



**CONSOLIDATED FINANCIAL STATEMENTS**

**AND**

**SUPPLEMENTARY INFORMATION**

**SEPTEMBER 30, 2017 AND 2016**

*CPAs / ADVISORS*



# DEACONESS HEALTH SYSTEM

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## REPORT OF INDEPENDENT AUDITORS

Board of Directors  
Deaconess Health System  
Evansville, Indiana

We have audited the accompanying consolidated financial statements of Deaconess Health System (the System), which comprise the consolidated balance sheets as of September 30, 2017 and 2016, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

### Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated 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 consolidated 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 consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the System's preparation and fair presentation of the consolidated 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 System'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 consolidated financial statements.

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

Board of Directors  
Deaconess Health System  
Evansville, Indiana

### Opinion

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

### Change in Accounting Principles

As discussed in Note 2 to the consolidated financial statements, the System adopted new accounting guidance, Accounting Standards Update (ASU) 2015-03, *Interest – Imputation of Interest*, which simplifies the presentation of debt issue costs. The System also adopted ASU No. 2014-15, *Presentation of Financial Statements – Going Concern (Topic 205-40): Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern*, which requires management to evaluate whether there are conditions or events that raise substantial doubt about the entity’s ability to continue as a going concern for a period of one year from the date the consolidated financial statements are issued. Our opinion is not modified with respect to these matters.

### Report on Supplementary Information

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary information identified in the accompanying table of contents is presented for purposes of additional analysis rather than to present the financial position and results of operations of the individual entities, and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The supplementary information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the supplementary information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

**Blue & Co., LLC**

Indianapolis, Indiana  
December 13, 2017

# DEACONESS HEALTH SYSTEM

## CONSOLIDATED BALANCE SHEETS SEPTEMBER 30, 2017 AND 2016

	2017	2016
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 78,754,009	\$ 65,507,886
Funds held by trustee, current portion	77,775,941	14,147
Patient accounts receivable, less allowance for estimated uncollectible amounts of \$22,571,000 in 2017 and \$20,875,000 in 2016	126,202,456	123,522,748
Inventories	9,872,713	9,442,131
Prepaid expenses and other current assets	39,383,185	39,158,717
Total current assets	331,988,304	237,645,629
<b>Investments limited as to use, less current portion</b>		
Board designated funds	635,274,520	559,849,326
Funds held by trustee	-0-	51,325,762
Board designated funds - Foundation	8,160,279	6,996,633
Donor restricted - Foundation	8,797,467	7,130,827
Total investments limited as to use	652,232,266	625,302,548
<b>Property and equipment</b>		
Land and improvements	28,239,429	25,416,295
Buildings and improvements	591,782,602	546,469,799
Furniture, fixtures and equipment	279,532,769	252,685,624
	899,554,800	824,571,718
Less allowances for depreciation	548,195,912	501,383,080
	351,358,888	323,188,638
Construction in progress	107,662,779	34,940,422
Total property and equipment, net	459,021,667	358,129,060
<b>Other assets</b>		
Investments in joint ventures	30,783,169	26,657,219
Goodwill and other intangibles	25,465,919	25,465,919
Other	18,202,639	17,500,181
Total other assets	74,451,727	69,623,319
Total assets	\$ 1,517,693,964	\$ 1,290,700,556

See accompanying notes to consolidated financial statements.

# DEACONESS HEALTH SYSTEM

## CONSOLIDATED BALANCE SHEETS SEPTEMBER 30, 2017 AND 2016

### LIABILITIES AND NET ASSETS

	2017	2016
<b>Current liabilities</b>		
Accounts payable and other accrued liabilities	\$ 67,081,395	\$ 43,487,769
Salaries, wages and related liabilities	50,713,323	47,345,648
Estimated third-party payor settlements	4,998,011	7,183,588
Accrued interest	996,230	668,663
Other current liabilities	480,938	474,678
Current portion of long-term debt	7,458,213	7,660,535
Total current liabilities	131,728,110	106,820,881
<b>Long-term liabilities</b>		
Long-term debt, less current portion	357,201,702	255,383,088
Other long-term liabilities	90,849,885	117,840,012
Total long-term liabilities	448,051,587	373,223,100
Total liabilities	579,779,697	480,043,981
<b>Net assets</b>		
Unrestricted	915,848,997	790,830,658
Non-controlling interest	13,267,803	12,695,090
Total unrestricted net assets	929,116,800	803,525,748
Temporarily restricted	6,941,800	5,297,883
Permanently restricted	1,855,667	1,832,944
Total net assets	937,914,267	810,656,575
Total liabilities and net assets	\$ 1,517,693,964	\$ 1,290,700,556

See accompanying notes to consolidated financial statements.

## DEACONESS HEALTH SYSTEM

### CONSOLIDATED STATEMENTS OF OPERATIONS YEARS ENDED SEPTEMBER 30, 2017 AND 2016

	2017	2016
<b>Unrestricted revenue and other support</b>		
Net patient service revenue	\$ 902,596,876	\$ 855,592,814
Less provision for bad debts	11,803,580	6,368,424
Net patient service revenue net of provision for bad debts	890,793,296	849,224,390
Other revenue	40,073,272	48,189,476
Total unrestricted revenue and other support	930,866,568	897,413,866
<b>Expenses</b>		
Salaries and wages	362,849,069	329,880,355
Employee benefits	98,994,614	85,564,778
Supplies	169,008,466	151,357,854
Contract services	96,122,440	103,664,245
Repairs and maintenance	28,636,106	24,540,096
Depreciation	45,411,426	45,181,500
Interest	6,958,924	7,156,575
Utilities	13,248,537	12,653,485
Other	61,777,467	54,682,976
Total expenses	883,007,049	814,681,864
Income from operations	47,859,519	82,732,002
<b>Nonoperating revenues (expenses)</b>		
Investment income	28,960,898	15,022,442
Contributions, gifts, and bequests	648,535	682,556
Grants	(1,485,785)	(1,392,786)
Total nonoperating revenues (expenses)	28,123,648	14,312,212
Excess revenues over expenses	75,983,167	97,044,214
<b>Other changes in unrestricted net assets</b>		
Net unrealized gain on investments	34,241,434	33,720,818
Benefit related changes other than net periodic benefit cost	30,311,340	(29,112,043)
Net assets released from restriction	559,207	206,901
Contributions from non-controlling interest	-0-	192,891
Distributions to non-controlling interest	(15,504,096)	(14,622,764)
Change in unrestricted net assets	125,591,052	87,430,017
<b>Temporarily restricted net assets</b>		
Contributions, gifts and bequests	2,084,835	1,230,491
Investment income	21,366	48,804
Net unrealized gain on investments	96,923	75,951
Net assets released from restriction	(559,207)	(206,901)
Change in temporarily restricted net assets	1,643,917	1,148,345
<b>Permanently restricted net assets</b>		
Change in beneficial interest in trusts	22,723	39,512
<b>Change in net assets</b>	<b>\$ 127,257,692</b>	<b>\$ 88,617,874</b>

See accompanying notes to consolidated financial statements.

## DEACONESS HEALTH SYSTEM

### CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS YEARS ENDED SEPTEMBER 30, 2017 AND 2016

	Unrestricted				Total
	Unrestricted	Non-controlling Interest	Temporarily Restricted	Permanently Restricted	
<b>Net assets</b>					
September 30, 2015	\$ 705,122,911	\$ 10,972,820	\$ 4,149,538	\$ 1,793,432	\$ 722,038,701
Excess revenues over expenses	80,892,071	16,152,143	-0-	-0-	97,044,214
Net unrealized gain on investments	33,720,818	-0-	75,951	-0-	33,796,769
Benefit related changes other than net periodic benefit cost	(29,112,043)	-0-	-0-	-0-	(29,112,043)
Net assets released from restriction	206,901	-0-	(206,901)	-0-	-0-
Investment income	-0-	-0-	48,804	-0-	48,804
Contributions, gifts, bequests and other changes	-0-	-0-	1,230,491	39,512	1,270,003
Contributions from non-controlling interest	-0-	192,891	-0-	-0-	192,891
Distributions to non-controlling interest	-0-	(14,622,764)	-0-	-0-	(14,622,764)
Change in net assets	<u>85,707,747</u>	<u>1,722,270</u>	<u>1,148,345</u>	<u>39,512</u>	<u>88,617,874</u>
September 30, 2016	790,830,658	12,695,090	5,297,883	1,832,944	810,656,575
Excess revenues over expenses	59,906,358	16,076,809	-0-	-0-	75,983,167
Net unrealized gain on investments	34,241,434	-0-	96,923	-0-	34,338,357
Benefit related changes other than net periodic benefit cost	30,311,340	-0-	-0-	-0-	30,311,340
Net assets released from restriction	559,207	-0-	(559,207)	-0-	-0-
Investment income	-0-	-0-	21,366	-0-	21,366
Contributions, gifts, bequests and other changes	-0-	-0-	2,084,835	22,723	2,107,558
Distributions to non-controlling interest	-0-	(15,504,096)	-0-	-0-	(15,504,096)
Change in net assets	<u>125,018,339</u>	<u>572,713</u>	<u>1,643,917</u>	<u>22,723</u>	<u>127,257,692</u>
September 30, 2017	<u>\$ 915,848,997</u>	<u>\$ 13,267,803</u>	<u>\$ 6,941,800</u>	<u>\$ 1,855,667</u>	<u>\$ 937,914,267</u>

See accompanying notes to consolidated financial statements.

# DEACONESS HEALTH SYSTEM

## CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED SEPTEMBER 30, 2017 AND 2016

	2017	2016
<b>Operating activities</b>		
Change in net assets	\$ 127,257,692	\$ 88,617,874
Adjustments to reconcile change in net assets to net cash flows from operating activities		
Depreciation	45,411,426	45,181,500
Provision for bad debts	11,803,580	6,368,424
Net unrealized gain on investments	(34,338,357)	(33,796,769)
Net realized gain on investments	(15,460,862)	(1,436,170)
Unrealized (gain) loss on interest rate swap	(789,351)	326,878
Loss on disposal of property and equipment	83,212	185,069
Amortization of debt issue costs and original issue discount/premium	(399,671)	(309,691)
Restricted contributions, gifts and bequests	(2,084,835)	(1,230,491)
Contributions from non-controlling interest	-0-	(192,891)
Distributions to non-controlling interest	15,504,096	14,622,764
Changes in operating assets and liabilities		
Patient accounts receivable	(14,483,288)	(10,658,612)
Inventories	(430,582)	(524,258)
Prepaid expenses and other current assets	5,266,250	(7,075,216)
Investments in joint ventures and other assets	(4,828,408)	(6,175,058)
Accounts payable and other accrued liabilities	13,468,626	(5,516,190)
Salaries, wages and related liabilities	3,367,675	1,613,340
Estimated third-party payor settlements	(2,185,577)	(5,041,154)
Accrued interest	327,567	(204,235)
Other current liabilities	6,260	159,356
Other long-term liabilities	(26,200,776)	28,496,450
Net cash flows from operating activities	121,294,677	113,410,920
<b>Investing activities</b>		
Purchases of property and equipment	(136,627,619)	(61,010,693)
Proceeds from disposal of property and equipment	365,374	569,288
Net transfers from trustee assets for principal, interest and construction draws	(26,436,032)	(51,306,155)
Purchases of board designated funds	(549,549,656)	(240,842,088)
Proceeds from sale of board designated funds	515,602,677	178,706,915
Purchase of assets	-0-	(2,221,189)
Net cash flows from investing activities	(196,645,256)	(176,103,922)
<b>Financing activities</b>		
Contributions from non-controlling interest	-0-	192,891
Distributions to non-controlling interest	(15,504,096)	(14,622,764)
Restricted contributions, gifts and bequests	2,084,835	1,230,491
Payments on long-term debt	(7,227,449)	(6,603,805)
Proceeds from long-term debt	104,830,000	53,461,672
Cash received for debt premium	4,723,563	-0-
Cash paid for debt issue costs	(310,151)	(206,395)
Net cash flows from financing activities	88,596,702	33,452,090
Change in cash and cash equivalents	13,246,123	(29,240,912)
<b>Cash and cash equivalents</b>		
Beginning of year	65,507,886	94,748,798
End of year	\$ 78,754,009	\$ 65,507,886

See accompanying notes to consolidated financial statements.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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### 1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

#### Nature of Operations

Deaconess Health System (the System) is an integrated multi-facility health system providing comprehensive health care services to southern Indiana, southeastern Illinois and western Kentucky, employing over 5,000 within the Tri-State area.

Deaconess Health System, Inc. was formed to coordinate management and strategic planning and provide operational facilities for entities within the System, the most significant of which are Deaconess Hospital, Inc. (the Hospital) and Deaconess Clinic, Inc. (the Clinic), not-for-profit corporations whose missions are to provide quality health care services with a compassionate and caring spirit to persons, families and communities of the Tri-State area.

The board of Deaconess Health System, Inc. is granted the authority to provide overall direction and control of the entities through their respective bylaws. Deaconess Health System, Inc. wholly owns the Clinic, Deaconess Care Integration, LLC, DCI Commercial ACO, LLC, OneCare, LLC, Deaconess Regional Healthcare Services Illinois, Inc. and Deaconess VNA Plus, LLC and is the sole corporate member of the Hospital.

The Clinic is comprised of Deaconess employed physicians practicing primary care and multi-specialty medicine within outpatient physician offices located throughout southern Indiana, southeastern Illinois and western Kentucky and two urgent care centers located in Evansville, Indiana. The facilities provide illness and injury care, preventative care, lab and x-ray services. The Clinic also encompasses the Deaconess Clinical Research Institute which provides drug research studies for the pharmaceutical industry.

Deaconess Care Integration, LLC is as an accountable care organization with the purpose of developing a care delivery model focused on quality metrics and reductions in cost for the Medicare population.

DCI Commercial ACO, LLC is a counterpart to Deaconess Care Integration, LLC, but with a focus on the commercial populations. Its purpose is to assist commercial clients with value based coverage programs.

OneCare, LLC was formed to develop a network of participating health care providers and pursue contracts, in concert with the aforementioned ACO's, with provider-owned health plans, commercial payors, employers, providers, suppliers and other third parties to provide high quality, cost-effective and coordinated health care services to their enrollees.

Deaconess Regional Healthcare Services Illinois, Inc. manages activities such as cardiology clinics and other ancillary services in Illinois.

Deaconess VNA Plus, LLC provides home health and hospice care services.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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The Hospital, located in Evansville, Indiana, is comprised of two general acute care facilities, a mental health facility and two outpatient primary care facilities for seniors. The inpatient services have a combined capacity of 516 intensive care, pediatric, medical/surgical, orthopaedic and neurosurgical beds.

The Hospital wholly owns Ready Development, LLC and holds majority ownership interests in the following entities:

- The Heart Hospital at Deaconess Gateway, LLC – 51%
- Progressive Health of Indiana, LLC – 51%
- Tri-State Radiation Oncology, LLC – 51%
- Deaconess Health Plans, LLC – 94%
- Mainspring Managers, LLC – 51%
- Vasmed, LLC – 51%
- OrthoAlign, LLC – 51%

Ready Development, LLC was formed to purchase and develop real estate for future use.

The Heart Hospital at Deaconess Gateway, LLC is a 24 bed hospital providing preventative care, medical care, emergent care, diagnostic testing, cardiovascular procedures, cardiovascular surgery and cardiac rehabilitation on an outpatient and inpatient basis.

Progressive Health of Indiana, LLC provides physical, occupational and speech therapy services throughout southern Indiana.

Tri-State Radiation Oncology, LLC provides oncology and cancer services, including radiation therapy, pain management, counseling and rehabilitation.

Deaconess Health Plans, LLC is a preferred provider organization – managed care network formed to encourage collaboration in providing patient service and cost management.

Mainspring Managers, LLC provides neurology services to treat brain, spinal cord and nervous system injuries, diseases and disorders.

Vasmed, LLC provides services and manage the vascular service line of the Hospital.

OrthoAlign, LLC was created to manage the cost and quality of orthopaedic procedures performed by the System.

### Principles of Consolidation

The consolidated financial statements include the accounts of Deaconess Health System and its wholly owned and controlled subsidiaries. All material inter-company accounts and transactions have been eliminated in consolidation. Noncontrolling interest represents the portion of net assets that is owned by investors that are external to and not included in the consolidated financial statements.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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### Investments in Joint Ventures

Investments in organizations where the System's ownership percentage is equal to or less than 50% are included in investments in joint ventures on the consolidated balance sheets. Investments in joint ventures approximated \$30,783,000 and \$26,657,000 as of September 30, 2017 and 2016, respectively. The System's portion of income from unconsolidated organizations is reported with other operating revenue and was approximately \$20,341,000 and \$18,156,000 for 2017 and 2016, respectively. A summary of the significant investments in joint ventures follows:

- The Hospital holds a 50% ownership in the Deaconess Women's Hospital of Southern Indiana, LLC d/b/a The Women's Hospital which is a 74-bed facility dedicated to comprehensive women's care, including obstetrics, neonatal intensive care, cancer treatment and infertility and imaging services.
- The Hospital holds a 50% ownership interest in Evansville Surgery Center Associates, LLC providing two locations of multispecialty outpatient surgery centers dedicated to the diagnosis and preoperative, intraoperative and postoperative care of patients.
- The Hospital holds 33.3% of the membership shares in The Healthcare Group, LLC, a preferred provider organization – managed care network. The Healthcare Group, LLC encourages collaboration in providing patient service and cost management.
- The Hospital holds a 27.5% ownership interest in HealthSouth/Deaconess, LLC, d/b/a HealthSouth Deaconess Rehabilitation Hospital, an 80-bed comprehensive facility dedicated to improving, maintaining or restoring physical strength, cognition and mobility through therapeutic methods and technologies for rehabilitation.
- The Hospital holds an ownership interest in the Tecumseh Health Reciprocal Risk Retention Group which was formed to provide liability insurance, reinsurance and risk management services to the members.
- The Hospital holds a 46% ownership interest in LoField Dialysis, LLC which was formed to provide dialysis and related services.

### Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, including the allowance for estimated uncollectible accounts, estimated third-party payor settlements, defined benefit plan obligations and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period and could differ from actual results.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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### Charity Care, Community Benefit and Assistance to the Uninsured

The System provides care to patients regardless of their ability to pay. A patient is classified as a charity patient by reference to certain established policies of the System. Essentially, these policies define charity services as those services for which no payment or reduced payment based upon a graduated scale, is anticipated, based on the Federal Poverty Income Guidelines, published by the Department of Health and Human Services and where incurred charges are considered significant when compared to the income of the patient. Because collection of amounts determined to qualify as charity care is not pursued, such amounts are not reported as revenue.

The System's charity care policy reflects the current economic conditions and other factors unique to the System's customer base. Charity care provided during 2017 and 2016, measured at established rates, was approximately \$50,733,000 and \$39,896,000, respectively. In addition, other programs and services for the benefit of the community are provided. The costs of these programs are included in operating expenses. The System receives reimbursements from certain governmental payors to assist in the funding of charity care.

Of the System's total expenses reported, an estimated \$17,418,000 and \$13,502,000 arose from providing services to charity patients during 2017 and 2016, respectively. The estimated costs of providing patient assistance services are based on a calculation which applies a ratio of costs to charges to the gross uncompensated charges associated with providing care to charity patients. The ratio of cost to charges is calculated based on the Hospital's total expenses to gross patient service revenue.

The System has a policy for uninsured patients with discounted rates similar to contractual payors. Uninsured self pay discounts provided to patients were approximately \$23,550,000 and \$26,163,000 in 2017 and 2016, respectively.

### Cash and Cash Equivalents

Cash and cash equivalents are defined as investments in highly liquid debt instruments with an original maturity of three months or less, excluding amounts whose use is limited by arrangements under trust agreements, board designation or by donors. The System maintains its cash in accounts, which at times may exceed federally insured limits. The policy of the System is to collateralize deposits. The System has not experienced any losses in such accounts and believes that it is not exposed to any significant credit risk on cash and cash equivalents.

Additional cash flows information for 2017 and 2016 is as follows:

	<u>2017</u>	<u>2016</u>
Supplemental cash flows information		
Cash paid for interest, net of capitalized interest	\$ 6,631,000	\$ 7,361,000
Property and equipment in liabilities	\$ 10,125,000	\$ 1,920,000

Capitalized interest expense, net of interest income was approximately \$4,238,000 and \$-0- for 2017 and 2016, respectively.

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# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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### Patient Accounts Receivable and Net Patient Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered. Estimated retroactive adjustments under reimbursement agreements with certain third-party payors are included with estimated third-party payor settlements. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

Patient accounts receivable is reduced by an allowance for uncollectible accounts based on the System's evaluation of its major payor sources of revenue, the aging of the accounts, historical losses, current economic conditions, and other factors unique to its service area and the healthcare industry. Management regularly reviews data about the major payor sources of revenue in evaluating the sufficiency of the allowance for uncollectible accounts. For receivables associated with services provided to patients who have third-party coverage, the System analyzes contractually due amounts and provides an allowance for uncollectible accounts and a provision for bad debts, if necessary. For receivables associated with self-pay payments, the System records a significant provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for uncollectible accounts.

During 2017, the System's allowance for uncollectible accounts changed approximately \$1,696,000 from \$20,875,000 to \$22,571,000. The uncollectible allowance for self-pay balances increased approximately \$1,076,000. The change is mainly the result of shifts in payor mix due to health care reform and an increase in insurance coverage for patients who were previously uninsured. The uncollectible allowance reserved for self-pay balances related to third party payors increased approximately \$620,000. The change is mainly the result of shifts in payor mix due to health care reform and an increase in insurance coverage for patients who were previously uninsured.

The System's self-pay related write-offs decreased by approximately \$1,660,000 and \$21,766,000 in 2017 and 2016, respectively. The decreases in 2017 and 2016 were the result of positive trends experienced in the collection of amounts from self-pay patients and shifts in payor mix due to health care reform and an increase in insurance coverage for patients who were previously uninsured.

As of September 30, 2017, the allowance for uncollectible accounts of approximately \$22,571,000 was comprised of \$15,426,000 reserved for self-pay balances and \$7,145,000 reserved for self-pay balances related to third party payors. As of September 30, 2016, the allowance for uncollectible accounts of approximately \$20,875,000 was comprised of \$14,350,000 reserved for self-pay balances and \$6,525,000 reserved for self-pay balances related to third party payors.

Medicaid expansion in Indiana and the surrounding states of Illinois and Kentucky combined with other health care reform initiatives, increased insurance coverage for patients who were previously uninsured. The System did change its policy related to charity care in 2017 and 2016. There were no changes to the policy for uninsured discounts in 2017 and 2016.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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### Inventories

Inventories (principally pharmaceuticals and medical supplies) are stated at the lower of cost (first in, first out) or market.

### Property and Equipment and Depreciation

Property and equipment are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable assets, ranging from 3 to 40 years, using the straight-line method. Equipment under capital leases are amortized on the straight-line method over the lease term or the estimated useful life of the equipment, if shorter.

### Foundation

The Hospital also encompasses a charitable Foundation supported by donations from the community. The Foundation, a department of the Hospital, has a separate advisory board that carries out the mission of supporting medical, charitable and educational activities as designated by the donors.

### Investments Limited as to Use

Investments are stated at fair value. Dividends, interest income and realized gains and losses on sales of investments are recorded as nonoperating investment income. Unrealized gains (losses) on investments are reported as other changes in net assets in the consolidated statements of operations.

Investments consist of short-term investments (principally cash equivalents), US Government and government agency obligations, marketable debt securities (corporate bonds and fixed income mutual funds), marketable equity securities (common and preferred corporate stock), equity mutual funds, private equity funds, and mortgage backed securities. Fair values for investments are based on quoted market prices. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

Private equity investments consist of limited partnerships investing in common stock of small and medium capitalization companies and mutual funds. Investments in those limited partnerships are reported at fair value as determined by the individual manager of each partnership. Although the manager uses its best judgment in estimating the fair value of the investments in the investment funds, there are inherent limitations in any estimation technique. Therefore, the values reported are not necessarily indicative of the amount that the investments funds could realize in a current transaction.

These estimated values may differ significantly from the values that would have been used had a ready market for the investments in the investment funds existed and the difference could be material. Private equity investments totaled approximately \$85,805,000 and \$21,987,000 (11.8% and 3.5% of investment portfolio) as of September 30, 2017 and 2016, respectively.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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Investments limited as to use include assets held by trustees under indenture agreements, amounts set aside by the Board of Directors for future capital improvements, retirement of debt over which the Board retains control and may at its discretion subsequently designate for other purposes and amounts designated by for the Foundation and donor restrictions. Amounts required to meet current liabilities of the System have been classified as current assets.

### Debt Issue Costs

Costs incurred in connection with the issuance of debt are amortized over the term of the related debt using the bonds outstanding method. Estimated annual amortization is approximately \$200,000.

### Business Combinations and Goodwill and Other Intangibles

The System accounts for a business combination using the acquisition method of accounting, and accordingly, the net assets of the acquired entity are recorded at their estimated fair values at the date of acquisition. Goodwill represents the excess of the purchase price over the fair value of net assets, including amounts assigned to identifiable intangible assets, if any. Goodwill is tested for impairment on an annual basis, or whenever an event occurs or circumstances indicate the carrying value of the goodwill may be impaired. The System performed the required annual impairment test for goodwill as of September 30, 2017 and 2016 using the income approach of calculating the present value of the future cash flows. The System determined no impairment of goodwill existed as of September 30, 2017 and 2016. As of September 30, 2017 and 2016, the System recorded goodwill and other intangibles of approximately \$25,466,000 related to the acquisition of majority owned entities.

### Medical Malpractice

The System participates in the State of Indiana Patient Compensation Fund (the Fund) and is covered under the Indiana Medical Malpractice Act (the Act). The Act provides for a maximum recovery of \$1,250,000 per occurrence (\$5,000,000 or \$7,500,000 annual aggregate based on hospital bed size), \$250,000 of which would be paid through the Hospital's malpractice insurance coverage and the balance would be paid by the Fund. Effective July 1, 2017, the maximum recovery under the Act was increased to \$1,650,000 per occurrence (\$8,000,000 or \$12,000,000 annual aggregate based on hospital bed size) with the healthcare provider responsible for the first \$400,000.

The Hospital is a member of a Vermont insurance company, Tecumseh Health Reciprocal Risk Retention Group (THRRRG), as a means to comply with the Hospital's required portion of the insurance coverage pursuant to the Act, as well as its general liability insurance and excess coverage. Membership in THRRRG includes 14 hospitals as of September 30, 2017. Coverage through THRRRG provides protection from liability in an amount not to exceed \$250,000 per incident and aggregate liability protection not to exceed \$7,500,000 per year. In addition, the System maintains a commercial umbrella/excess liability policy with a limit of \$15,000,000 each occurrence, \$15,000,000 aggregate per member and \$30,000,000 total policy aggregate.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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### Other Long-Term Liabilities

Other long-term liabilities include obligations related to the unfunded status of defined benefit plans, other employee benefit programs and derivative liabilities related to an interest rate swap.

### Performance Indicator

The consolidated statements of operations contain a performance indicator, excess revenues over expenses. Consistent with industry practice, unrealized gain and loss on other than trading investments, benefit related changes other than net periodic benefit cost, equity transfers, contributions restricted for long-term purposes and certain other items are excluded from the performance indicator.

### Income Taxes

Deaconess Health System, Inc., the Hospital and the Clinic are not-for-profit corporations as described in Section 501(c)(3) of the Internal Revenue Code and are generally exempt from income taxes. However, they are required to file Federal Form 990 – Return of Organization Exempt from Income Tax, which is an informational return only.

Accounting principles generally accepted in the United States of America require management to evaluate tax positions taken by the System and recognize a tax liability if the System has taken an uncertain position that more likely than not would not be sustained upon examination by various Federal and state taxing authorities. Management has analyzed the tax positions taken by the System and has concluded that as of September 30, 2017 and 2016, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the accompanying consolidated financial statements. The System is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress.

The remaining consolidated subsidiaries are organized as limited liability companies, whereby net taxable income is taxed directly to the members of the limited liability companies. Thus, the consolidated financial statements do not include any provision for Federal or state income taxes related to these entities.

These entities have filed their Federal and state income tax returns for periods through their most recent fiscal year ends (primarily December 31, 2016). These income tax returns are generally open to examination by the relevant taxing authorities for a period of three years from the later of the date the return was filed or its due date (including approved extensions).

### Contribution Revenues and In-Kind Donations

Unconditional promises to give cash and other assets to the System are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in

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## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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the consolidated statements of operations as net assets released from restriction. Donor-restricted contributions whose restrictions are met within the same year as received are included in nonoperating revenues (expenses) in the accompanying consolidated financial statements. In-kind donations are recorded as revenue and expense in the accompanying consolidated financial statements. These donations consist mainly of medical supplies and services which are recorded at their estimated fair values.

#### Temporarily Restricted Net Assets

Temporarily restricted net assets include those assets whose use by the System has been temporarily limited primarily for capital projects or a specified time period or purpose. The following is a summary of temporarily restricted net assets as of September 30, 2017 and 2016:

	<u>2017</u>	<u>2016</u>
Patient medical care	\$ 2,034,025	\$ 1,552,339
Education and scholarship	1,173,537	895,627
Capital projects	1,189,424	907,751
Other System support	2,544,814	1,942,166
	<u>\$ 6,941,800</u>	<u>\$ 5,297,883</u>

#### Permanently Restricted Net Assets

Permanently restricted net assets are contributed with donor restrictions requiring they be held in perpetuity with income used to support the System's activities. The following is a summary of permanently restricted net assets as of September 30, 2017 and 2016:

	<u>2017</u>	<u>2016</u>
Beneficial interest in trusts	\$ 1,163,587	\$ 1,140,864
Other	692,080	692,080
	<u>\$ 1,855,667</u>	<u>\$ 1,832,944</u>

#### Electronic Health Records (EHR) Incentive Payments

The System receives EHR incentive payments under the Medicare and Medicaid programs. To qualify for the EHR incentive payments, the System must meet "meaningful use" criteria that become more stringent over time. The System periodically submits and attests to its use of certified EHR technology, satisfaction of meaningful use objectives, and various patient data. These submissions generally include performance measures for each annual EHR reporting period (Federal fiscal year ending September 30). The related EHR incentive payments are paid out over a four year transition schedule and are based upon data that is captured in the System's cost reports. The payment calculation is based upon an initial amount as

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# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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adjusted for discharges, Medicare and Medicaid utilization using inpatient days multiplied by a factor of total charges excluding charity care to total charges, and a transitional factor that ranges from 100% in first payment year and thereby decreasing by 25% each payment year until it is completely phased out in the fifth year.

The System recognizes EHR incentive payments as grant income, under the ratable recognition method, when there is reasonable assurance that the System will comply with the conditions of the meaningful use objectives and any other specific requirements. In addition, the financial statement effects of the income must be both recognizable and measurable. During 2017 and 2016, the System recognized approximately \$12,000 and \$466,000, respectively, in EHR incentive payments as income.

EHR incentive income is included in other revenue in the consolidated statements of operations. EHR incentive income recognized is based on management's estimate and amounts are subject to change, with such changes impacting operations in the period the changes occur. Receipt of these funds is subject to the fulfillment of certain obligations by the Hospital as prescribed by the program, subject to future audits and may be subject to repayment upon a determination of noncompliance.

### Advertising Costs

Advertising costs are expensed as incurred. Total expense for 2017 and 2016 was approximately \$1,335,000 and \$1,368,000, respectively.

### Functional Expenses

The System provides health care services to patients in the community and the surrounding areas. Health care services and other certain related expenses approximated 93% of total expenses in 2017 and 2016. General and administrative expenses approximated 6% in 2017 and 2016. Fundraising expenses comprised less than 1% of total expenses in 2017 and 2016.

Certain costs have been allocated among health care services, general and administrative and fundraising categories based on the actual direct expenditures and cost allocations based upon time spent by the System's personnel. Although the methods used were appropriate, alternative methods may provide different results.

### Reclassification

Certain 2016 amounts in the consolidated financial statements have been reclassified to conform to the 2017 presentation. The reclassifications have no effect on previously reported net assets or change in net assets.

### Going Concern Evaluation

The System evaluates whether there are conditions or events that raise substantial doubt about the System's ability to continue as a going concern for a period of one year from the date the consolidated financial statements are issued.

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# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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### Subsequent Events

The System evaluates events or transactions occurring subsequent to the consolidated balance sheet date for recognition and disclosure in the accompanying consolidated financial statements through the date the consolidated financial statements are issued which is December 13, 2017.

### **2. CHANGE IN ACCOUNTING PRINCIPLES**

During 2017, the System adopted Accounting Standards Update (ASU) No. 2015-03, *Interest – Imputation of Interest*, which simplifies the presentation of debt issue costs by presenting them as direct deduction from face amount of the related debt. Previously, debt issue costs were aggregated and presented as a deferred charge within the other assets section of the consolidated balance sheet. Debt issue costs will continue to be amortized over the term of the related debt, but are now are presented as a component of interest expense in the consolidated statement of operations. The 2016 consolidated financial statements have been retroactively restated to adopt this ASU as detailed in the following table:

	Originally Reported	Effects of Implementation	Restated
Consolidated balance sheet			
Debt issue costs	\$ 1,379,744	\$ (1,379,744)	\$ -0-
Long-term debt, less current portion	\$ 256,762,832	\$ (1,379,744)	\$ 255,383,088

The System previously recorded the amortization of debt issue costs within interest expense, so the adoption of this ASU did not have any effect on the consolidated statements of operations or cash flows for 2016.

The System also adopted ASU No. 2014-15, *Presentation of Financial Statements – Going Concern (Topic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*. ASU No. 2014-15 requires management to evaluate whether there are conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a period of one year from the date the consolidated financial statements are issued. When conditions or events that raise substantial doubt exist, additional disclosures will be required to enable financial statement users to understand those conditions or events, management's evaluation of them and management's plans that either alleviated substantial doubt, or are intended to mitigate the conditions or events that raise substantial doubt. The adoption of ASU No. 2014-15 did not have a material effect on the accompanying consolidated financial statements.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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### 3. NET PATIENT SERVICE REVENUE

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

#### Medicare

Inpatient acute care services, outpatient services and physician services rendered to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary according to patient classification systems that are based on clinical, diagnostic and other factors. Certain outpatient services and defined medical education costs related to Medicare beneficiaries are paid based on cost reimbursement methodologies. The System's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review by a peer review organization. Inpatient non-acute care services are generally reimbursed based upon cost reimbursement methodologies.

#### Medicaid and Hospital Assessment Fee Program

Medicaid services are paid at prospectively determined rates per day or per discharge for inpatients or per occasion of service for outpatients. To the extent that services to Medicare and Medicaid program beneficiaries are reimbursed based on cost reimbursement methodologies, final settlement is determined after submission of annual cost reports and audits thereof by the fiscal intermediary.

The System participates in the State of Indiana's Hospital Assessment Fee (HAF) Program. The purpose of the HAF Program is to fund the State share of enhanced Medicaid payments and Medicaid Disproportionate Share payments for Indiana hospitals as reflected in the HAF Program expense reported in the consolidated statements of operations. The Medicaid enhanced payments relate to both fee for service and managed care claims. During 2017 and 2016, the Hospital recognized HAF Program expense of approximately \$23,464,000 and \$20,622,000, respectively, which resulted in Medicaid rate increases. HAF Program expense is included in other expenses on the consolidated statements of operations while the Medicaid rate increases are recorded in net patient service revenue.

Estimates for final settlements of all unaudited Medicare and Medicaid cost reports through September 30, 2017 have been recorded. Cost reports through September 30, 2014 have been audited and settled as of September 30, 2017.

The System also entered into payment agreements with certain other commercial insurance carriers, health maintenance organizations and preferred provider organizations. The basis for payment under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

A reconciliation of the amount of services provided to patients at established rates to net patient service revenue as presented in the consolidated statements of operations for 2017 and 2016 is as follows:

	2017	2016
Patient service revenue	\$ 2,571,826,454	\$ 2,407,322,824
Adjustments		
Charity care	50,732,693	39,896,399
Uninsured self pay discounts	23,549,636	26,162,500
Contractual adjustments	1,594,947,249	1,485,671,111
Total adjustments	1,669,229,578	1,551,730,010
Net patient service revenue	902,596,876	855,592,814
Less provision for bad debts	11,803,580	6,368,424
Net patient service revenue net of provision for bad debts	\$ 890,793,296	\$ 849,224,390

Changes to any previous year's estimated settlement are reflected in the period the intermediary finalizes its audit of cost reports, or when additional information becomes available. Settlements related to prior year cost reports and other estimated third-party items resulted in an increase to net patient service revenue of approximately \$300,000 and \$4,079,000 in 2017 and 2016, respectively.

The following is mix of gross patient accounts receivable and gross patient service revenue as of September 30, 2017 and 2016 and for the years ended:

	Receivable		Revenue	
	2017	2016	2017	2016
Medicare	28%	29%	47%	47%
Medicaid	15%	12%	15%	15%
Commercial and managed care	41%	42%	35%	35%
Self pay and other	16%	17%	3%	3%
	100%	100%	100%	100%

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. Compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs. As a result, there is at least a reasonable possibility that recorded estimates will change in the near term.

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

#### 4. INVESTMENTS

Investments at fair value consisted of the following as of September 30:

	2017	2016
Board designated funds		
Cash	\$ 9,432,837	\$ 3,023,450
Common stocks	145,906,483	110,632,864
Mutual funds	194,672,648	277,275,817
US Government and government agency obligations	62,818,617	54,962,791
Corporate bonds	119,107,035	88,157,456
Mortgage backed securities	17,531,976	3,810,396
Private equity	85,804,924	21,986,552
	635,274,520	559,849,326
Funds held by trustee		
Cash	-0-	20,053
Money market mutual funds	21,842,460	25,012,463
US Government and government agency obligations	55,933,481	26,307,393
Less current portion	(77,775,941)	(14,147)
	-0-	51,325,762
Board designated - Foundation and donor restricted - Foundation		
Cash	107,394	164,384
Common stocks	2,489,147	2,124,124
Mutual funds	12,148,678	9,457,790
US Government and government agency obligations	184,045	1,104,640
Accrued interest and other	2,028,482	1,276,522
	16,957,746	14,127,460
Investments limited as to use, net	\$ 652,232,266	\$ 625,302,548

Investments reported as current assets are those that the System has made available for use in operations within the next twelve months. Investments limited as to use that are required for obligations classified as current liabilities are also reported in current assets.

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

A detail of investment income for both unrestricted and donor restricted for 2017 and 2016 is as follows:

	2017	2016
Interest and dividends	\$ 12,732,051	\$ 13,961,954
Unrealized gain (loss) on interest rate swap	789,351	(326,878)
Net realized gain	15,460,862	1,436,170
Investment income, net	\$ 28,982,264	\$ 15,071,246

See Note "Derivative Financial Instruments – Interest Rate Swaps" for additional information on unrealized gain or loss on interest rate swap.

The following schedules summarize the fair value of securities included in investments limited as to use that have gross unrealized losses (the amount by which historical cost exceeds the fair value) as of September 30, 2017 and 2016. The schedules further segregate the securities that have been in a gross unrealized position as of September 30, 2017 and 2016, for less than twelve months and those for twelve months or more. The gross unrealized losses of less than twelve months are a reflection of the normal fluctuations of the market and are therefore considered temporary. The gross unrealized losses of twelve months or longer are reflective of current market fluctuations. The majority of the decline is attributable to several securities which industry experts expect recovery in the short-term future. These individual investments have projected recoveries in value in 2018. The decline in value is determined by management to be temporary, and unrealized losses have not been reclassified to realized losses as of September 30, 2017 and 2016.

Description of Securities	September 30, 2017					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Common stocks	\$ 16,022,607	\$ 1,917,603	\$ 5,324,024	\$ 517,409	\$ 21,346,631	\$ 2,435,012
Corporate bonds	29,091,087	369,862	19,085,344	785,275	48,176,431	1,155,137
Mortgage backed securities	46,436,008	558,270	5,406,938	140,563	51,842,946	698,833
Total temporarily impaired securities	\$ 91,549,702	\$ 2,845,735	\$ 29,816,306	\$ 1,443,247	\$121,366,008	\$ 4,288,982

Description of Securities	September 30, 2016					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Common stocks	\$ 2,989,170	\$ 304,494	\$ 14,955,873	\$ 2,355,229	\$ 17,945,043	\$ 2,659,723
Mutual funds	16,996,288	820,913	93,570,874	2,552,393	110,567,162	3,373,306
Corporate bonds	-0-	-0-	208,250	39,629	208,250	39,629
Mortgage backed securities	-0-	-0-	1,256,687	21,144	1,256,687	21,144
Total temporarily impaired securities	\$ 19,985,458	\$ 1,125,407	\$109,991,684	\$ 4,968,395	\$129,977,142	\$ 6,093,802

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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### 5. FAIR VALUE MEASUREMENTS

The framework for measuring fair value provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). The three levels of the fair value hierarchy are described as follows:

- Level 1: Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the System has the ability to access.
- Level 2: Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; inputs other than quoted prices that are observable for the asset or liability; inputs that are derived principally from or corroborated by observable market data by correlation or other means. If the asset or liability has a specified (contractual) term, the level 2 input must be observable for substantially the full term of the asset or liability.
- Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used as of September 30, 2017 and 2016:

- *Common stocks*: Valued based on the closing price reported on the active market on which the individual securities are traded.
- *Mutual funds*: Valued based on quoted net asset value (NAV) of the shares held by the System at year-end. The NAV is based on the value of the underlying assets owned by the fund, minus its liabilities and then divided by the number of shares outstanding. The NAV is quoted in an active market.
- *Money market mutual funds*: Valued based at the subscription and redemption activity at a \$1 stable NAV. However, on a daily basis the funds are valued at their daily NAV calculated using the amortized cost of securities.
- *US Government and government agency obligations*: Valued based on the closing price reported on the active market on which the securities are traded.

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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- *Corporate bonds and mortgage backed securities:* Valued using pricing models maximizing the use of observable inputs for similar securities.
- *Private equity investments:* Valued at the NAV of units of the fund. The NAV, as provided by the investment manager, is used as a practical expedient to estimate fair value. The private equity investments consist of investments in a variety of domestic and foreign equity and debt securities, managed accounts and other investment vehicles that employ diversified styles and strategies. The NAV is based on the fair value of the underlying investments held by the fund less its liabilities. Due to the nature of the investments held by the fund, changes in market conditions and the economic environment may significantly impact the NAV of the fund and, consequently, the fair value of the System's interests in the funds. Although a secondary market exists for these investments, it is not active and individual transactions are typically not observable. When transactions do occur in this limited secondary market, they may occur at discounts to the reported NAV. It is therefore reasonably possible that if the System were to sell these investments in the secondary market, a buyer may require a discount to the reported NAV, and the discount could be significant.
- *Derivative (Interest rate swap agreement):* Valued using pricing models that are derived principally from observable market data based on discounted cash flows and interest rate yield curves at quoted intervals for the full term of the swap. See the Note disclosure "Derivatives Financial Instruments – Interest Rate Swaps" for additional information related to derivatives.

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

Assets and liabilities measured at fair value on a recurring basis as of September 30, 2017 and 2016 are as follows:

	September 30, 2017			
	Total	Level 1	Level 2	Level 3
<b>Assets</b>				
Investments limited as to use				
Money market mutual funds	\$ 21,842,460	\$ -0-	\$ 21,842,460	\$ -0-
Common stocks				
Consumer	31,697,676	31,697,676	-0-	-0-
Financial services	24,144,057	24,144,057	-0-	-0-
Industrial and materials	30,636,631	30,636,631	-0-	-0-
Technology	25,336,211	25,336,211	-0-	-0-
Healthcare	14,558,699	14,558,699	-0-	-0-
Other	22,022,356	22,022,356	-0-	-0-
Total common stocks	148,395,630	148,395,630	-0-	-0-
Mutual funds				
Large growth	27,167,011	27,167,011	-0-	-0-
Large value	26,158,671	26,158,671	-0-	-0-
Large blend	152,846,038	152,846,038	-0-	-0-
Other	649,606	649,606	-0-	-0-
Total mutual funds	206,821,326	206,821,326	-0-	-0-
US Government and government agency obligations				
	118,936,143	118,936,143	-0-	-0-
Corporate bonds				
Consumer	23,265,794	-0-	23,265,794	-0-
Financial services	29,744,284	-0-	29,744,284	-0-
Industrial and materials	47,138,452	-0-	47,138,452	-0-
International	9,113,591	-0-	9,113,591	-0-
Other	9,844,914	-0-	9,844,914	-0-
Total corporate bonds	119,107,035	-0-	119,107,035	-0-
Mortgage backed securities				
	17,531,976	-0-	17,531,976	-0-
	632,634,570	<u>\$ 474,153,099</u>	<u>\$ 158,481,471</u>	<u>\$ -0-</u>
Cash	9,540,231			
Private equity (a)	85,804,924			
Accrued interest and other	2,028,482			
	<u>\$ 730,008,207</u>			
<b>Liabilities</b>				
Derivative	<u>\$ 507,487</u>	<u>\$ -0-</u>	<u>\$ 507,487</u>	<u>\$ -0-</u>

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

	September 30, 2016			
	Total	Level 1	Level 2	Level 3
<b>Assets</b>				
Investments limited as to use				
Money market mutual funds	\$ 25,012,463	\$ -0-	\$ 25,012,463	\$ -0-
Common stocks				
Consumer	28,290,957	28,290,957	-0-	-0-
Financial services	13,881,127	13,881,127	-0-	-0-
Industrial and materials	28,000,772	28,000,772	-0-	-0-
Technology	18,186,834	18,186,834	-0-	-0-
Healthcare	10,702,115	10,702,115	-0-	-0-
Other	13,695,183	13,695,183	-0-	-0-
Total common stocks	112,756,988	112,756,988	-0-	-0-
Mutual funds				
Intermediate term bond	183,535,844	183,535,844	-0-	-0-
International equity	36,385,801	36,385,801	-0-	-0-
Large cap	64,486,174	64,486,174	-0-	-0-
Small cap	744,060	744,060	-0-	-0-
Other	1,581,728	1,581,728	-0-	-0-
Total mutual funds	286,733,607	286,733,607	-0-	-0-
US Government and government agency obligations	82,374,824	82,374,824	-0-	-0-
Corporate bonds				
Consumer	18,863,944	-0-	18,863,944	-0-
Financial services	24,950,672	-0-	24,950,672	-0-
Industrial and materials	22,148,998	-0-	22,148,998	-0-
International	7,954,455	-0-	7,954,455	-0-
Other	14,239,387	-0-	14,239,387	-0-
Total corporate bonds	88,157,456	-0-	88,157,456	-0-
Mortgage backed securities	3,810,396	-0-	3,810,396	-0-
	598,845,734	\$ 481,865,419	\$ 116,980,315	\$ -0-
Cash	3,207,887			
Private equity (a)	21,986,552			
Accrued interest and other	1,276,522			
	<u>\$ 625,316,695</u>			
<b>Liabilities</b>				
Derivative	\$ 1,296,838	\$ -0-	\$ 1,296,838	\$ -0-

(a) In accordance with Subtopic 820-10, certain investments that were measured at NAV per share or its equivalent have not been classified in the fair value hierarchy. The fair value amounts presented in this table are intended to permit reconciliation of the fair value hierarchy to the line items presented at fair value in the consolidated balance sheets.

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

The following tables summarize the private equity investments measured at fair value based on NAV per share as of September 30, 2017 and 2016:

September 30, 2017				
Investment	Fair Value	Unfunded Commitments	Redemption Frequency	Redemption Notice Period
Private equity	\$ 26,800,699	None	Monthly	45 days
Private equity	59,004,225	None	Daily	Daily
	\$ 85,804,924			

September 30, 2016				
Investment	Fair Value	Unfunded Commitments	Redemption Frequency	Redemption Notice Period
Private equity	\$ 21,986,552	None	Monthly	45 days

The System's policy is to recognize transfers between levels as of the end of the reporting period. There were no transfers during 2017 and 2016.

Realized gain and loss are reported in the consolidated statements of operations as a component of investment income. Net realized gains of approximately \$15,461,000 and \$1,436,000 were recorded during 2017 and 2016, respectively. The market value of investments exceeded the cost by approximately \$89,409,000 and \$55,071,000 as of September 30, 2017 and 2016, respectively. The unrealized gain or loss is included in earnings for the period attributable to the change in unrealized gain or loss relating to assets held as of September 30, 2017 and 2016 and is reported in the consolidated statements of operations as net unrealized gain or loss on investments. During 2017 and 2016, the System recognized an unrealized gain of approximately of \$34,338,000 and \$33,797,000, respectively.

The System holds investments which are exposed to various risks such as interest rate, market, and credit. Due to the level of risk associated with these securities and the level of uncertainty related to changes in the value, it is at least reasonably possible that changes in the various risk factors will occur in the near term that could materially affect the amounts reported in the accompanying consolidated financial statements.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

### 6. LONG-TERM DEBT

The following is a summary of long-term debt as of September 30, 2017 and 2016:

	2017	2016
Hospital Revenue Bonds, Series 2011A		
Term bonds, payable through March 2029 in amounts ranging from \$770,000 to \$1,630,000 with interest; fixed rates ranging from 2.50% to 6.00%	\$ 14,900,000	\$ 15,835,000
Hospital Revenue Bonds, Series 2012B		
Term bonds, payable through January 2022 in amounts ranging from \$880,000 to \$1,755,000 with interest; fixed rate 2.30%	7,660,000	8,865,000
Hospital Revenue Bonds, Series 2012C		
Term bonds, payable through January 2019 in amounts ranging from \$1,100,000 to \$1,625,000 with interest; fixed rate 2.28%	3,145,000	4,560,000
Hospital Revenue Bonds, Series 2013A		
Term bonds, payable through March 2035 in amounts ranging from \$470,000 to \$8,070,000 with interest; fixed rates ranging from 3.00% to 5.00%	65,665,000	66,300,000
Hospital Revenue Bonds, Series 2013B		
Term bonds, payable through March 2029 in amounts ranging from \$1,000,000 to \$1,735,000 with interest; variable based on 70% of BBA LIBOR rate, 2.012% as of September 30, 2017	17,180,000	18,305,000
Hospital Revenue Bonds, Series 2013C		
Term bonds, payable through March 2036 in amounts ranging from \$250,000 to \$2,840,000 with interest; variable based on 67% of BBA LIBOR rate plus 90 basis points, 1.729% as of September 30, 2017	39,680,000	39,930,000
Refunding Revenue Bonds, Series 2015A		
Term bonds, payable from March 2017 through March 2039 in amounts ranging from \$140,000 to \$20,255,000 with interest; fixed rates ranging from 3.00% to 5.00%	48,060,000	48,270,000
Series 2016 Term Loan Agreement		
payable from January 2019 through January 2025 in amounts ranging from \$500,000 through \$2,100,000 with final payment of \$39,900,000 due in August 2026, fixed interest at 2.5%	53,000,000	53,000,000
Hospital Revenue Bonds, Series 2016A		
Serial bonds, payable through March 2039 in amounts ranging from \$405,000 to \$1,920,000 with interest; fixed rates ranging from 3.00% to 5.00%	18,970,000	-0-
Term bonds, payable on March 1, 2044 in amounts ranging from \$9,760,000 to \$45,000,000 with interest; fixed rates ranging from 3.125% to 5.000%	85,860,000	-0-
Other	3,253,921	4,706,370
	357,373,921	259,771,370
Current portion	(7,458,213)	(7,660,535)
Original issue premiums (discounts), net	8,842,615	4,651,996
Debt issue costs	(1,556,621)	(1,379,743)
Long-term debt, net of current portion	\$ 357,201,702	\$ 255,383,088

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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During 2017, the System issued, through the Indiana Finance Authority (the Authority), the Hospital Revenue Bonds, Series 2016A in the amount of \$104,830,000. The proceeds from the Series 2016A bonds, along with the proceeds from the Series 2016 Term Loan Agreement, were used to construct a new patient tower along with other related facility needs on the System's Gateway Campus.

In 2013, the System, the Authority and Fifth Third Bank entered into Bond Purchase Contracts (Contracts) whereby Fifth Third purchased from the Authority all of the Series 2012B, 2012C and 2013B bonds in a private placement. The Series 2013C bonds were purchased from the Authority by Bank of America in a private placement.

Under the terms of the Contracts, Fifth Third and Bank of America agreed to hold the Series 2012B and 2012C bonds through the stated bond maturity dates. The Contracts for the Series 2013B and 2013C bonds are through 2023. At the end of the Contract periods for the Series 2013B and 2013C bonds, these bonds could be remarketed to the original holders or to new investors at interest rate options as provided in the bond documents. If the Series 2013B and 2013C bonds cannot be remarketed at the end of the Contract periods, the System would be subject to payment of the remaining principal.

The System entered into an interest rate swap agreement with Fifth Third on the Series 2013B bonds. See the Note disclosure "Derivatives Financial Instruments – Interest Rate Swaps" for additional information.

All of the revenue bonds are secured by a security interest in the System's revenue. The System covenants that it will not permit any lien or security interest on the System facility other than certain permitted encumbrances. In addition, the various agreements require maintenance of certain debt service income ratios, limit additional borrowings, and require compliance with various other restrictive covenants. As of September 30, 2017 and 2016, the System believed it was in compliance with the restrictive covenants.

As of September 30, 2017, the System had outstanding property and equipment commitments of approximately \$153,000,000.

Aggregate maturities of long-term debt are as follows:

Year Ending September 30,	
2018	\$ 7,458,213
2019	7,626,266
2020	8,807,986
2021	8,702,755
2022	8,805,000
Thereafter	315,973,701
	<u>\$ 357,373,921</u>

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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### 7. DERIVATIVE FINANCIAL INSTRUMENTS – INTEREST RATE SWAPS

#### Objectives and Strategies for Using Derivatives

The System makes limited use of derivative financial instruments for the purpose of managing interest rate risk. In particular, forward interest rate swaps (which are designated as cash flow hedges) are used to manage the risk associated with interest rates on variable-rate borrowings and to lower its overall borrowing costs.

As of September 30, 2017 and 2016, the System had outstanding an interest rate swap agreement with Fifth Third, having a notional amount of \$17,180,000 and \$18,305,000, respectively. The agreement effectively changes the System's interest rate exposure on its Series 2013B bonds through March 2029 to a fixed 2.78%. The interest rate swap agreement matures at the time the related long-term debt matures. The System is exposed to credit loss in the event of nonperformance by the other parties to the interest rate swap agreement. However, the System does not anticipate nonperformance by the counterparties.

The derivative is not designated as a hedging instrument, and is marked-to-market on the consolidated balance sheet at fair value. The related gains and losses are included in excess revenues over expenses, the performance indicator, for the reporting period. Cash flows from interest rate swap contracts are classified as an operating activity on the consolidated statement of cash flows.

The asset derivatives are reported in the consolidated balance sheets as other assets and liability derivatives are reported as derivative liabilities in the other long-term liabilities. As of September 30, 2017 and 2016, the fair values of derivatives recorded in the consolidated balance sheets are as follows:

	<u>2017</u>	<u>2016</u>
Other long-term liabilities		
Derivative liability	\$ 507,487	\$ 1,296,838

During 2017 and 2016, the amount of gain or loss recognized in the consolidated statements of operations and reported as a component of investment income under nonoperating revenues (expenses) is as follows:

	<u>2017</u>	<u>2016</u>
Nonoperating revenues (expenses)		
Investment income		
Unrealized gain (loss) on derivative	\$ 789,351	\$ (326,878)

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

#### 8. DEFINED BENEFIT PENSION PLAN

The System offers a noncontributory defined benefit pension plan covering eligible employees. Benefits are based on each participant's years of service and compensation. Contributions to the plan are based on actuarially determined amounts sufficient to meet the benefits to be paid to plan participants. The defined benefit pension plan is closed to new participants. Participants should refer to the plan documents for more complete information. The following table sets forth the funded status of the benefit plan and amounts recognized in the consolidated financial statements as of and for the years ended September 30, 2017 and 2016.

	2017	2016
Change in benefit obligation		
Benefit obligation, beginning of year	\$ 315,892,947	\$ 278,607,271
Service cost	7,359,689	6,089,293
Interest cost	9,507,983	10,327,319
Benefits paid	(17,752,820)	(18,180,135)
Actuarial (gain) loss	(15,805,851)	39,049,199
Benefit obligation, end of year	\$ 299,201,948	\$ 315,892,947
Changes in plan assets		
Fair value of plan assets, beginning of year	\$ 205,639,786	\$ 197,593,167
Actual return on plan assets	20,009,444	18,222,754
Employer contributions	8,004,000	8,004,000
Benefits paid	(17,752,820)	(18,180,135)
Fair value of plan assets, end of year	\$ 215,900,410	\$ 205,639,786
Funded status		
Funded status of the plan, end of year	\$ (83,301,538)	\$ (110,253,161)
Amounts recognized in the consolidated balance sheets consist of		
Other long-term liabilities	\$ (83,301,538)	\$ (110,253,161)
Amounts not yet reflected in net periodic benefit cost and included in other changes in unrestricted net assets		
Prior service (cost) credit	\$ -0-	\$ -0-
Accumulated gain (loss)	(90,296,201)	(120,607,541)
Other changes in unrestricted net assets	(90,296,201)	(120,607,541)
Cumulative employer contributions in excess (deficit) of net periodic benefit cost	6,994,663	10,354,380
Net amount recognized in the consolidated balance sheets	\$ (83,301,538)	\$ (110,253,161)

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

Other pension disclosures for 2017 and 2016 include:

	2017	2016
Components of net periodic benefit cost		
Service cost	\$ 7,359,689	\$ 6,089,293
Interest cost	9,507,983	10,327,319
Expected return on plan assets	(14,767,040)	(14,778,942)
Amortization of prior year service cost	-0-	-0-
Amortization of (gain) loss	9,263,085	6,493,344
Net periodic benefit cost	\$ 11,363,717	\$ 8,131,014
Other changes in unrestricted net assets		
Net gain arising during year	\$ (21,048,255)	\$ 35,605,387
Amortization of prior service cost	-0-	-0-
Amortization of gain (loss)	(9,263,085)	(6,493,344)
Total other changes in unrestricted net assets	\$ (30,311,340)	\$ 29,112,043
Estimated amounts that will be amortized from other changes in unrestricted net assets over the next fiscal year		
Amortization of prior service (cost) credit	\$ -0-	\$ -0-
Amortization of gain (loss)	\$ (6,402,546)	\$ (9,263,085)
Weighted-average actuarial assumptions to determine benefit obligations of September 30		
Discount rate	3.79%	3.57%
Rate of compensation increase	3.50%	3.50%
Measurement date	9/30/17	9/30/16
Weighted-average actuarial assumptions to determine net periodic benefit cost as of September 30		
Discount rate	3.57%	4.36%
Expected long-term rate of return	7.25%	7.50%
Rate of compensation increase	3.50%	3.50%
Additional year end information		
Projected benefit obligation	\$ 299,201,948	\$ 315,892,947
Accumulated benefit obligation	\$ 280,122,488	\$ 293,792,216
Fair value of plan assets	\$ 215,900,410	\$ 205,639,786

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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The following is a schedule by year of expected benefit payments for the years after September 30, 2017:

Year Ending September 30,	
2018	\$ 9,015,380
2019	10,031,128
2020	10,991,425
2021	11,948,605
2022	12,918,343
2023-2027	<u>78,221,576</u>
	<u>\$ 133,126,457</u>

Determination of net periodic pension cost for the years ended September 30, 2017 and 2016 is based on assumptions and census data as of January 1, 2017 and 2016, respectively.

The principal long-term determinant of a portfolio's investment return is its asset allocation. The pension benefits plan allocation includes growth assets (60%) and fixed income (40%). In addition, active management strategies have added value relative to passive benchmark returns. The expected long-term rate of return assumption is based on the mix of assets in the plan, the long-term earnings expected to be associated with each asset class, and the additional return expected through active management. This assumption is periodically benchmarked against peer plans.

The amortization of any prior service cost is determined using a straight-line amortization of the cost over the average remaining service period of employees expected to receive benefits under the pension benefits plan. The pension benefits plan's weighted-average, asset allocations as of September 30, 2017 and 2016, by asset category, are as follows:

	<u>2017</u>	<u>2016</u>
Equity		
Mutual funds	37%	37%
Common/collective trusts	10%	19%
Common stocks	<u>13%</u>	<u>4%</u>
Total equity	60%	60%
Fixed income		
Mutual funds	11%	26%
Bonds	11%	0%
Common/collective trusts	<u>11%</u>	<u>8%</u>
Total fixed income	33%	34%
Cash equivalents	2%	1%
Private equity	<u>5%</u>	<u>5%</u>
	<u>100%</u>	<u>100%</u>

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## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

The allocation strategy for the pension benefits plan currently comprises approximately 50% to 70% growth investments (target of 60%) and 30% to 50% fixed-income investments (target of 40%). Within the growth investment classification, the plan asset strategy encompasses equity and equity-like instruments that are expected to represent approximately 60% of the System's plan asset portfolio of both public and private market investments. The largest component of these equity and equity-like instruments is public equity securities that are well diversified and invested in U.S. and international companies.

Fair value of mutual funds and marketable equity securities are based on the quoted prices in active markets. Common/collective trusts are valued at the NAV on a private market that is not active. However, the underlying investments are traded on an active market. The fair value of the private equity funds is valued at the percentage ownership of the NAV as reported to the plan by the individual managers.

The following is an analysis of fair value of the major classes of pension benefits plan assets of September 30, 2017 and 2016:

	2017	2016
Level 1		
Mutual funds		
Intermediate bond	\$ 23,639,161	\$ 54,750,932
Large blend	57,129,220	58,001,979
Foreign	22,570,662	18,775,580
Total mutual funds	103,339,043	131,528,491
Common stocks		
Financial services	5,231,977	2,633,462
Industrial and materials	4,726,967	1,131,585
Other	18,663,974	4,066,306
Total common stocks	28,622,918	7,831,353
Total Level 1	131,961,961	139,359,844
Level 2		
Fixed income bonds		
Domestic	21,154,412	-0-
High yield	410,418	-0-
Foreign	1,695,223	-0-
Total Level 2	23,260,053	-0-
Cash equivalents	4,567,933	1,989,149
Common/collective trusts - not classified	44,359,679	53,943,259
Private equity - not classified	11,750,784	10,347,534
	\$ 215,900,410	\$ 205,639,786

See the Note disclosure "Fair Value Measurements" for additional information.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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In 2017 and 2016, the System made available lump sum cash outs to certain eligible vested terminated participants. The System expects to contribute in excess of the required funding amounts to its pension benefits plan in 2018 of approximately \$8,000,000.

The System also offers a 401k plan to eligible employees where the System makes base contributions to eligible employees based on years of service in addition to matching contributions (25% of employee deferral up to 6% of eligible earnings) based on the eligible employees' contribution to the 401k plan. Total expense for the System's contributions for eligible employees for 2017 and 2016 was approximately \$10,066,000 and \$8,472,000, respectively.

### 9. RELATED PARTY TRANSACTIONS

The Hospital is a joint-owner of The Women's Hospital. The Hospital owns the building in which The Women's Hospital is located and leases the space to The Women's Hospital currently at approximately \$230,000 per month with an option to increase that amount annually through 2031. The Hospital provides ancillary services (lab, radiology) for The Women's Hospital. Ancillary services provided were approximately \$3,182,000 and \$3,022,000 in 2017 and 2016, respectively.

The Hospital is a joint owner of Evansville Surgery Center Associates, LLC (Surgery Center). The Hospital recorded contract service expense related to the Surgery Center of approximately \$28,952,000 and \$28,597,000 in 2017 and 2016, respectively. As of September 30, 2017 and 2016, the Hospital had a liability to the Surgery Center of approximately \$3,708,000 and \$3,769,000, respectively.

The Hospital is a joint-owner of HealthSouth Deaconess Rehabilitation Hospital. The Hospital provides ancillary services (lab, radiology) to HealthSouth Deaconess Rehabilitation Hospital. Ancillary services provided were approximately \$1,033,000 and \$837,000 in 2017 and 2016, respectively.

Related party transactions between the System and other joint ventures in 2017 and 2016 were not significant to the System's overall consolidated financial statements.

### 10. COMMITMENTS AND CONTINGENCIES

#### Operating leases

The System leases various equipment and facilities under operating leases expiring at various dates through 2026. Total lease expense for 2017 and 2016 was approximately \$12,739,000 and \$12,496,000, respectively.

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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The following are the minimum lease payments for the years after September 30, 2017:

Year Ending September 30,	
2018	\$ 15,838,000
2019	16,100,000
2020	13,519,000
2021	12,296,000
2022	11,529,000
Thereafter	<u>18,301,000</u>
	<u>\$ 87,583,000</u>

#### Litigation

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

#### Health Insurance

The System's employee health care insurance is provided through a combination of insured, self-insured and purchased re-insurance coverage from a commercial carrier. The System maintains an estimated liability for the amount of claims incurred but not reported. Substantially all employees are covered for major medical benefits. The self-insured health coverage carries a stop-loss maximum of \$350,000 per case with no aggregate limit.

#### **11. RECENTLY ISSUED ACCOUNTING STANDARDS**

On May 28, 2014, the Financial Accounting Standards Board (the FASB) issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The core principle of this 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 those goods or services". On August 12, 2015, the FASB further amended this guidance and issued ASU 2015-14, *Revenue from Contracts with Customers (Topic 606)*, which deferred the effective date for all entities by one year. These new standards, which the System is not required to adopt until its year ending September 30, 2019, deal with the timing of reporting revenues from contracts with customers, and disclosures related thereto.

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2017 AND 2016

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On January 5, 2016, the FASB issued ASU No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. This new standard, which the System is not required to adopt until its year ending September 30, 2019, is intended to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. The primary impact on the System will be that changes in the fair value of equity investments will be recognized in net income, rather than in other comprehensive income as currently required.

On February 25, 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. This new standard, which the System is not required to adopt until its year ending September 30, 2020, is intended to improve financial reporting about leasing transactions by requiring entities that lease assets to recognize on their balance sheet the assets and liabilities for the rights and obligations created by those leases, and to provide additional disclosures regarding the leases. Leases with terms (as defined in the ASU) of twelve months or less are not required to be reflected on an entity's balance sheet.

On August 18, 2016, the FASB issued ASU No. 2016-14 *Presentation of Financial Statements of Not-for-Profit Entities (Topic 958)* that amends how a not-for-profit organization classifies its net assets, as well as the information it presents in financial statements and notes about its liquidity, financial performance, and cash flows. This new standard, which the System is not required to adopt until its year ending September 30, 2019, requires improved presentation and disclosures to help not-for-profits provide more relevant information about their resources (and the changes in those resources) to donors, grantors, creditors, and other users. This ASU completes the first phase of a two phase project to amend not-for-profit financial reporting requirements.

On November 17, 2016, the FASB issued ASU No. 2016-18, *Statement of Cash (Topic 230) – Restricted Cash*. This new standard intends to eliminate diversity in practice by requiring the statement of cash flows to present the change in the total cash and cash equivalents, which will include restricted cash and cash equivalents. The System will be required to adopt this new standard in the year ending September 30, 2019.

The System is presently evaluating the effects that these ASUs will have on its future financial consolidated statements, including related disclosures.

**SUPPLEMENTARY INFORMATION**

# DEACONESS HEALTH SYSTEM

## CONSOLIDATING BALANCE SHEET SEPTEMBER 30, 2017

	Consolidated Deaconess Health System	Eliminations	Deaconess Health System Obligated Group	Deaconess Clinic, Inc.	Progressive Health of Indiana, LLC	The Heart Hospital At Deaconess Gateway, LLC	Tri-State Radiation Oncology, LLC	Deaconess VNA Plus, LLC	Other Entities
<b>Assets</b>									
Current assets									
Cash and cash equivalents	\$ 78,754,009	\$ -0-	\$ 69,617,750	\$ -0-	\$ 334,137	\$ 807,734	\$ 2,303,112	\$ 1,496,122	\$ 4,195,154
Funds held by trustee, current portion	77,775,941	-0-	77,775,941	-0-	-0-	-0-	-0-	-0-	-0-
Patient accounts receivable, net	126,202,456	-0-	100,265,840	9,951,925	92,478	9,703,427	1,008,925	3,221,064	1,958,797
Inventories	9,872,713	-0-	7,553,395	-0-	2,980	1,590,334	-0-	-0-	726,004
Prepaid expenses and other current assets	39,383,185	(11,647,040)	41,997,297	2,033,662	2,603,769	297,223	151,551	247,002	3,699,721
Total current assets	331,988,304	(11,647,040)	297,210,223	11,985,587	3,033,364	12,398,718	3,463,588	4,964,188	10,579,676
Investments limited as to use, less current portion									
Board designated funds	635,274,520	-0-	635,274,520	-0-	-0-	-0-	-0-	-0-	-0-
Board designated funds - Foundation	8,160,279	-0-	8,160,279	-0-	-0-	-0-	-0-	-0-	-0-
Donor restricted - Foundation	8,797,467	-0-	8,797,467	-0-	-0-	-0-	-0-	-0-	-0-
Total investments limited as to use	652,232,266	-0-	652,232,266	-0-	-0-	-0-	-0-	-0-	-0-
Property and equipment									
Land and improvements	28,239,429	-0-	27,230,716	-0-	-0-	-0-	-0-	-0-	1,008,713
Buildings and improvements	591,782,602	-0-	591,138,921	-0-	2,426	-0-	641,255	-0-	-0-
Furniture, fixtures and equipment	279,532,769	-0-	240,864,082	10,924,262	63,476	15,417,406	8,472,870	3,479,852	310,821
	899,554,800	-0-	859,233,719	10,924,262	65,902	15,417,406	9,114,125	3,479,852	1,319,534
Less allowances for depreciation	548,195,912	-0-	525,654,160	5,926,741	50,832	8,946,830	4,744,836	2,648,550	223,963
	351,358,888	-0-	333,579,559	4,997,521	15,070	6,470,576	4,369,289	831,302	1,095,571
Construction in progress	107,662,779	-0-	107,104,176	190,682	-0-	253,573	-0-	-0-	114,348
Total property and equipment, net	459,021,667	-0-	440,683,735	5,188,203	15,070	6,724,149	4,369,289	831,302	1,209,919
Other assets									
Investments in joint ventures	30,783,169	(19,266,081)	49,629,826	87,924	-0-	-0-	-0-	-0-	331,500
Goodwill and other intangibles	25,465,919	-0-	18,509,986	297,118	-0-	6,658,815	-0-	-0-	-0-
Other	18,202,639	-0-	16,773,677	1,665,260	(236,298)	-0-	-0-	-0-	-0-
Total other assets	74,451,727	(19,266,081)	84,913,489	2,050,302	(236,298)	6,658,815	-0-	-0-	331,500
Total assets	\$ 1,517,693,964	\$ (30,913,121)	\$ 1,475,039,713	\$ 19,224,092	\$ 2,812,136	\$ 25,781,682	\$ 7,832,877	\$ 5,795,490	\$ 12,121,095

See report of independent auditors on pages 1 and 2.

# DEACONESS HEALTH SYSTEM

## CONSOLIDATING BALANCE SHEET SEPTEMBER 30, 2017

	Consolidated Deaconess Health System	Eliminations	Deaconess Health System Obligated Group	Deaconess Clinic, Inc.	Progressive Health of Indiana, LLC	The Heart Hospital At Deaconess Gateway, LLC	Tri-State Radiation Oncology, LLC	Deaconess VNA Plus, LLC	Other Entities
<b>Liabilities and net assets</b>									
Current liabilities									
Accounts payable and other accrued liabilities	\$ 67,081,395	\$ (11,647,040)	\$ 56,527,031	\$ 11,758,278	\$ (2,850)	\$ 3,341,768	\$ 2,914,051	\$ 1,937,190	\$ 2,252,967
Salaries, wages and related liabilities	50,713,323	-0-	36,502,619	11,453,413	633,042	1,211,418	162,910	455,287	294,634
Estimated third-party payor settlements	4,998,011	-0-	3,832,430	-0-	-0-	1,165,581	-0-	-0-	-0-
Accrued interest	996,230	-0-	993,588	-0-	-0-	2,642	-0-	-0-	-0-
Other current liabilities	480,938	-0-	-0-	-0-	-0-	-0-	119,618	-0-	361,320
Current portion of long-term debt	7,458,213	-0-	6,022,900	-0-	-0-	712,553	673,764	48,996	-0-
Total current liabilities	131,728,110	(11,647,040)	103,878,568	23,211,691	630,192	6,433,962	3,870,343	2,441,473	2,908,921
Long-term liabilities									
Long-term debt, less current portion	357,201,702	-0-	355,469,154	-0-	-0-	1,041,539	330,837	360,172	-0-
Other long-term liabilities	90,849,885	-0-	90,849,885	-0-	-0-	-0-	-0-	-0-	-0-
Total long-term liabilities	448,051,587	-0-	446,319,039	-0-	-0-	1,041,539	330,837	360,172	-0-
Total liabilities	579,779,697	(11,647,040)	550,197,607	23,211,691	630,192	7,475,501	4,201,180	2,801,645	2,908,921
Net assets									
Unrestricted	915,848,997	(32,533,884)	916,044,639	(3,987,599)	2,181,944	18,306,181	3,631,697	2,993,845	9,212,174
Non-controlling interest	13,267,803	13,267,803	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Total unrestricted net assets	929,116,800	(19,266,081)	916,044,639	(3,987,599)	2,181,944	18,306,181	3,631,697	2,993,845	9,212,174
Temporarily restricted	6,941,800	-0-	6,941,800	-0-	-0-	-0-	-0-	-0-	-0-
Permanently restricted	1,855,667	-0-	1,855,667	-0-	-0-	-0-	-0-	-0-	-0-
Total net assets	937,914,267	(19,266,081)	924,842,106	(3,987,599)	2,181,944	18,306,181	3,631,697	2,993,845	9,212,174
Total liabilities and net assets	<u>\$ 1,517,693,964</u>	<u>\$ (30,913,121)</u>	<u>\$ 1,475,039,713</u>	<u>\$ 19,224,092</u>	<u>\$ 2,812,136</u>	<u>\$ 25,781,682</u>	<u>\$ 7,832,877</u>	<u>\$ 5,795,490</u>	<u>\$ 12,121,095</u>

See report of independent auditors on pages 1 and 2.

# DEACONESS HEALTH SYSTEM

## CONSOLIDATING STATEMENT OF OPERATIONS YEAR ENDED SEPTEMBER 30, 2017

	Consolidated Deaconess Health System	Eliminations	Deaconess Health System Obligated Group	Deaconess Clinic, Inc.	Progressive Health of Indiana, LLC	The Heart Hospital At Deaconess Gateway, LLC	Tri-State Radiation Oncology, LLC	Deaconess VNA Plus, LLC	Other Entities
<b>Unrestricted revenue and other support</b>									
Net patient service revenue	\$ 902,596,876	\$ -0-	\$ 737,247,167	\$ 81,135,490	\$ 1,003,608	\$ 56,754,168	\$ 13,598,631	\$ 11,864,671	\$ 993,141
Less provision for bad debts	11,803,580	-0-	11,522,671	659,114	29,124	(438,841)	-0-	31,512	-0-
Net patient service revenue net of provision for bad debts	890,793,296	-0-	725,724,496	80,476,376	974,484	57,193,009	13,598,631	11,833,159	993,141
Other revenue	40,073,272	(39,018,248)	24,249,315	5,117,075	24,791,426	2,117	-0-	209,527	24,722,060
Total unrestricted revenue and other support	930,866,568	(39,018,248)	749,973,811	85,593,451	25,765,910	57,195,126	13,598,631	12,042,686	25,715,201
<b>Expenses</b>									
Salaries and wages	362,849,069	-0-	258,366,329	72,878,877	12,832,885	9,163,005	1,552,402	6,288,223	1,767,348
Employee benefits	98,994,614	-0-	78,982,091	12,645,927	2,370,829	2,836,867	282,037	1,466,581	410,282
Supplies	169,008,466	-0-	129,069,905	8,483,351	100,442	14,730,997	121,458	394,188	16,108,125
Contract services	96,122,440	(52,394,532)	121,079,846	10,875,326	2,162,130	10,426,510	1,011,323	-0-	2,961,837
Repairs and maintenance	28,636,106	-0-	27,270,954	624,368	2,933	735,205	-0-	-0-	2,646
Depreciation	45,411,426	-0-	41,606,612	886,631	2,907	1,850,580	616,722	426,800	21,174
Interest	6,958,924	-0-	6,807,996	-0-	-0-	56,786	94,142	-0-	-0-
Utilities	13,248,537	-0-	11,373,842	1,428,028	58,446	297,420	63,173	-0-	27,628
Other	61,777,467	(2,205,814)	43,429,962	8,185,269	746,221	4,632,152	1,279,342	5,491,676	218,659
Total expenses	883,007,049	(54,600,346)	717,987,537	116,007,777	18,276,793	44,729,522	5,020,599	14,067,468	21,517,699
Income (loss) from operations	47,859,519	15,582,098	31,986,274	(30,414,326)	7,489,117	12,465,604	8,578,032	(2,024,782)	4,197,502
<b>Nonoperating revenues (expenses)</b>									
Investment income (loss)	28,960,898	-0-	28,968,138	(8,770)	-0-	471	-0-	-0-	1,059
Contributions, gifts, and bequests	648,535	-0-	648,535	-0-	-0-	-0-	-0-	-0-	-0-
Grants	(1,485,785)	-0-	(1,485,785)	-0-	-0-	-0-	-0-	-0-	-0-
Total nonoperating revenues (expenses)	28,123,648	-0-	28,130,888	(8,770)	-0-	471	-0-	-0-	1,059
Excess revenues over (under) expenses	75,983,167	15,582,098	60,117,162	(30,423,096)	7,489,117	12,466,075	8,578,032	(2,024,782)	4,198,561
<b>Other changes in unrestricted net assets</b>									
Net unrealized gain on investments	34,241,434	-0-	34,241,434	-0-	-0-	-0-	-0-	-0-	-0-
Benefit related changes other than net periodic benefit cost	30,311,340	-0-	30,311,340	-0-	-0-	-0-	-0-	-0-	-0-
Net assets released from restriction	559,207	-0-	559,207	-0-	-0-	-0-	-0-	-0-	-0-
Capital contributions	-0-	(31,758,410)	-0-	24,159,577	-0-	-0-	-0-	5,018,627	2,580,206
Distributions	(15,504,096)	17,450,177	-0-	-0-	(8,374,574)	(10,537,506)	(9,529,000)	-0-	(4,513,193)
Change in unrestricted net assets	125,591,052	1,273,865	125,229,143	(6,263,519)	(885,457)	1,928,569	(950,968)	2,993,845	2,265,574
<b>Temporarily restricted net assets</b>									
Contributions, gifts, and bequests	2,084,835	-0-	2,084,835	-0-	-0-	-0-	-0-	-0-	-0-
Net unrealized gain on investments	21,366	-0-	21,366	-0-	-0-	-0-	-0-	-0-	-0-
Investment income	96,923	-0-	96,923	-0-	-0-	-0-	-0-	-0-	-0-
Net assets released from restriction	(559,207)	-0-	(559,207)	-0-	-0-	-0-	-0-	-0-	-0-
Change in temporarily restricted net assets	1,643,917	-0-	1,643,917	-0-	-0-	-0-	-0-	-0-	-0-
<b>Permanently restricted net assets</b>									
Change in beneficial interest in trusts	22,723	-0-	22,723	-0-	-0-	-0-	-0-	-0-	-0-
<b>Change in net assets</b>	<b>\$ 127,257,692</b>	<b>\$ 1,273,865</b>	<b>\$ 126,895,783</b>	<b>\$ (6,263,519)</b>	<b>\$ (885,457)</b>	<b>\$ 1,928,569</b>	<b>\$ (950,968)</b>	<b>\$ 2,993,845</b>	<b>\$ 2,265,574</b>

See report of independent auditors on pages 1 and 2.

## DEACONESS HEALTH SYSTEM

### CONSOLIDATING BALANCE SHEET – DEACONESS HEALTH SYSTEM OBLIGATED GROUP SEPTEMBER 30, 2017

	Deaconess Health System Obligated Group	Eliminations	Deaconess Health System, Inc.	Deaconess Hospital, Inc.
<b>Assets</b>				
Current assets				
Cash and cash equivalents	\$ 69,617,750	\$ -0-	\$ 3,609,346	\$ 66,008,404
Funds held by trustee, current portion	77,775,941	-0-	-0-	77,775,941
Patient accounts receivable, net	100,265,840	-0-	-0-	100,265,840
Inventories	7,553,395	-0-	-0-	7,553,395
Prepaid expenses and other current assets	41,997,297	(6,209,537)	2,375,639	45,831,195
Total current assets	297,210,223	(6,209,537)	5,984,985	297,434,775
Investments limited as to use, less current portion				
Board designated funds	635,274,520	-0-	-0-	635,274,520
Board designated funds - Foundation	8,160,279	-0-	-0-	8,160,279
Donor restricted - Foundation	8,797,467	-0-	-0-	8,797,467
Total investments limited as to use	652,232,266	-0-	-0-	652,232,266
Property and equipment				
Land and improvements	27,230,716	-0-	2,256,759	24,973,957
Buildings and improvements	591,138,921	-0-	32,892,487	558,246,434
Furniture, fixtures and equipment	240,864,082	-0-	11,964	240,852,118
	859,233,719	-0-	35,161,210	824,072,509
Less allowances for depreciation	525,654,160	-0-	23,845,165	501,808,995
	333,579,559	-0-	11,316,045	322,263,514
Construction in progress	107,104,176	-0-	222,874	106,881,302
Total property and equipment, net	440,683,735	-0-	11,538,919	429,144,816
Other assets				
Investments in joint ventures	49,629,826	-0-	2,285,442	47,344,384
Goodwill and other intangibles	18,509,986	-0-	-0-	18,509,986
Other	16,773,677	(73,229)	-0-	16,846,906
Total other assets	84,913,489	(73,229)	2,285,442	82,701,276
Total assets	\$ 1,475,039,713	\$ (6,282,766)	\$ 19,809,346	\$ 1,461,513,133

See report of independent auditors on pages 1 and 2.

## DEACONESS HEALTH SYSTEM

### CONSOLIDATING BALANCE SHEET – DEACONESS HEALTH SYSTEM OBLIGATED GROUP SEPTEMBER 30, 2017

	Deaconess Health System Obligated Group	Eliminations	Deaconess Health System, Inc.	Deaconess Hospital, Inc.
<b>Liabilities and net assets</b>				
Current liabilities				
Accounts payable and other accrued liabilities	\$ 56,527,031	\$ (6,209,537)	\$ 6,587,885	\$ 56,148,683
Salaries, wages and related liabilities	36,502,619	-0-	-0-	36,502,619
Estimated third-party payor settlements	3,832,430	-0-	-0-	3,832,430
Accrued interest	993,588	-0-	-0-	993,588
Current portion of long-term debt	6,022,900	-0-	-0-	6,022,900
Total current liabilities	103,878,568	(6,209,537)	6,587,885	103,500,220
Long-term liabilities				
Long-term debt, less current portion	355,469,154	-0-	-0-	355,469,154
Other long-term liabilities	90,849,885	-0-	-0-	90,849,885
Total long-term liabilities	446,319,039	-0-	-0-	446,319,039
Total liabilities	550,197,607	(6,209,537)	6,587,885	549,819,259
Net assets				
Unrestricted	916,044,639	(73,229)	13,221,461	902,896,407
Temporarily restricted	6,941,800	-0-	-0-	6,941,800
Permanently restricted	1,855,667	-0-	-0-	1,855,667
Total net assets	924,842,106	(73,229)	13,221,461	911,693,874
Total liabilities and net assets	<u>\$ 1,475,039,713</u>	<u>\$ (6,282,766)</u>	<u>\$ 19,809,346</u>	<u>\$ 1,461,513,133</u>

See report of independent auditors on pages 1 and 2.

## DEACONESS HEALTH SYSTEM

### CONSOLIDATING STATEMENT OF OPERATIONS – DEACONESS HEALTH SYSTEM OBLIGATED GROUP YEAR ENDED SEPTEMBER 30, 2017

	Deaconess Health System Obligated Group	Eliminations	Deaconess Health System, Inc.	Deaconess Hospital, Inc.
<b>Unrestricted revenue and other support</b>				
Net patient service revenue	\$ 737,247,167	\$ -0-	\$ -0-	\$ 737,247,167
Less provision for bad debts	11,522,671	-0-	-0-	11,522,671
Net patient service revenue net of provision for bad debts	725,724,496	-0-	-0-	725,724,496
Other revenue (expense)	24,249,315	(1,373,162)	(30,440,346)	56,062,823
Total unrestricted revenue and other support	749,973,811	(1,373,162)	(30,440,346)	781,787,319
<b>Expenses</b>				
Salaries and wages	258,366,329	-0-	-0-	258,366,329
Employee benefits	78,982,091	-0-	-0-	78,982,091
Supplies	129,069,905	-0-	4,260	129,065,645
Contract services	121,079,846	-0-	1,124,463	119,955,383
Repairs and maintenance	27,270,954	-0-	397,741	26,873,213
Depreciation	41,606,612	-0-	880,837	40,725,775
Interest	6,807,996	-0-	-0-	6,807,996
Utilities	11,373,842	-0-	332,157	11,041,685
Other	43,429,962	(1,373,162)	200,034	44,603,090
Total expenses	717,987,537	(1,373,162)	2,939,492	716,421,207
Income (loss) from operations	31,986,274	-0-	(33,379,838)	65,366,112
<b>Nonoperating revenues (expenses)</b>				
Investment income	28,968,138	-0-	9,773	28,958,365
Contributions, gifts, and bequests	648,535	-0-	-0-	648,535
Grants	(1,485,785)	-0-	-0-	(1,485,785)
Total nonoperating revenues (expenses)	28,130,888	-0-	9,773	28,121,115
Excess revenues over (under) expenses	60,117,162	-0-	(33,370,065)	93,487,227
<b>Other changes in unrestricted net assets</b>				
Net unrealized gain on investments	34,241,434	-0-	-0-	34,241,434
Benefit related changes other than net periodic benefit cost	30,311,340	-0-	-0-	30,311,340
Net assets released from restriction	559,207	-0-	-0-	559,207
Transfers	-0-	-0-	29,718,751	(29,718,751)
Change in unrestricted net assets	125,229,143	-0-	(3,651,314)	128,880,457
<b>Temporarily restricted net assets</b>				
Contributions, gifts, and bequests	2,084,835	-0-	-0-	2,084,835
Investment income	21,366	-0-	-0-	21,366
Net unrealized gain on investments	96,923	-0-	-0-	96,923
Net assets released from restriction	(559,207)	-0-	-0-	(559,207)
Change in temporarily restricted net assets	1,643,917	-0-	-0-	1,643,917
<b>Permanently restricted net assets</b>				
Contributions, gifts, and bequests	22,723	-0-	-0-	22,723
<b>Change in net assets</b>	<b>\$ 126,895,783</b>	<b>\$ -0-</b>	<b>\$ (3,651,314)</b>	<b>\$ 130,547,097</b>

See report of independent auditors on pages 1 and 2.