

CONSOLIDATED FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION

Frederick Regional Health System, Inc. and Subsidiaries
Years Ended June 30, 2017 and 2016
With Report of Independent Auditors

Ernst & Young LLP



Building a better
working world

Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Financial Statements
and Supplementary Information

Years Ended June 30, 2017 and 2016

Contents

Report of Independent Auditors.....	1
Consolidated Financial Statements	
Consolidated Balance Sheets	3
Consolidated Statements of Operations	5
Consolidated Statements of Changes in Net Assets	6
Consolidated Statements of Cash Flows.....	7
Notes to Consolidated Financial Statements.....	8
Supplementary Information	
Supplementary Consolidating Balance Sheet	50
Supplementary Consolidating Statement of Operations	52



Report of Independent Auditors

The Board of Directors
Frederick Regional Health System, Inc. and Subsidiaries

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

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of 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 did not audit the financial statements of Monocacy Insurance, Ltd., a wholly-owned subsidiary, which statements reflect total assets of \$17,151,561 and \$14,010,249 as of June 30, 2017 and 2016, respectively, and net loss after elimination of intercompany revenues of \$3,007,016 and \$2,880,630, respectively, for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Monocacy Insurance, Ltd., is based solely on the report of the other auditors. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of 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, based on our audits and the report of other auditors, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Frederick Regional Health System, Inc. and Subsidiaries as of June 30, 2017 and 2016, and the consolidated results of their operations, changes in their net assets, and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Supplementary Information

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary consolidating 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 information has been subjected to the auditing procedures applied in the audit 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. In our opinion, the information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

Ernst + Young LLP

October 10, 2017

Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Balance Sheets
(In Thousands)

	June 30	
	2017	2016
Assets		
Current assets:		
Cash and cash equivalents	\$ 26,610	\$ 34,525
Patient receivables, net	47,039	45,935
Other receivables	3,046	5,057
Inventory	5,749	6,055
Prepaid expenses	2,995	3,328
Assets limited as to use	9,163	3,081
Promises to give, net	1,272	1,056
Total current assets	<u>95,874</u>	<u>99,037</u>
Net property and equipment	247,592	216,683
Other assets:		
Assets limited as to use	1,708	1,113
Investments – donor restricted	2,429	6,857
Promises to give, net	4,823	5,361
Long-term investments	150,554	130,641
Other investments	12,006	12,492
Other assets	6,812	6,085
Total other assets	<u>178,332</u>	<u>162,549</u>
Total assets	<u><u>\$ 521,798</u></u>	<u><u>\$ 478,269</u></u>

	Year Ended June 30	
	2017	2016
Liabilities and net assets		
Current liabilities:		
Current maturities of long-term debt, line of credit and capital lease obligations	\$ 11,861	\$ 7,007
Accounts payable	32,127	31,544
Accrued expenses	20,933	19,688
Advances from third-party payors	7,719	8,982
Other current liabilities	2,596	1,937
Total current liabilities	<u>75,236</u>	<u>69,158</u>
Long-term liabilities, net of current portion:		
Long-term debt and capital lease obligations	182,112	157,879
Interest rate swap contract	9,559	14,058
Accrued pension expense	18,747	24,887
Other long-term liabilities	22,220	19,367
Total long-term liabilities, net of current portion	<u>232,638</u>	<u>216,191</u>
Total liabilities	<u>307,874</u>	<u>285,349</u>
Net assets:		
Unrestricted	205,402	179,647
Temporarily restricted	7,546	12,297
Permanently restricted	976	976
Total net assets	<u>213,924</u>	<u>192,920</u>
Total liabilities and net assets	<u>\$ 521,798</u>	<u>\$ 478,269</u>

See accompanying notes.

Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Statements of Operations (In Thousands)

	Year Ended June 30	
	2017	2016
Unrestricted revenue and other support:		
Net patient service revenue	\$ 397,260	\$ 376,716
Provision for bad debts	(10,506)	(4,683)
Net patient service revenue less provision for bad debts	386,754	372,033
Other operating revenues	7,898	7,608
Gifts, bequests, and contributions	2,722	3,620
Net assets released from restrictions	100	167
Total unrestricted revenue and other support	397,474	383,428
Operating expenses:		
Salaries and wages	145,378	135,669
Employee benefits	36,426	34,122
Professional fees	15,899	15,505
Cost of goods sold	60,495	56,634
Supplies	10,557	9,423
Contract services	76,812	75,004
Other	14,128	12,658
Utilities	4,174	4,292
Insurance	3,428	2,719
Depreciation and amortization	23,791	23,789
Interest	4,391	4,495
Total operating expenses	395,479	374,310
Operating income before pension settlement loss	1,995	9,118
Pension settlement loss	(3,911)	(2,279)
Operating (loss) income	(1,916)	6,839
Other income gain (loss), net:		
Gain (loss) on sale of assets	31	(8)
Loss on extinguishment of debt	(122)	-
Investment gain, net	6,604	4,858
Change in unrealized gains (losses) on trading securities, net	3,232	(6,006)
Realized and unrealized gains (losses) on interest rate swap contact, net	2,505	(5,048)
Other nonoperating (loss) income, net	(426)	484
Total other income (loss), net	11,824	(5,720)
Excess of unrestricted revenue and other support over expenses	9,908	1,119
Other changes in unrestricted net assets:		
Pension adjustment	9,503	(4,439)
Released from restriction used to purchase capital	6,344	246
Increase (decrease) in unrestricted net assets	\$ 25,755	\$ (3,074)

See accompanying notes.

Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Statements of Changes in Net Assets
(In Thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Net assets, June 30, 2015	\$ 182,721	\$ 9,451	\$ 976	\$ 193,148
Excess of unrestricted revenue and other support over expenses	1,119	-	-	1,119
Pension adjustment	(4,439)	-	-	(4,439)
Released from restriction used to purchase capital	246	(246)	-	-
Assets released from restrictions	-	(167)	-	(167)
Restricted gifts, bequests, and contributions	-	3,259	-	3,259
Changes in net assets	<u>(3,074)</u>	<u>2,846</u>	<u>-</u>	<u>(228)</u>
Net assets, June 30, 2016	179,647	12,297	976	192,920
Excess of unrestricted revenue and other support over expenses	9,908	-	-	9,908
Pension adjustment	9,503	-	-	9,503
Released from restriction used to purchase capital	6,344	(6,344)	-	-
Assets released from restrictions	-	(100)	-	(100)
Restricted gifts, bequests, and contributions	-	1,693	-	1,693
Changes in net assets	<u>25,755</u>	<u>(4,751)</u>	<u>-</u>	<u>21,004</u>
Net assets, June 30, 2017	<u>\$ 205,402</u>	<u>\$ 7,546</u>	<u>\$ 976</u>	<u>\$ 213,924</u>

See accompanying notes.

Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Statements of Cash Flows (In Thousands)

	Year Ended June 30	
	2017	2016
Operating activities		
Changes in net assets	\$ 21,004	\$ (228)
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Loss on the refunding of debt	122	–
Depreciation of property and equipment	23,791	23,789
Amortization of original issue discount, premium, and bond issue costs	(73)	(72)
Loss (gain) of joint ventures and Premier non-cash component	1,983	(1,630)
(Gain) loss on sale of property and equipment	(13)	70
Change in unrealized (gains) losses on trading securities, net	(5,827)	6,006
Proceeds from realized gains on investments – trading	(7,011)	(4,166)
(Increase) decrease in investments – trading	(2,357)	1,448
Proceeds from restricted contributions	(6,444)	(411)
Realized and unrealized (gains) losses in interest rate swap, net	(2,505)	5,048
Change in operating assets and liabilities:		
Receivables, patient, and other	907	1,080
Other assets	(727)	(3,091)
Inventories and prepaids	639	(947)
Pledges receivable	322	(1,844)
Accounts payable	583	9,492
Accrued expenses	1,245	1,286
Accrued pension expense	(6,140)	6,019
Advances from third-party payors	(1,263)	(831)
Other short-term liabilities	659	(483)
Other long-term liabilities	2,853	(172)
Net cash provided by operating activities	21,748	40,363
Investing activities		
(Increase) decrease in assets limited as to use, nontrading, net	(7,367)	7,739
Realized losses on interest rate swap contract	(1,994)	(2,267)
Increase in other investments	(1,497)	(4,888)
Purchases of property and equipment	(54,687)	(34,936)
Net cash used in investing activities	(65,545)	(34,352)
Fundraising and financing activities		
Proceeds from restricted contributions	6,444	411
Repayments of long-term debt	(65,251)	(5,329)
Deferred financing costs paid	(356)	–
Proceeds from borrowing	95,045	2,000
Net cash provided by (used in) fundraising and financing activities	35,882	(2,918)
Net (decrease) increase in cash and cash equivalents	(7,915)	3,093
Cash and cash equivalents at the beginning of the year	34,525	31,432
Cash and cash equivalents at the end of the year	\$ 26,610	\$ 34,525
Supplemental disclosures		
Property and equipment acquired under capital lease	\$ –	\$ 3,824
Cash paid for interest	\$ 5,199	\$ 4,929

See accompanying notes.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

June 30, 2017

1. Organization and Mission

Frederick Regional Health System, Inc. (the System) is a not-for-profit parent corporation formed on June 23, 2011, exempt from income tax under Section 501(a) of the Internal Revenue Code (the Code) as an organization described in Section 501(c)(3) whereby only unrelated business income as defined by Section 512(a)(1) of the Code is subject to federal income tax. The System has received a determination letter from the Internal Revenue Service (IRS) stating that it is exempt from federal income taxes under Section 501(c) of the Code.

Frederick Memorial Hospital, Inc. (FMH) is a not-for-profit hospital, exempt from federal income tax under Section 501(a) of the Code as an organization described in Section 501(c)(3) whereby only unrelated business income as defined by Section 512(a)(1) of the Code is subject to federal income tax. FMH is located in Frederick, Maryland, and provides health care services primarily to residents of Frederick County. FMH has received a determination letter from the IRS stating that it is exempt from federal income taxes under Section 501(c) of the Code.

Monocacy Insurance, Ltd. (MIL) is a Cayman Islands-domiciled single-parent captive incorporated on May 24, 2011, and holds an Unrestricted Class B insurance license issued under Section 7(2) of the Cayman Island Insurance Law. MIL directly provides primary medical professional liability and primary general liability coverage to the System.

Monocacy Health Partners, LLC (MHP) serves as a physician enterprise, providing governance, management, and support functions for employed physicians. MHP is a not-for-profit corporation, formed on June 23, 2011, and operational as of October 1, 2013, exempt from income tax under Section 501(a) of the Code as an organization described in Section 501(c)(3) whereby only unrelated business income as defined by Section 512(a)(1) of the Code is subject to federal income tax. MHP has received a determination letter from the IRS stating that it is exempt from federal income taxes under Section 501(c) of the Code.

Frederick Health Services Corporation (FHSC) is a Maryland for-profit corporation, all of the stock of which is owned by the System. FHSC is subject to federal and state income taxes. No provision for income taxes has been recorded for 2017 or 2016 due to the availability of net operating loss carryforwards. FHSC recorded a net deferred tax asset of \$613 and \$1,105, respectively, which is presented in other assets on the consolidated balance sheet.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

1. Organization and Mission (continued)

On March 25, 2014, Frederick Integrated Healthcare Network, LLC (FIHN) was formed and is operated exclusively as a charitable organization for charitable, scientific, and educational purposes within the meaning of Section 501(c)(3) of the Code and the Regulations thereunder as they now exist or as they may hereafter be amended. FIHN was formed to maintain and operate a program of clinical integration and an accountable care organization among health care providers. FIHN is a single-member LLC and a disregarded entity of FRHS for income tax purposes.

The Obligated Group for repayment of the Maryland Health and Higher Educational Facilities Authority (MHHEFA) Series 2012A, Series 2017A and 2017B Bonds includes FMH, MHP, and FRHS.

On July 7, 2014, Frederick Memorial Hospital, Meritus Health, and Western Maryland Health System established Trivergent Health Alliance (THA), the parent company to Trivergent Health Alliance MSO (MSO). MSO is a managed services organization that provides regional health care services. The purpose of MSO is to increase operational efficiencies, reduce costs, and enhance the quality of care by focusing efforts in the following areas: human resources, information technology, laboratory services, materials management, pharmacy services, and revenue cycle. FMH contributed working capital of \$100 to THA and \$900 to the MSO for a 33% ownership interest, which is presented in other assets on the consolidated balance sheet. Upon establishment of the MSO, all employees within the six service areas transferred employment from FMH to the MSO. The related cost to purchase the service from MSO is recorded on the consolidated statement of operations within contract services for the years ended June 30, 2017 and 2016, respectively. The System paid a total of \$35,229 and \$34,549 to the MSO during the years ended June 30, 2017 and 2016, respectively.

2. Significant Accounting Policies

Principles of Consolidation

The accompanying consolidated financial statements include the accounts and transactions of the System and its wholly owned subsidiaries: FMH, MIL, FHSC, MHP, and FIHN.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

2. Significant Accounting Policies (continued)

FMH has two wholly owned subsidiaries: Hospice of Frederick County, Inc. (HFC) and Emmitsburg Properties, LLC, both of which have been consolidated with FMH into the System in the accompanying consolidated financial statements. HFC, an independent 501(c)(3) organization controlled by FMH, operates as a fundraising organization for the benefit of hospice services and operates the Kline Hospice House. Emmitsburg Properties, LLC is inactive with no transactions or balances in the accompanying consolidated financial statements.

FHSC has three wholly owned subsidiaries: Rosehill of Frederick, LLC and Corporate Occupational Health Solutions, LLC, which are for-profit limited liability companies, and Frederick Surgical Services Corporation, all of which have been consolidated with FHSC into the System in the accompanying consolidated financial statements.

The accompanying consolidated financial statements include the accounts of the System and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP). Certain prior year balances have been reclassified to conform to the current year's presentation.

Donor-Restricted Gifts

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets if restricted for capital or reported in the statements of operations as net assets released from restrictions if restricted for operating purposes. Donations received with no restrictions and donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying consolidated statements of operations as other operating revenues.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

2. Significant Accounting Policies (continued)

Cash and Cash Equivalents

Cash and cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less. Those money market funds that are classified as long-term investments are excluded from cash and cash equivalents.

Patient Receivables and Allowances

The System's policy is to write off all patient accounts that have been identified as uncollectible. An allowance for doubtful accounts is recorded for accounts not yet written off that are anticipated to become uncollectible. Insurance coverage and credit information is obtained from patients when available. No collateral is obtained for accounts receivable.

When determining the allowance, the System considers the collectability of accounts based on past experience, taking into account contractually due amounts from third-party payors and current collection trends on third-party and self-pay receivables. Self-pay receivables include both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill. Credit risks are assessed based on historical write-offs, net of recoveries, as well as an analysis of the aged accounts receivable balances with allowances generally increasing as the receivable ages. The analysis of receivables is performed monthly, and the allowances are adjusted accordingly.

Inventory

Inventory is stated at the lower of cost or market. Cost is determined using the first-in, first-out method.

Cost of Goods Sold

Cost of goods sold consists primarily of drugs, medical supplies, and surgical implants used in the care and treatment of patients.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

2. Significant Accounting Policies (continued)

Investments and Assets Limited as to Use

The fair values of individual investments are based on quoted market prices of individual securities or investments or estimated amounts using quoted market prices of similar investments. Private equity investments and hedge funds are carried at cost. Realized and unrealized investment return from all unrestricted investments and assets limited as to use are included in the consolidated statements of operations as part of nonoperating gains and losses. Investment income (loss) on investments of temporarily and permanently restricted assets is added to or deducted from the appropriate restricted fund balance if the income is restricted. The cost of securities sold is based on the specific-identification method. Investments are classified as either current or noncurrent based on maturity dates and availability for current operations.

Substantially all of the System's investment portfolio (excluding certain assets limited as to use) is classified as trading, with unrealized gains and losses included in excess of unrestricted revenue and other support over expenses. Certain trustee assets that are included in assets limited as to use are classified as other than trading. These assets primarily consist of funds held for payment of principal and interest on bonds and deferred compensation trusts.

Investment Risk and Uncertainties

The System invests in professionally managed portfolios that contain corporate bonds, U.S. government obligations, municipal obligations, asset-backed securities, marketable equity securities, hedge funds, money market funds, private equity, and alternative investments. Such investments are exposed to various risks, such as interest rate, market, and credit. Due to the level of risk associated with such investments and the level of uncertainty related to changes in the value of such investments, it is at least reasonably possible that changes in risks in the near term would materially affect investment balances and the amounts reported in the financial statements.

Property and Equipment

Property and equipment are carried at historical cost. Items acquired by gift are recorded at fair value at the time of acquisition. Depreciation is recorded on the straight-line method over the estimated useful lives of the depreciable assets. Leasehold improvements are amortized using the straight-line method over the shorter of the lease term or the estimated useful lives of the assets.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

2. Significant Accounting Policies (continued)

Valuation of Long-Lived Assets

The System accounts for the valuation of long-lived assets under Accounting Standards Codification 360-10-45, *Accounting for the Impairment or Disposal of Long-Lived Assets*. This guidance requires that long-lived assets and certain identifiable intangible assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

Recoverability of the long-lived asset is measured by a comparison of the carrying amount of the asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. Assets to be disposed of are reportable at the lower of the carrying amount or fair value, less costs to sell.

Debt Issuance Costs

Debt issuance costs related to the Series 2012 and Series 2017 MHHEFA Bonds are being amortized over the life of the debt using the effective-interest method and are netted in long-term debt in the balance sheet.

Patient Service Revenue and Allowances

The System has agreements with third-party payors that provide for payments to the System for patient services at amounts different from its established rates. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated adjustments under reimbursement agreements with third-party payors. Estimated adjustments are accrued in the period the related services are rendered and are adjusted in future periods as final settlements are determined.

The System's revenues may be subject to adjustment as a result of examination by government agencies or contractors and as a result of differing interpretation of government regulations, medical diagnosis, charge coding, medical necessity, or other contract terms. The resolution of these matters, if any, often is not finalized until subsequent to the period during which the services were rendered.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

2. Significant Accounting Policies (continued)

Performance Indicator

The performance indicator is the excess of unrestricted revenue and other support over expenses. Changes in unrestricted net assets, consistent with industry practice, includes pension adjustments and net assets released from restriction for capital purposes.

Fair Value of Financial Instruments

The carrying amounts reported on the accompanying consolidated balance sheets for cash and cash equivalents, other receivables, accounts payable, accrued expenses, and advances from third-party payors approximate their fair values. The fair value of the System's notes receivable, revenue bond notes, and other long-term debt approximate the carrying amounts, based on loans with similar terms and average maturities.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This guidance is intended to improve and converge with international standards the financial reporting requirements for revenue from contracts with customers. It will be effective for fiscal year 2019, and early adoption is permitted beginning in fiscal year 2018. The Company is currently assessing the potential impact this ASU will have on the Company's consolidated results of operations, financial position and cash flows.

In April 2015, the FASB issued ASU No. 2015-03, *Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*. The amendments in this ASU require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

2. Significant Accounting Policies (continued)

with debt discounts. This guidance is effective for fiscal year 2017. The guidance did not materially impact the System's consolidated results of operations, net assets, or cash flows.

In February 2016, the FASB issued ASU No. 2016-02, *Leases* (ASU 2016-02). This ASU amends the existing accounting standards for lease accounting, including requiring lessees to recognize most leases on their balance sheets. This guidance is effective for annual and interim reporting periods of public entities beginning after December 15, 2018, with early adoption permitted. The Company is currently assessing the potential impact this ASU will have on the Company's consolidated results of operations, financial position and cash flows.

In March 2017, FASB issued ASU 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. The ASU amends ASC 715, *Compensation — Retirement Benefits*, to require employers that present a measure of operating income in their statement of income to include only the service cost component of net periodic pension cost and net periodic postretirement benefit cost in operating expenses (together with other employee compensation costs). The other components of net benefit cost, including amortization of prior service cost/credit, and settlement and curtailment effects, are to be included in nonoperating expenses. The ASU is effective for fiscal years beginning after December 15, 2017, for public business entities and early adoption is permitted. The System expects to adopt this standard in fiscal 2018.

3. Patient Receivables and Patient Service Revenue

Patient receivables consist of the following at June 30:

	<u>2017</u>	<u>2016</u>
Gross patient receivables	\$ 65,570	\$ 61,732
Less estimated uncollectible accounts and contractual allowances	<u>(18,531)</u>	<u>(15,797)</u>
Net patient receivables	<u>\$ 47,039</u>	<u>\$ 45,935</u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

3. Patient Receivables and Patient Service Revenue (continued)

Patient service revenue consists of the following for the years ended June 30:

	<u>2017</u>	<u>2016</u>
Inpatient charges	\$ 226,245	\$ 197,542
Outpatient charges	<u>276,976</u>	<u>276,818</u>
Gross charges	503,221	474,360
Less contractual and other allowances	(97,726)	(85,715)
Less charity care	<u>(8,235)</u>	<u>(11,929)</u>
Net patient service revenue	397,260	376,716
Less provision for bad debts	<u>(10,506)</u>	<u>(4,683)</u>
Net patient service revenue less provision for bad debts	<u>\$ 386,754</u>	<u>\$ 372,033</u>

The System provides care to patients who meet certain criteria under its charity care policy. The System charges at its established rates but waives all or a portion of reimbursement. Because the System does not pursue collection of amounts determined to qualify as charity care, these revenues are not reported as net patient service revenue. Using the cost to charge ratio to approximate cost, charity care provided for the years ended June 30, 2017 and 2016, was \$6,065 and \$9,092, respectively. The state of Maryland rate system includes components within the rates to partially compensate hospitals for uncompensated care.

4. Assets Limited as to Use

A summary of assets that are limited as to use substantially for debt service and deferred compensation trusts at June 30 is as follows:

	<u>2017</u>	<u>2016</u>
Current:		
Principal, interest, and other – bonds	\$ 3,104	\$ 3,001
Construction funds	6,008	–
Loss escrow account	51	80
	<u>\$ 9,163</u>	<u>\$ 3,081</u>
Noncurrent:		
Deferred compensation trusts	\$ 1,708	\$ 1,113
	<u>\$ 1,708</u>	<u>\$ 1,113</u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

4. Assets Limited as to Use (continued)

The assets that are limited as to use consist of the following at June 30:

	<u>2017</u>	<u>2016</u>
Current:		
Cash and money market accounts	\$ 9,112	\$ 3,001
Mutual funds	51	80
	<u>\$ 9,163</u>	<u>\$ 3,081</u>
Noncurrent:		
Cash and money market accounts	\$ –	\$ 15
Corporate or other bonds	199	84
Mutual funds	1,509	1,014
	<u>\$ 1,708</u>	<u>\$ 1,113</u>

The noncurrent assets limited as to use mutual funds are primarily invested equities and bonds chosen by deferred compensation plan participants.

5. Promises to Give

Promises to give are discounted and are due as follows at June 30:

	<u>2017</u>	<u>2016</u>
Less than one year	\$ 1,496	\$ 1,242
One to five years	3,825	3,959
More than five years	3,151	3,847
	<u>8,472</u>	<u>9,048</u>
Less discounting and allowance for uncollectible promises	2,377	2,631
Total promises to give, net	<u>6,095</u>	<u>6,417</u>
Less current portion of promises to give, net	1,272	1,056
	<u>\$ 4,823</u>	<u>\$ 5,361</u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

5. Promises to Give (continued)

Promises to give include \$1,039 and \$1,197 for the years ended June 30, 2017 and 2016, respectively, related to charitable remainder trusts. This net amount represents the excess of the fair value of the related trust accounts over the net present value of the annuities to be paid out of the trust to the named beneficiaries over their estimated life expectancy.

6. Investments

Long-term investments represent unrestricted investments and unrestricted income earned on unrestricted, temporarily restricted, and permanently restricted investments.

Donor-restricted investments are designated by the donors for expenses relating to capital projects, replacement or improvement of existing assets, or to cover the cost of services rendered as charity care and other programs.

Long-term and donor-restricted investments consist of the following at June 30:

	2017		2016	
	Cost	Fair Value	Cost	Fair Value
Cash and cash equivalents	\$ 6,616	\$ 6,616	\$ 8,079	\$ 8,079
U.S. government obligations	4,383	4,389	4,065	4,212
Corporate obligations	4,900	4,967	4,070	4,332
Mortgage-backed securities	3,849	3,854	4,689	4,798
Equity securities	29,487	37,231	28,908	35,302
Mutual funds	74,973	77,467	65,667	63,193
	<u>\$ 124,208</u>	<u>\$ 134,524</u>	<u>\$ 115,478</u>	<u>\$ 119,916</u>

Fair value of investments carried at cost at June 30 is as follows:

	2017		2016	
	Cost	Fair Value	Cost	Fair Value
Private equity investments	\$ 4,379	\$ 4,746	\$ 3,307	\$ 3,982
Hedge funds	14,080	14,384	—	—
	<u>\$ 18,459</u>	<u>\$ 19,130</u>	<u>\$ 3,307</u>	<u>\$ 3,982</u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

6. Investments (continued)

The System was invested in a hedge fund that was accounted for under the equity method of accounting, which approximated fair value. The carrying value of the fund was \$14,270 as of June 30, 2016. During fiscal year 2017, the System realized a \$593 gain and liquidated the investment in full. Valuation of this equity investment was primarily based on financial data supplied by the underlying investee fund. The System provided notice of intent to redeem its shares 65 days prior to the redemption date. Within 45 days of the redemption date, 90% of the redemption value was returned to the System, with the balance payable 30 days after the receipt of the fund's annual audited financial statements. Value was based on historical cost, appraisals, or other estimates that require varying degrees of judgment. The historic cost of this investment was \$11,500 as of June 30, 2016.

The System is now invested in hedge funds that are accounted for at historic cost. The historic cost of these investments is \$14,080 at June 30, 2017. The estimated fair value of these investments are primarily based on financial data supplied by the underlying investee fund. The estimated fair value of these investments is \$14,384 at June 30, 2017.

Investments are allocated as follows at June 30:

	<u>2017</u>	<u>2016</u>
Investment allocation:		
Unrestricted long-term investments	\$ 150,554	\$ 130,641
Donor-restricted investments	2,429	6,857
	<u>\$ 152,983</u>	<u>\$ 137,498</u>

Investment income, including income from short-term investments, for the years ended June 30, is as follows:

	<u>2017</u>	<u>2016</u>
Unrestricted:		
Net realized gains	\$ 8,274	\$ 1,412
Interest and dividends, net of investment expense	1,621	2,760
(Loss) income from joint ventures	(3,291)	686
	<u>\$ 6,604</u>	<u>\$ 4,858</u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

6. Investments (continued)

Investment expense was \$380 and \$392 for the fiscal years ended June 30, 2017 and 2016, respectively.

Other investments consist of the following at June 30:

	Carrying Value		Income (loss)	
	2017	2016	2017	2016
Premier Class B	\$ 3,901	\$ 2,820	\$ —	\$ —
Joint ventures	8,105	9,672	(3,291)	685
	<u>\$ 12,006</u>	<u>\$ 12,492</u>	<u>\$ (3,291)</u>	<u>\$ 685</u>

Investments in joint ventures are accounted for using the equity method, unless otherwise noted, at June 30, and are as follows:

	Entity	Interest %	2017	2016
Colonial Regional Alliance	FMH	14.3%	\$ 5	\$ 30
Carroll Occupational Health, LLC	FHSC	25.0	158	129
Comp Claim Management, LLC	FHSC	50.0	40	52
Premier Purchasing Partners (cost method)	FMH	—	392	392
Mt. Airy Health Services, LLC	FMH	50.0	702	494
Mt. Airy Med-Services, LLC	FHSC	50.0	4,417	4,985
Mt. Airy Plaza, LLC	FHSC	50.0	(44)	18
Trivergent Health Alliance	FMH	33.3	100	100
Trivergent Health Alliance MSO	FMH	33.3	900	900
Advanced Health Collaborative	FRHS	—	42	42
Hopkins Health Advantage, Inc.	FMH	6.0	184	—
Behavioral Health Partners of Frederick, Inc.	FMH	50.0	239	465
Frederick Surgical Center, LLC	FHSC	36.2	860	2,065
MNR of Frederick, LLC	FHSC	22.5	110	—
			<u>\$ 8,105</u>	<u>\$ 9,672</u>

The fair value of these joint ventures is not readily determinable.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

6. Investments (continued)

Group Purchasing Organization Initial Public Offering

The System has participated and owned equity in the Premier Limited Partnership (Premier), which has served as a group purchasing organization for many years. This participation provides purchasing contract rates and rebates the System would not be able to obtain on its own. The System accounts for its investment in Premier on the cost method of accounting.

During the year ended June 30, 2014, Premier restructured from a privately held company to a public company and completed an initial public offering (IPO) of its equity securities. Several financial transactions occurred with those holding equity in Premier before the IPO, including the System. As a result, the System received a cash payment of approximately \$1.1 million in exchange for 16% of its previous ownership in Premier. In addition, in exchange for the extension of the group purchasing contract, the System received partial ownership of the new public company (the Class B units).

During the year ended June 30, 2014, the System received 233,669 Class B units that are earned in seven separate tranches over an 85-month period ending October 31, 2020. The opportunity will exist in the future for these Class B units to be converted to the Premier public company stock.

Prior to vesting, the Class B units may be transferred or sold with the approval of Premier. The System recognized \$1,081 and \$944 related to vesting of 33,381 and 33,381 Class B units for the years ended June 30, 2017 and 2016, respectively. These amounts are recorded as an investment on the accompanying consolidated balance sheets and were recognized as a reduction of supplies expense in the accompanying consolidated statements of operations, as the value of the Class B shares is tied to the group purchasing contract and is considered a vendor incentive.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

7. Fair Value Measurements

Assets and liabilities recorded at fair value in the accompanying consolidated balance sheets are categorized based upon the level of judgment associated with the inputs used to measure their fair value.

FASB guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability (i.e., the exit price) in an orderly transaction between market participants at the measurement date, emphasizing that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, the FASB establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Levels 1 and 2 of the hierarchy) and the reporting entity's own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy).

The Level inputs, as defined by FASB guidance for fair value measurements and disclosures, are as follows:

- Level 1 – Inputs utilize unadjusted quoted prices in active markets for identical assets or liabilities that the System has the ability to access at the measurement date.
- Level 2 – Inputs are inputs other than quoted prices included in Level 1 that are observable for the assets or liabilities, either directly or indirectly. Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the assets or liabilities (other than quoted prices), such as interest rates, foreign exchange rates, and yield curves that are observable at commonly quoted intervals.
- Level 3 – Inputs are unobservable inputs for the assets or liabilities, which are typically based on an entity's own assumptions, as there is little, if any, related market activity.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

7. Fair Value Measurements (continued)

The determination of the fair value level within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The System's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the assets or liabilities. The following tables present the System's assets and liabilities measured at fair value on a recurring basis, aggregated by the level in the fair value hierarchy within which those measurements fall, as of June 30:

	Fair Value Measurements at Reporting Date Using			
	Fair Value at June 30, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets				
Cash and cash equivalents	\$ 42,339	\$ 42,339	\$ —	\$ —
Equity securities	37,231	37,231	—	—
U.S. government obligations	4,195	—	4,195	—
Agency securities	193	—	193	—
Corporate and other bonds	5,167	—	5,167	—
Mutual funds	79,026	79,026	—	—
Mortgage-backed securities	3,854	—	3,854	—
Private equity investments	4,746	—	—	4,746
Hedge funds	14,384	—	—	14,384
Contributions receivable	6,095	—	—	6,095
Total assets	<u>\$ 197,230</u>	<u>\$ 158,596</u>	<u>\$ 13,409</u>	<u>\$ 25,225</u>
Liabilities				
Interest rate swap liability	\$ (9,559)	\$ —	\$ (9,959)	\$ —
Total liabilities	<u>\$ (9,559)</u>	<u>\$ —</u>	<u>\$ (9,959)</u>	<u>\$ —</u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)
(Dollars in Thousands)

7. Fair Value Measurements (continued)

	Fair Value Measurements at Reporting Date Using			
	Fair Value at June 30, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets				
Cash and cash equivalents	\$ 45,620	\$ 45,620	\$ —	\$ —
Equity securities	35,302	35,302	—	—
U.S. government obligations	4,212	—	4,212	—
Agency securities	182	—	182	—
Corporate and other bonds	4,233	—	4,233	—
Mutual funds	64,288	64,288	—	—
Mortgage-backed securities	4,798	—	4,798	—
Private equity investments	3,982	—	—	3,982
Contributions receivable	6,417	—	—	6,417
Total assets	<u>\$ 169,034</u>	<u>\$ 145,210</u>	<u>\$ 13,425</u>	<u>\$ 10,399</u>
Liabilities				
Interest rate swap liability	\$ (14,058)	\$ —	\$ (14,058)	\$ —
Total liabilities	<u>\$ (14,058)</u>	<u>\$ —</u>	<u>\$ (14,058)</u>	<u>\$ —</u>

The fair value of the System's trading securities is determined by third-party service providers utilizing various methods dependent upon the specific type of investment. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Where significant inputs, including benchmark yields, broker-dealer quotes, issuer spreads, bids, offers, the London Interbank Offered Rate (LIBOR) curve, and measures of volatility, are used by these third-party dealers or independent pricing services to determine fair values, the securities are classified within Level 2. Private equity investments and hedge funds are carried at cost.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

7. Fair Value Measurements (continued)

Assets utilizing Level 1 inputs include exchange-traded equity securities and equity and fixed-income mutual funds. Assets and liabilities utilizing Level 2 inputs include U.S. government securities, corporate bonds, mortgage-backed securities, and interest rate swaps. Assets utilizing Level 3 inputs are contributions receivable, private equity investments and hedge funds.

Interest Rate Swap

The System entered into an interest rate swap agreement in conjunction with the issuance of variable rate bonds. The swap contract is valued using models based on readily observable market parameters for all substantial terms of the contract. The fair market value of the swap agreement is included as interest rate swap contract in the accompanying consolidated balance sheets. The fair market value calculation includes a credit valuation adjustment as required of \$547 and \$724, reducing the interest rate swap agreement liability position on June 30, 2017 and 2016, respectively. The change in the fair market value of the swap agreement is included in excess of unrestricted revenue and other support over expenses, as the swap is not designated as an effective hedge.

Credit exposure associated with nonperformance by the counterparty to the derivative instrument is generally limited to the uncollateralized fair value of the asset related to instruments recognized in the balance sheets.

Other

Assets utilizing Level 3 inputs are contributions receivable, private equity investments and hedge funds. Contributions receivable are recorded net of allowance for uncollectible pledges and discounted to net present value. The present value of estimated future cash flows using a discount rate commensurate with the risks involved is an appropriate measure of fair value for unconditional promises to give cash and is considered Level 3. The fair value of the System's private equity and hedge fund investments are determined by third-party service providers utilizing various methods dependent upon the specific type of investment.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

7. Fair Value Measurements (continued)

The following table provides a reconciliation of the beginning and ending balances of items measured at fair value on a recurring basis in the previous table that used significant unobservable inputs (Level 3):

	Year Ended June 30	
	2017	2016
Contributions receivable		
Beginning balance, July 1	\$ 6,417	\$ 4,573
New pledges	1,959	4,034
Collections on pledges	(1,401)	(1,090)
Write-off of pledges	(1,002)	(50)
Changes in reserves and discounting factor	122	(1,050)
Ending balance, June 30	<u>\$ 6,095</u>	<u>\$ 6,417</u>

	Year Ended June 30	
	2017	2016
Private equity investments		
Beginning balance, July 1	\$ 3,982	\$ 4,593
Purchases	1,959	886
Losses	(307)	(744)
Return of capital	(888)	(753)
Ending balance, June 30	<u>\$ 4,746</u>	<u>\$ 3,982</u>

	Year Ended June 30	
	2017	2016
Hedge funds		
Beginning balance, July 1	\$ —	\$ —
Purchases	14,050	—
Settlements	—	—
Gains	334	—
Ending balance, June 30	<u>\$ 14,384</u>	<u>\$ —</u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

8. Property and Equipment

Property and equipment consist of the following at June 30:

	Estimated Useful Lives	2017	2016
Land	–	\$ 6,013	\$ 5,973
Land improvements	08–20 years	2,190	1,869
Buildings	20–40 years	239,102	219,825
Fixed equipment	10–20 years	17,239	17,004
Movable equipment	03–20 years	218,487	212,921
Leasehold improvements	05–20 years	29,878	27,165
		512,909	484,757
Less accumulated depreciation		307,604	285,011
		205,305	199,746
Construction in process, renovations, and deposits		42,287	16,937
		\$ 247,592	\$ 216,683

Construction in progress consists of the System’s building construction and renovations. As these projects are completed, the related assets are transferred out of construction in progress and into the appropriate asset category and are depreciated over the applicable useful lives.

Capitalized computer software, net of accumulated amortization, as of June 30, 2017 and 2016, was \$3,224 and \$5,607, respectively. Amortization of computer software was \$3,165 and \$3,784 for fiscal years 2017 and 2016, respectively.

The net book value of assets under capital lease arrangements totaled \$3,213 and \$4,545 as of June 30, 2017 and 2016, respectively. Depreciation expense related to assets under capital lease arrangements was \$1,342 and \$1,245 for the fiscal years ended June 30, 2017 and 2016, respectively.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

9. Long-Term Debt

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

	<u>2017</u>	<u>2016</u>
MHHEFA Series 2012A Bonds	\$ 95,996	\$ 97,055
MHHEFA Series 2012B Bonds	—	63,250
MHHEFA Series 2017A Bonds	29,000	—
MHHEFA Series 2017B Bonds	60,645	—
Line of credit	7,000	2,000
Capital lease obligations	2,769	3,872
Deferred finance costs	(1,437)	(1,291)
	<u>193,973</u>	<u>164,886</u>
Less current maturities	11,861	7,007
	<u>\$ 182,112</u>	<u>\$ 157,879</u>

Series 2012A MHHEFA Revenue Bonds

In December 2012, the System obtained a loan of \$96,240 in MHHEFA Revenue Bonds, Frederick Memorial Hospital Issue, Series 2012A. The MHHEFA Series 2012A Bonds were issued to refund all of the MHHEFA Series 2002 Bonds and to finance a portion of certain construction and equipment costs of the System. The Series 2012A Bonds were issued with a premium of \$3,990, which is being amortized over the life of the bonds. The accumulated amortization was \$729 at June 30, 2017. The annual interest rate on the bond loan ranges between 3% and 5% over the term of the bond. Interest is payable semiannually on each January 1 and July 1, through July 1, 2038.

Series 2012A Bonds maturing on or after July 1, 2023, are subject to redemption prior to maturity beginning on July 1, 2022, at the option of the authority at the principal amount of the Series 2012A Bonds to be redeemed plus accrued interest thereon to the date set for redemption.

Under the provisions of the bond agreement, the System has granted to the authority a security interest in all receipts now owned and hereafter acquired. The Series 2012A Bonds are secured ratably with the Series 2012B Bonds. The fair value of the Series 2012A MHHEFA Revenue Bonds is estimated based on quoted prices in active markets for identical assets. The fair value of the 2012A Bonds as of June 30, 2017, is estimated at \$95,667.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

9. Long-Term Debt (continued)

There is no debt service reserve requirement associated with the Series 2012A Bonds.

The bond agreement contains certain financial covenants.

Series 2012B MHHEFA Revenue Bonds

In December 2012, the System obtained a loan of \$70,020 in MHHEFA Revenue Bonds, Frederick Memorial Hospital Issue, Series 2012B. The MHHEFA Series 2012B Bonds were issued to refund all of the MHHEFA Series 2008 Bonds. In June 2017, the 2012B MHHEFA Revenue Bonds were redeemed and refinanced with 2017B MHHEFA Revenue Bonds.

Series 2017A MHHEFA Revenue Bonds

In June 2017, the System obtained a loan of \$29,000 in MHHEFA Revenue Bonds, Frederick Memorial Hospital issue, Series 2017A. Upon settlement of the bonds, MHHEFA and the obligated group entered into a financing agreement with BB&T Community Holdings Co. (BB&T) whereby BB&T became the initial purchaser of the Series 2017A Bonds. The interest rate on the bonds is based on an index floating rate determined by BB&T equal to the applicable percentage by LIBOR plus the applicable spread plus any Tax Equity and Fiscal Responsibility Act (TEFRA) adjustment. Interest on the bonds is payable monthly and was \$20 for June 2017.

The proceeds of the Series 2017A Bonds were used for completion of the 2017 Project which consists of the construction of the James M. Stockman Cancer Institute, renovations to a building used as a business center and renovations to the sterile processing department.

Series 2017A Bonds are subject to redemption at the option of the authority at the principal amount of the Series 2017A Bonds to be redeemed plus accrued interest to the date set for redemption. The Series 2017A Bonds, which mature on July 1, 2042, are secured ratably with the Series 2017B Bonds. The System is required to make annual payments to BB&T sufficient to meet the annual debt service requirements for the succeeding year. Annual sinking fund installments for the Series 2017A Bonds range from \$7,085 on July 1, 2039 to \$7,415 on July 1, 2042.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

9. Long-Term Debt (continued)

Series 2017B MHHEFA Revenue Bonds

In June 2017, the System obtained a loan of \$60,645 in MHHEFA Revenue Bonds, Frederick Memorial Hospital issue, Series 2017B. Upon settlement of the bonds, MHHEFA and the obligated group entered into a financing agreement with BB&T Community Holdings Co. (BB&T) whereby BB&T became the initial purchaser of the Series 2017B Bonds. The interest rate on the bonds is based on an index floating rate determined by BB&T equal to the applicable percentage by LIBOR plus the applicable spread plus the TEFRA adjustment, if any. Interest on the bonds is payable monthly and was \$41 for June 2017.

The proceeds of the Series 2017B Bonds were used to pay financing costs and for the refunding of the Series 2012B Bonds.

Series 2017B Bonds are subject to redemption at the option of the authority at the principal amount of the Series 2017B Bonds to be redeemed plus accrued interest to the date set for redemption. The Series 2017B Bonds, which mature on July 1, 2035, are secured ratably with the Series 2017A Bonds. The System is required to make annual payments to BB&T sufficient to meet the annual debt service requirements for the succeeding year. Annual sinking fund installments for the Series 2017B Bonds range from \$3,155 on July 1, 2017 to \$2,090 on July 1, 2035.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

9. Long-Term Debt (continued)

Capital Lease Obligations

As of June 30, 2017, the System has entered into certain capital lease obligations to secure major medical equipment. Future payments under these obligations are as follows:

Years ending June 30:	
2018	\$ 836
2019	814
2020	814
2021	430
2022	—
Total payments	<u>2,894</u>
Less interest payments	<u>125</u>
Total lease obligations, principal	2,769
Less current portion	<u>777</u>
Long-term obligations under capital leases	<u><u>\$ 1,992</u></u>

Debt service requirements on long-term debt, line of credit and capital lease obligations, excluding original issue premium on bonds at June 30, 2017, of \$3,261 is as follows:

	<u>Principal</u>
Years ending June 30:	
2018	\$ 11,861
2019	5,013
2020	5,223
2021	5,057
2022	4,875
Thereafter	<u>160,120</u>
	<u><u>\$ 192,149</u></u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

9. Long-Term Debt (continued)

On September 9, 2013, the System entered into a \$20,000 revolving line of credit with a lending institution for the purpose of funding short-term working capital needs. The line of credit bears a variable interest rate of one-month LIBOR plus 1.5% per annum, adjusted monthly. All outstanding principal and interest must be repaid within two years of closing. There must not be any outstanding principal balance for at least 30 consecutive days during each year the line of credit is available. A \$5,000 draw was taken upon closing. The outstanding balance on this line of credit was \$7,000 and \$2,000 as of June 30, 2017 and 2016, respectively. The line of credit agreement was amended on November 4, 2015, extending the maturity date to December 1, 2017, and decreased the revolving loan commitment from \$20,000 to \$15,000.

10. Interest Rate Swap Contract

The System records its derivatives as assets or liabilities at fair value. A derivative is typically defined as an instrument, whose value is derived from an underlying instrument, index or rate, has a notional amount, requires little or no initial investment, and can be net settled. The System participates in an interest rate swap contract that is considered a derivative financial instrument.

The System has an interest rate swap contract with a third-party with a notional amount of \$60,245 on June 30, 2017, which reduces annually by an amount equal to the sinking fund installment due on bonds until maturity on July 1, 2035. The System is exposed to credit loss in the event of nonperformance by the counterparty to the interest rate swap contract. However, the System does not anticipate nonperformance by the counterparty. Under the swap contract, the System pays interest at a fixed rate of 3.0804% per annum and receives interest at a variable rate equal to 67% of the one-month LIBOR (0.8252% as of June 30, 2017). The swap contract requires payments to be made or received monthly. The fair value of the swap contract was a liability of \$9,559 and \$14,058 at June 30, 2017 and 2016, respectively.

The System accrued net payments under its interest rate swap program of \$1,994 and \$2,267 during fiscal years 2017 and 2016, respectively. These amounts are included within realized and unrealized losses on interest rate swap contract, net in the accompanying consolidated statements of operations and investing activities in the accompanying consolidated statements of cash flows.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

10. Interest Rate Swap Contract (continued)

The interest rate swap contract is not designated as an effective cash flow hedge. The System's objectives of entering into the interest rate swap contract include limiting or hedging variable interest rate payments to achieve lower overall borrowing costs than a comparable unhedged fixed rate borrowing, to alter the pattern of debt service payments, and to improve asset/liability matching. Changes in the fair value of the derivative financial instrument are recognized in realized and unrealized losses on interest rate swap contract, net in the accompanying consolidated statements of operations and investing activities in the accompanying consolidated statements of cash flows. The carrying value of the System's derivative financial instrument approximates fair value. The interest rate swap contract is valued using models based on readily observable market parameters for all substantial terms of the contract.

Credit exposure associated with nonperformance by the counterparties to derivative instruments is generally limited to the uncollateralized fair value of the asset related to instruments recognized in the consolidated balance sheets. The System attempts to mitigate the risk of nonperformance by selecting counterparties with high credit ratings and monitoring their creditworthiness.

The System's derivative agreements do not contain any credit support provisions that require it to post collateral if there are declines in the derivative value or its credit rating.

Balance Sheet Location	Fair Value	
	2017	2016
Asset derivatives		
Derivatives not designated as hedging instruments:		
Interest rate contracts	\$ —	\$ —
Liability derivatives		
Interest rate swap contract	\$ 9,559	\$ 14,058
Total derivatives not designated as hedging instruments	\$ 9,559	\$ 14,058

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)
(Dollars in Thousands)

10. Interest Rate Swap Contract (continued)

A summary of the effect of the nonhedging derivatives on the System's income statement for the year ended June 30, 2017, is as follows:

Type of Nonhedging Derivatives	Income Statement Location of (Loss) Gain Recognized	Derivative (Loss) Gain Recognized
Interest rate swap contract – realized losses	Other loss	\$ (1,994)
Interest rate swap contract – unrealized gain	Other gain	4,499
Total		\$ 2,505

A summary of the effect of the nonhedging derivatives on the System's income statement for the year ended June 30, 2016, is as follows:

Type of Nonhedging Derivatives	Income Statement Location of (Loss) Gain Recognized	Derivative (Loss) Gain Recognized
Interest rate swap contract – realized losses	Other loss	\$ (2,267)
Interest rate swap contract – unrealized losses	Other loss	(2,781)
Total		\$ (5,048)

11. Employee Benefit Plans

The System has a defined benefit pension plan (Plan) that was curtailed on June 30, 2007. The System uses a measurement date of June 30 to determine plan assets and benefit obligations. The curtailment is such that participants will no longer accrue benefits under the Plan and no new participants will be accepted. Current participant accounts will not receive any service credits or increases in benefits for post-curtailed compensation increases beyond June 30, 2007, however, the System will make annual contributions to the Plan in accordance with actuarially determined amounts to meet future accumulated benefit obligations under the frozen Plan.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

11. Employee Benefit Plans (continued)

Effective July 1, 2007, a modified defined contribution plan (403b) was implemented as described below.

The following provides a reconciliation of the changes in fair value of the Plan's assets and projected benefit obligations and the Plan's funded status based on a June 30, 2017 and 2016, measurement date:

	2017	2016
	<i>(In Thousands)</i>	
Accumulated benefit obligation	\$ 71,678	\$ 87,362
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	\$ 87,362	\$ 88,180
Service cost	599	605
Interest cost	2,681	3,595
Actuarial (gain) loss	(4,675)	9,518
Benefits paid and administrative expenses	(2,458)	(3,215)
Settlement payments	(12,908)	(9,361)
Settlement loss (gain)	1,077	(1,958)
Projected benefit obligation at end of year	71,678	87,362
Change in plan assets:		
Fair value of plan assets at beginning of year	62,475	69,312
Actual return on plan assets	1,821	1,741
Employer contribution	4,000	4,000
Benefits paid	(1,902)	(2,385)
Administrative expenses	(555)	(832)
Settlement payments	(12,908)	(9,361)
Fair value of plan assets at end of year	52,931	62,475
Funded status	(18,747)	(24,887)
Net amount recognized	\$ (18,747)	\$ (24,887)

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

11. Employee Benefit Plans (continued)

The discount rate actuarial assumption was changed from 3.59% to 3.85%, resulting in a \$4,483 decrease in the projected benefit obligation as of June 30, 2017.

Net amounts recognized in unrestricted net assets that have not been recognized in net periodic benefit cost are as follows:

	June 30	
	2017	2016
Net actuarial loss	\$ 16,874	\$ 26,325
Prior service cost	133	185
Total recognized in unrestricted net assets	<u>\$ 17,007</u>	<u>\$ 26,510</u>

The following table sets forth the weighted-average assumptions used to determine benefit obligations:

	June 30	
	2017	2016
Discount rate	3.85%	3.59%
Rate of compensation increase	N/A	N/A

The following table sets forth the weighted-average assumptions used to determine net periodic benefit cost:

	Year Ended June 30	
	2017	2016
Discount rate	3.59%	4.42%
Expected return on plan assets	3.75%	4.50%
Rate of compensation increase	N/A	N/A

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

11. Employee Benefit Plans (continued)

Net periodic pension cost included the following components:

	<u>2017</u>	<u>2016</u>
Service costs	\$ 599	\$ 605
Interest cost	2,681	3,595
Expected return on plan assets	(2,291)	(2,898)
Amortization of prior service cost	52	52
Amortization of net (gain) or loss	2,412	1,946
Settlement	3,911	2,279
Net periodic pension cost	<u>\$ 7,364</u>	<u>\$ 5,579</u>

The estimated net loss that is expected to be amortized from other changes in unrestricted net assets into net periodic benefit cost for the year ending June 30, 2018, is \$1,552.

The System determines the expected long-term rate of return on Plan assets by taking into consideration the historical returns of various asset classes and the types of investments the Plan is expected to hold.

The Plan asset allocation as of the measurement date presented as a percentage of total plan assets was as follows:

	<u>2017</u>	<u>2016</u>
Equity securities	27%	26%
Debt securities	60	63
Cash	3	1
Hedge funds	10	10
Total	<u>100%</u>	<u>100%</u>

The Plan assets are recorded at fair value and are categorized based upon the level of judgment associated with the inputs used to measure their fair value.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

11. Employee Benefit Plans (continued)

FASB guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability (i.e., the exit price) in an orderly transaction between market participants at the measurement date, emphasizing that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, the FASB establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Levels 1 and 2 of the hierarchy) and the reporting entity's own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy). The Level inputs, as defined by FASB guidance for fair value measurements and disclosures, are as follows:

- Level 1 – Inputs utilize unadjusted quoted prices in active markets for identical assets or liabilities that the System has the ability to access at the measurement date.
- Level 2 – Inputs are inputs other than quoted prices included in Level 1 that are observable for the assets or liabilities, either directly or indirectly. Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the assets or liabilities (other than quoted prices), such as interest rates, foreign exchange rates, and yield curves that are observable at commonly quoted intervals.
- Level 3 – Inputs are unobservable inputs for the assets or liabilities, which are typically based on an entity's own assumptions, as there is little, if any, related market activity.

The determination of the fair value level within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

11. Employee Benefit Plans (continued)

The System's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the assets or liabilities. The following tables present the Plan's assets and liabilities measured at fair value on a recurring basis, aggregated by the level in the fair value hierarchy within which those measurements fall, as of June 30:

	Fair Value Measurements at Reporting Date Using			
	Fair Value at June 30, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets				
Cash and cash equivalents	\$ 1,581	\$ 1,581	\$ —	\$ —
Equity securities	14,079	14,079	—	—
Fixed income mutual funds	32,397	32,397	—	—
Hedge funds and other alternative	4,874	—	—	4,874
Total assets	<u>\$ 52,931</u>	<u>\$ 48,057</u>	<u>\$ —</u>	<u>\$ 4,874</u>

	Fair Value Measurements at Reporting Date Using			
	Fair Value at June 30, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets				
Cash and cash equivalents	\$ 230	\$ 230	\$ —	\$ —
Equity securities	16,027	16,027	—	—
Fixed income mutual funds	40,039	40,039	—	—
Hedge funds and other alternative	6,179	—	—	6,179
Total assets	<u>\$ 62,475</u>	<u>\$ 56,296</u>	<u>\$ —</u>	<u>\$ 6,179</u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)
(Dollars in Thousands)

11. Employee Benefit Plans (continued)

The following table provides a reconciliation of the beginning and ending balances of items measured at fair value on a recurring basis in the previous table that used significant unobservable inputs (Level 3):

	<u>Hedge Funds</u>	<u>Total</u>
Balance at June 30, 2015	\$ 8,858	\$ 8,858
Purchases	—	—
Settlements	(2,000)	(2,000)
Losses, net	(679)	(679)
Balance at June 30, 2016	6,179	6,179
Purchases	4,770	4,770
Settlements	(6,239)	(6,239)
Gains, net	164	164
Balance at June 30, 2017	<u>\$ 4,874</u>	<u>\$ 4,874</u>

The fair value of the Plan's trading securities is determined by third-party service providers utilizing various methods dependent upon the specific type of investment. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Assets utilizing Level 1 inputs include exchange-traded equity securities and equity and fixed income mutual funds. Assets utilizing Level 3 inputs are hedge funds.

The hedge funds are accounted for at fair value, which has been estimated using the net asset value per share of the fund as of June 30, 2017.

Assets of the Plan are invested in a manner consistent with fiduciary standards of the Employee Retirement Income Security Act of 1974, namely, (a) the safeguards and diversity to which a prudent investor would adhere must be present and (b) all transactions undertaken on behalf of the Plan must be for the sole interest of Plan participants and beneficiaries to provide benefits in a prudent manner. Investment objectives of the Plan also include the following:

- Achieve an annualized total return that equals or exceeds the actuarial target
- Preserve the value of the Plan's assets

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

11. Employee Benefit Plans (continued)

- Diversify assets sufficiently, and, in accordance with modern portfolio theory, avoid large specific risks (losses) and minimize the volatility of the portfolio
- Provide sufficient liquidity to Plan benefit payment outflows and meet the Plan's requirements

The strategic target asset allocation for the Plan is 23% in equities, 62% in fixed income securities, 10% in hedge funds, and 5% real estate.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

2018	\$	1,875
2019		2,110
2020		2,380
2021		2,651
2022		2,896
2023–2027		17,373

The System also has a tax-deferred annuity savings (403b) plan available to substantially all employees. In conjunction with the curtailment of the defined benefit pension plan, the System modified the (403b) plan effective July 1, 2007. Under the terms of the modified plan, every eligible employee receives a base contribution of 2.5% of earnings. The System will match 50.0% to 70.0% on employee contributions up to 5.0% of employee earnings depending on years of service. In addition, certain employees are eligible for transition credits based on age and years of service to the System. The System's contribution for base matching and transition credits totaled \$4,993 and \$4,795 for fiscal years 2017 and 2016, respectively.

In December 2005, the System adopted two nonqualified deferred compensation plans with an effective date of December 15, 2004, for certain members of executive management. Under these plans, participating employees may contribute amounts from their compensation to the plan and may receive a discretionary employer contribution. Employees are fully vested in all employee contributions to the plans. Vesting in employer contributions occurs in accordance with the underlying plan documents. All assets of the plans are held in separate trusts. Total contributions by the System to the plans were \$438 and \$358 for the years ended June 30, 2017 and 2016, respectively.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

12. Concentration of Credit Risk

The System has funds on deposit with financial institutions in excess of amounts insured by the Federal Deposit Insurance Corporation. The System grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors (in percentages) at June 30 was as follows:

	<u>2017</u>	<u>2016</u>
Medicare	27%	25%
Medicaid	20	22
Blue Cross	14	15
HMOs and PPOs	19	19
Commercial insurance and other third-party payors	5	5
Patients	15	14
	<u>100%</u>	<u>100%</u>

13. Functional Expenses

The System and its subsidiaries provide general health care services to residents within its geographic location. Expenses related to providing these services are as follows:

	<u>2017</u>	<u>2016</u>
Health care services	\$ 348,906	\$ 328,873
General and administrative	50,484	47,716
	<u>\$ 399,390</u>	<u>\$ 376,589</u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

14. Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes or periods at June 30:

	<u>2017</u>	<u>2016</u>
Health care services:		
Buildings and equipment	\$ 5,750	\$ 10,192
Restricted by time only	1,093	1,051
Education programs	336	483
Indigent care and research	367	571
	<u>\$ 7,546</u>	<u>\$ 12,297</u>

Permanently restricted net assets consist of investments to be held in perpetuity, the income from which is expendable for:

	<u>2017</u>	<u>2016</u>
General health care services (reported as other operating revenue)	\$ 971	\$ 971
Specific health care services (reported as net assets released from restrictions)	5	5
	<u>\$ 976</u>	<u>\$ 976</u>

During 2017 and 2016, net assets were released from donor restrictions by incurring expenses or capital expenditures satisfying the restricted purposes in the amounts of \$6,444 and \$411, respectively.

15. Contingencies

The System has been named as a defendant in various legal proceedings arising from the performance of its normal activities. In the opinion of management, after consultation with legal counsel and after consideration of applicable insurance, the amount of the System's ultimate liability under all current legal proceedings will not have a material adverse effect on its consolidated financial position or results of operations.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

15. Contingencies (continued)

The System is partially self-insured against employee medical claims. Expenses include claims paid and a provision for claims incurred but not reported. As of June 30, 2017 and 2016, the System has recorded a liability for claims incurred but not reported of \$1,755 and \$1,567, respectively. The program has an annual aggregate stop-loss provision of \$500 per employee.

On July 1, 2011, MIL, a single-parent captive, was created to provide a flexible risk financing structure to meet the needs of the System's organization. As of June 30, 2012, MIL provides FMH with Primary Medical Professional Liability and Primary General Liability coverage with policy limits of liability of \$1,000 each and every medical incident with a \$3,000 annual aggregate for the 2011/2012 policy year and with a \$5,000 annual aggregate for the 2012/2013 policy year onwards. The MIL Primary Policy coverage form is mature claims-made with a retroactive date of July 1, 2005. The policy funding is retrospectively rated.

MIL has also issued an Excess Umbrella Liability mature claims-made policy with a retroactive date of July 1, 2005. This policy is structured on a "dualtower" design. The Excess Medical Professional Liability Tower follows the form of the underlying Primary Medical Professional Liability coverage providing \$20,000 limits of liability (\$10,000 prior to July 1, 2016). The Umbrella Liability Tower provides \$20,000 limits of liability (\$10,000 prior to July 1, 2016) excess of scheduled underlying coverages. The "dualtowers" are 100% reinsured with a commercial carrier with an AM Best rating of A- or better.

Effective June 30, 2012, MIL assumed Professional Liability and Comprehensive General Liability coverage previously included under FMH's self-insured plan, for incidents occurring between July 1, 2005 and June 30, 2011, that were reported to FMH prior to June 30, 2011. The policy provides limits of liability of \$1,000 each and every medical incident for the hospital professional liability and \$1,000 each and every medical incident for comprehensive general liability. The policy is subject to a \$3,000 annual aggregate for the hospital professional liability and comprehensive general liability combined, which applies to each covered year separately on a claims-made basis.

Effective June 30, 2012, MIL further assumed Professional Liability and Comprehensive General Liability coverage previously included under another FMH self-insurance plan, for incidents occurring between July 1, 1999 and June 30, 2001, with a limit of liability of \$100 per claim.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)
(Dollars in Thousands)

15. Contingencies (continued)

The Primary Medical Professional and Primary General Liability policy is 100% MIL retained risk. The Excess Umbrella Liability coverage is fully reinsured with a commercial carrier with an AM Best rating of A- or better.

There are known claims and incidents that could result in the assertion of additional claims, as well as claims from unknown incidents that could be asserted arising from services provided to patients. Effective July 1, 2011, the System adopted ASU 2010-23, *Measuring Charity Care for Disclosure*, which clarified that a health care entity should not net insurance recoveries against a related claim liability. The System maintains reserves, including excess coverage, in the amount of \$15,351 and \$13,008 at June 30, 2017 and 2016, respectively, and a related reinsurance receivable of \$6,105 and \$4,889 at June 30, 2017 and 2016, respectively. The System employs an independent actuary to estimate the ultimate settlement of such claims.

These reserves are recorded on an undiscounted basis at June 30, 2017 and 2016. In management's opinion, the amounts recorded provide an adequate reserve for loss contingencies. However, changes in circumstances affecting professional liability claims could cause these estimates to change by material amounts in the short term.

16. Commitments

Operating Leases

The System and its subsidiaries lease facilities under various operating leases, the last of which expires in 2030. The System has various options to renew the leases. The System also leases equipment under various operating leases. Rent expense under all operating leases was \$5,304 and \$4,926 for 2017 and 2016, respectively. Future minimum payments under noncancelable operating leases are as follows:

Years ending June 30:	
2018	\$ 3,823
2019	3,511
2020	3,327
2021	3,066
2022	3,115
Thereafter	20,597
	<u>\$ 37,439</u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

16. Commitments (continued)

Workers' Compensation

The System is self-insured against workers' compensation claims, up to \$500 per occurrence, and has excess insurance coverage of \$1,000 per occurrence. Expenses include claims paid and a provision for claims incurred but not reported.

Letter of Credit

The System has a letter of credit issued by a lending institution in the amount of \$1,046. This letter of credit is renewed on an annual basis and is required by the state of Maryland as collateral for unemployment benefits.

17. Regulatory Environment

Medicare and Medicaid

The Medicare and Medicaid reimbursement programs represent a substantial portion of the System's revenues. The System's operations are subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, and government health care program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse.

Over the past several years, government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by health care providers. Violations of these laws and regulations could result in expulsion from government health care programs, together with the imposition of fines and penalties, as well as repayments for patient services previously billed. Compliance with fraud and abuse standards and other government regulations can be subject to future government review and interpretation.

Also, future changes in federal and state reimbursement funding mechanisms and related government budgeting constraints could have an adverse effect on the System.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

17. Regulatory Environment (continued)

In 1983, Congress approved a Medicare prospective payment plan for most inpatient services as part of the Social Security Amendment Act of 1983. Hospitals in Maryland are currently exempt from these federal reimbursement regulations under a special waiver. The waiver currently in effect is subject to renewal based upon criteria defined in the federal law. Under these payment arrangements with Medicare, a retroactive adjustment could occur if certain performance standards are not attained by all hospitals on a statewide basis. The impact, if any, of any retroactive adjustment of the Medicare prospective payment system, should hospitals in Maryland become subject to such system, on future operations of the System, has not been determined.

State of Maryland Health Services Cost Review Commission

Certain hospital charges are subject to review and approval by the Maryland Health Services Cost Review Commission (HSCRC or the Commission). Hospital management has filed the required forms with the Commission and believes the hospital to be in compliance with Commission requirements.

Through June 2017, the current rate of reimbursement for principally all inpatient services and certain other services to patients under the Medicare and Medicaid programs is based on an agreement between the Centers for Medicare and Medicaid Services and the Commission. This agreement is based upon a waiver from Medicare prospective payment system reimbursement principles granted to the state of Maryland under Section 1814(b) of the Social Security Act. As of January 2014, the Centers for Medicare and Medicaid Services approved a modernized waiver that will be in place as long as Maryland hospitals commit to achieving significant quality improvements, limits on all-payor per capita hospital growth, and limits on annual Medicare per capita hospital cost growth to a rate lower than the national annual per capita growth rate. This model is projected to save Medicare at least \$330,000 over the next five years.

Beginning in fiscal year 2014, the System entered into an agreement with the HSCRC to participate in the Global Budgeted Revenue (GBR) program. GBR methodology encourages hospitals to focus on population health strategies by establishing a fixed annual revenue cap for each GBR hospital. The agreement is evergreen in nature and covers both regulated inpatient and outpatient revenues.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

17. Regulatory Environment (continued)

Under GBR, hospital revenue is known at the beginning of each fiscal year. Annual revenue is calculated from a base year and is adjusted annually for inflation, infrastructure requirements, population changes, performance in quality-based programs, and changes in levels of uncompensated care. Revenue may also be adjusted annually for market levels and shifts of services to unregulated services.

The Commission's rate-setting methodology for hospital service centers consists of establishing an acceptable unit rate for defined inpatient and outpatient service centers within the Hospital. The actual average unit charge for each service center is compared to the approved rate month and annually.

Overcharges and undercharges due to either patient volume or price variances, adjusted for penalties where applicable, are applied to decrease (in the case of overcharges) or increase (in the case of undercharges) future approved rates on an annual basis. The System exceeded the allowable target by \$293 and \$501 for the years ended June 30, 2017 and 2016, respectively.

The timing of the HSCRC's rate adjustments for the System could result in an increase or reduction in rates due to the variances and penalties described above in a year subsequent to the year in which such items occur, and there is at least a possibility that the amounts may be material. The System's policy is to record revenue based on actual charges for services to patients in the year in which the services are performed. The Hospital recognizes unbilled revenue for in-house patients.

The HSCRC established an uncompensated care fund whereby certain hospitals are required to contribute to the fund to help cover the costs associated with uncompensated care for all Maryland hospitals equitably. The System's contribution to the fund was \$2,682 and \$3,945 for the years ended June 30, 2017 and 2016, respectively.

18. Subsequent Events

The Company has evaluated subsequent events through October 10, 2017, the date of issuance of these consolidated financial statements. The following events have occurred subsequent to the year-ended June 30, 2017 that required disclosure in the consolidated financial statements.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

18. Subsequent Events (continued)

Effective July 1, 2017, the Frederick Memorial Hospital, Inc. Retirement Plan (Plan) was amended to allow Plan participants, who terminated employment prior to June 1, 2017, and have an actuarially equivalent lump sum payment as of December 1, 2017, of \$75 or less, to elect a distribution in the form of an annuity or lump sum payment according to certain restrictions. The impact of this amendment has not yet been determined.

A single premium guaranteed annuity contract in the amount \$10,106 was purchased on August 16, 2017, which transferred the liability of 121 vested participants from the Plan which is projected to result in an approximate \$9,600 reduction of the Pension Obligation Liability of the Plan. The impacted Plan participants were those receiving monthly benefit payments less than \$800. The estimated amount of settlement expense in fiscal year 2018 as the result of both the lump sum payment and annuity contract purchase is estimated to be \$3,300.

During September 2017, the System received a waiver to the Line of Credit requirement that there must not be any outstanding principal balance for at least 30 consecutive days during each year the line of credit is available. This waiver is limited to the period ended September 3, 2017. The outstanding balance on this line of credit was \$7,000 as of September 30, 2017 and June 30, 2016, respectively.

No other significant subsequent events were noted that would require recognition or disclosure at this time.

Supplementary Information

Frederick Regional Health System, Inc. and Subsidiaries

Supplementary Consolidating Balance Sheet
(Dollars in Thousands)

June 30, 2017

	Frederick Regional Health System, Inc.	Frederick Memorial Hospital, Inc. Consolidated	Monocacy Insurance, Ltd.	Monocacy Health Partners, LLC	Frederick Health Services Corporation	Frederick Integrated Healthcare Network, LLC	Elimination	Frederick Regional Health System, Inc. Consolidated
Assets								
Current assets:								
Cash and cash equivalents	\$ 29	\$ 24,022	\$ 282	\$ 882	\$ 1,361	\$ 34	\$ —	\$ 26,610
Patient receivables, net	—	44,191	—	2,394	454	—	—	47,039
Other receivables	—	3,046	—	—	—	—	—	3,046
Inventory	—	5,749	—	—	—	—	—	5,749
Prepaid expenses	—	2,778	6	6	205	—	—	2,995
Assets limited as to use	—	9,112	51	—	—	—	—	9,163
Promises to give, net	—	1,272	—	—	—	—	—	1,272
Total current assets	29	90,170	339	3,282	2,020	34	—	95,874
Net property and equipment	—	240,192	—	2,965	4,435	—	—	247,592
Other assets:								
Assets limited as to use	—	1,708	—	—	—	—	—	1,708
Investments – donor restricted	—	2,429	—	—	—	—	—	2,429
Promises to give, net	—	4,823	—	—	—	—	—	4,823
Long-term investments	—	139,529	11,025	—	—	—	—	150,554
Other investments	230,628	22,754	—	—	5,540	—	(246,916)	12,006
Other assets	—	9,277	5,788	—	613	—	(8,866)	6,812
Intercompany receivables	—	47,010	—	—	—	—	(47,010)	—
Total other assets	230,628	227,530	16,813	—	6,153	—	(302,792)	178,332
Total assets	\$ 230,657	\$ 557,892	\$ 17,152	\$ 6,247	\$ 12,608	\$ 34	\$ (302,792)	\$ 521,798

Frederick Regional Health System, Inc. and Subsidiaries

Supplementary Consolidating Balance Sheet (continued)

(Dollars in Thousands)

	Frederick Regional Health System, Inc.	Frederick Memorial Hospital, Inc. Consolidated	Monocacy Insurance, Ltd.	Monocacy Health Partners, LLC	Frederick Health Services Corporation	Frederick Integrated Healthcare Network, LLC	Elimination	Frederick Regional Health System, Inc. Consolidated								
Liabilities and net assets																
Current liabilities:																
Current maturities of long-term debt, line of credit and capital lease obligations	\$	–	\$	11,861	\$	–	\$	–	\$	11,861						
Accounts payable	–	31,679	–	63	385	–	–	–	32,127							
Accrued expenses	–	17,524	72	2,657	680	–	–	20,933								
Advances from third-party payors	–	7,719	–	–	–	–	–	7,719								
Loans payable, affiliates	–	–	–	–	4,565	–	(4,565)	–								
Other current liabilities	–	1,958	4,301	638	–	–	(4,301)	2,596								
Total current liabilities	–	70,741	4,373	3,358	5,630	–	(8,866)	75,236								
Long-term liabilities, net of current portion:																
Long-term debt and capital lease obligations	–	182,112	–	–	–	–	–	182,112								
Interest rate swap contract	–	9,559	–	–	–	–	–	9,559								
Accrued pension expense	–	18,747	–	–	–	–	–	18,747								
Other long-term liabilities	–	9,241	12,659	320	–	–	–	22,220								
Intercompany liabilities	403	–	–	44,706	–	1,901	(47,010)	–								
Total long-term liabilities, net of current portion	403	219,659	12,659	45,026	–	1,901	(47,010)	232,638								
Total liabilities	403	290,400	17,032	48,384	5,630	1,901	(55,876)	307,874								
Net assets:																
Unrestricted	230,254	258,970	120	(42,137)	6,978	(1,867)	(246,916)	205,402								
Temporarily restricted	–	7,546	–	–	–	–	–	7,546								
Permanently restricted	–	976	–	–	–	–	–	976								
Total net assets	230,254	267,492	120	(42,137)	6,978	(1,867)	(246,916)	213,924								
Total liabilities and net assets	\$	230,657	\$	557,892	\$	17,152	\$	6,247	\$	12,608	\$	34	\$	(302,792)	\$	521,798

Frederick Regional Health System, Inc. and Subsidiaries

Supplementary Consolidating Statement of Operations
(Dollars in Thousands)

Year Ended June 30, 2017

	Frederick Regional Health System, Inc.	Frederick Memorial Hospital, Inc.	Monocacy Insurance, Ltd.	Monocacy Health Partners, LLC	Frederick Health Services Corporation	Frederick Integrated Healthcare Network, LLC	Elimination	Frederick Regional Health System, Inc. Consolidated
Net patient service revenue	\$ –	\$ 366,939	\$ –	\$ 24,752	\$ 5,697	\$ –	\$ (128)	\$ 397,260
Provision for bad debts	–	(10,045)	–	(461)	–	–	–	(10,506)
Net patient service revenue less provision for bad debts	–	356,894	–	24,291	5,697	–	(128)	386,754
Other operating revenue	–	4,594	2,282	1,436	2,743	411	(3,568)	7,898
Gifts, bequests, and contributions	–	2,598	–	124	–	–	–	2,722
Net assets released from restrictions	–	100	–	–	–	–	–	100
Total unrestricted revenue and other support	–	364,186	2,282	25,851	8,440	411	(3,696)	397,474
Operating expenses:								
Salaries and contract labor	–	114,482	–	25,822	4,490	615	(31)	145,378
Employee benefits	–	30,138	–	5,188	1,048	88	(36)	36,426
Professional fees	–	15,189	129	212	129	240	–	15,899
Cost of goods sold	–	57,980	–	1,745	770	–	–	60,495
Supplies	–	10,280	–	268	–	9	–	10,557
Contract services	–	74,042	–	3,215	316	157	(918)	76,812
Other	–	10,845	91	2,642	972	8	(430)	14,128
Utilities	–	3,833	–	255	86	–	–	4,174
Insurance	–	2,290	2,542	789	88	–	(2,281)	3,428
Depreciation and amortization	–	22,755	–	771	265	–	–	23,791
Interest	–	4,373	–	–	190	–	(172)	4,391
Total operating expenses	–	346,207	2,762	40,907	8,354	1,117	(3,868)	395,479
Operating income before pension settlement loss	–	17,979	(480)	(15,056)	86	(706)	172	1,995
Pension settlement loss	–	(3,911)	–	–	–	–	–	(3,911)
Operating income (loss)	–	14,068	(480)	(15,056)	86	(706)	172	(1,916)

Frederick Regional Health System, Inc. and Subsidiaries

Supplementary Consolidating Statement of Operations (continued)

(Dollars in Thousands)

	Frederick Regional Health System, Inc.	Frederick Memorial Hospital, Inc.	Monocacy Insurance, Ltd.	Monocacy Health Partners, LLC	Frederick Health Services Corporation	Frederick Integrated Healthcare Network, LLC	Elimination	Frederick Regional Health System, Inc. Consolidated
Other income (loss):								
Gain on sale of assets	\$ -	\$ 31	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 31
Loss on extinguishment of debt	-	(122)	-	-	-	-	-	(122)
Investment income (loss)	-	7,667	158	-	(1,049)	-	(172)	6,604
Change in unrealized gains (losses) on trading securities, net	-	2,910	322	-	-	-	-	3,232
Realized and unrealized gains (losses) on interest rate swap contract, net	-	2,505	-	-	-	-	-	2,505
Other nonoperating income (loss)	-	93	-	-	(519)	-	-	(426)
Total other income (loss)	-	13,084	480	-	(1,568)	-	(172)	11,824
Excess of unrestricted revenue and other support over expenses	-	27,152	-	(15,056)	(1,482)	(706)	-	9,908
Other changes in unrestricted net assets:								
Pension adjustment	-	9,503	-	-	-	-	-	9,503
Released from restriction used to purchase capital	-	6,344	-	-	-	-	-	6,344
Total other changes in unrestricted net assets	-	15,847	-	-	-	-	-	15,847
Increase (decrease) in unrestricted net assets	\$ -	\$ 42,999	\$ -	\$ (15,056)	\$ (1,482)	\$ (706)	\$ -	\$ 25,755

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2017 Ernst & Young LLP.
All Rights Reserved.

ey.com

