

Essentia Health

Consolidated Financial Report
With Independent Auditor's Report Thereon
With Supplementary Information
June 30, 2019 and 2018

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RSM US LLP

Independent Auditor's Report

The Board of Directors
Essentia Health

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Essentia Health, which comprise the consolidated balance sheets as of June 30, 2019 and 2018, the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements (collectively, the financial statements).

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Essentia Health as of June 30, 2019 and 2018, 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.

Emphasis of Matter

As discussed in Note 2 to the financial statements, Essentia Health adopted new accounting guidance: Accounting Standards Update No. 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*, and Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. Our opinion is not modified with respect to this matter.

RSM US LLP

Minneapolis, Minnesota
October 7, 2019

Essentia Health

Consolidated Balance Sheets
June 30, 2019 and 2018
(Dollars in Thousands)

	2019	2018
Assets		
Current assets:		
Cash and cash equivalents	\$ 24,897	\$ 29,025
Short-term investments	30,705	29,995
Current portion of assets whose use is limited (Note 6)	14,850	13,096
Patient service accounts receivable (Note 5)	237,315	228,948
Prepaid expenses and other receivables	59,196	50,269
Inventories	52,459	50,434
Total current assets	419,422	401,767
Assets whose use is limited, less current portion (Note 6):		
Funds designated by Board	1,030,446	954,385
Funds held by trustee	612,910	452
Funds held under self-insurance program	51,950	49,481
Funds held for deferred compensation and other	115,595	109,013
	1,810,901	1,113,331
Property and equipment, net (Note 8)	739,073	714,760
Other noncurrent assets, net (Note 9)	109,846	109,932
Total assets	\$ 3,079,242	\$ 2,339,790

See notes to consolidated financial statements.

	2019	2018
Liabilities and Net Assets		
Current liabilities:		
Accounts payable	\$ 41,834	\$ 35,651
Payable to third-party payors (Note 5)	5,263	2,835
Accrued liabilities:		
Salaries, wages and benefits	163,093	157,044
Interest	20,488	8,329
Current portion of long-term debt (Note 10)	22,333	23,156
Other	24,655	24,715
Total current liabilities	277,666	251,730
Long-term debt (Note 10)	1,164,381	548,987
Employee benefit plan and deferred compensation liabilities (Note 12)	179,621	167,825
Self-insurance program liabilities (Note 13)	52,884	54,525
Other noncurrent liabilities	57,620	53,535
Total liabilities	1,732,172	1,076,602
Net assets:		
Without donor restrictions	1,334,212	1,251,666
With donor restrictions	12,858	11,522
Total net assets	1,347,070	1,263,188
Total liabilities and net assets	\$ 3,079,242	\$ 2,339,790

Essentia Health

Consolidated Statements of Operations and Changes in Net Assets
Years Ended June 30, 2019 and 2018
(Dollars in Thousands)

	2019	2018
Operating revenue:		
Patient service revenue (Note 5)	\$ 2,102,254	\$ 2,010,148
Other operating revenue	65,933	56,128
Total operating revenue	2,168,187	2,066,276
Expenses (Note 14):		
Salaries, wages and related benefits	1,346,976	1,299,906
Supplies	358,651	336,662
Purchased services and professional fees	83,247	83,946
Utilities and maintenance	72,891	71,059
Professional liability and general insurance	15,960	23,039
Depreciation and amortization	91,068	91,462
Interest	25,725	25,456
Provider and other taxes	34,914	31,928
Other	78,354	79,868
Campus replacement and other costs (Note 15)	6,931	11,986
Total expenses	2,114,717	2,055,312
Income from operations	53,470	10,964
Nonoperating gains (losses), net:		
Investment income on funds designated by Board	19,510	15,299
Net realized gains on investments	35,066	19,724
Net change in unrealized gains and losses on trading securities	(3,066)	53,092
(Loss) gain on swap agreements	(2,680)	3,457
Other, net	(4,013)	(1,383)
Total nonoperating gains, net	44,817	90,189
Excess of revenue and gains over expenses and losses	98,287	101,153
Other changes in net assets without donor restrictions:		
Pension and other postretirement liability adjustments	(16,977)	18,380
Other, net	1,236	876
Increase in net assets without donor restrictions	82,546	120,409

(Continued)

Essentia Health

Consolidated Statements of Operations and Changes in Net Assets (Continued)
Years Ended June 30, 2019 and 2018
(Dollars in Thousands)

	2019	2018
Net assets with donor restrictions:		
Contributions	\$ 4,688	\$ 2,878
Net assets released from restrictions and other changes, net	(3,352)	(2,659)
Increase in net assets with donor restrictions	<u>1,336</u>	<u>219</u>
Total increase in net assets	83,882	120,628
Net assets at beginning of year	<u>1,263,188</u>	1,142,560
Net assets at end of year	<u>\$ 1,347,070</u>	<u>\$ 1,263,188</u>

See notes to consolidated financial statements.

Essentia Health

Consolidated Statements of Cash Flows Years Ended June 30, 2019 and 2018 (Dollars in Thousands)

	2019	2018
Cash flows from operating activities:		
Increase in net assets	\$ 83,882	\$ 120,628
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	97,306	94,955
Loss (gain) on swap agreements	2,680	(3,457)
Share of joint ventures and related organizations' net income, net	(1,034)	(1,486)
Loss on refinancing	881	-
Net change in unrealized gains and losses on trading securities	3,066	(53,092)
Pension and other postretirement liability adjustments	16,977	(18,380)
Changes in assets and liabilities:		
Patient accounts receivable	(8,367)	5,584
Accounts payable and accrued liabilities	26,819	(14,931)
Professional, pension and other noncurrent liabilities	(10,785)	(3,098)
Other, net	(14,393)	(3,637)
Net cash provided by operating activities	197,032	123,086
Cash flows from investing activities:		
Purchase of property and equipment, net	(121,270)	(79,515)
Change in investments in joint ventures and related organizations, net	4,146	1,393
Purchase of trading securities, net	(86,330)	(23,451)
(Increase) decrease in funds held by trustee	(611,402)	538
Net cash used in investing activities	(814,856)	(101,035)
Cash flows from financing activities:		
Proceeds from issuance and borrowings of long-term debt	754,117	19,500
Refinancing of long-term debt	(111,969)	-
Principal payments on long-term debt	(21,801)	(36,448)
Payments of debt issuance costs	(6,651)	-
Net cash provided by (used in) financing activities	613,696	(16,948)
Net (decrease) increase in cash and cash equivalents	(4,128)	5,103
Cash and cash equivalents at beginning of year	29,025	23,922
Cash and cash equivalents at end of year	\$ 24,897	\$ 29,025
Supplemental disclosures of cash flow information:		
Interest paid, net of capitalized interest	\$ 37,885	\$ 24,775

See notes to consolidated financial statements.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 1. Organization

Essentia Health (Essentia), a Minnesota nonprofit corporation headquartered in Duluth, Minnesota, is the parent of an integrated health system serving patients in Minnesota, Wisconsin, North Dakota and Idaho.

Essentia is the parent company of the following entities:

- St. Mary's Duluth Clinic Health System (operating as Essentia Health East [EH East]) in Duluth, Minnesota
- Brainerd Lakes Integrated Health System (operating as Essentia Health Central [EH Central]) in Brainerd, Minnesota
- Innovis Health LLC (operating as Essentia Health West [EH West]) in Fargo, North Dakota
- Critical Access Group (CAG)
- Essentia Health Insurance Services (EHIS), a Cayman-based captive insurance company
- Essentia Health Foundation (EHF)

Many Essentia entities have adopted an operating name as part of a systemwide rebranding strategy using the Essentia brand.

Essentia is a regional leader in the development and advancement of business, clinical and financial models for the delivery of high-quality and cost-effective health care. Essentia provides integrated health care delivery through its physician group practices, ambulatory and outpatient centers, acute care hospitals (including tertiary referral centers), and community, rural and critical access hospitals.

Essentia has been determined to qualify as a tax-exempt charitable, educational and scientific organization under section 501(c)(3) of the Internal Revenue Code (the Code) and also has been determined to be generally exempt from state income tax under Minnesota Statute 290.05, Subdivision 2.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 1. Organization (Continued)

EH East directly or indirectly controls the following tax-exempt entities:

Legal Entity	Operating Name, if Applicable	Location
St. Mary's Medical Center	Essentia Health St. Mary's Medical Center	Duluth, Minnesota
The Duluth Clinic, Ltd.	N/A	Duluth, Minnesota
SMDC Medical Center	Essentia Health Duluth	Duluth, Minnesota
Polinsky Medical Rehabilitation Center	Essentia Health Polinsky Medical Rehabilitation Center	Duluth, Minnesota
Midwest Medical Equipment and Supplies, Inc.	Essentia Health Medical Equipment & Supplies	Duluth, Minnesota
Northern Pines Medical Center	Essentia Health Northern Pines	Aurora, Minnesota
Pine Medical Center	Essentia Health Sandstone	Sandstone, Minnesota
St. Mary's Hospital of Superior	Essentia Health St. Mary's Hospital Superior	Superior, Wisconsin
Deer River Healthcare Center, Inc.	Essentia Health Deer River	Deer River, Minnesota
Essentia Health Virginia, LLC	Essentia Health Virginia	Virginia, Minnesota
Essentia Institute of Rural Health	N/A	Duluth, Minnesota
Essentia Health Sandstone Medical, LLC	N/A	Sandstone, Minnesota
Divine Properties, LLC	N/A	Duluth, Minnesota

EH Central is the sole corporate member of the following tax-exempt entities:

Legal Entity	Operating Name	Location
St. Joseph's Medical Center	Essentia Health St. Joseph's Medical Center	Brainerd, Minnesota
Brainerd Medical Center, Inc.	Essentia Health Brainerd Specialty Clinic	Brainerd, Minnesota

EH West is the sole member of the following tax-exempt entities:

Legal Entity	Operating Name, if Applicable	Location
St. Mary's Regional Health Center	Essentia Health St. Mary's Detroit Lakes	Detroit Lakes, Minnesota
St. Mary's Innovis Health	N/A	Detroit Lakes, Minnesota
Bridges Medical Center	Essentia Health Ada	Ada, Minnesota
First Care Medical Services	Essentia Health Fosston	Fosston, Minnesota
Graceville Health Center	Essentia Health Holy Trinity Hospital	Graceville, Minnesota

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 1. Organization (Continued)

CAG is the sole corporate member of the following tax-exempt entities:

Operating Name	Location
Clearwater Valley Hospital and Clinics	Orofino, Idaho
St. Mary's Hospital	Cottonwood, Idaho

In addition to their membership rights, Essentia and Benedictine Sisters Benevolent Association (BSBA), a sponsor of Essentia's Catholic hospitals, have retained various reserved powers over Essentia's hospitals.

Essentia's investments in joint ventures and related organizations are recorded in other noncurrent assets in the consolidated balance sheets as follows:

	June 30	
	2019	2018
Benedictine Health System (cost method)	\$ 53,227	\$ 55,673
St. Francis Medical Center (cost method)	4,343	4,343
Park Rapids Area Health Care, LLC (equity method)	3,083	3,345
Brainerd Lakes Surgery Center (equity method)	1,438	1,790
Other joint ventures (equity method)	1,156	1,208
	<u>\$ 63,247</u>	<u>\$ 66,359</u>

Essentia's share of net income (loss) on its investments in joint ventures is included in other operating revenue in the accompanying consolidated statements of operations and changes in net assets, depending on the nature of the investment, as follows:

	Years Ended June 30	
	2019	2018
Other operating revenue	<u>\$ 1,034</u>	<u>\$ 1,486</u>

In accordance with a reorganization agreement between Benedictine Health System (BHS) and Essentia effective December 31, 2007, upon any subsequent dissolution or sale of BHS or any of BHS' subsidiaries, Essentia would be entitled to receive the net proceeds of the dissolved or sold entity up to BHS' net asset value as of December 31, 2007. Management considers that no material impairment of Essentia's net investment in BHS has occurred as of June 30, 2019 and 2018.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 1. Organization (Continued)

The following is a summary of the combined operating results and balance sheet information of investments accounted for under the equity method as of and for the years ended June 30:

	2019	2018
Total revenue	\$ 25,800	\$ 24,497
Excess of revenue and gains over expenses and losses	4,536	3,840
Total assets	17,494	18,132
Net assets	12,682	12,970

Note 2. Summary of Significant Accounting Policies

Basis of presentation: The financial statements represent the consolidated financial position, results of operations, and cash flows of Essentia. All significant interaffiliate accounts and transactions have been eliminated in consolidation.

Use of estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP) requires management to make estimates and assumptions that affect the amounts reported in these financial statements and accompanying notes. Estimates also affect the reported amounts of revenue and expenses during the reporting period. Although estimates are considered to be fairly stated at the time that the estimates were made, actual results could differ from those estimates.

Cash and cash equivalents: Cash and cash equivalents include currency on hand, demand deposits with banks or other financial institutions, and short-term investments with maturities of 90 days or less from the date of purchase. Cash deposits are federally insured in limited amounts.

Short-term investments: Short-term investments are stated at fair value and include corporate bonds and notes with maturities of one year or less from the date of purchase, certificates of deposit and certain mutual funds. Short-term investments are available to meet Essentia's operating cash requirements.

Patient service accounts receivable: Patient service accounts receivable are based upon the estimated amounts expected to be paid from patients and third-party payors (see Note 5).

Inventories: Inventories, including drugs and supplies, are stated at the lower of cost (using either the average cost basis or the first-in, first-out basis) or net realizable value.

Assets whose use is limited: Assets whose use is limited are composed primarily of investments held for trading, which are stated at fair value, and include assets designated by the Board of Directors (over which the Board retains control and may, at its discretion, subsequently use for other purposes) for future capital improvements and retirement of debt; investments of EHS, which was formed as a professional liability funding arrangement; assets held by trustee under indenture agreements for construction and debt service payments; and other assets, which consist mainly of deferred compensation assets (designated to fund deferred compensation liabilities) and Foundation assets designated to support health care operations and capital needs.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 2. Summary of Significant Accounting Policies (Continued)

Investment income earned on funds held by the bond trustee is reported as other operating revenue, since the interest expense on the related bonds is reported as an operating expense. Investment income earned on bond proceeds of \$12,900, in 2019, is reported as an adjustment to interest capitalized related to construction of property and equipment. All other investment income (including realized gains and losses on investments, interest, dividends, and net change in unrealized gains and losses) is reported as nonoperating gains. Realized gains and losses are determined using the specific-identification method.

Derivative financial instruments: Essentia uses fixed-payor and basis-swap instruments as part of a risk management strategy to manage exposure to fluctuations in interest rates and to manage the overall cost of its debt (see Note 10). Derivatives are used to hedge identified and approved exposures and are not used for speculative purposes.

All derivatives are recognized as either assets or liabilities and are measured at fair value. Essentia uses pricing models for various types of derivative instruments that take into account the present value of estimated future cash flows. None of the swaps have been designated as a hedge. Accordingly, all changes in the fair values of the swaps and the net difference between interest received and paid are reported as nonoperating gains or losses on swap agreements in the consolidated statements of operations and changes in net assets.

Property and equipment: Property and equipment is stated at cost, if purchased, or at fair value on the date received, if donated, less accumulated depreciation. Depreciation is provided on a straight-line basis over estimated useful lives but not in excess of the terms of associated ground leases, if any.

Maintenance and repairs are charged to expense as incurred. Major improvements that extend the useful life of the related item are capitalized and depreciated. The cost and accumulated depreciation of property and equipment retired or disposed of are removed from the related accounts, and any residual value after considering proceeds is charged or credited to nonoperating gains (losses).

Intangible assets: Identifiable intangible assets are amortized on a straight-line basis over a range of 15 to 40 years based on the expected useful lives.

Asset impairment: Essentia periodically evaluates whether events and circumstances have occurred that may affect the estimated useful life or recoverability of the net book value of property and equipment and identifiable intangible assets. If such events or circumstances indicate that the carrying amounts may not be recoverable, the assets are written down to fair value and an impairment loss is recorded.

Self-insurance: The provision for estimated self-insured general and professional liability claims includes actuarially determined estimates of the undiscounted ultimate costs for both reported claims and claims incurred but not reported (IBNR). Most of the entities that comprise Essentia are self-insured for workers' compensation claims, and the estimated liability is discounted.

Costs of borrowing: Bond premiums and financing costs incurred in connection with long-term obligations are deferred and amortized over the life of the obligations, using the effective-interest method.

Interest incurred on borrowed funds during the period of construction of capital assets is capitalized, net of investment income on assets held by trustee, as a component of the cost of acquiring those assets. For the years ended June 30, 2019 and 2018, capitalized interest totaled \$7,299 and \$164, respectively.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 2. Summary of Significant Accounting Policies (Continued)

Charity and uncompensated care: Essentia provides health care services to patients who meet certain criteria under its charity care policies without charge or at amounts less than established rates. Since Essentia does not pursue collection of these amounts, they are not reported as revenue.

Excess of revenue and gains over expenses and losses: The consolidated statements of operations and changes in net assets include excess of revenue and gains over expenses and losses. Changes in net assets without donor restrictions, which are excluded from excess of revenue and gains over expenses and losses, include pension and other postretirement liability adjustments and contributions of capital.

Net assets: Net assets, revenues, gains and losses are classified based on the existence or absence of donor- or grantor-imposed restrictions. Accordingly, net assets and changes therein are classified and reported as follows:

Net assets without donor restrictions: Net assets without donor restrictions are net assets that are not subject to donor-imposed restrictions and may be expended for any purpose in performing the primary objectives of Essentia. These net assets may be used at the discretion of Essentia's management and the Board of Directors.

Net assets with donor restrictions: Net assets with donor restrictions are net assets subject to stipulations imposed by donors and grantors. Some donor restrictions are temporary in nature; those restrictions will be met by actions of Essentia or by the passage of time. Other donor restrictions are perpetual in nature, whereby the donor has stipulated the funds be maintained in perpetuity.

Deferred taxes: Essentia records a valuation allowance for deferred tax assets when it is more likely than not that some portion of the deferred tax assets will not be realized. The ultimate realization of these deferred tax assets depends on the ability of Essentia's affiliates to generate sufficient taxable income in the future.

Recent accounting pronouncements adopted in the current year: Effective July 1, 2018, Essentia adopted Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, using the full retrospective method of transition to contracts that were not complete as of July 1, 2018. As disclosed in the June 30, 2018, financial statements, Essentia originally planned on utilizing the modified retrospective method of transition to the new revenue recognition guidance; however, during the implementation process, management decided to change its election and utilize the full retrospective method. This ASU replaced existing revenue recognition guidance, including industry-specific guidance, and requires revenue to be recognized in an amount that reflects the consideration the entity expects to be entitled in an exchange of goods or services.

The adoption of ASU 2014-09 did not have a material effect on the financial statements. The adoption of this ASU resulted in changes to presentation and disclosure of revenue. The primary effect is certain amounts previously reported as provision for bad debts are now considered implicit price concessions reported as a reduction of patient service revenue. There was no adjustment required to the opening balance of net assets for the adoption of this ASU. Comparative financial information has been restated.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 2. Summary of Significant Accounting Policies (Continued)

In August 2016, the FASB issued ASU No. 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. The amendments in the ASU are intended to improve the information provided in the financial statements of not-for-profit entities with respect to net asset classification, liquidity, financial performance and cash flows. Essentia adopted the standard on July 1, 2018. Comparative financial information has been restated. The adoption of ASU 2016-14 did not have a material effect on the financial statements.

Recent accounting pronouncements not yet adopted: In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, which changes how entities account for equity investments that do not result in consolidation and are not accounted for under the equity method of accounting. Entities will be required to measure these investments at fair value at the end of each reporting period and recognize changes in fair value in net income. ASU 2016-01 also changes certain disclosure requirements and other aspects of current U.S. GAAP. ASU 2016-01 will be effective for Essentia for the fiscal year ending June 30, 2020. For the fiscal year ended June 30, 2017, Essentia elected to early adopt the amendment within ASU 2016-01 that no longer requires disclosure of the fair value of financial instruments that are not measured at fair value, and as such, these disclosures are not included herein. Management is currently evaluating the potential impact that the remaining provisions of this update will have on Essentia's financial reporting.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. The guidance in ASU 2016-02 supersedes the lease recognition requirements in *FASB Accounting Standards Codification (ASC) Topic 840, Leases* (formerly Statement of Financial Accounting Standards No. 13). ASU 2016-02 requires that assets and liabilities be recognized for financing and operating lease arrangements and that additional qualitative and quantitative financial statement disclosures be made. ASU 2016-02 is effective for Essentia for the fiscal year ending June 30, 2020. Management is currently evaluating the potential impact the adoption of this update will have on Essentia's financial reporting. The primary effect of adopting the new standard will be to record right to use obligations for leases currently accounted for as operating leases.

In November 2016, the FASB issued ASU No. 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force)*. This guidance requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. The ASU will be effective for Essentia's fiscal year ending June 30, 2020. Management is currently evaluating the potential impact the adoption of this update will have on Essentia's financial reporting.

In August 2018, the FASB issued ASU No. 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement*. This ASU improves the effectiveness of the notes to financial statements through changes in the disclosure requirements for fair value measurement. The ASU is effective for the fiscal year ending June 30, 2021, and will be applied using a retrospective approach. Management is currently evaluating the potential impact the adoption of this update will have on Essentia's financial reporting.

In August 2018, the FASB issued ASU No. 2018-14, *Compensation—Retirement Benefits—Defined Benefit Plans—General (Subtopic 715-20): Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans*. This ASU modifies the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. The ASU is effective for the fiscal year ending June 30, 2022. Management is currently evaluating the potential impact the adoption of this update will have on Essentia's financial reporting.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 3. Availability and Liquidity

Financial assets available for general expenditure within one year of the consolidated balance sheet date, comprise the following at June 30:

	2019	2018
Cash and cash equivalents	\$ 24,897	\$ 29,025
Short-term investments	30,705	29,995
Current portion of assets whose use is limited	14,545	11,734
Patient accounts receivable	237,315	228,948
Third-party payor receivable	22,308	18,169
Other receivables	17,235	11,080
Assets whose use is limited, funds designated by board	1,030,446	954,385
Total financial assets available within one year	<u>\$ 1,377,451</u>	<u>\$ 1,283,336</u>

Essentia has board-designated assets whose use is limited of \$1,030,446 and \$954,385 at June 30, 2019 and 2018, respectively, and are not available for general expenditure within the next year. However, the board-designated amounts could be made available, if necessary.

In the event of an unanticipated liquidity need, Essentia could also draw upon \$90,000 of available line of credit.

As a part of a liquidity management plan, Essentia Health structures its financial assets to be available as its general expenditures, liabilities and other obligations come due. Cash in excess of daily requirements is invested.

Note 4. Service to the Community

In the furtherance of its charitable purpose, Essentia provides a wide variety of benefits to the communities it serves, including offering various community-based social service programs, such as free clinics, health screenings, in-home caregiver services, social service and support counseling for patients and families, pastoral care, crisis intervention, transportation to and from the health care campuses, and the donation of space for use by community groups.

In addition, a large number of health-related educational programs are provided for the benefit of the community, including health enhancements and wellness, classes on specific medical conditions, unreimbursed costs of medical education, telephone information services, and costs related to programs designed to improve the general health status of the community.

Essentia also provides medical care without charge or at a reduced cost primarily through (a) services provided at no charge to the uninsured and (b) services provided to patients expressing a willingness to pay but who are determined to be unable to pay because of socioeconomic factors. The cost of providing charity care is measured by applying an overall cost-to-charge ratio to the charges incurred. Total cost includes salaries, wages and related benefits, professional fees, supplies, purchased services, repairs and maintenance, and general and administrative expenses. The cost of charity care provided was approximately \$19,200 and \$17,700 for the years ended June 30, 2019 and 2018, respectively.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 5. Patient Service Revenue

Patient service revenue: Patient service revenue is reported at the amount that reflects the consideration to which Essentia expects to be entitled in exchange for providing patient care. These amounts are due from patients, third-party payors (including health insurers and government programs) and others, and include variable consideration for retroactive revenue adjustments due to settlement of audits, reviews and investigations. Generally, Essentia bills the patients and third-party payors several days after the services are performed and/or the patient is discharged from the facility. Revenue is recognized as performance obligations are satisfied.

Performance obligations are determined based on the nature of the services provided by Essentia. A portion of Essentia's revenue relates to performance obligations satisfied over time, and is recognized based on actual charges incurred in relation to total expected (or actual) charges. Essentia believes that this method provides a faithful depiction of the transfer of services over the term of the performance obligation based on the inputs needed to satisfy the obligation. Generally, performance obligations satisfied over time relate to patients in our hospitals receiving inpatient acute care services. Essentia measures the performance obligation from admission into the hospital to the point when there are no further services required for the patient, which is generally at the time of discharge. For most outpatient and physician services, the patient simultaneously receives and consumes the benefits of the services as the services are provided.

Because our patient service performance obligations relate to contracts with a duration of less than one year, Essentia has elected to apply the optional exemption provided in ASC Subtopic 606-10-50-14(a) and, therefore, is not required to disclose the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied or partially unsatisfied at the end of the reporting period. The unsatisfied or partially unsatisfied performance obligations referred to above are primarily related to inpatient acute care services at the end of the reporting period. The performance obligations for these contracts are generally completed when the patients are discharged, which generally occurs within days or weeks of the end of the reporting period.

Essentia determines the transaction price based on standard charges for goods and services provided, reduced by contractual adjustments provided to third-party payors, discounts provided to uninsured patients in accordance with Essentia's policy, and/or implicit price concessions provided primarily to uninsured patients. Essentia determines its estimates of contractual adjustments and discounts based on contractual agreements, its discount policies, and historical experience. Essentia determines its estimate of implicit price concessions based on its historical collection experience with these classes of patients using a portfolio approach as a practical expedient to account for patient contracts as collective groups rather than individually. The financial statement effects of using this practical expedient are not materially different from an individual contract approach.

Agreements with third-party payors typically provide for payments at amounts less than established charges. A summary of the payment arrangements with major third-party payors follows:

- **Medicare:** Certain inpatient acute care services are paid at prospectively determined rates per discharge based on clinical, diagnostic and other factors. Certain services are paid based on cost-reimbursement methodologies subject to certain limits. Physician services are paid based upon established fee schedules. Outpatient services are paid using prospectively determined rates.
- **Medicaid:** Reimbursements for Medicaid services are generally paid at prospectively determined rates per discharge, per occasion of service, or per covered member.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 5. Patient Service Revenue (Continued)

- **Other:** Payment agreements with certain commercial insurance carriers, health maintenance organizations and preferred provider organizations provide for payment using prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

Laws and regulations concerning government programs, including Medicare and Medicaid, are complex and subject to varying interpretation. As a result of investigations by governmental agencies, various health care organizations have received requests for information and notices regarding alleged noncompliance with those laws and regulations, which, in some instances, have resulted in organizations entering into significant settlement agreements. Compliance with such laws and regulations may also be subject to future government review and interpretation as well as significant regulatory action, including fines, penalties and potential exclusion from the related programs. There can be no assurance that regulatory authorities will not challenge Essentia's compliance with these laws and regulations, and it is not possible to determine the impact (if any) such claims or penalties would have upon Essentia. In addition, the contracts Essentia has with commercial payors also provide for retroactive audit and review of claims.

Settlements with third-party payors for retroactive adjustments due to audits, reviews or investigations are considered variable consideration and are included in the determination of the estimated transaction price for providing patient care. These settlements are estimated based on the terms of the payment agreement with the payor, correspondence from the payor and Essentia's historical settlement activity, including an assessment to ensure that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the retroactive adjustment is subsequently resolved. Estimated settlements are adjusted in future periods as adjustments become known (that is, new information becomes available), or as years are settled or are no longer subject to such audits, reviews and investigations. Adjustments arising from a change in the transaction price were not significant for the years ended June 30, 2019 and 2018.

Generally patients who are covered by third-party payors are responsible for related deductibles, copays and coinsurance, which vary in amount. Essentia also provides services to uninsured patients, and offers those uninsured patients a discount, either by policy or law, from standard charges. Essentia estimates the transaction price for patients with deductibles, copays and coinsurance and from those who are uninsured based on historical experience and current market conditions. The initial estimate of the transaction price is determined by reducing the standard charge by any contractual adjustments, discounts, and implicit price concessions. Subsequent changes to the estimate of the transaction price are generally recorded as adjustments to patient service revenue in the period of the change. For the years ended June 30, 2019 and 2018, there was no significant revenue recognized due to changes in its estimates of implicit price concessions for performance obligations satisfied in prior years. Subsequent changes that are determined to be the result of an adverse change in the patient's ability to pay are recorded as bad-debt expense. Bad-debt expense for the years ended June 30, 2019 and 2018, was not significant.

Consistent with Essentia's mission, care is provided to patients regardless of their ability to pay. Therefore, Essentia has determined it has provided implicit price concessions to uninsured patients and patients with other uninsured balances (for example, copays and deductibles). The implicit price concessions included in estimating the transaction price represent the difference between amounts billed to patients and the amounts Essentia expects to collect based on its collection history with those patients.

Patients who meet Essentia's criteria for charity care are provided care without charge or at amounts less than established rates. Such amounts determined to qualify as charity care are not reported as revenue.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 5. Patient Service Revenue (Continued)

The composition of patient service revenue by payor for the years ended June 30 are as follows:

	2019	2018
Medicare	\$ 741,048	\$ 684,705
Medicaid	248,973	261,785
BCBS	415,031	433,669
Managed care, commercial:		
Insurance and other payors	660,209	606,185
Private-pay	36,993	23,804
	<u>\$ 2,102,254</u>	<u>\$ 2,010,148</u>

The composition of patient service revenue by line of business for the years ended June 30 are as follows:

	2019	2018
Outpatient	\$ 1,502,150	\$ 1,422,888
Inpatient	558,619	550,227
Long-term care	28,084	28,529
Total patient care revenue	<u>2,088,853</u>	<u>2,001,644</u>
Durable medical equipment	13,401	8,504
Total medical service revenue	<u>\$ 2,102,254</u>	<u>\$ 2,010,148</u>

Essentia has elected the practical expedient allowed under ASC Subtopic 606-10-32-18 and does not adjust the promised amount of consideration from patients and third-party payors for the effects of a significant financing component due to Essentia's expectation that the period between the time the service is provided to a patient and the time that the patient or a third-party payor pays for that service will be one year or less. However, Essentia does, in certain instances, enter into payment agreements with patients that allow payments in excess of one year. For those cases, the financing component is not deemed to be significant to the contract.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 6. Investments and Assets Whose Use Is Limited

At June 30, assets whose use is limited consisted of, and were limited for, the following purposes:

	2019	2018
Cash and cash equivalents	\$ 579,788	\$ 100,719
Domestic equity securities	388,397	270,433
International equity securities	114,709	66,098
Equity mutual funds	179,452	334,576
Debt security mutual funds	250,388	97,183
Hedge funds	166,808	185,395
Other	146,209	72,023
	<u>\$ 1,825,751</u>	<u>\$ 1,126,427</u>
Funds designated by Board	\$ 1,030,446	\$ 954,385
Funds held by trustee	613,215	1,813
Funds held under self-insurance program	66,369	60,991
Funds held for deferred compensation and other	115,721	109,238
	<u>1,825,751</u>	<u>1,126,427</u>
Less current portion	14,850	13,096
Total noncurrent assets whose use is limited	<u>\$ 1,810,901</u>	<u>\$ 1,113,331</u>

Essentia invests in certain alternative investments, principally funds of hedge funds. Essentia uses the net asset value (NAV) per share of its investments in alternative investments to estimate fair value. As such, alternative investments are excluded from the fair value hierarchy presented in Note 7 but are included as a reconciling item to arrive at total investments.

At June 30, 2019 and 2018, Essentia's ownership percentage of alternative investments ranged from 0.1% to 6.7%. Through these investments, Essentia may be indirectly involved in investment activities such as securities lending, short sales of securities, options, warrants, trading in futures and forward contracts, swap contracts and other derivative products. Derivatives are used to maintain asset mix or adjust portfolio risk exposure. While these financial instruments may contain varying degrees of risk and may be subject to redemption lockups, Essentia's risk is limited to its capital balance in each investment.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 6. Investments and Assets Whose Use Is Limited (Continued)

At June 30, 2019 and 2018, alternative investments recorded at NAV consisted of the following:

	2019			
	Fair Value	Unfunded Commitment	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
Absolute return funds (a)	\$ 81,003	\$ -	90–182 days	65–90 days
Hedge funds (b)	85,805	-	Monthly to annually	1–105 days
	<u>\$ 166,808</u>	<u>\$ -</u>		
	2018			
	Fair Value	Unfunded Commitment	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
Absolute return funds (a)	\$ 79,952	\$ -	90–182 days	65–90 days
Hedge funds (b)	105,443	1,500	Monthly to annually	1–105 days
	<u>\$ 185,395</u>	<u>\$ 1,500</u>		

- (a) This category includes investments in absolute return funds, which are actively managed commingled fund of funds that derive the majority of their returns from factors other than the directional flow of the markets in which they invest. Representative strategies include high-yield credit, distressed debt, merger arbitrage and relative value. The fair values of the investments in this category generally carry lockup restrictions that do not allow investors to seek redemption in the first year after acquisition. Following the initial lockup period, liquidity is generally available monthly, quarterly or annually following a redemption request. Over 98% of the investments in this category have at least annual liquidity.
- (b) This category includes investments in hedge equity funds, which are actively managed commingled fund of funds that derive the majority of their returns from factors other than the directional flow of the markets in which they invest. Representative strategies include long-short strategies; merger and arbitrage strategies; the use of options; and investing in non-U.S. currencies, commodities, precious metals and stock indices. The fair values of the investments in this category generally carry lockup restrictions that do not allow investors to seek redemption in the first year after acquisition. Following the initial lockup period, liquidity is generally available monthly, quarterly or annually following a redemption request. Over 97% of the investments in this category have at least annual liquidity.

Due to the level of risk associated with certain investments, it is reasonably possible that changes in the values of certain investments will occur in the near term and that such changes could materially affect the amounts reported in the financial statements subsequent to year-end.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 6. Investments and Assets Whose Use Is Limited (Continued)

Investment return for the years ended June 30 consists of and was reported in the consolidated statements of operations and changes in net assets as follows:

	2019	2018
Dividends and interest	\$ 25,673	\$ 20,921
Net realized gains on investments	35,066	19,724
Net change in unrealized gains and losses on trading securities	(3,066)	53,092
Gross investment income	<u>57,673</u>	<u>93,737</u>
Less investment expenses related to investment return	6,133	5,484
	<u>\$ 51,540</u>	<u>\$ 88,253</u>
Other operating revenue	\$ 18	\$ 17
Nonoperating gains	51,510	88,115
Other changes in net assets with donor restrictions	12	121
	<u>\$ 51,540</u>	<u>\$ 88,253</u>

Note 7. Fair Value of Financial Instruments

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. The disclosure framework consists of a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Essentia's valuation methodologies for assets and liabilities measured at fair value are as follows:

- Fair value for Level 1 is based upon quoted market prices in active markets for identical instruments.
- Fair value for Level 2 is based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets. Inputs are obtained from various sources, including market participants, dealers and brokers.
- Fair value for Level 3 is based on unobservable market data, primarily credit valuation adjustments (CVAs) for derivative financial instruments. The fair value is determined by an independent third party utilizing a discounted cash flow methodology for valuing derivative financial instruments. The valuations reflect a credit spread adjustment to the London Interbank Offered Rate (LIBOR) swap curve in order to reflect CVAs for nonperformance risk. The credit spread adjustment is derived from other comparably rated entities' bonds priced in the market.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 7. Fair Value of Financial Instruments (Continued)

The methods described above may produce a fair value calculation that is not indicative of net realizable value or reflective of future fair values. Furthermore, while Essentia believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

Financial instruments carried at fair value as of June 30, 2019, for each caption on the consolidated balance sheet, are analyzed by the fair value hierarchy as follows:

	2019			Total Fair Value
	Level 1	Level 2	Level 3	
Assets:				
Short-term investments:				
Domestic equity securities	\$ 12,731	\$ -	\$ -	\$ 12,731
Mutual funds—equity securities	3,573	-	-	3,573
Other	11,095	2,497	-	13,592
Current assets whose use is limited:				
Mutual funds—debt securities	1,084	-	-	1,084
Other	7,784	305	-	8,089
Long-term assets whose use is limited:				
Domestic equity securities	385,183	-	-	385,183
International equity securities	113,631	-	-	113,631
Mutual funds—equity securities	175,961	-	-	175,961
Mutual funds—debt securities	249,304	-	-	249,304
Preferred equity securities	-	5,621	-	5,621
Certificates of deposit	-	14,863	-	14,863
U.S. government agency debt securities	-	21,516	-	21,516
Corporate debt securities	-	103,903	-	103,903
Swap assets	-	-	5,247	5,247
Total assets valued at fair value	<u>\$ 960,346</u>	<u>\$ 148,705</u>	<u>\$ 5,247</u>	<u>1,114,298</u>
Investments recorded at fair value based on NAV				166,808
Investments recorded at cost (cash and cash equivalents)				580,597
Total assets				<u>\$ 1,861,703</u>
Liabilities:				
Swap liabilities	\$ -	\$ -	\$ (13,237)	\$ (13,237)

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 7. Fair Value of Financial Instruments (Continued)

Financial instruments carried at fair value as of June 30, 2018, for each caption on the consolidated balance sheet, are analyzed by the fair value hierarchy as follows:

	2018			Total Fair Value
	Level 1	Level 2	Level 3	
Assets:				
Short-term investments:				
Domestic equity securities	\$ 9,754	\$ -	\$ -	\$ 9,754
Mutual funds—equity securities	9,500	-	-	9,500
Other	5,049	2,607	-	7,656
Current assets whose use is limited:				
Other	6,262	1,513	-	7,775
Long-term assets whose use is limited:				
Domestic equity securities	268,855	-	-	268,855
International equity securities	65,518	-	-	65,518
Mutual funds—equity securities	330,471	-	-	330,471
Mutual funds—debt securities	97,183	-	-	97,183
Preferred equity securities	-	5,542	-	5,542
Certificates of deposit	-	14,229	-	14,229
U.S. government agency debt securities	-	20,051	-	20,051
Corporate debt securities	-	30,688	-	30,688
Swap assets	-	-	3,548	3,548
Total assets valued at fair value	<u>\$ 792,592</u>	<u>\$ 74,630</u>	<u>\$ 3,548</u>	<u>870,770</u>
Investments recorded at fair value based on NAV				185,395
Investments recorded at cost (cash and cash equivalents)				103,805
Total assets				<u>\$ 1,159,970</u>
Liabilities:				
Swap liabilities	\$ -	\$ -	\$ (10,285)	\$ (10,285)

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 7. Fair Value of Financial Instruments (Continued)

The following table is a rollforward of the consolidated balance sheet amounts for financial instruments classified by Essentia in Level 3 of the valuation hierarchy:

	Swap Assets and Liabilities, Net
	<u>Net</u>
Fair value at June 30, 2017	\$ (11,710)
Realized and unrealized gain, net, on swap agreements included in excess of revenue and gains over expenses and losses	3,457
Settlements	<u>1,516</u>
Fair value at June 30, 2018	(6,737)
Realized and unrealized loss, net, on swap agreements included in excess of revenue and gains over expenses and losses	(2,680)
Settlements	<u>1,427</u>
Fair value at June 30, 2019	<u>\$ (7,990)</u>

Note 8. Property and Equipment

Property and equipment at June 30, are summarized as follows:

	2019	2018
	<u>2019</u>	<u>2018</u>
Land and land improvements	\$ 51,958	\$ 50,663
Buildings and building improvements	954,519	925,556
Furniture and equipment	<u>607,772</u>	<u>575,379</u>
	1,614,249	1,551,598
Accumulated depreciation and amortization	<u>(935,718)</u>	<u>(860,426)</u>
	678,531	691,172
Construction in progress	<u>60,542</u>	<u>23,588</u>
	<u>\$ 739,073</u>	<u>\$ 714,760</u>

In January 2016, Essentia entered into agreements to lease a hospital building in Sandstone, Minnesota. Since the transaction did not qualify for sale-leaseback treatment, the building is treated as a financing transaction. The completed building cost of \$20,677 at June 30, 2019 and 2018, and the related other long-term liability of \$19,389 and \$20,004 at June 30, 2019 and 2018, respectively, are included in the accompanying consolidated balance sheets.

In January 2009, Essentia entered into agreements to lease a portion of a medical office building. Since the transaction did not qualify for sale-leaseback treatment, the building is treated as a financing transaction. The completed building cost of \$10,272 at June 30, 2019 and 2018, and the related other long-term liability of \$7,873 and \$8,212 at June 30, 2019 and 2018, respectively, are included in the accompanying consolidated balance sheets.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 9. Other Noncurrent Assets

Other noncurrent assets at June 30 are summarized as follows:

	2019	2018
Notes receivable	\$ 8,791	\$ 8,223
Investment in joint ventures and related organizations (Note 1)	63,247	66,359
Intangible assets, less accumulated amortization of \$2,362 and \$1,933 in 2019 and 2018, respectively	7,833	6,762
Other	29,975	28,588
	<u>\$ 109,846</u>	<u>\$ 109,932</u>

Note 10. Long-Term Debt

Long-term debt at June 30 consists of the following:

	Annual Interest Rate	2019	2018
Essentia Obligated Group Revenue Bonds:			
Series 2008A, 2008B and 2008C, due through 2037	3.00% to 5.50%	\$ 199,094	\$ 199,307
Senior Secured Notes QQQ, due through 2035	3.99%	127,440	141,235
Senior Secured Notes VVV, due through 2040	3.90%	89,065	89,855
Series 2018A and 2018B, due through 2058	4.13% to 5.25%	723,485	-
Other, primarily capital leases and mortgages payable with annual principal payments through 2051	Various	36,344	35,997
Essentia Obligated Group revenue bonds repaid in fiscal year 2019:			
Series 2014	Variable rate	-	69,190
Series 2008D and 2008E	4.75% to 5.00%	-	42,779
Total debt before premiums and deferred financing costs		<u>1,175,428</u>	<u>578,363</u>
Series 2018A and 2018B unamortized bond premiums		22,348	-
Deferred financing costs, net		(11,062)	(6,220)
Total debt		<u>1,186,714</u>	<u>572,143</u>
Less current portion		22,333	23,156
		<u>\$ 1,164,381</u>	<u>\$ 548,987</u>

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 10. Long-Term Debt (Continued)

Essentia's Obligated Group consists of the following entities:

Legal Entity	Operating Name
Critical Access Group	CAG
St. Mary's Duluth Clinic Health System	EH East
St. Joseph's Medical Center	Essentia Health St. Joseph's Medical Center
St. Mary's Regional Health Center	Essentia Health St. Mary's Detroit Lakes
St. Mary's Medical Center	Essentia Health St. Mary's Medical Center
SMDC Medical Center	Essentia Health Duluth
Polinsky Medical Rehabilitation Center	EH Polinsky Rehabilitation Center
St. Mary's Hospital of Superior	Essentia Health St. Mary's Hospital Superior
Brainerd Medical Center, Inc.	Essentia Health Brainerd Specialty Clinic
Brainerd Lakes Integrated Health System	EH Central
St. Mary's Innovis Health	St. Mary's Innovis Health
The Duluth Clinic, Ltd.	The Duluth Clinic Ltd.
Innovis Health, LLC	EH West

Certain indebtedness of members of the Obligated Group and related entities is secured by notes issued under the Second Amended and Restated Master Trust Indenture, dated as of November 1, 2018 (the Master Trust Indenture, or MTI), and related documents, which require Obligated Group members to be jointly and severally obligated for the debt service on all obligations issued thereunder. Certain of Essentia's debt agreements contain "cross-default" provisions that may result in an event of default if there is a failure under other debt agreements to meet payment terms or to observe other covenants that would result in an acceleration of payments due.

All Obligated Group members have pledged certain unrestricted receivables and certain pass-through obligations for payment of long-term indebtedness issued under the MTI. No pass-through obligations were subject to the pledge as of June 30, 2019. Most of the non-Obligated Group's debt is secured by certain assets of the entity that has borrowed the proceeds from the debt issue.

In November 2018, Essentia issued Health Care Facilities Revenue Bonds, Series 2018, in the amount of \$723,485. The outstanding balances on the Series 2008E Revenue Bonds, Series 2014-MN Variable Rate Revenue Bonds and Series 2014-ND Variable Rate Revenue Bonds in the amounts of \$42,635, \$26,960 and \$42,230, respectively, were refinanced with part of the proceeds. Essentia recognized a loss on refinancing of \$881 in 2019, which is recorded in other, net nonoperating gains (losses) on the consolidated statements of operations and changes in net assets.

In December 2016, Essentia issued nonrated, taxable Senior Secured Notes VVV in the amount of \$90,000. The outstanding balance on the Series 2008D Revenue Bonds in the amount of \$63,700 was advance refunded with the proceeds.

In February 2013, Essentia issued nonrated, taxable Senior Secured Notes QQQ in the amount of \$159,525. The outstanding Variable Rate Revenue Bonds, Series 2010, in the amount of \$101,305 and certain other revenue bonds totaling \$7,087 were refinanced with the proceeds.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 10. Long-Term Debt (Continued)

In February 2010, Essentia restructured a portion of the outstanding Variable Rate Demand Revenue Bonds, Series 2008, which included converting \$234,195 of Series 2008A, Series 2008B and Series 2008C-1 Variable Rate Demand Bonds to fixed-rate bonds with annual interest rates ranging from 3.00% to 5.50%.

Essentia has a long-term master revolving line of credit with BMO Harris Bank N.A. under which it may borrow up to an aggregate of \$90,000. The annual interest rate is based on LIBOR plus an applicable margin (3.05% at June 30, 2019). The line of credit terminates in July 2021, with the option of extension upon mutual consent of the bank and Essentia. The line of credit is secured by a note issued under the MTI and is an obligation of the Essentia Obligated Group. As of June 30, 2019 and 2018, there were no amounts outstanding on the line of credit.

Deferred financing costs, consisting primarily of underwriting fees and discounts, credit enhancement fees and legal fees, are amortized using the interest method over the period that the obligation is outstanding.

The aggregate annual maturities of long-term debt, excluding the line of credit, for the five years subsequent to June 30, 2019, are as follows:

Years ending June 30:

2020	\$	22,333
2021		19,893
2022		19,915
2023		19,802
2024		20,414

The MTI contains various covenants, including the requirement for the Essentia Obligated Group to maintain certain financial ratios, limit the incurrence of significant additional indebtedness, and limit transfers to non-Obligated Group members. Management believes the Obligated Group is in compliance with these covenants as of June 30, 2019.

The proceeds of bonds, which were placed in various trust funds to be used in accordance with the applicable indenture provisions, are as follows at June 30:

	2019	2018
Bond interest, principal and construction funds	\$ 612,738	\$ 1,361
Debt service reserve funds	477	452
	<u>613,215</u>	<u>1,813</u>
Less current portion	305	1,361
Total long-term portion	<u>\$ 612,910</u>	<u>\$ 452</u>

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 10. Long-Term Debt (Continued)

The following is a summary of the outstanding positions under swap arrangements at June 30, 2019:

Instrument Type	Notional Amount	Maturity Date	Rate Paid	Rate Received
Fixed-payor swaps	\$ 50,875	2032 to 2037 with mandatory tender 2023	3.37% to 3.44%	68% of 1-month LIBOR
Basis swaps	31,860	2040 with mandatory tender 2023	SIFMA	68% of 1-month LIBOR plus 0.61%
Basis swaps	81,860	2040	SIFMA	68% of 3-month LIBOR plus 0.56%; 91.25% of 3-month LIBOR

Interest paid and received is based on swap rates, which are derived from LIBOR, the Securities Industry and Financial Markets Association (SIFMA), and the International Swaps and Derivatives Association (ISDA).

Swap assets are reported in other noncurrent assets, and swap liabilities are reported in other noncurrent liabilities in the consolidated balance sheets, as follows:

	Notional Amount	Assets		Liabilities		Nonoperating (Loss) Gain	
		2019	2018	2019	2018	2019	2018
Fixed-payor swaps	\$ 50,875	\$ -	\$ -	\$ 13,237	\$ 9,202	\$ (4,964)	\$ 1,565
Basis swaps	113,720	5,247	3,548	-	1,083	2,284	1,892
Total swaps	\$ 164,595	\$ 5,247	\$ 3,548	\$ 13,237	\$ 10,285	\$ (2,680)	\$ 3,457

Certain Essentia derivative instruments contain provisions that require Essentia to post collateral when the net liability of the derivative instruments is greater than predetermined thresholds up to \$10,000. No collateral was required at June 30, 2019 or 2018.

Derivative transactions contain credit risk in the event the parties are unable to meet the terms of the contract, which is generally limited to the fair value due from counterparties on outstanding contracts. At June 30, 2019 and 2018, the counterparties with fair values due to Essentia had Standard & Poor's credit quality ratings ranging from A to BBB+.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 11. Income Taxes

Deferred tax assets at June 30, 2019 and 2018, relate primarily to federal and state net operating loss (NOL) carryovers. As of June 30, 2019, Essentia had federal NOLs of \$2,662 and state NOLs of \$4,671. These NOLs resulted in a deferred tax asset of \$926 and \$1,213 at June 30, 2019 and 2018, respectively. Due to the operating performance of Essentia's subsidiaries, a valuation allowance of \$190 and \$1,213 has been established at June 30, 2019 and 2018, respectively, since it is more likely than not that some of the deferred tax assets will not be realized.

The statute of limitations for tax years ended June 30, 2016 through June 30, 2019, remains open to examination by the major U.S. taxing jurisdictions to which Essentia is subject. In addition, for all tax years generating an NOL prior to June 30, 2016, tax authorities have the right to adjust the amount of the NOL.

Note 12. Employee Benefit Plans

Defined benefit retirement plans: Essentia sponsors two defined benefit retirement plans, which cover certain groups of Essentia's employees (collectively, the Plans). Although the defined benefit plans are closed to new participants, certain plan participants continue to accrue benefits.

Effective July 31, 2002, the St. Mary's Medical Center plan, which is the most significant of the defined benefit retirement plans, received a letter from the Internal Revenue Service ruling this plan a "Church Plan" as defined in the Code section 414(e). As a result, the funding requirements of the Employee Retirement Income Security Act of 1974 and the Pension Protection Act of 2006 do not apply to the St. Mary's Medical Center plan.

A summary of the change in the benefit obligation, the change in plan assets and the resulting funded status, the amounts recognized in the consolidated balance sheets, and the components of net periodic pension cost of the Plans as of and for the years ended June 30 (measurement date) are as follows:

	2019	2018
Change in benefit obligation:		
Benefit obligation at beginning of year	\$ 255,759	\$ 270,606
Service cost	565	753
Interest cost	9,685	8,680
Actuarial loss (gain)	25,819	(12,326)
Benefits paid	(12,002)	(10,636)
Settlement	-	(1,318)
Benefit obligation at end of year	<u>279,826</u>	<u>255,759</u>
Change in plan assets:		
Fair value of plan assets at beginning of year	180,984	168,596
Actual return on plan assets	15,971	12,937
Contributions	11,649	12,075
Benefits paid	(12,002)	(10,636)
Expenses paid	(670)	(670)
Settlement	-	(1,318)
Fair value of plan assets at end of year	<u>195,932</u>	<u>180,984</u>
Net liability recognized (underfunded plans)	<u>\$ (83,894)</u>	<u>\$ (74,775)</u>

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 12. Employee Benefit Plans (Continued)

Accumulated benefit obligation was \$278,708 and \$254,646 at June 30, 2019 and 2018, respectively.

Essentia offers eligible employees a nonqualified, tax-deferred compensation retirement plan. Employees defer compensation into the plan on a pretax basis. For the most part, the plan operates similar to a defined contribution plan. Essentia has recorded the investments maintained as part of the deferred compensation plan of \$87,424 and \$82,056 for the years ended June 30, 2019 and 2018, respectively, within assets whose use is limited, other, with a corresponding liability being recorded within employee benefit plan liabilities.

Changes in plan assets and benefit obligations recognized in net assets without donor restrictions during the years ended June 30 consist of the following:

	2019	2018
Current-year actuarial loss (gain)	\$ 21,599	\$ (13,526)
Amortization of unrecognized net actuarial loss	(2,948)	(3,393)
Recognition of net loss	-	(614)
Total	<u>\$ 18,651</u>	<u>\$ (17,533)</u>

Actuarial losses included in net assets without donor restrictions that have not been recognized in net periodic pension cost at June 30, 2019 and 2018, were \$124,251 and \$105,600, respectively. It is expected that actuarial losses recognized in net periodic pension cost during the year ending June 30, 2020, will be \$3,650. Unrecognized actuarial losses are amortized on a straight-line basis.

Components of net periodic pension cost for the years ended June 30 are as follows:

	2019	2018
Service cost	\$ 565	\$ 753
Interest cost	9,685	8,680
Expected return on plan assets	(11,751)	(11,735)
Amortization of unrecognized net actuarial loss	2,948	3,393
Recognition of net loss	-	614
Net periodic pension cost	<u>\$ 1,447</u>	<u>\$ 1,705</u>

	2019	2018
Weighted-average assumptions:		
Discount rate at end of year (used to determine benefit obligation)	3.51% to 3.48%	4.23% to 4.25%
Discount rate at beginning of year (used to determine net periodic benefit cost)	4.23% to 4.25%	3.79% to 3.84%
Expected annual return on plan assets	6.50%	6.95%
Rate of annual compensation increase	3.00%	2.60%

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 12. Employee Benefit Plans (Continued)

The components of net periodic pension cost, other than service cost component, are included in the line item "Other, net" in the nonoperating gains, net section in the consolidated statements of operations and changes in net assets. Service cost is reported within salaries, wages and related benefits in the consolidated statements of operations and changes in net assets.

The overall weighted-average return on plan assets is determined by applying management's judgment to the results of modeling long-term capital market expectations for assets class returns and historical asset class risk and correlation data as well as benchmarking data.

The Investment Committee of the Plans, which consists of at least two members of the Board of Directors and a minimum of four staff members, annually reviews and approves the investment policy and asset allocation targets. The Investment Committee activities are supported by an independent investment consulting firm. The investment policy covers responsibilities of the investment managers, investment objectives, asset allocation targets and ranges, asset guidelines and manager review criteria. The Investment Committee reviews asset allocation quarterly to determine if the current structure is appropriate and whether any changes are necessary. All assets are invested with outside managers.

The current target allocation and the actual asset allocation as of June 30 are as follows:

	Asset Allocation		
	Target	2019	2018
Equity securities	0% to 70%	45%	43%
Debt securities	30% to 90%	32%	30%
Cash and cash equivalents	0% to 20%	2%	5%
Other (primarily alternative investments)	0% to 50%	21%	22%
Total		100%	100%

The fair value of the Plans' pension plan assets was determined using the fair value hierarchy, as defined in Note 7, as follows, at June 30, 2019:

	2019			
	Level 1	Level 2	Level 3	Total
Assets:				
Domestic equity securities	\$ 53,570	\$ -	\$ -	\$ 53,570
International equity securities	14,826	-	-	14,826
Mutual funds—equity securities	20,017	-	-	20,017
Mutual funds—debt securities	1,188	-	-	1,188
Corporate debt securities	-	61,276	-	61,276
Immediate participation guarantee contracts	-	-	8,273	8,273
	<u>\$ 89,601</u>	<u>\$ 61,276</u>	<u>\$ 8,273</u>	<u>159,150</u>

Investments recorded at fair value based on NAV	32,952
Investments recorded at cost (cash and cash equivalents)	3,830
	<u>\$ 195,932</u>

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 12. Employee Benefit Plans (Continued)

The fair value of the Plans' pension plan assets was determined using the fair value hierarchy, as defined in Note 7, as follows, at June 30, 2018:

	2018			Total
	Level 1	Level 2	Level 3	
Assets:				
Domestic equity securities	\$ 39,651	\$ -	\$ -	\$ 39,651
International equity securities	10,861	-	-	10,861
Mutual funds—equity securities	27,804	-	-	27,804
Mutual funds—debt securities	1,107	-	-	1,107
Corporate debt securities	-	53,805	-	53,805
Immediate participation guarantee contracts	-	-	7,554	7,554
	<u>\$ 79,423</u>	<u>\$ 53,805</u>	<u>\$ 7,554</u>	<u>140,782</u>
Investments recorded at fair value based on NAV				32,030
Investments recorded at cost (cash and cash equivalents)				8,172
				<u>\$ 180,984</u>

Fair value methodologies for Level 1 and Level 2 investments, as well as investments recorded at NAV, are consistent with the inputs described in Note 7. Fair value for Level 3 immediate participation guarantee contracts (IPGC) is based on the present value of a hypothetical bond with similar characteristics of the underlying assets in an unquoted market.

The following table is a rollforward of the pension plan assets classified within Level 3 of the valuation hierarchy defined above:

	Immediate Participation Guarantee Contracts
Fair value at June 30, 2017	\$ 7,928
Purchases, issuances and settlements, net	(18)
Actual return on plan assets	(356)
Fair value at June 30, 2018	<u>7,554</u>
Purchases, issuances and settlements, net	236
Actual return on plan assets	483
Fair value at June 30, 2019	<u>\$ 8,273</u>
Change in unrealized gains on investments held at June 30, 2019	<u>\$ 483</u>

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 12. Employee Benefit Plans (Continued)

At June 30, 2019 and 2018, alternative investments recorded at NAV consisted of the following:

	2019			
	Fair Value	Unfunded Commitment	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
Absolute return funds (a)	\$ 12,267	\$ -	90–182 days	65 days
Hedge funds (b)	9,696	-	Quarterly to annually	65 days
Private equity funds (c)	10,989	4,642	Not eligible	
	<u>\$ 32,952</u>	<u>\$ 4,642</u>		

	2018			
	Fair Value	Unfunded Commitment	Redemption Frequency (If Currently Eligible)	Redemption Notice Period
Absolute return funds (a)	\$ 14,074	\$ -	90–182 days	65 days
Hedge funds (b)	8,503	-	Quarterly to annually	65 days
Private equity funds (c)	9,453	6,607	Not eligible	
	<u>\$ 32,030</u>	<u>\$ 6,607</u>		

(a) and (b) See Note 6 for description of these funds.

(c) This category includes investments in private equity funds. The funds seek U.S. and global exposure to the private asset subclasses of venture capital, buyouts, debt, real estate and real assets over the course of a market cycle through a diversified fund of funds.

During the year ending June 30, 2020, Essentia expects to make discretionary pension contributions of \$11,000 to the Plans.

The following benefits, which reflect expected future service, are expected to be paid:

Years ending June 30:	
2020	\$ 13,149
2021	13,362
2022	13,969
2023	14,864
2024	15,461
2025–2029	82,649

Other postretirement benefits: In addition to the defined benefit plans, Essentia sponsors various other postretirement benefit plans. The projected benefit obligation related to these plans was approximately \$8,800 and \$11,400 as of June 30, 2019 and 2018, respectively. Expense (income) recognized by Essentia for those plans was approximately \$(102) and \$673 for the years ended June 30, 2019 and 2018, respectively.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 12. Employee Benefit Plans (Continued)

Other plans: Under a collective bargaining agreement, Essentia contributes to a union-sponsored multiemployer retirement plan. The risks of participating in a multiemployer plan differ from the risks of participating in a single-employer plan in the following aspects: (a) assets contributed to a multiemployer plan by one employer may be used to provide benefits to employees of other participating employers; (b) if a participating employer stops contributing to the plan, the unfunded obligations of the plan may be borne by the remaining participating employers; and (c) if Essentia chooses to stop participating in its multiemployer plan and if the plan is underfunded, Essentia may be required to pay the plan an amount based on the underfunded status of the plan, referred to as the withdrawal liability.

Essentia's participation in the multiemployer plan for the years ended June 30, 2019 and 2018, is outlined in the table below. The "EIN/Pension Plan Number" column provides the Employee Identification Number (EIN) and the three-digit plan number, if applicable. Unless otherwise noted, the most recent Pension Protection Act zone status available in 2019 and 2018 is for the plan's year-end at December 31, 2018 and 2017, respectively. The zone status is based on information that Essentia received from the plan and is certified by the plan's actuary. Among other factors, plans in the red zone are generally less than 65% funded, plans in the yellow zone are less than 80% funded, and plans in the green zone are at least 80% funded. The "FIP/RP Status Pending/Implemented" column indicates plans for which a financial improvement plan (FIP) or a rehabilitation plan (RP) is either pending or has been implemented. The last column lists the range of expiration dates of various collective bargaining agreements to which the plan is subject.

Pension Fund	EIN/Pension Plan Number	Pension Protection Act Zone Status		FIP/RP Status Pending/Implemented	Contributions of Essentia		Surcharge Imposed	Expiration Date of Collective Bargaining Agreement
		2019	2018		2019	2018		
Steelworkers								
Pension Trust	23-6648508/499	Green	Green	N/A	\$ 4,290	\$ 4,161	No	June 30, 2019 to March 31, 2022

The union-sponsored multiemployer plan was at least 80% funded at December 31, 2018 and 2017. Total amounts expensed under the union-sponsored multiemployer plan were \$4,115 and \$4,166 for the years ended June 30, 2019 and 2018, respectively. Essentia is required to make contributions ranging from 3% to 5% of covered employees' gross earnings for the year ended December 31, 2018. At the date Essentia's financial statements were issued, the Form 5500 that is filed to satisfy certain reporting requirements was not available for the union-sponsored multiemployer plan's year ended December 31, 2018.

Substantially all of Essentia's entities have individual defined contribution plans covering most of their employees. Contributions are based on a percentage of eligible employees' salaries. Total pension expense relating to the defined contribution pension plans was \$41,680 and \$41,123 for the years ended June 30, 2019 and 2018, respectively.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 13. Self-Insurance Program

EHIS provides insurance coverage to most of Essentia's members (except the critical access hospitals) on a claims-made basis with limits of \$5,000 per claim and \$12,000 in the aggregate per policy year for professional liabilities and \$3,000 per claim and \$6,000 in the aggregate for each policy year for general liabilities. Premiums are based on claims experience. Essentia's rural critical access hospitals are insured by a commercial insurance policy with a \$25 deductible and limits of \$2,000 per claim and \$6,000 in the aggregate per policy year on a claims-made basis for both professional liability and general liability risks. Essentia has self-funded the estimated value of professional and general liability claims, which amounted to \$50,665 and \$56,896 at June 30, 2019 and 2018, respectively, based on historical data, and includes IBNR claims. Essentia has purchased excess professional and general liability insurances from the commercial insurance market with limits totaling \$35,000 per claim and in the aggregate per policy year.

Essentia is self-insured for workers' compensation claims, employee health care claims, and unemployment compensation risks, with stop-loss coverage above certain limits. Essentia is required to post security under its self-insured workers' compensation program, which was \$11,911 and \$11,919 at June 30, 2019 and 2018, respectively. Essentia has entered into a surety bond agreement to comply with this requirement.

Note 14. Functional Expenses

The financial statements present certain expenses that are attributed to more than one program or supporting function. Therefore, expenses require allocation on a reasonable basis that is consistently applied. Accordingly, costs are allocated to the benefited programs and supporting services based on direct costs incurred for all expense classifications.

The expenses reported in the consolidated statements of operations and changes in net assets for the years ended June 30, 2019 and 2018, supported the following programs and functions:

	2019			
	Health Care Services	Management and General	Fundraising	Total Functional Expenses
Salaries, wages and related benefits	\$ 1,019,922	\$ 326,867	\$ 187	\$ 1,346,976
Supplies	311,372	47,269	10	358,651
Purchased services and professional fees	65,640	17,532	75	83,247
Utilities and maintenance	60,067	12,823	1	72,891
Professional liability and general insurance	6,050	9,910	-	15,960
Depreciation and amortization	78,050	13,016	2	91,068
Interest	21,413	4,312	-	25,725
Provider and other taxes	29,684	5,230	-	34,914
Other	61,933	16,172	249	78,354
Campus replacement and other costs	5,216	1,715	-	6,931
	<u>\$ 1,659,347</u>	<u>\$ 454,846</u>	<u>\$ 524</u>	<u>\$ 2,114,717</u>

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 14. Functional Expenses (Continued)

	2018			Total Functional Expenses
	Health Care Services	Management and General	Fundraising	
Salaries, wages and related benefits	\$ 982,532	\$ 317,264	\$ 110	\$ 1,299,906
Supplies	291,928	44,726	8	336,662
Purchased services and professional fees	67,114	16,806	26	83,946
Utilities and maintenance	57,635	13,423	1	71,059
Professional liability and general insurance	11,186	11,852	1	23,039
Depreciation and amortization	78,026	13,433	3	91,462
Interest	21,086	4,370	-	25,456
Provider and other taxes	27,114	4,814	-	31,928
Other	63,585	16,135	148	79,868
Campus replacement and other costs	2,933	9,053	-	11,986
	<u>\$ 1,603,139</u>	<u>\$ 451,876</u>	<u>\$ 297</u>	<u>\$ 2,055,312</u>

Note 15. Campus Replacement and Other Costs

During fiscal years 2019 and 2018, Essentia incurred certain expenses related to consulting and other fees for the Vision Northland Project (see Note 16), accelerated depreciation on certain property that will be impacted by the Vision Northland Project, and leadership transition costs that occurred in 2018.

Note 16. Commitments and Contingencies

Essentia Health will invest approximately \$800,000 to construct a replacement bed tower, clinic space and surgical suites to address aging facilities on the Essentia East medical campus in downtown Duluth, Minnesota (the Vision Northland Project). The project cost is composed of \$675,000 of construction costs and \$125,000 related to infrastructure and financing costs. Once vacated, the future use of the current hospital space is yet to be determined. The remaining total cost of this project is anticipated to be \$650,000, most of which will be funded with proceeds from the Series 2018 bonds.

Essentia has various remodeling projects underway. The remaining total cost of the projects is anticipated to be \$22,238.

Essentia has leases for equipment and satellite office facilities, which are classified as operating leases. Rental expense under these operating leases totaled \$15,844 and \$17,019 for the years ended June 30, 2019 and 2018, respectively.

Essentia Health

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 16. Commitments and Contingencies (Continued)

Future minimum lease payments on operating leases in effect on June 30, 2019, for each of the five subsequent years and thereafter are as follows:

Years ending June 30:	
2020	\$ 9,263
2021	8,537
2022	7,884
2023	7,599
2024	7,213
Thereafter	39,732
	<u>\$ 80,228</u>

In connection with a corporate reorganization of BSBA, assets and liabilities of certain facilities were transferred to Essentia in 1985. BSBA retains title to the land occupied by these facilities and has leased the land to the facilities through June 30, 2040. Minimum lease payments are \$24,021 over the remaining lease period, adjusted for inflation. Lease payments were \$900 and \$881 for the years ended June 30, 2019 and 2018, respectively.

Essentia is a defendant in legal proceedings arising in the ordinary course of business. Although the outcomes of these proceedings cannot be determined, in the opinion of management, they will not have a material adverse effect on Essentia's consolidated financial position or results of operations. However, there can be no assurance that this will be the case.

At June 30, 2019, 36% of employees are represented by 39 collective bargaining agreements, of which nine will expire within one year.

Note 17. Subsequent Events

Essentia's management evaluated events and transactions occurring subsequent to June 30, 2019, through October 7, 2019, the date of issuance of the financial statements. During this period, there were no subsequent events requiring recognition or disclosure in the financial statements, except as described below.

In August 2019, Essentia entered into a letter of intent with an unrelated party to explore the potential transfer of membership interest in the CAG entities.

Supplementary Information



RSM US LLP

Independent Auditor's Report on the Supplementary Information

The Board of Directors
Essentia Health

We have audited the consolidated financial statements of Essentia Health as of and for the years ended June 30, 2019 and 2018, and have issued our report thereon, which contains an unmodified opinion on those consolidated financial statements (see Pages 1 and 2). Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary information is presented for purposes of additional analysis 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, except for that portion marked "unaudited," 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. The information marked "unaudited" has not been subjected to the auditing procedures applied in the audits of the consolidated financial statements, and accordingly, we do not express an opinion or provide any assurance on it. In our opinion, except for that portion marked "unaudited," the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

RSM US LLP

Minneapolis, Minnesota
October 7, 2019

Essentia Health

**Schedule of Community Service and Charity Care Provided (Unaudited)
Years Ended June 30, 2019 and 2018
(Dollars in Thousands)**

Essentia Health maintains records to identify and monitor the level of community service and charity care provided. These records include management’s estimate of the cost of services and supplies furnished for community service programs, the cost to provide charity care and the cost in excess of reimbursement from public programs, which were estimated as follows for the years ended June 30, 2019 and 2018:

	<u>2019</u>	<u>2018</u>
Cost of providing charity care	\$ 19,226	\$ 17,690
Costs in excess of Medicaid payments	68,687	81,362
Medicaid surcharge and MinnesotaCare tax	28,227	25,226
Community services	4,992	4,658
Education and workforce development	5,337	6,019
Research	1,632	1,424
Cash and in-kind donations	133	525
Total cost of community benefits*	128,234	136,904
Cost in excess of Medicare payments	148,193	177,641
Other care provided without compensation (bad debt, at cost)	24,896	14,734
Discounts offered to uninsured patients (at cost)	8,968	15,399
Taxes and fees	6,063	5,768
Total value of community contributions	\$ 316,354	\$ 350,446
Cost of community benefits as a percent of total operating expenses	<u>6.1%</u>	<u>6.7%</u>
Value of community contributions as a percent of total operating expenses	<u>15.0%</u>	<u>17.1%</u>

*As defined in the Catholic Health Association/VHA Inc. guidelines.

Essentia Health

Consolidating Balance Sheet June 30, 2019 (Dollars in Thousands)

	Essentia Health Obligated Group Members	Essentia Health Non-Obligated Group Members	Eliminations	Consolidated Essentia Health
Assets				
Current assets:				
Cash and cash equivalents	\$ 9,687	\$ 15,210	\$ -	\$ 24,897
Short-term investments	30,065	640	-	30,705
Current portion of assets whose use is limited	37	14,813	-	14,850
Patient service accounts receivable	202,341	34,974	-	237,315
Amounts due from affiliates	3,376	-	(3,376)	-
Prepaid expenses and other receivables	48,967	10,380	(151)	59,196
Inventories	45,517	6,942	-	52,459
Total current assets	339,990	82,959	(3,527)	419,422
Assets whose use is limited, less current portion:				
Funds designated by Board	956,984	73,462	-	1,030,446
Funds held by trustee	612,433	477	-	612,910
Funds held under self-insurance program	-	51,950	-	51,950
Funds held for deferred compensation and other	87,458	28,137	-	115,595
	1,656,875	154,026	-	1,810,901
Property and equipment, net	653,690	85,383	-	739,073
Other noncurrent assets, net	105,397	7,930	(3,481)	109,846
Total assets	\$ 2,755,952	\$ 330,298	\$ (7,008)	\$ 3,079,242

	Essentia Health Obligated Group Members	Essentia Health Non-Obligated Group Members	Eliminations	Consolidated Essentia Health
Liabilities and Net Assets				
Current liabilities:				
Accounts payable	\$ 37,399	\$ 4,712	\$ (277)	\$ 41,834
Payable to third-party payors	3,585	1,678	-	5,263
Accrued liabilities:				
Salaries, wages and benefits	151,561	11,532	-	163,093
Interest	20,314	174	-	20,488
Amounts due to affiliates	-	3,099	(3,099)	-
Current portion of long-term debt	20,310	2,174	(151)	22,333
Other	11,270	13,385	-	24,655
Total current liabilities	244,439	36,754	(3,527)	277,666
Long-term debt	1,140,534	27,328	(3,481)	1,164,381
Employee benefit plan and deferred compensation liabilities	178,335	1,286	-	179,621
Self-insurance program liabilities	31,734	21,150	-	52,884
Other noncurrent liabilities	27,734	29,886	-	57,620
Total liabilities	1,622,776	116,404	(7,008)	1,732,172
Net assets:				
Without donor restrictions	1,133,142	201,070	-	1,334,212
With donor restrictions	34	12,824	-	12,858
Total net assets	1,133,176	213,894	-	1,347,070
Total liabilities and net assets	\$ 2,755,952	\$ 330,298	\$ (7,008)	\$ 3,079,242

Essentia Health

Consolidating Balance Sheet June 30, 2018 (Dollars in Thousands)

	Essentia Health Obligated Group Members	Essentia Health Non-Obligated Group Members	Eliminations	Consolidated Essentia Health
Assets				
Current assets:				
Cash and cash equivalents	\$ 15,620	\$ 13,405	\$ -	\$ 29,025
Short-term investments	29,378	617	-	29,995
Current portion of assets whose use is limited	1,089	12,007	-	13,096
Patient service accounts receivable	193,529	35,419	-	228,948
Amounts due from affiliates	1,339	2,000	(3,339)	-
Prepaid expenses and other receivables	42,443	7,977	(151)	50,269
Inventories	44,611	5,823	-	50,434
Total current assets	328,009	77,248	(3,490)	401,767
Assets whose use is limited, less current portion:				
Funds designated by Board	885,275	69,110	-	954,385
Funds held by trustee	-	452	-	452
Funds held under self-insurance program	-	49,481	-	49,481
Funds held for deferred compensation and other	82,090	26,923	-	109,013
	967,365	145,966	-	1,113,331
Property and equipment, net	631,089	83,671	-	714,760
Other noncurrent assets, net	105,401	8,164	(3,633)	109,932
Total assets	\$ 2,031,864	\$ 315,049	\$ (7,123)	\$ 2,339,790

	Essentia Health Obligated Group Members	Essentia Health Non-Obligated Group Members	Eliminations	Consolidated Essentia Health
Liabilities and Net Assets				
Current liabilities:				
Accounts payable	\$ 30,451	\$ 5,200	\$ -	\$ 35,651
Payable to third-party payors	2,449	386	-	2,835
Accrued liabilities:				
Salaries, wages and benefits	146,244	10,800	-	157,044
Interest	8,147	182	-	8,329
Amounts due to affiliates	2,000	1,339	(3,339)	-
Current portion of long-term debt	21,173	2,134	(151)	23,156
Other	9,678	15,037	-	24,715
Total current liabilities	220,142	35,078	(3,490)	251,730
Long-term debt	525,184	27,436	(3,633)	548,987
Employee benefit plan and deferred compensation liabilities	166,533	1,292	-	167,825
Self-insurance program liabilities	31,467	23,058	-	54,525
Other noncurrent liabilities	23,780	29,755	-	53,535
Total liabilities	967,106	116,619	(7,123)	1,076,602
Net assets:				
Without donor restrictions	1,064,724	186,942	-	1,251,666
With donor restrictions	34	11,488	-	11,522
Total net assets	1,064,758	198,430	-	1,263,188
Total liabilities and net assets	\$ 2,031,864	\$ 315,049	\$ (7,123)	\$ 2,339,790

Essentia Health

Consolidating Statement of Operations and Changes in Net Assets Year Ended June 30, 2019 (Dollars in Thousands)

	Essentia Health Obligated Group Members	Essentia Health Non-Obligated Group Members	Eliminations	Consolidated Essentia Health
Operating revenue:				
Patient service revenue	\$ 1,829,887	\$ 272,367	\$ -	\$ 2,102,254
Other operating revenue	88,413	32,624	(55,104)	65,933
Total operating revenue	1,918,300	304,991	(55,104)	2,168,187
Expenses:				
Salaries, wages and related benefits	1,198,165	167,969	(19,158)	1,346,976
Supplies	328,712	29,939	-	358,651
Purchased services and professional fees	55,553	47,551	(19,857)	83,247
Utilities and maintenance	65,479	7,660	(248)	72,891
Professional liability and general insurance	17,811	12,316	(14,167)	15,960
Depreciation and amortization	80,208	10,860	-	91,068
Interest	24,201	1,524	-	25,725
Provider and other taxes	30,413	4,501	-	34,914
Other	59,387	20,641	(1,674)	78,354
Campus replacement and other costs	6,931	-	-	6,931
Total expenses	1,866,860	302,961	(55,104)	2,114,717
Income from operations	51,440	2,030	-	53,470
Nonoperating gains (losses), net:				
Investment income on funds designated by Board	17,216	2,294	-	19,510
Net realized gains on investments	30,305	4,761	-	35,066
Net change in unrealized gains and losses on trading securities	(3,375)	309	-	(3,066)
Loss on swap agreements	(2,680)	-	-	(2,680)
Other, net	(3,092)	(921)	-	(4,013)
Total nonoperating gains, net	38,374	6,443	-	44,817
Excess of revenue and gains over expenses and losses	89,814	8,473	-	98,287
Other changes in net assets without donor restrictions:				
Pension and other postretirement liability adjustments	(16,914)	(63)	-	(16,977)
Other, net	(4,482)	5,718	-	1,236
Increase in net assets without donor restrictions	68,418	14,128	-	82,546

(Continued)

Essentia Health

Consolidating Statement of Operations and Changes in Net Assets (Continued)
Year Ended June 30, 2019
(Dollars in Thousands)

	Essentia Health Obligated Group Members	Essentia Health Non-Obligated Group Members	Eliminations	Consolidated Essentia Health
Net assets with donor restrictions:				
Contributions	\$ 568	\$ 4,120	\$ -	\$ 4,688
Net assets released from restrictions and other changes, net	(568)	(2,784)	-	(3,352)
Increase in net assets with donor restrictions	-	1,336	-	1,336
Total increase in net assets	68,418	15,464	-	83,882
Net assets at beginning of year	1,064,758	198,430	-	1,263,188
Net assets at end of year	<u>\$ 1,133,176</u>	<u>\$ 213,894</u>	<u>\$ -</u>	<u>\$ 1,347,070</u>

Essentia Health

Consolidating Statement of Operations and Changes in Net Assets Year Ended June 30, 2018 (Dollars in Thousands)

	Essentia Health Obligated Group Members	Essentia Health Non-Obligated Group Members	Eliminations	Consolidated Essentia Health
Operating revenue:				
Patient service revenue	\$ 1,747,021	\$ 263,127	\$ -	\$ 2,010,148
Other operating revenue	80,880	31,140	(55,892)	56,128
Total operating revenue	1,827,901	294,267	(55,892)	2,066,276
Expenses:				
Salaries, wages and related benefits	1,154,087	164,489	(18,670)	1,299,906
Supplies	309,542	27,120	-	336,662
Purchased services and professional fees	55,756	47,733	(19,543)	83,946
Utilities and maintenance	63,979	7,305	(225)	71,059
Professional liability and general insurance	18,218	20,991	(16,170)	23,039
Depreciation and amortization	79,613	11,849	-	91,462
Interest	23,846	1,610	-	25,456
Provider and other taxes	27,974	3,954	-	31,928
Other	60,804	20,348	(1,284)	79,868
Campus replacement and other costs	11,870	116	-	11,986
Total expenses	1,805,689	305,515	(55,892)	2,055,312
Income (loss) from operations	22,212	(11,248)	-	10,964
Nonoperating gains (losses), net:				
Investment income on funds designated by Board	13,665	1,634	-	15,299
Net realized gains on investments	17,037	2,687	-	19,724
Net change in unrealized gains and losses on trading securities	45,390	7,702	-	53,092
Gain on swap agreements	3,457	-	-	3,457
Other, net	(1,747)	364	-	(1,383)
Total nonoperating gains, net	77,802	12,387	-	90,189
Excess of revenue and gains over expenses and losses	100,014	1,139	-	101,153
Other changes in net assets without donor restrictions:				
Pension and other postretirement liability adjustments	18,362	18	-	18,380
Other, net	(3,466)	4,342	-	876
Increase in net assets without donor restrictions	114,910	5,499	-	120,409

(Continued)

Essentia Health

Consolidating Statement of Operations and Changes in Net Assets (Continued)
Year Ended June 30, 2018
(Dollars in Thousands)

	Essentia Health Obligated Group Members	Essentia Health Non-Obligated Group Members	Eliminations	Consolidated Essentia Health
Net assets with donor restrictions:				
Contributions	\$ 385	\$ 2,493	\$ -	\$ 2,878
Net assets released from restrictions and other changes, net	(385)	(2,274)	-	(2,659)
Increase in net assets with donor restrictions	-	219	-	219
Total increase in net assets	114,910	5,718	-	120,628
Net assets at beginning of year	949,848	192,712	-	1,142,560
Net assets at end of year	\$ 1,064,758	\$ 198,430	\$ -	\$ 1,263,188

