreement expires and can either be extended or the bonds may be repurchased by the Medical Center. Interest was 1.29% and 0.90% at June 30, 2017 and 2016, respectively.

Under the terms of the Loan Agreement, the Medical Center has granted the Authority a mortgage lien on certain Medical Center facilities and has pledged its gross revenues, to the extent permitted by law, to the Authority. The Loan Agreement requires the Medical Center to maintain certain financial covenants, including a debt service coverage ratio and days cash on hand, as defined. At June 30, 2017 and 2016, the Medical Center has complied with all financial covenants in the Loan Agreement.

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE F - LONG-TERM DEBT - Continued

As of June 30, 2017, the principal payments on the Medical Center's long-term debt are as follows:

2018	\$ 3,810,000
2019	3,955,000
2020	4,115,000
2021	4,270,000
2022	4,425,000
Thereafter	<u>172,130,000</u>
	<u>\$ 192,705,000</u>

Interest Rate Swap

The Medical Center entered into an interest rate swap agreement in April 2003 to manage its exposure to fluctuations in interest rates relating to the Series 2003 bonds. The interest rate swap does not qualify for hedge accounting. The Series 2003 bonds were extinguished in October 2009; however, the interest rate swap agreement remains in place. The notional amount declines annually until the termination of the agreement on July 1, 2023. As of June 30, 2017 and 2016, the notional amount was \$16,035,000 and \$18,375,000, respectively. Under the agreement, the Medical Center receives a floating rate based on 68% of the 30-day U.S. dollar LIBOR rate and pays a fixed rate of 3.53% each month. The Medical Center recorded a noncash gain on the fair value of the swap of \$807,453 and \$47,779 for the years ended June 30, 2017 and 2016, respectively, with such amounts recorded as other income in the accompanying statements of operations and changes in net assets. The Medical Center has recorded the fair value of the interest rate swap as a liability of \$1,149,966 and \$1,957,420 at June 30, 2017 and 2016, respectively.

The Medical Center has established policies and procedures to limit the potential for counterparty credit risk, including establishing limits for credit exposure and continually assessing the creditworthiness of counterparties. As a matter of practice, the Medical Center will enter into transactions only with counterparties whose obligations are rated "A-" or above as rated by Standard & Poor's, or "A3" or above as rated by Moody's.

The Medical Center's exposure to credit risk, associated with its derivative financial instruments, is measured on an individual counterparty basis, as well as by groups of counterparties that share similar attributes. As of September 27, 2017 the Medical Center was not exposed to any risk of loss.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE G - POSTRETIREMENT BENEFIT PLANS

The Medical Center sponsors a noncontributory defined benefit pension plan (Pension Plan), covering substantially all employees, which was frozen for all participants effective January 1, 2008, except those whose age and years of vesting service total 65 or more as of December 31, 2007. These grandfathered participants will continue to add to the Pension Plan benefits in the future based on current plan provisions. For all other employees, Pension Plan benefits will not increase after December 31, 2007. The Medical Center's policy is to fund benefit costs accrued subject to limitations under the Employee Retirement Income Security Act of 1974. The actuarial cost method used to compute funding levels is the Projected Unit Credit Method. The mortality table used for projecting the benefit obligations is the RP-2014 Generational Mortality Table with annual updates for projected improvements.

In addition, the Medical Center provides certain reimbursement for health care benefits for eligible retirees (Other benefits). Certain employees who retire at age 65, or at age 55 with 10 consecutive years of service, and who are insured under the Medical Center's health insurance plan while an active employee, are eligible for coverage. Effective June 30, 2012, the Medical Center revised its assumption related to the percentage of future retirees that elect coverage and continue to elect coverage post-age 65 based on the updated historical experience. Effective January 1, 2013, the other benefit plans were amended to exclude all new hires, including rehires.

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE G - POSTRETIREMENT BENEFIT PLANS - Continued

The following table summarizes information about the benefit plans:

	Pension benefits		Other benefits	
	June 30			
	2017	2016	2017	2016
Accumulated benefit obligation	\$ <u>214,138,234</u>	\$ <u>213,086,234</u>	\$ <u>N/A</u>	\$ <u>N/A</u>
Change in benefit obligation				
Benefit obligation at beginning of year	\$ 216,384,468	\$ 196,396,456	\$ 14,710,379	\$ 13,634,964
Service cost	1,954,757	1,938,293	393,826	444,050
Interest cost	8,140,398	8,763,882	510,921	575,806
Actuarial (gain) loss	(1,151,737)	16,137,945	3,946,357	1,033,362
Benefits paid	<u>(7,456,176)</u>	<u>(6,852,108)</u>	<u>(967,284)</u>	<u>(977,803)</u>
Benefit obligation at end of year	<u>217,871,710</u>	<u>216,384,468</u>	<u>18,594,199</u>	<u>14,710,379</u>
Change in plan assets				
Fair value of the plan assets at beginning of year	152,723,032	145,851,528	-	-
Actual return on plan assets	11,529,750	8,723,612	-	-
Contributions by the Medical Center	5,000,000	5,000,000	967,284	977,803
Benefits paid	<u>(7,456,176)</u>	<u>(6,852,108)</u>	<u>(967,284)</u>	<u>(977,803)</u>
Fair value of the plan assets at end of year	<u>161,796,606</u>	<u>152,723,032</u>	<u>-</u>	<u>-</u>
Funded status at year end	\$ <u>(56,075,104)</u>	\$ <u>(63,661,436)</u>	\$ <u>(18,594,199)</u>	\$ <u>(14,710,379)</u>
Net amounts recognized in the balance sheets consist of				
Current liabilities, as accrued salaries, wages and benefits	\$ -	\$ -	\$ (1,241,164)	\$ (1,040,000)
Noncurrent liabilities	<u>(56,075,104)</u>	<u>(63,661,436)</u>	<u>(17,353,035)</u>	<u>(13,670,379)</u>
Accrued retirement benefits	\$ <u>(56,075,104)</u>	\$ <u>(63,661,436)</u>	\$ <u>(18,594,199)</u>	\$ <u>(14,710,379)</u>
Amounts recognized in unrestricted net assets but not yet recognized in net periodic benefit costs consist of				
Net actuarial loss	\$ 83,736,778	\$ 88,939,636	\$ 6,501,813	\$ 2,634,740
Prior service cost (credit)	<u>-</u>	<u>-</u>	<u>(818,951)</u>	<u>(908,161)</u>
	\$ <u>83,736,778</u>	\$ <u>88,939,636</u>	\$ <u>5,682,862</u>	\$ <u>1,726,579</u>

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE G - POSTRETIREMENT BENEFIT PLANS - Continued

	Pension benefits		Other benefits	
	June 30			
	2017	2016	2017	2016
Components of net periodic benefit cost				
Service cost	\$ 1,954,757	\$ 1,938,293	\$ 393,826	\$ 444,050
Interest cost	8,140,398	8,763,882	510,921	575,806
Expected return on plan assets	(9,753,570)	(9,342,681)	-	-
Amortization of prior service cost (credit)	-	8,398	(89,210)	(89,210)
Amortization of actuarial loss	<u>2,274,941</u>	<u>1,696,901</u>	<u>79,284</u>	<u>22,025</u>
	2,616,526	3,064,793	894,821	952,671
Other changes in benefit obligations recognized in other changes in unrestricted net assets				
Prior service (cost) credit	-	(8,398)	89,210	89,210
Net (gain) loss	<u>(5,202,858)</u>	<u>15,060,113</u>	<u>3,867,073</u>	<u>1,011,337</u>
	<u>(5,202,858)</u>	<u>15,051,715</u>	<u>3,956,283</u>	<u>1,100,547</u>
Total recognized in net benefit cost and other changes in unrestricted net assets	<u>\$ (2,586,332)</u>	<u>\$ 18,116,508</u>	<u>\$ 4,851,104</u>	<u>\$ 2,053,218</u>

At June 30, 2017, the expected estimated amount from unrestricted net assets into net periodic benefit cost for the next year is:

	Pension benefits	Other benefits
Net actuarial loss	\$ 2,100,000	\$ 386,866
Prior service credit	-	(89,210)
	<u>\$ 2,100,000</u>	<u>\$ 297,656</u>

	Pension benefits		Other benefits	
	June 30			
	2017	2016	2017	2016
Weighted-average assumptions used to determine benefit obligations were				
Discount rate	3.93%	3.82%	3.84%	3.65%
Rate of compensation increase	3.00%	3.00%	N/A	N/A
Measurement date	June 30	June 30	June 30	June 30

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE G - POSTRETIREMENT BENEFIT PLANS - Continued

	<u>Pension benefits</u>		<u>Other benefits</u>	
	<u>June 30</u>			
	<u>2017</u>	<u>2016</u>	<u>2017</u>	<u>2016</u>
Weighted-average assumptions used to determine net periodic benefit costs were				
Discount rate	3.82%	4.58%	3.65%	4.30%
Expected long-term return on plan assets	6.50%	6.50%	N/A	N/A
Rate of compensation increase	3.00%	3.00%	N/A	N/A

The expected long-term rate of return on the Pension benefits' total assets is developed based on applying historical average total returns by asset class to the Pension benefits' current asset allocation.

The current health care cost trend rates used to measure the future benefits under the postretirement health care plans are: (1) 8% for pre-65 year old retirees, decreasing to 5% by 2021 and remaining at that level thereafter; and (2) 7.6% for retirees age 65 and older, decreasing to 5% by 2019 and remaining at that level thereafter. A one percentage-point change in assumed health-care cost trend rates would have the following effects on the year ended June 30, 2017:

	<u>1% increase</u>	<u>1% (decrease)</u>
Incremental effect on total service and interest cost components of benefit cost	\$ 37,910	\$ (32,184)
Incremental effect on postretirement benefit obligation	\$ 410,618	\$ (354,876)

The Pension benefits' weighted average asset allocation as of the measurement dates of June 30, 2017 and 2016, by asset category, follows:

	<u>2017</u>	<u>2016</u>
Asset category		
Cash and cash equivalents	5%	4%
Fixed income	44	45
Equity securities	<u>51</u>	<u>51</u>
Total	<u>100%</u>	<u>100%</u>

The target asset allocation is 60% in equity securities and 40% in fixed income.

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE G - POSTRETIREMENT BENEFIT PLANS - Continued

Fair Value of the Plan Assets

The following fair value hierarchy table presents information about each major category of the Pension benefits' financial assets measured at fair value using the market approach on a recurring basis as of June 30, 2017 and 2016:

	<u>Fair value measurement at report date using</u>			
	<u>Total</u>	<u>Quoted prices in active markets for identical assets (Level 1)</u>	<u>Significant other observable inputs (Level 2)</u>	<u>Significant unobservable inputs (Level 3)</u>
<u>2017</u>				
Cash and cash equivalents	\$ 8,893,185	\$ 8,893,185	\$ -	\$ -
Fixed income ^(a)	70,754,518	-	70,754,518	-
Equity securities ^(b)	<u>82,148,903</u>	<u>82,148,903</u>	<u>-</u>	<u>-</u>
	<u>\$ 161,796,606</u>	<u>\$ 91,042,088</u>	<u>\$ 70,754,518</u>	<u>\$ -</u>
<u>2016</u>				
Cash and cash equivalents	\$ 6,111,720	\$ 6,111,720	\$ -	\$ -
Fixed income ^(a)	68,437,416	-	68,437,416	-
Equity securities ^(b)	<u>78,173,896</u>	<u>78,173,896</u>	<u>-</u>	<u>-</u>
	<u>\$ 152,723,032</u>	<u>\$ 84,285,616</u>	<u>\$ 68,437,416</u>	<u>\$ -</u>

^(a) Comprised of investment grade bonds of U.S. issuers from various industries and a commingled trust fund.

^(b) Comprised of mutual funds investing in at least 90% of assets in common stock of companies with large market capitalizations similar to companies in the Standard & Poor's (S&P) 500 Index.

Investment Strategies

The funding obligations of the Pension benefits are long-term in nature; consequently, the investment of the Pension benefits' assets should have a long-term focus. The Pension benefits' assets are invested in accordance with sound investment practices that emphasize long-term fundamentals. The investment objectives for the plan's assets are:

- To achieve a positive rate of return over the long term that significantly contributes to meeting the Pension benefits' obligations, including actuarial interest and benefit payment obligations;

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE G - POSTRETIREMENT BENEFIT PLANS - Continued

- To earn long-term returns that keep pace with or exceed the long-run inflation rate;
- To diversify the Pension benefits' assets in order to reduce the risk of wide swings in market value from year to year, or of incurring large losses; and
- To achieve investment results over the long term that compare favorably with those of other benefit plans and of appropriate market indices.

It is expected that these objectives can be obtained through a well-diversified portfolio structure in a manner consistent with this investment policy.

Cash Flows

The Medical Center expects to contribute \$8,000,000 to the Pension Plan and \$1,240,000 to the Other benefits for the year ending June 30, 2018. The following benefit payments, which reflect expected future service, as appropriate, are expected to be made in future years:

<u>Year ending June 30,</u>	<u>Pension</u> <u>benefits</u>	<u>Other</u> <u>benefits</u>
2018	\$ 9,458,000	\$ 1,240,000
2019	10,155,000	1,310,000
2020	10,875,000	1,350,000
2021	11,597,000	1,350,000
2022	12,165,000	1,370,000
2023-2027	66,243,000	5,890,000

The Medical Center also offers a defined contribution savings plan to all full-time and part-time employees of the Medical Center. The Medical Center matches participant contributions for active participants as of December 31, who have completed at least 1,000 hours of service during the calendar year. The match is 50% of the first 4% of compensation. Effective on January 1, 2008, grandfathered participants will continue to receive a match of 50% of the first 4% of compensation, and for non-grandfathered participants, 50% of the first 6% of compensation. Additionally, non-grandfathered participants also receive a 3% contribution of compensation. The Medical Center's expense for the defined contribution savings plan for the years ended June 30, 2017 and 2016 was \$9,664,439 and \$10,615,916, respectively.

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE H - ESTIMATED INSURANCE LIABILITY COSTS

Medical Professional Liability Insurance

The Medical Center maintains medical malpractice insurance coverage under an annual claims-made policy with a deductible amount of \$3,000,000 on a per-claim basis and \$9,000,000 in the aggregate. The Medical Center provides for estimated losses which have been reported and losses which have been incurred but not reported. At June 30, 2017 and 2016, the malpractice claims liability totaled \$11,230,335 and \$12,554,994, respectively, including the estimated current portion of this liability, totaling \$1,357,130 and \$1,578,244 reported in accounts payable and other accrued expenses.

Workers' Compensation Insurance

The Medical Center has a self-insured workers' compensation program subject to a self-insured retention of \$800,000 per claim for the years ended June 30, 2017 and 2016. Claims exceeding the self-insured retention are covered under an excess insurance policy, the maximum limit of indemnity is statutory and the employers' liability maximum limit of indemnity per occurrence and aggregate is \$1,000,000 for 2017 and 2016. At June 30, 2017 and 2016, the workers' compensation liability totaled \$5,529,210 and \$6,049,428, respectively, including the estimated current portion of this liability, totaling \$1,247,341 and \$1,372,860, respectively, reported in accounts payable and other accrued expenses.

NOTE I - COMMITMENTS AND CONTINGENCIES

Litigation

The Medical Center is involved in litigation and regulatory investigations arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without a material adverse effect on the Medical Center's financial position or results of operations.

Operating Leases

The Medical Center leases equipment through lease agreements expiring on various dates through June 2025. Certain of these leases contain options to extend the lease terms. Lease expense for the years ended June 30, 2017 and 2016 was \$3,489,526 and \$2,717,264, respectively. Future minimum lease payments are as follows for the years ending June 30:

2018	\$ 3,264,367
2019	2,181,077
2020	1,924,963
2021	1,752,915
2022	1,165,188
Thereafter	<u>1,700,135</u>
	<u>\$ 11,988,645</u>

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE J - CONCENTRATIONS OF CREDIT RISK

The Medical Center grants credit without collateral to patients, most of whom are local residents and are insured under third-party agreements. The mix of net accounts receivable from patients and third-party payors at June 30, 2017 and 2016 was as follows:

	<u>2017</u>	<u>2016</u>
Medicare	29%	23%
Blue Cross	12	18
Medicaid	20	23
Self-pay	16	9
Workers' compensation	3	8
Commercial and other	<u>20</u>	<u>19</u>
Total	<u>100%</u>	<u>100%</u>

In addition, the Medical Center invests its cash and cash equivalents primarily with banks and financial institutions. These deposits may be in excess of federally insured limits. Management believes that the credit risk related to these deposits is minimal.

NOTE K - FUNCTIONAL EXPENSES

The Medical Center provides general health-care services to residents within its geographic location. Expenses related to providing these services for the years ended June 30, 2017 and 2016 are as follows:

	<u>2017</u>	<u>2016</u>
Healthcare services	\$ 380,798,194	\$ 369,331,149
General and administrative services	<u>165,712,997</u>	<u>164,425,646</u>
	<u>\$ 546,511,191</u>	<u>\$ 533,756,795</u>

NOTE L - FAIR VALUE OF FINANCIAL INSTRUMENTS

The Medical Center measures fair value as the price that would be received to sell an asset or paid to transfer a liability (the exit price) in an orderly transaction between market participants at the measurement date. The accounting guidance outlines a valuation framework and creates a fair value hierarchy in order to increase the consistency and comparability of fair value measurements and the related disclosures.

The fair value hierarchy is broken down into three levels based on the source of inputs: Level 1 - defined as observable inputs such as quoted prices in active markets; Level 2 - defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3 - defined as unobservable inputs in which little or no market data exists, therefore, requiring an entity to develop its own assumptions.

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE L - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued

In determining fair value, the Medical Center uses the market approach, which utilizes prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

In determining fair value, the Medical Center uses quoted prices and observable inputs. Observable inputs are inputs that market participants would use in pricing the assets or liabilities based on market data obtained from sources independent of the Medical Center.

Financial assets and liabilities carried at fair value are classified in the table below:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<u>June 30, 2017</u>				
Assets				
Cash and cash equivalents	\$ 88,607,873	\$ -	\$ -	\$ 88,607,873
Government securities and corporate bonds	-	205,713,586	-	205,713,586
Equity securities	336,056,642	-	-	336,056,642
Beneficial interest in perpetual trusts	<u>-</u>	<u>-</u>	<u>6,407,165</u>	<u>6,407,165</u>
Total assets	<u>\$ 424,664,515</u>	<u>\$ 205,713,586</u>	<u>\$ 6,407,165</u>	<u>\$ 636,785,266</u>
Liabilities				
Interest rate swap	<u>\$ -</u>	<u>\$ 1,149,966</u>	<u>\$ -</u>	<u>\$ 1,149,966</u>
Total liabilities	<u>\$ -</u>	<u>\$ 1,149,966</u>	<u>\$ -</u>	<u>\$ 1,149,966</u>
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<u>June 30, 2016</u>				
Assets				
Cash and cash equivalents	\$ 123,541,861	\$ -	\$ -	\$ 123,541,861
Government securities and corporate bonds	-	200,304,393	-	200,304,393
Equity securities	296,452,493	-	-	296,452,493
Beneficial interest in perpetual trusts	<u>-</u>	<u>-</u>	<u>6,007,066</u>	<u>6,007,066</u>
Total assets	<u>\$ 419,994,354</u>	<u>\$ 200,304,393</u>	<u>\$ 6,007,066</u>	<u>\$ 626,305,813</u>
Liabilities				
Interest rate swap	<u>\$ -</u>	<u>\$ 1,957,420</u>	<u>\$ -</u>	<u>\$ 1,957,420</u>
Total liabilities	<u>\$ -</u>	<u>\$ 1,957,420</u>	<u>\$ -</u>	<u>\$ 1,957,420</u>

(Continued)

NOTES TO FINANCIAL STATEMENTS - CONTINUED

June 30, 2017 and 2016

NOTE L - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued

Net unrealized gains (losses) on the Level 3 assets were \$400,099 and \$(377,571) for the years ended June 30, 2017 and 2016, respectively.

NOTE M - SUBSEQUENT EVENTS

The Medical Center evaluated its June 30, 2017 financial statements for subsequent events through September 27, 2017, the date the financial statements were available to be issued. The Medical Center is not aware of any subsequent events which would require recognition or disclosure in the financial statements.