



Financial Statements and Report of  
Independent Certified Public Accountants

**Bayhealth Medical Center, Inc.**

June 30, 2018 and 2017



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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, 2018 and 2017, 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, 2018 and 2017, 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.

A handwritten signature in black ink that reads "Grant Thornton LLP". The signature is written in a cursive, flowing style.

Philadelphia, Pennsylvania

October 10, 2018

Bayhealth Medical Center, Inc.

**BALANCE SHEETS**

June 30,

	<u>2018</u>	<u>2017</u>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 29,188,522	\$ 26,267,030
Assets limited as to use	15,270,214	12,397,210
Patient accounts receivable, less allowance for uncollectibles of \$48,104,000 in 2018 and \$40,238,000 in 2017	66,719,865	61,532,615
Supplies	14,044,771	14,165,392
Prepaid expenses and other assets	<u>10,160,797</u>	<u>9,659,384</u>
Total current assets	135,384,169	124,021,631
Assets limited as to use		
Internally designated	176,474,734	241,634,711
Held by trustees	<u>14,876,782</u>	<u>12,407,469</u>
	191,351,516	254,042,180
Other investments	353,144,569	337,671,681
Prepaid expenses and other assets	10,181,064	8,111,050
Property and equipment, net	504,999,884	396,058,936
Beneficial interest in net assets of Bayhealth Foundation	12,887,636	16,499,669
Beneficial interest in perpetual trusts	<u>6,562,833</u>	<u>6,407,165</u>
<b>TOTAL</b>	<b><u>\$ 1,214,511,671</u></b>	<b><u>\$ 1,142,812,312</u></b>
<b>LIABILITIES AND NET ASSETS</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable and other accrued expenses	\$ 42,108,928	\$ 41,431,099
Construction and retainage payable	10,936,939	7,626,150
Accrued salaries, wages and benefits	46,702,757	42,883,956
Current portion of long-term debt	5,360,000	3,810,000
Accrued interest payable	2,672,160	3,183,702
Estimated settlements due to third-party payors	<u>14,390,481</u>	<u>10,298,827</u>
Total current liabilities	122,171,265	109,233,734
Retainage payable	-	577,259
Interest rate swap	609,526	1,149,966
Accrued postretirement benefit costs	44,342,107	73,428,139
Estimated professional liability costs	9,532,706	9,873,205
Estimated workers' compensation costs	3,020,213	4,281,869
Long-term debt, net of current portion	<u>189,468,981</u>	<u>186,361,263</u>
Total liabilities	<u>369,144,798</u>	<u>384,905,435</u>
<b>NET ASSETS</b>		
Unrestricted	825,067,567	738,400,415
Temporarily restricted	13,736,473	13,099,297
Permanently restricted	<u>6,562,833</u>	<u>6,407,165</u>
Total net assets	<u>845,366,873</u>	<u>757,906,877</u>
<b>TOTAL</b>	<b><u>\$ 1,214,511,671</u></b>	<b><u>\$ 1,142,812,312</u></b>

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>2018</u>	<u>2017</u>
UNRESTRICTED NET ASSETS		
Revenues		
Net patient service revenue	\$ 636,181,419	\$ 606,456,958
Less: provision for bad debts	<u>(36,316,283)</u>	<u>(38,883,840)</u>
Net patient service revenue less provision for bad debts	599,865,136	567,573,118
Other revenue	<u>15,907,538</u>	<u>16,139,578</u>
Total revenues	615,772,674	583,712,696
Expenses		
Salaries and benefits	339,517,352	320,072,070
Supplies and other expenses	195,759,508	183,542,407
Interest	4,429,683	5,862,677
Depreciation and amortization	<u>32,524,050</u>	<u>37,034,037</u>
Total expenses	<u>572,230,593</u>	<u>546,511,191</u>
Operating income before other items	43,542,081	37,201,505
Other items:		
Loss on early extinguishment of debt	(8,755,755)	-
Curtailed of benefit obligations	6,619,796	-
Investment return, net	27,176,710	41,188,889
Change in fair value of interest rate swap	540,440	807,454
Change in beneficial interest in net assets of Bayhealth Foundation	(249,812)	(23,283)
Other, net	<u>343,296</u>	<u>304,983</u>
Total other items	<u>25,674,675</u>	<u>42,278,043</u>
Excess of revenues over expenses	69,216,756	79,479,548
OTHER CHANGES IN UNRESTRICTED NET ASSETS		
Other changes in benefit obligations	<u>17,450,396</u>	<u>1,246,575</u>
Increase in unrestricted net assets	<u>86,667,152</u>	<u>80,726,123</u>
TEMPORARILY RESTRICTED NET ASSETS		
Other	(603)	(2,580)
Change in beneficial interest in net assets of Bayhealth Foundation	<u>637,779</u>	<u>5,768,083</u>
Increase in temporarily restricted net assets	<u>637,176</u>	<u>5,765,503</u>
PERMANENTLY RESTRICTED NET ASSETS		
Change in beneficial interest in perpetual trusts	<u>155,668</u>	<u>400,099</u>
Increase in permanently restricted net assets	<u>155,668</u>	<u>400,099</u>
INCREASE IN NET ASSETS	87,459,996	86,891,725
NET ASSETS, beginning of year	<u>757,906,877</u>	<u>671,015,152</u>
NET ASSETS, end of year	<u>\$ 845,366,873</u>	<u>\$ 757,906,877</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>2018</u>	<u>2017</u>
<b>OPERATING ACTIVITIES</b>		
Increase in net assets	\$ 87,459,996	\$ 86,891,725
Adjustments to reconcile increase in net assets to net cash provided by operating activities		
Other changes in benefit obligations	(17,450,396)	(1,246,575)
Curtailment of benefit obligations	(6,619,796)	-
Loss on early extinguishments of debt	8,755,755	-
Change in fair value of interest rate swap	(540,440)	(807,454)
Net realized and unrealized gains on investments	(16,788,295)	(30,524,791)
Depreciation and amortization	32,524,050	37,034,037
Provision for bad debts	36,316,283	38,883,840
Change in beneficial interest in perpetual trusts	(155,668)	(400,099)
Change in beneficial interest in net assets of Bayhealth Foundation	(387,967)	(5,748,380)
Changes in assets and liabilities		
Patient accounts receivable - net	(41,503,533)	(40,540,878)
Supplies	120,621	(2,733,404)
Prepaid expenses and other assets	(2,571,427)	151,380
Accounts payable and other accrued expenses	(53,419)	(3,759,591)
Accrued salaries, wages and benefits	3,628,801	(6,525,491)
Accrued interest payable	(511,542)	(5,174)
Estimated settlements due to third-party payors	4,091,654	(1,964,624)
Accrued postretirement benefit costs	(4,825,840)	(2,457,101)
Estimated professional liability costs	69,386	(1,407,531)
Estimated workers' compensation costs	<u>(940,293)</u>	<u>(520,218)</u>
Net cash provided by operating activities before trading securities	80,617,930	64,319,671
Change in investments - trading securities	<u>60,695,282</u>	<u>3,846,479</u>
Net cash provided by operating activities	<u>141,313,212</u>	<u>68,166,150</u>
<b>INVESTING ACTIVITIES</b>		
Capital expenditures, net	(139,090,289)	(83,128,926)
Distribution from Bayhealth Foundation	4,000,000	3,000,000
Investment unconsolidated joint ventures	-	(2,019,000)
Change in investments - other than trading securities	<u>437,785</u>	<u>28,960</u>
Net cash used in investing activities	<u>(134,652,504)</u>	<u>(82,118,966)</u>
<b>FINANCING ACTIVITIES</b>		
Proceeds from the issuance of long-term debt	196,726,666	-
Debt issuance costs incurred	(1,480,579)	-
Repayment of long-term debt	<u>(198,985,303)</u>	<u>(3,685,000)</u>
Net cash used in financing activities	<u>(3,739,216)</u>	<u>(3,685,000)</u>
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	2,921,492	(17,637,816)
CASH AND CASH EQUIVALENTS - beginning of year	<u>26,267,030</u>	<u>43,904,846</u>
CASH AND CASH EQUIVALENTS - end of year	<u>\$ 29,188,522</u>	<u>\$ 26,267,030</u>
<b>SUPPLEMENTAL CASH FLOW INFORMATION</b>		
Cash paid for interest, net of amounts capitalized	<u>\$ 4,941,225</u>	<u>\$ 5,867,851</u>
<b>SUPPLEMENTAL NONCASH INVESTING ACTIVITIES</b>		
Change in accrual for the purchase of property and equipment	<u>\$ 2,733,530</u>	<u>\$ 7,965,088</u>

The accompanying notes are an integral part of these statements.

**NOTES TO FINANCIAL STATEMENTS**

June 30, 2018 and 2017

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, and the reported fair values of certain 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, 2018 and 2017

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 2018, the allowance for doubtful accounts increased 19.5%, 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.

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**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

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 \$2,440,276 and \$1,559,049 was capitalized for the years ended June 30, 2018 and 2017, respectively.

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.

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**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

9. 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 interest rate swap agreement is included in other items 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 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.

10. 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.

11. 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 \$38,930 and \$44,065 as of June 30, 2018 and 2017, 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.

12. 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 other changes in benefit obligations.

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**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

13. 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.

14. 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.

15. 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 \$12,863,000 and \$7,744,000 for the years ended June 30, 2018 and 2017, 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.

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**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

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.

16. 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, 2018, the Medical Center’s tax years ended June 30, 2015 through 2018 for the federal tax jurisdiction remain open.

17. 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 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.

(Continued)

**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

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.

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.

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

18. Reclassifications

Certain amounts in the 2017 financial statements have been reclassified to be consistent with the 2018 presentation.

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, 2016, with the exception of the 2005 report for Kent General Hospital and the 2007 and 2009 reports 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.

(Continued)

**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

NOTE C - NET PATIENT SERVICE REVENUE - Continued

Net revenue from the Medicare and Medicaid programs accounted for approximately 36% and 21%, and 35% and 20%, respectively, of the Medical Center’s net patient service revenue for the years ended June 30, 2018 and 2017, 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, 2018 and 2017, net patient service revenue reflects net (decreases) increases of approximately (\$2,421,000) and \$3,268,000, 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.

Patient service revenue for both years ended June 30, 2018 and 2017, 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)	<u>93%</u>	<u>7%</u>	<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.

**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

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>2018</u>	<u>2017</u>
Internally designated		
Cash and cash equivalents	\$ 48,794,417	\$ 36,503,382
Government securities and corporate bonds	111,023,757	149,139,515
Equity securities	<u>27,593,499</u>	<u>63,617,964</u>
	187,411,673	249,260,861
Less amounts required for current liabilities	<u>(10,936,939)</u>	<u>(7,626,150)</u>
	<u>\$ 176,474,734</u>	<u>\$ 241,634,711</u>
Held by trustees		
Under bond indenture agreements		
Cash and cash equivalents	<u>\$ 6,143,865</u>	<u>\$ 5,031,091</u>
Under malpractice funding arrangement		
Cash and cash equivalents	845,880	920,199
Government securities and corporate bonds	5,154,442	4,464,974
Equity securities	<u>7,065,870</u>	<u>6,762,265</u>
	<u>13,066,192</u>	<u>12,147,438</u>
Total held by trustees	19,210,057	17,178,529
Less amounts required for current liabilities	<u>(4,333,275)</u>	<u>(4,771,060)</u>
	<u>\$ 14,876,782</u>	<u>\$ 12,407,469</u>

Other Investments

Other investments at June 30, consisted of:

	<u>2018</u>	<u>2017</u>
Cash and cash equivalents	\$ 24,201,229	\$ 19,886,171
Government securities and corporate bonds	51,555,740	52,109,097
Equity securities	<u>277,387,600</u>	<u>265,676,413</u>
	<u>\$ 353,144,569</u>	<u>\$ 337,671,681</u>

(Continued)

**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

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

Investment Return

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

	<u>2018</u>	<u>2017</u>
Investment return, net		
Interest and dividend income	\$ 12,337,391	\$ 12,503,291
Net realized gains on sales of securities	28,834,683	15,635,717
Change in net unrealized gains and losses on trading securities	(12,046,388)	14,889,074
Investment fees	<u>(1,948,976)</u>	<u>(1,839,193)</u>
	<u>\$ 27,176,710</u>	<u>\$ 41,188,889</u>

NOTE E - PROPERTY AND EQUIPMENT

Property and equipment at June 30, consisted of:

	<u>Estimated useful lives</u>	<u>2018</u>	<u>2017</u>
Land		\$ 29,263,410	\$ 23,250,934
Land improvements	2 to 25 years	3,676,586	3,451,928
Buildings and improvements	5 to 40 years	278,047,803	273,669,972
Major movable and fixed equipment	3 to 20 years	<u>340,865,155</u>	<u>329,595,710</u>
		651,852,954	629,968,544
Construction in progress		<u>217,429,159</u>	<u>98,555,635</u>
		869,282,113	728,524,179
Less accumulated depreciation		<u>(364,282,229)</u>	<u>(332,465,243)</u>
		<u>\$ 504,999,884</u>	<u>\$ 396,058,936</u>

Depreciation expense for the years ended June 30, 2018 and 2017 totaled \$32,882,871 and \$36,916,700, respectively.

The Medical Center has a remaining commitment for the construction of the Milford Memorial replacement hospital for \$104,926,865 as of June 30, 2018. The replacement hospital is currently under construction and is to be funded primarily through internally designated funds and is projected to be completed during February 2019.

**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

NOTE F - LONG-TERM DEBT

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

	<u>2018</u>	<u>2017</u>
Project Revenue Bonds, Series 2017A, net of unamortized premium of \$6,887,913 at June 30, 2018	\$ 119,007,913	\$ -
Project Revenue Bonds, Series 2009A, net of unamortized premium of \$647,956 at June 30, 2017	-	128,022,044
Variable Rate Refunding Revenue Bonds, Series 2017B	77,250,000	-
Variable Rate Refunding Revenue Bonds, Series 2012	<u>-</u>	<u>64,035,000</u>
	196,257,913	192,057,044
Less: Unamortized deferred financing costs, net	(1,428,932)	(1,885,781)
Current portion of long-term debt	<u>(5,360,000)</u>	<u>(3,810,000)</u>
	<u>\$ 189,468,981</u>	<u>\$ 186,361,263</u>

Fair Value

The Medical Center uses quoted market prices in estimating the fair value of the revenue bonds. The fair value of long-term debt was \$193,491,000 and \$198,841,000 at June 30, 2018 and 2017, respectively.

Bonds

Series 2017A Bonds

In December 2017, the Medical Center entered into a financing arrangement with the Delaware Health Facilities Authority (the Authority) to issue \$112,120,000 Revenue Bonds, Bayhealth Medical Center Project, Series 2017A (Series 2017A). The Series 2017A bonds proceeds were used to extinguish the Project Revenue Bonds, Series 2009A (Series 2009A). A bond premium of \$7,346,666 and issuance costs of \$1,271,721 relating to the Series 2017A bonds are being amortized over the life of the bonds. Unamortized bond issuance costs totaled \$1,189,604 at June 30, 2018. As a result of the extinguishment of the Series 2009A bonds, a loss on early extinguishment of \$8,755,755 was recognized. The loss was comprised of the write-off of the unamortized bond premium and deferred financing costs and future interest payments of the Series 2009A bonds.

The Series 2017A bonds include serial bonds bearing interest at rates ranging from 3.375% to 5.000%, with maturities annually through July 1, 2044, with principal payment ranging from \$1,780,000 to \$4,560,000. Term bonds, bearing interest at rates ranging from 3.000% to 4.000%, with maturities occurring on July 1, 2032 through July 1, 2043, are subject to mandatory sinking fund (principal) payments beginning July 1, 2032, ranging from \$7,500,000 to \$31,930,000 as set forth in the bond indenture agreements. The Series 2017A interest is payable semiannually on each January 1 and July 1.

(Continued)

**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

NOTE F - LONG-TERM DEBT - Continued

Series 2017B Bonds

In December 2017, the Medical Center entered into a financing arrangement with the Authority and a national bank to issue privately placed \$77,250,000 Variable Rate Refunding Revenue Bonds, Bayhealth Medical Center Project, Series 2017B (Series 2017B). The Series 2017B bonds proceeds were used to extinguish the Variable Rate Refunding Revenue Bonds, Series 2012 (Series 2012) and to finance the Milford Memorial replacement hospital. Bond issuance costs of \$247,858 relating to the Series 2017A bonds are being amortized over the life of the bonds. Unamortized bond issuance costs totaled \$239,328 at June 30, 2018.

The Series 2017B bonds have annual sinking fund (principal) payments through July 1, 2039 ranging from \$1,780,000 to \$11,065,000 and bear interest based on a daily LIBOR rate (as defined) which was 2.29% at June 30, 2018.

Series 2009A Bonds

The Series 2009A bonds included serial bonds bearing interest at rates ranging from 3.70% 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, were subject to mandatory sinking fund (principal) payments beginning July 1, 2026, ranging from \$5,730,000 to \$34,930,000 as set forth in the bond indenture agreements. The Series 2019A bonds were legally defeased by the issuance of the Series 2017A bonds.

Series 2012 Bonds

The Series 2012 bonds had annual sinking fund (principal) payments through July 1, 2039 ranging from \$1,940,000 to \$3,835,000 with interest based on a daily LIBOR rate (as defined), which was 1.29% at June 30, 2017 payable monthly until July 1, 2019. The Series 2012 bonds were redeemed by the issuance of the 2017B bonds.

Under the terms of the loan agreements, the Medical Center has pledged its gross revenues, to the extent permitted by law, to the Authority and bank. 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, 2018 and 2017, the Medical Center has complied with all financial covenants in the loan agreement.

As of June 30, 2018, the principal payments on long-term debt are as follows:

2019	\$ 5,360,000
2020	4,900,000
2021	5,010,000
2022	5,150,000
2023	5,295,000
Thereafter	<u>163,655,000</u>
	<u>\$ 189,370,000</u>

(Continued)

**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

NOTE F - LONG-TERM DEBT - Continued

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, 2018 and 2017, the notional amount was \$13,620,000 and \$16,035,000, 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 \$540,440 and \$807,454 for the years ended June 30, 2018 and 2017, respectively, with such amounts recorded as other items 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 \$609,526 and \$1,149,966 at June 30, 2018 and 2017, 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 October 10, 2018, the Medical Center was not exposed to any risk of loss.

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.

Prior to January 1, 2018, the Medical Center provided certain reimbursement for health care benefits for eligible retirees (Other benefits). Employees who retired at age 65, or at age 55 with 10 consecutive years of service, and who were insured under the Medical Center's health insurance plan while an active employee, were 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 benefits plan was amended to exclude all new hires, including rehires. Effective January 1, 2018 the Other benefits plan was closed to new retirees over age 65. Post-65 coverage ended after December 31, 2017, except for a small select group of grandfathered retirees.

(Continued)

**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

NOTE G - POSTRETIREMENT BENEFIT PLANS - Continued

The following table summarizes information about the benefit plans:

	Pension benefits		Other benefits	
	June 30			
	2018	2017	2018	2017
Accumulated benefit obligation	\$ <u>204,662,697</u>	\$ <u>214,138,234</u>	\$ <u>N/A</u>	\$ <u>N/A</u>
Change in benefit obligation				
Benefit obligation at beginning of year	\$ 217,871,710	\$ 216,384,468	\$ 18,594,199	\$ 14,710,379
Service cost	1,669,268	1,954,757	271,515	393,826
Plan amendments	-	-	(1,025,857)	-
Interest cost	8,304,950	8,140,398	321,562	510,921
Actuarial (gain) loss	(12,453,318)	(1,151,737)	394,471	3,946,357
Gain due to curtailment	-	-	(12,797,748)	-
Benefits paid	<u>(8,143,921)</u>	<u>(7,456,176)</u>	<u>(1,069,032)</u>	<u>(967,284)</u>
Benefit obligation at end of year	<u>207,248,689</u>	<u>217,871,710</u>	<u>4,689,110</u>	<u>18,594,199</u>
Change in plan assets				
Fair value of the plan assets at beginning of year	161,796,606	152,723,032	-	-
Actual return on plan assets	6,513,007	11,529,750	-	-
Contributions by the Medical Center	6,000,000	5,000,000	1,069,032	967,284
Benefits paid	<u>(8,143,921)</u>	<u>(7,456,176)</u>	<u>(1,069,032)</u>	<u>(967,284)</u>
Fair value of the plan assets at end of year	<u>166,165,692</u>	<u>161,796,606</u>	<u>-</u>	<u>-</u>
Funded status at year end	\$ <u>(41,082,997)</u>	\$ <u>(56,075,104)</u>	\$ <u>(4,689,110)</u>	\$ <u>(18,594,199)</u>
Net amounts recognized in the balance sheets consist of				
Current liabilities, as accrued salaries, wages and benefits	\$ -	\$ -	\$ (1,430,000)	\$ (1,241,164)
Noncurrent liabilities	<u>(41,082,997)</u>	<u>(56,075,104)</u>	<u>(3,259,110)</u>	<u>(17,353,035)</u>
Accrued retirement benefits	\$ <u>(41,082,997)</u>	\$ <u>(56,075,104)</u>	\$ <u>(4,689,110)</u>	\$ <u>(18,594,199)</u>
Amounts recognized in unrestricted net assets but not yet recognized in net periodic benefit costs consist of				
Net actuarial loss	\$ 73,093,237	\$ 83,736,778	\$ (150,412)	\$ 6,501,813
Prior service credit	<u>-</u>	<u>-</u>	<u>(973,581)</u>	<u>(818,951)</u>
	\$ <u>73,093,237</u>	\$ <u>83,736,778</u>	\$ <u>(1,123,993)</u>	\$ <u>5,682,862</u>

(Continued)

**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

NOTE G - POSTRETIREMENT BENEFIT PLANS - Continued

	Pension benefits		Other benefits	
	June 30			
	2018	2017	2018	2017
Components of net periodic benefit cost				
Service cost	\$ 1,669,268	\$ 1,954,757	\$ 271,515	\$ 393,826
Interest cost	8,304,950	8,140,398	321,562	510,921
Expected return on plan assets	(10,383,773)	(9,753,570)	-	-
Amortization of prior service credit	-	-	(153,760)	(89,210)
Gain due to curtailment	-	-	(6,619,796)	-
Amortization of actuarial loss	<u>2,060,989</u>	<u>2,274,941</u>	<u>151,277</u>	<u>79,284</u>
	1,651,434	2,616,526	(6,029,202)	894,821
Other changes in benefit obligations recognized in other changes in unrestricted net assets				
Prior service (credit) cost	-	-	(154,630)	89,210
Net actuarial (gain) loss	<u>(10,643,541)</u>	<u>(5,202,858)</u>	<u>(6,652,225)</u>	<u>3,867,073</u>
	<u>(10,643,541)</u>	<u>(5,202,858)</u>	<u>(6,806,855)</u>	<u>3,956,283</u>
Total recognized in net benefit cost and other changes in unrestricted net assets	<u>\$ (8,992,107)</u>	<u>\$ (2,586,332)</u>	<u>\$ (12,836,057)</u>	<u>\$ 4,851,104</u>

At June 30, 2018, 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	\$ 2,000,000	\$ -
Prior service credit	<u>-</u>	<u>(190,000)</u>
	<u>\$ 2,000,000</u>	<u>\$ (190,000)</u>

	Pension benefits		Other benefits	
	June 30			
	2018	2017	2018	2017
Weighted-average assumptions used to determine benefit obligations were				
Discount rate	4.31%	3.93%	3.59%	3.84%
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, 2018 and 2017

NOTE G - POSTRETIREMENT BENEFIT PLANS - Continued

	Pension benefits		Other benefits	
	June 30			
	2018	2017	2018	2017
Weighted-average assumptions used to determine net periodic benefit costs were				
Discount rate	3.93%	3.82%	3.84%/2.62%(a)	3.65%
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

(a) The discount rate was 3.84% from July 1, 2017 to October 31, 2017 and 2.62% from November 1, 2017 to June 30, 2018.

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, 2018:

	<u>1% increase</u>	<u>1% (decrease)</u>
Incremental effect on total service and interest cost components of benefit cost	\$ 3,564	\$ (3,420)
Incremental effect on postretirement benefit obligation	\$ 76,924	\$ (73,771)

The Pension benefits' weighted average asset allocation as of the measurement dates of June 30, 2018 and 2017, by asset category, follows:

	<u>2018</u>	<u>2017</u>
Asset category		
Cash and cash equivalents	2%	5%
Fixed income	45	44
Equity securities	<u>53</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, 2018 and 2017

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, 2018 and 2017:

	<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>2018</u>				
Cash and cash equivalents	\$ 7,863,064	\$ 7,863,064	\$ -	\$ -
Fixed income <sup>(a)</sup>	70,730,298	-	70,730,298	-
Equity securities <sup>(b)</sup>	<u>87,572,330</u>	<u>87,572,330</u>	<u>-</u>	<u>-</u>
	<u>\$ 166,165,692</u>	<u>\$ 95,435,394</u>	<u>\$ 70,730,298</u>	<u>\$ -</u>
<u>2017</u>				
Cash and cash equivalents	\$ 8,893,185	\$ 8,893,185	\$ -	\$ -
Fixed income <sup>(a)</sup>	70,754,518	-	70,754,518	-
Equity securities <sup>(b)</sup>	<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>

<sup>(a)</sup> Comprised of investment grade bonds of U.S. issuers from various industries and a commingled trust fund.

<sup>(b)</sup> 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, 2018 and 2017

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 benefits plan 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 \$1,050,000 to the Other benefits plan for the year ending June 30, 2019. 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 benefits</u>	<u>Other benefits</u>
2019	\$ 10,274,000	\$ 1,050,000
2020	10,928,000	980,000
2021	11,548,000	810,000
2022	12,087,000	680,000
2023	12,554,000	550,000
2024-2028	66,973,000	990,000

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, 2018 and 2017 was \$11,273,799 and \$9,664,439, respectively.

**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

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, 2018 and 2017, the malpractice claims liability totaled \$11,299,721 and \$11,230,335, respectively, including the estimated current portion of this liability, totaling \$1,767,015 and \$1,357,130 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, 2018 and 2017. 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 2018 and 2017. At June 30, 2018 and 2017, the workers' compensation liability totaled \$4,588,917 and \$5,529,210, respectively, including the estimated current portion of this liability, totaling \$1,568,704 and \$1,247,341, 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, 2018 and 2017 was \$3,595,806 and \$3,489,526, respectively. Future minimum lease payments are as follows for the years ending June 30:

2019	\$ 3,001,653
2020	2,620,136
2021	2,350,102
2022	1,528,096
2023	1,415,412
Thereafter	<u>2,983,544</u>
	<u>\$ 13,898,943</u>

**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

**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, 2018 and 2017 was as follows:

	<u>2018</u>	<u>2017</u>
Medicare	30%	29%
Blue Cross	10	12
Medicaid	24	20
Self-pay	16	16
Workers' compensation	2	3
Commercial and other	<u>18</u>	<u>20</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, 2018 and 2017 are as follows:

	<u>2018</u>	<u>2017</u>
Healthcare services	\$ 398,284,282	\$ 380,798,194
General and administrative services	<u>173,946,311</u>	<u>165,712,997</u>
	<u>\$ 572,230,593</u>	<u>\$ 546,511,191</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, 2018 and 2017

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, 2018</u>				
Assets				
Cash and cash equivalents	\$ 109,173,913	\$ -	\$ -	\$ 109,173,913
Government securities and corporate bonds	-	167,733,939	-	167,733,939
Equity securities	312,046,969	-	-	312,046,969
Beneficial interest in perpetual trusts	<u>-</u>	<u>-</u>	<u>6,562,833</u>	<u>6,562,833</u>
Total assets	<u>\$ 421,220,882</u>	<u>\$ 167,733,939</u>	<u>\$ 6,562,833</u>	<u>\$ 595,517,654</u>
Liabilities				
Interest rate swap	<u>\$ -</u>	<u>\$ 609,526</u>	<u>\$ -</u>	<u>\$ 609,526</u>
Total liabilities	<u>\$ -</u>	<u>\$ 609,526</u>	<u>\$ -</u>	<u>\$ 609,526</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>

Net unrealized gains on the Level 3 assets were \$155,668 and \$400,099 for the years ended June 30, 2018 and 2017, respectively.

**NOTES TO FINANCIAL STATEMENTS - CONTINUED**

June 30, 2018 and 2017

NOTE M - SUBSEQUENT EVENTS

The Medical Center evaluated its June 30, 2018 financial statements for subsequent events through October 10, 2018, 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.