

CONSOLIDATED FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION

Frederick Regional Health System, Inc. and Subsidiaries
Years Ended June 30, 2019 and 2018
With Report of Independent Auditors

Ernst & Young LLP



Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Financial Statements
and Supplementary Information

Years Ended June 30, 2019 and 2018

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

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.

Auditors' 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 \$21,473,946 and \$17,643,829 as of June 30, 2019 and 2018, respectively, and net loss after elimination of intercompany revenues of \$4,177,260 and \$3,273,203, 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 at June 30, 2019 and 2018, 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.

Adoption of New Accounting Pronouncements

As discussed in Note 2 to the consolidated financial statements, the System changed its method for revenue recognition as a result of the adoption of the amendments to the FASB Accounting Standards Codification resulting from Accounting Standards Update 2014-09, *Revenue from Contracts with Customers*, effective July 1, 2018. The System also changed the presentation and related disclosures of net assets as a result of the adoption of the amendments to the FASB Accounting Standards Codification resulting from Accounting Standards Update 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*, effective June 30, 2019. Additionally, the System changed its method for measuring and disclosing certain financial assets and financial liabilities resulting from Accounting Standards Update 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*, effective July 1, 2018. Our opinion is not modified with respect to these matters.

Supplementary Information

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying supplementary information is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The 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

September 30, 2019

Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Balance Sheets
(In Thousands)

	June 30	
	2019	2018
Assets		
Current assets:		
Cash and cash equivalents	\$ 30,310	\$ 32,772
Patient receivables	48,170	49,211
Other receivables	3,434	2,017
Inventory	5,445	5,779
Prepaid expenses	3,509	2,592
Assets limited as to use	3,243	3,267
Promises to give, net	817	981
Total current assets	<u>94,928</u>	<u>96,619</u>
Net property and equipment	233,155	237,197
Other assets:		
Assets limited as to use	1,175	1,294
Investments – donor restricted	3,057	2,729
Promises to give, net	3,922	4,559
Long-term investments	185,877	161,254
Other investments	8,513	12,566
Other assets	6,556	7,087
Total other assets	<u>209,100</u>	<u>189,489</u>
Total assets	<u><u>\$ 537,183</u></u>	<u><u>\$ 523,305</u></u>

	June 30	
	2019	2018
Liabilities and net assets		
Current liabilities:		
Current maturities of long-term debt, line of credit, and capital lease obligations	\$ 5,223	\$ 5,013
Accounts payable	23,119	26,570
Accrued expenses	26,405	24,327
Advances from third-party payors	7,722	8,027
Other current liabilities	2,616	2,909
Total current liabilities	<u>65,085</u>	<u>66,846</u>
Long-term liabilities, net of current portion:		
Long-term debt and capital lease obligations	168,386	174,573
Interest rate swap contract	8,365	6,706
Accrued pension expense	14,373	14,475
Other long-term liabilities	21,489	21,500
Total long-term liabilities, net of current portion	<u>212,613</u>	<u>217,254</u>
Total liabilities	<u>277,698</u>	<u>284,100</u>
Net assets:		
Without donor restrictions	251,689	230,938
With donor restrictions	7,796	8,267
Total net assets	<u>259,485</u>	<u>239,205</u>
Total liabilities and net assets	<u>\$ 537,183</u>	<u>\$ 523,305</u>

See accompanying notes.

Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Statements of Operations and Changes In Net Assets
(In Thousands)

	Year Ended June 30	
	2019	2018
Net assets without donor restrictions:		
Unrestricted revenues:		
Patient service revenue (net of contractual allowances)	\$ 423,999	\$ 417,855
Provision for uncollectible accounts	–	(11,873)
Net patient service revenue	<u>423,999</u>	<u>405,982</u>
Other Revenue	9,956	13,112
Total unrestricted revenues	<u>433,955</u>	<u>419,094</u>
Operating expenses:		
Salaries and wages	168,233	158,792
Employee benefits	35,635	33,661
Professional fees	14,593	16,144
Cost of goods sold	70,377	61,541
Supplies	11,502	11,221
Contract services	74,177	75,544
Other	13,221	13,269
Utilities	4,651	4,525
Insurance	2,763	3,436
Depreciation and amortization	22,848	25,128
Interest	5,847	5,224
Total operating expenses	<u>423,847</u>	<u>408,485</u>
Income from operations	10,108	10,609
Other income, net:		
(Loss) gain on sale of assets	(14)	13
Investment gain, net	5,434	7,774
Change in unrealized gains (losses) on trading securities, net	8,089	(1,272)
Realized and unrealized (losses) gains on interest rate swap contact, net	(2,861)	1,271
Periodic pension expense	(1,399)	(2,038)
Pension settlement expense	–	(3,544)
Other non-operating gains (losses), net	108	(205)
Total other income, net	<u>9,357</u>	<u>1,999</u>
Excess of revenue over expenses	<u>\$ 19,465</u>	<u>\$ 12,608</u>

Continued on page 6.

Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Statements of Operations and Changes in Net Assets (continued)
(In Thousands)

	Without Donor Restrictions	With Donor Restrictions	Total
Net assets, June 30, 2017	\$ 205,402	\$ 8,522	\$ 213,924
Excess of revenues over expenses	12,608	–	12,608
Pension adjustment	10,633	–	10,633
Released from restriction used to purchase capital	2,295	(2,295)	–
Assets released from restrictions	–	(208)	(208)
Restricted gifts, bequests, and contributions	–	2,248	2,248
Changes in net assets	<u>25,536</u>	<u>(255)</u>	<u>25,281</u>
Net assets, June 30, 2018	230,938	8,267	239,205
Excess of revenue over expenses	19,465	–	19,465
Pension adjustment	(2,500)	–	(2,500)
Other changes in unrestricted net assets	2,848	–	2,848
Released from restriction used to purchase capital	938	(938)	–
Assets released from restrictions	–	(282)	(282)
Restricted gifts, bequests, and contributions	–	749	749
Changes in net assets	<u>20,751</u>	<u>(471)</u>	<u>20,280</u>
Net assets, June 30, 2019	<u>\$ 251,689</u>	<u>\$ 7,796</u>	<u>\$ 259,485</u>

See accompanying notes.

Frederick Regional Health System, Inc. and Subsidiaries

Consolidated Statements of Cash Flows (In Thousands)

	Year Ended June 30	
	2019	2018
Operating activities		
Changes in net assets	\$ 20,280	\$ 25,281
Adjustments to reconcile changes in net assets to net cash provided by operating activities:		
Depreciation of property and equipment	22,848	25,128
Amortization of original issue discount, premium, and bond issue costs	(64)	(70)
(Gains) losses on joint ventures and Premier noncash component	(3,814)	1,233
Loss (gain) on sale of property and equipment	24	(7)
Change in unrealized (gains) losses on trading securities, net	(8,088)	1,272
Proceeds from realized gains on investments – trading	(5,433)	(7,776)
Increase in investments – trading	(1,849)	(4,496)
Proceeds from restricted contributions	(328)	(300)
Realized and unrealized losses (gains) in interest rate swap, net	2,861	(1,271)
Changes in operating assets and liabilities:		
Receivables, patient, and other	(376)	(1,143)
Other assets	531	(274)
Inventories and prepaids	(583)	373
Pledges receivable	801	555
Accounts payable	(3,451)	(5,557)
Accrued expenses	2,078	3,394
Accrued pension expense	(102)	(4,272)
Advances from third-party payors	(305)	308
Other short-term liabilities	(293)	313
Other long-term liabilities	(11)	(720)
Net cash provided by operating activities	24,726	31,971
Investing activities		
Decrease in assets limited as to use, non-trading, net	143	6,310
Realized losses on interest rate swap contract	(1,202)	(1,582)
Increase in other investments	(1,714)	(1,793)
Purchases of property and equipment	(18,850)	(15,416)
Net proceeds from sale of assets	20	689
Net cash used in investing activities	(21,603)	(11,792)
Fundraising and financing activities		
Proceeds from restricted contributions	328	300
Repayments of long-term debt	(5,913)	(14,080)
Deferred financing costs paid	–	(237)
Net cash used in fundraising and financing activities	(5,585)	(14,017)
Net (decrease) increase in cash and cash equivalents	(2,462)	6,162
Cash and cash equivalents at the beginning of the year	32,772	26,610
Cash and cash equivalents at the end of the year	\$ 30,310	\$ 32,772
Supplemental disclosures		
Property and equipment acquired under capital lease	\$ –	\$ –
Cash paid for interest	\$ 6,035	\$ 5,657

See accompanying notes.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(Dollars in Thousands)

June 30, 2019

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, primary general liability coverage, and cyber 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 2019 or 2018 due to the availability of net operating loss carryforwards. FHSC recorded a net deferred tax asset of \$555 and \$411 as of June 30, 2019 and 2018, 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 (FMH), Meritus Health, and Western Maryland Health System (WMHS) 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 current purpose of MSO is to increase operational efficiencies, reduce costs, and enhance the quality of care by focusing efforts in the following areas: laboratory services, materials management, and pharmacy services. The human resource area returned to the three individual hospitals during December 2018 and is no longer provided by THA. The revenue cycle area was returned to FMH during July 2019. 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 sheets. 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 the MSO is recorded on the consolidated statement of operations within contract services for the years ended June 30, 2019 and 2018. The System paid a total of \$29,048 and \$32,377 to the MSO during the years ended June 30, 2019 and 2018, respectively. Subsequent to year end, WMHS withdrew its membership from Trivergent due to a clinical affiliation with an outside health system. FMH and Meritus Health assumed a 50% ownership of Trivergent for its continued services going forward.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

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.

FMH has one wholly owned subsidiary, Hospice of Frederick County, Inc. (HFC), which has 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.

FHSC has three wholly owned subsidiaries: Rosehill of Frederick, LLC, Corporate Occupational Health Solutions, LLC and Comp Claim Management, LLC, all of which are for-profit limited liability companies that 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 donor restricted 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, the asset is reclassified to without donor restrictions 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.

Other Revenue

Other revenue consists primarily of other operating revenue as well as gifts, bequests and contributions. During fiscal year 2018, FIHN received approximately \$5,130 in Medicare shared savings from the Center for Medicare and Medicaid Services (CMS), of which approximately \$3,400 was recorded in patient service revenue on a consolidated basis at the System and the remaining \$1,700 was not recorded as revenue as it was distributed to providers participating in the accountable care organization (ACO) and not employed by the System. No shared savings amounts were recorded in fiscal year 2019.

Inventory

Inventory is stated at the lower of cost or net realizable value. 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.

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. Realized and unrealized investment returns 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. Long-term investments represent investments without donor restrictions and income earned on investments with and without donor restrictions. 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.

Frederick Regional Health System, Inc. and Subsidiaries

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

2. Significant Accounting Policies (continued)

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 revenue 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 Liquidity Management

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 consolidated financial statements.

As part of its liquidity management, the System's strategy is to structure its financial assets to be available to satisfy general operating expenses, current liabilities, and other obligations as they come due. The System has a committed line of credit, as discussed in Note 9, to help manage unanticipated liquidity needs.

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 using 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.

Valuation of Long-Lived Assets

The System accounts for the valuation of long-lived assets under Accounting Standards Codification (ASC) 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.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

2. Significant Accounting Policies (continued)

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 consolidated balance sheets.

Patient Receivables and Revenues

Patient receivable include charges for amounts due from all patients less price concessions relating to allowances for the excess of established charges over the payments to be received on behalf of patients covered by Medicare, Medicaid and other insurers. The provision for price concessions is based upon management's assessment of historical and expected net collections considering historical business and economic conditions, trends in health care coverage, and other collection indicators. Periodically throughout the year, management assesses the adequacy of the price concessions based upon historical experience of self-pay accounts receivable, including those balances after insurance payments and not covered by insurance.

The System's revenues generally relate to contracts with patients in which our performance obligations are to provide health care services to the patients. These revenues are based upon the estimated amounts that management expects to be entitled to receive from patients and third-party payors. Refer to Note 3 for additional information regarding the recognition of revenues in accordance with generally accepted accounting principles.

Performance Indicator

The performance indicator is the excess of revenue over expenses. Other changes in net assets, consistent with industry practice, include pension adjustments and net assets released from restriction for capital purposes.

Frederick Regional Health System, Inc. and Subsidiaries

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

2. Significant Accounting Policies (continued)

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 values 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 consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Net Assets

Net resources that are not restricted by donors are included in Net assets without donor restrictions. Gifts of long-lived operating assets, such as property, plant or equipment, are reported as Net assets without donor restrictions and excluded from income. Resources restricted by donors for a specified time or purpose are reported as Net assets with donor restrictions.

When the specific purposes are met, either through passage of a stipulated time period or when the purpose for restriction is accomplished, they are released to Other operating revenues in the Statement of Operations and Changes in Net Assets. Resources restricted by donors for additions to property, plant and equipment are initially reported as Net assets with donor restrictions and are transferred to Net assets without donor restrictions when expended. Donor-imposed restrictions, which stipulate that the resources be maintained permanently, are reported as net assets with donor restrictions.

Investment income related to net assets with donor restrictions is classified as net assets without donor restrictions based on the intent of the donor.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

2. Significant Accounting Policies (continued)

Recent Accounting Pronouncements

Effective January 1, 2018, the System adopted Financial Accounting Standards Board (FASB) Accounting Standard Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, using the modified retrospective method of transition. This ASU converged and replaced existing revenue recognition guidance, including industry-specific guidance and requires revenue to be recognized in an amount that reflects the consideration the entity expects to be entitled in an exchange of goods or services. The adoption of this ASU did not materially impact the consolidated financial statements, refer to footnote three for additional information.

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. The update addresses the complexity and understandability of net asset classification, deficiencies in information about liquidity and availability of resources, and the lack of consistency in the type of information provided about expenses and investment return. The System has adjusted the presentation of these statements accordingly. The ASU has been applied retrospectively to all periods presented.

In August 2018, the FASB issued ASU 2018-15, *Intangibles – Goodwill and Other – Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract*. The amendments help entities evaluate the accounting for implementation costs paid by a customer in a cloud computing arrangement by providing guidance for determining when the service contract includes a software license. The System is evaluating the impact of this guidance, which will be effective in 2021.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, which requires various changes to the measurement and disclosure of equity investments. For the System, the most relevant change under ASU 2016-01 is that certain private equity and hedge fund investments that are currently accounted for using the cost method will be measured at fair value. The System applied the standard prospectively as required on July 1, 2018, and therefore the standard did not have an impact on the period ended June 30, 2018. The impact of adoption during the period on the consolidated balance sheets of was an increase to long-term investments and other investments of \$2,387 and \$461, respectively. The impact to the consolidated statement of operations and change in net assets was an increase in other changes in net assets of \$2,848.

Frederick Regional Health System, Inc. and Subsidiaries

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

2. Significant Accounting Policies (continued)

In February 2016, the FASB issued ASU 2016-02, *Leases*. This ASU amends the existing accounting standards for lease accounting, including requiring lessees to recognize most leases on their balance sheets. It will be effective and adopted for fiscal year 2020. The System is currently assessing the potential impact this ASU will have on the System's consolidated results of operations, financial position, and cash flows.

3. Patient Receivables and Patient Service Revenue

Patient receivables consist of the following at June 30:

	<u>2019</u>	<u>2018</u>
Gross patient receivables	\$ 69,867	\$ 69,029
Less estimated uncollectible accounts and contractual allowances	<u>(21,697)</u>	<u>(19,818)</u>
Net patient receivables	<u>\$ 48,170</u>	<u>\$ 49,211</u>

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

	<u>2019</u>	<u>2018</u>
Inpatient charges	\$ 231,161	\$ 239,541
Outpatient charges	<u>321,033</u>	<u>280,584</u>
Gross charges	<u>552,194</u>	<u>520,125</u>
Less contractual and other allowances	<u>(128,195)</u>	<u>(102,270)</u>
Net patient service revenue	<u>423,999</u>	<u>417,855</u>
Less provision for bad debts	-	<u>(11,873)</u>
Net patient service revenue	<u>\$ 423,999</u>	<u>\$ 405,982</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)

In May 2014, the FASB issued a new standard related to revenue recognition. The System adopted the new standard effective July 1, 2018, using the modified retrospective method. The most significant change from the adoption of the new standard relates to the System's presentation of the provision for bad debts. Under the previous standards, the System's estimate for amounts not expected to be collected based upon historical experience, were reflected as provision for bad debts and deducted from net patient service revenue to arrive at net patient service revenue less provision for bad debts. Under the new standard, those amounts will continue to be recognized as a reduction to net patient service revenue, however, not reflected separately as provision for bad debts, and accordingly the caption net patient service revenue less provision for bad debts will no longer be presented on the consolidated statements of operations and changes in net assets. Subsequent changes in the estimate of collectability due to a change in the financial status of a payor, for example a bankruptcy, will be recognized as bad debt expense in operating expenses. The adoption of the new standard did not have a material impact on the consolidated financial statements.

The System's revenues generally relate to contracts with patients in which our performance obligations are to provide health care services to the patients. Revenues are recorded during the period the obligations to provide health care services are satisfied. Performance obligations for revenues are recognized based on charges incurred in relation to total expected charges. 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. Management continually reviews the contractual estimation process to incorporate updates to laws and regulations and any changes in managed care contractual terms resulting from contract renegotiations and renewals.

The System's revenues are based upon the estimated amounts that management expects to be entitled to receive from patients and third-party payors. Estimates of explicit price concessions, formerly contractual allowances, under managed care and commercial insurance plans are based upon the payment terms specified in the related contractual agreements. Revenues related to uninsured patients and uninsured copayment and deductible amounts for patients who have health care coverage may have discounts applied (uninsured discounts and contractual discounts). Management also records estimated implicit price concessions (based primarily on historical collection experience) related to uninsured accounts to record self-pay revenues at the estimated amounts that it expects to collect.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

3. Patient Receivables and Patient Service Revenue (continued)

Additionally, 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. Settlements with third-party payors for retroactive adjustments due to audits, reviews, or investigations are considered variable consideration and are included in the determination of the estimated transaction price for providing patient care. These settlements are estimated based on the terms of the payment agreements with the payor, correspondence from the payor and the System's historical settlement activity, including an assessment to ensure it is probable a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the retroactive adjustment is subsequently resolved. Estimated settlements are adjusted in future periods as adjustments become known, or as years are settled or are no longer subject to such audits, reviews and investigations.

The System has elected the practical expedient allowed under FASB ASC 606-10-32-18 and does not adjust the promised amount of consideration from patients and third-party payors for the effects of a significant financing component due to the System's expectation that the period between the time the service is provided to a patient and the time that the patient or third-party payor pays for that service will be one year or less.

The estimates for implicit price concessions are based upon management's assessment of historical write-offs and expected net collections, business and economic conditions, trends in federal, state and private employer health care coverage and other collection indicators. Management relies on the results of detailed reviews of historical write-offs and collections at facilities that represent a majority of the System's revenues and patient receivable as a primary source of information in estimating the collectability of patient receivable.

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, 2019 and 2018, was \$6,346 and \$5,664, respectively. The state of Maryland rate system includes components within the rates to partially compensate hospitals for uncompensated care.

Frederick Regional Health System, Inc. and Subsidiaries

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

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>2019</u>	<u>2018</u>
Current:		
Principal, interest, and other – bonds	\$ 3,049	\$ 3,074
Construction funds	102	99
Loss escrow account	92	94
	<u>\$ 3,243</u>	<u>\$ 3,267</u>
Noncurrent:		
Deferred compensation trusts	\$ 1,175	\$ 1,294
	<u>\$ 1,175</u>	<u>\$ 1,294</u>

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

	<u>2019</u>	<u>2018</u>
Current:		
Cash and money market accounts	\$ 3,243	\$ 3,173
Mutual funds	–	94
	<u>\$ 3,243</u>	<u>\$ 3,267</u>
Noncurrent:		
Corporate or other bonds	\$ 20	\$ 35
Mutual funds	1,155	1,259
	<u>\$ 1,175</u>	<u>\$ 1,294</u>

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

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

5. Promises to Give

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

	<u>2019</u>	<u>2018</u>
Less than one year	\$ 961	\$ 1,154
One to five years	2,937	3,729
More than five years	<u>2,634</u>	<u>2,736</u>
	6,532	7,619
Less discounting and allowance for uncollectible promises	<u>1,793</u>	2,079
Total promises to give, net	4,739	5,540
Less current portion of promises to give, net	817	981
	<u>\$ 3,922</u>	<u>\$ 4,559</u>

Promises to give include \$1,026 and \$1,225 for the years ended June 30, 2019 and 2018, 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

Investments are held for the following uses:

	<u>2019</u>	<u>2018</u>
Principal, interest, and other – bonds	\$ 3,049	\$ 3,074
Construction funds	102	99
Loss escrow account	92	94
Deferred compensation trusts	1,175	1,294
Investments, restricted	3,057	2,729
Investments	<u>185,877</u>	<u>161,254</u>
	193,352	168,544
Less assets limited as to use, short term	3,243	3,267
Noncurrent investments	<u>\$ 190,109</u>	<u>\$ 165,277</u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

6. Investments (continued)

Long-term investments represent investments without donor restrictions and income earned on investments with and without donor restrictions.

Investments with donor restrictions 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.

To satisfy its long-term rate-of-return objectives, the System relies on a balanced investment strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). The System targets a diversified asset allocation that places a greater emphasis on mutual fund and equity-based investments to achieve its long-term return objectives within prudent risk constraints.

Long-term investments with and without donor restrictions recorded at fair value consist of the following at June 30:

	2019		2018	
	Cost	Fair Value	Cost	Fair Value
Cash and cash equivalents	\$ 8,602	\$ 8,602	\$ 9,076	\$ 9,059
U.S. government obligations	4,383	4,563	4,404	4,336
Corporate obligations	4,733	4,912	5,040	4,886
Mortgage-backed securities	4,713	4,762	4,128	4,039
Equity securities	34,355	49,704	33,150	41,144
Mutual funds	76,277	89,529	75,223	76,945
Private equity investments	5,524	6,986	—	—
Hedge funds	18,050	19,876	—	—
	\$ 156,637	\$ 188,934	\$ 131,021	\$ 140,409

Frederick Regional Health System, Inc. and Subsidiaries

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

6. Investments (continued)

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

	2019		2018	
	Cost	Fair Value	Cost	Fair Value
Private equity investments	\$ —	\$ —	\$ 5,524	\$ 5,759
Hedge funds	—	—	18,050	20,202
	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 23,574</u>	<u>\$ 25,961</u>

The System is invested in private equity and hedge funds that are accounted for at fair value. The estimated fair value of these investments is primarily based on financial data supplied by the underlying investee fund.

	2019	2018
Investment allocation:		
Long-term investments without donor restrictions	\$ 185,877	\$ 161,254
Investments with donor restrictions	3,057	2,729
	<u>\$ 188,934</u>	<u>\$ 163,983</u>

Investment income for the years ended June 30 is as follows:

	2019	2018
Unrestricted:		
Net realized gains	\$ 1,199	\$ 6,470
Interest and dividends, net of investment expense	3,790	3,047
Gains (loss) from joint ventures	445	(1,743)
	<u>\$ 5,434</u>	<u>\$ 7,774</u>

Investment expense was \$279 and \$416 for the fiscal years ended June 30, 2019 and 2018, respectively.

Frederick Regional Health System, Inc. and Subsidiaries

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

6. Investments (continued)

Other investments consist of the following at June 30:

	Carrying Value		Income (Loss)	
	2019	2018	2019	2018
Premier Class B	\$ 1,225	\$ 5,336	\$ –	\$ –
Joint ventures	7,288	7,230	445	(1,743)
	<u>\$ 8,513</u>	<u>\$ 12,566</u>	<u>\$ 445</u>	<u>\$ (1,743)</u>

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

	Entity	Interest %	2019	2018
Carroll Occupational Health, LLC	FHSC	25.0	\$ 128	\$ 108
Comp Claim Management, LLC	FHSC	–	–	24
Mt. Airy Health Services, LLC	FMH	50.0	702	702
Mt. Airy Med-Services, LLC	FHSC	50.0	4,126	4,278
Mt. Airy Plaza, LLC	FHSC	50.0	(319)	(166)
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	287	495
Behavioral Health Partners of Frederick, Inc.	FMH	50.0	–	–
Frederick Surgical Center, LLC	FHSC	40.6	764	447
MNR of Frederick, LLC	FHSC	22.5	558	300
			<u>\$ 7,288</u>	<u>\$ 7,230</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 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.

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 any unsold 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 \$1,658 and \$1,043 related to the vesting of 33,381 and 33,381 Class B units for the years ended June 30, 2019 and 2018, 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.

During the year ended June 30, 2019, upon vesting of the fifth tranche, the System converted all existing vested Class B shares (166,906 in total) to Class A and sold them, recognizing a gain of \$280 recorded as investment income on the consolidated statements of operations.

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, 2019	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	\$ 42,063	\$ 42,063	\$ —	\$ —
Equity securities	49,704	49,704	—	—
U.S. government obligations	4,369	—	4,369	—
Agency securities	194	—	194	—
Corporate and other bonds	4,933	—	4,933	—
Mutual funds	90,775	90,775	—	—
Mortgage-backed securities	4,762	—	4,762	—
Private equity investments	6,986	—	—	6,986
Hedge funds	19,876	—	—	19,876
Promises to give, net	4,739	—	—	4,739
Total assets	<u>\$ 228,401</u>	<u>\$ 182,542</u>	<u>\$ 14,258</u>	<u>\$ 31,601</u>
Liabilities				
Interest rate swap liability	\$ (8,365)	\$ —	\$ (8,365)	\$ —
Total liabilities	<u>\$ (8,365)</u>	<u>\$ —</u>	<u>\$ (8,365)</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, 2018	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	\$ 45,003	\$ 45,003	\$ —	\$ —
Equity securities	41,145	41,145	—	—
U.S. government obligations	4,120	—	4,120	—
Agency securities	216	—	216	—
Corporate and other bonds	4,921	—	4,921	—
Mutual funds	78,298	78,298	—	—
Mortgage-backed securities	4,039	—	4,039	—
Private equity investments	5,759	—	—	5,759
Hedge funds	20,202	—	—	20,202
Promises to give, net	5,540	—	—	5,540
Total assets	<u>\$ 209,243</u>	<u>\$ 164,446</u>	<u>\$ 13,296</u>	<u>\$ 31,501</u>
Liabilities				
Interest rate swap liability	\$ (6,706)	\$ —	\$ (6,706)	\$ —
Total liabilities	<u>\$ (6,706)</u>	<u>\$ —</u>	<u>\$ (6,706)</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 fair market value.

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 promises to give, 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 \$374 and \$360, reducing the interest rate swap agreement liability position on June 30, 2019 and 2018, respectively. The change in the fair market value of the swap agreement is included in excess of revenue 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 promises to give, private equity investments, and hedge funds. Promises to give are recorded net of an 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 is 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	
	2019	2018
Promises to give		
Beginning balance, July 1	\$ 5,540	\$ 6,095
New pledges	430	1,397
Collections on pledges	(1,606)	(2,219)
Write-off of pledges	(137)	(216)
Changes in reserves and discounting factor	512	483
Ending balance, June 30	<u>\$ 4,739</u>	<u>\$ 5,540</u>
Private equity investments		
Beginning balance, July 1	\$ 5,759	\$ 4,746
Purchases	1,067	2,190
Gains (losses)	546	(133)
Return of capital	(386)	(1,044)
Ending balance, June 30	<u>\$ 6,986</u>	<u>\$ 5,759</u>
Hedge funds		
Beginning balance, July 1	\$ 20,202	\$ 14,384
Purchases	—	4,000
(Losses) gains	(326)	1,818
Ending balance, June 30	<u>\$ 19,876</u>	<u>\$ 20,202</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	2019	2018
Land	–	\$ 6,013	\$ 6,013
Land improvements	8–20 years	2,927	2,927
Buildings	20–40 years	263,051	256,701
Fixed equipment	10–20 years	23,591	23,468
Movable equipment	3–20 years	248,392	235,746
Leasehold improvements	5–20 years	32,311	32,700
		<u>576,285</u>	<u>557,555</u>
Less accumulated depreciation		<u>351,522</u>	<u>329,624</u>
		224,763	227,931
Construction in process, renovations, and deposits		8,392	9,266
		<u>\$ 233,155</u>	<u>\$ 237,197</u>

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, 2019 and 2018, was \$4,892 and \$2,850, respectively. Amortization of computer software was \$1,011 and \$2,773 for fiscal years 2019 and 2018, respectively.

The net book value of assets under capital lease arrangements totaled \$1,530 and \$2,316 as of June 30, 2019 and 2018, respectively. Depreciation expense related to assets under capital lease arrangements was \$876 and \$897 for the fiscal years ended June 30, 2019 and 2018, 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>2019</u>	<u>2018</u>
MHHEFA Series 2012A Bonds	\$ 93,781	\$ 94,906
MHHEFA Series 2017A Bonds	25,880	26,780
MHHEFA Series 2017B Bonds	54,215	57,490
Capital lease obligations	1,219	1,991
Deferred finance costs	(1,486)	(1,581)
	<u>173,609</u>	<u>179,586</u>
Less current maturities	5,223	5,013
	<u>\$ 168,386</u>	<u>\$ 174,573</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 \$1,049 at June 30, 2019. 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 2017A and 2017B 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, 2019, is estimated at \$94,659.

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 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 of LIBOR plus the applicable spread plus any Tax Equity and Fiscal Responsibility Act (TEFRA) adjustment. The average interest rate on the bond loan is 2.64% for the year ended June 30, 2019. The carrying value of the 2017A Bonds approximates fair value.

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 \$5,195 on July 1, 2042.

After experiencing an increase to the effective interest rate due to the reduction of the maximum marginal tax rate of BB&T, on January 1, 2018, amendments to the financing agreement between MHHEFA, the System, and BB&T were executed that changed the definition of the applicable percentage of LIBOR and the applicable spread in the calculation of the index floating rate on the Series 2017A and 2017B Bonds. Effective April 1, 2018, these amendments resulted in a reduction of the index floating rate and interest expense related to this debt going forward.

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 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 of LIBOR plus the applicable spread plus the TEFRA adjustment, if any. The average interest rate on the bond loan is 2.64% for the year ended June 30, 2019. The carrying value of the 2017B Bonds approximates fair value.

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.

Capital Lease Obligations

As of June 30, 2019, 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:	
2020	\$ 814
2021	431
2022	—
Total payments	<u>1,245</u>
Less interest payments	<u>26</u>
Total lease obligations, principal	1,219
Less current portion	<u>792</u>
Long-term obligations under capital leases	<u>\$ 427</u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

9. Long-Term Debt (continued)

Debt service requirements on long-term debt and capital lease obligations, excluding original issue premium and deferred financing costs at June 30, 2019, of \$2,941 and \$1,486, respectively, are as follows:

	<u>Principal</u>
Years ending June 30:	
2020	\$ 5,223
2021	5,056
2022	4,875
2023	5,130
2024	5,400
Thereafter	146,470
	<u>\$ 172,154</u>

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. The outstanding balance on this line of credit was \$0 as of June 30, 2019 and 2018, 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. A second amendment was made on November 30, 2017, extending the maturity date to January 31, 2020.

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 \$53,855 on June 30, 2019, 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

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

10. Interest Rate Swap Contract (continued)

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 (2.398%) as of June 28, 2019. The swap contract requires payments to be made or received monthly. The fair value of the swap contract was a liability of \$8,365 and \$6,706 at June 30, 2019 and 2018, respectively.

The System accrued net payments under its interest rate swap program of \$1,202 and \$1,583 during fiscal years 2019 and 2018, 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.

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.

Frederick Regional Health System, Inc. and Subsidiaries

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

10. Interest Rate Swap Contract (continued)

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	
	2019	2018
Asset derivatives		
Derivatives not designated as hedging instruments:		
Interest rate contracts	\$ —	\$ —
Liability derivatives		
Interest rate swap contract	\$ 8,365	\$ 6,706
Total derivatives not designated as hedging instruments	\$ 8,365	\$ 6,706

A summary of the effect of the non-hedging derivatives on the System's consolidated statement of operations for the year ended June 30, 2019, is as follows:

Type of Non-hedging Derivatives	Statement of Operations	
	Location of Loss Recognized	Derivative Loss Recognized
Interest rate swap contract – realized loss	Other loss	\$ (1,202)
Interest rate swap contract – unrealized loss	Other loss	(1,659)
Total		\$ (2,861)

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 non-hedging derivatives on the System's consolidated statement of operations for the year ended June 30, 2018, is as follows:

Type of Non-hedging Derivatives	Statement of Operations Location of (Loss) Gain Recognized	Derivative (Loss) Gain Recognized
Interest rate swap contract – realized loss	Other loss	\$ (1,583)
Interest rate swap contract – unrealized gain	Other gain	<u>2,854</u>
Total		<u><u>\$ 1,271</u></u>

11. Employee Benefit Plans

The System has a defined benefit pension plan (the 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.

Effective July 1, 2017, the 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. The number of plan participants that chose the lump-sum distribution election was 152, which resulted in a reduction of approximately \$4,800 in plan assets and benefit obligation.

A single premium guaranteed annuity contract was purchased on August 16, 2017, for 121 retired participants and beneficiaries in pay status receiving monthly annuity payments of less than \$800 dollars. This reduced the plan assets and benefit obligation by approximately \$10,106 and transferred this benefit obligation from the Plan to the insurer. The settlement expense in the period as a result of both the lump-sum payment and annuity contract purchase was \$3,544.

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, 2019 and 2018, measurement date:

	<u>2019</u>	<u>2018</u>
Accumulated benefit obligation	<u>\$ 57,296</u>	<u>\$ 51,808</u>
Change in projected benefit obligation:		
Projected benefit obligation at beginning of year	\$ 51,808	\$ 71,678
Service cost	–	778
Interest cost	2,136	2,272
Actuarial gain	4,264	(4,360)
Benefits paid and other expenses	(912)	(1,989)
Settlement payments	–	(14,911)
Settlement loss (gain)	–	(1,660)
Projected benefit obligation at end of year	<u>57,296</u>	<u>51,808</u>
Change in plan assets:		
Fair value of plan assets at beginning of year	37,333	52,931
Actual return on plan assets	3,141	1,302
Employer contribution	4,000	–
Benefits paid	(912)	(1,152)
Administrative expenses	(640)	(837)
Settlement payments	–	(14,911)
Fair value of plan assets at end of year	<u>42,922</u>	<u>37,333</u>
Funded status	<u>(14,373)</u>	<u>(14,475)</u>
Net amount recognized	<u>\$ (14,373)</u>	<u>\$ (14,475)</u>

The discount rate actuarial assumption was changed from 4.17% to 3.56%, resulting in a \$5,068 increase in the projected benefit obligation as of June 30, 2019.

Frederick Regional Health System, Inc. and Subsidiaries

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

11. Employee Benefit Plans (continued)

Net amounts recognized in net assets without donor restrictions that have not been recognized in net periodic benefit cost are as follows:

	June 30	
	2019	2018
Net actuarial loss	\$ 8,845	\$ 6,292
Prior service cost	29	82
Total recognized in unrestricted net assets	<u>\$ 8,874</u>	<u>\$ 6,374</u>

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

	June 30	
	2019	2018
Discount rate	3.56%	4.17%
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	
	2019	2018
Discount rate	4.17%	3.85%
Expected return on plan assets	3.75%	3.75%
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:

	2019	2018
Service costs	\$ —	\$ 778
Interest cost	2,136	2,272
Expected return on plan assets	(965)	(1,561)
Amortization of prior service cost	52	52
Amortization of net loss	176	1,275
Settlement	—	3,544
Net periodic pension cost	\$ 1,399	\$ 6,360

The estimated net loss that is expected to be amortized from other changes in net assets without donor restrictions into net periodic benefit cost for the year ending June 30, 2020, is \$526.

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

	2019	2018
Equity securities	25%	26%
Debt securities	63	59
Cash	—	1
Hedge funds	12	14
Total	100%	100%

The Plan's 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 2019	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	\$ 5	\$ 5	\$ -	\$ -
Equity securities	10,685	10,685	-	-
Fixed income mutual funds	27,335	27,335	-	-
Hedge funds and other alternative	4,897	-	-	4,897
Total assets	\$ 42,922	\$ 38,025	\$ -	\$ 4,897

Frederick Regional Health System, Inc. and Subsidiaries

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

11. Employee Benefit Plans (continued)

	Fair Value Measurements at Reporting Date Using			
	Fair Value at June 30 2018	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	\$ 744	\$ 744	\$ –	\$ –
Equity securities	9,583	9,583	–	–
Fixed income mutual funds	22,132	22,132	–	–
Hedge funds and other alternative	4,874	–	–	4,874
Total assets	\$ 37,333	\$ 32,459	\$ –	\$ 4,874

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):

	Hedge Funds	Total
Balance at June 30, 2017	\$ 4,874	\$ 4,874
Purchases	–	–
Settlements	–	–
Gains, net	–	–
Balance at June 30, 2018	4,874	4,874
Purchases	–	–
Settlements	–	–
Gains, net	23	23
Balance at June 30, 2019	\$ 4,897	\$ 4,897

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

11. Employee Benefit Plans (continued)

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, 2019.

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
- 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 20% in equities, 62% in fixed income securities, 10% in hedge funds, 5% real estate, and 3% in cash.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

11. Employee Benefit Plans (continued)

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

2020	\$	1,615
2021		1,720
2022		1,960
2023		2,170
2024		2,360
2025–2029		13,970

The System also has a tax-deferred annuity savings (403(b)) plan available to substantially all employees. In conjunction with the curtailment of the defined benefit pension plan, the System modified the 403(b) plan effective July 1, 2007. Effective January 1, 2018, the plan was amended such that all new hires will be automatically enrolled in the 403(b) plan at 3% of employee earnings, which will be automatically increased 1% annually up to 10%. Employees can opt out of this automatic enrollment and annual increase. The System will match 100% on employee contributions up to 5.0% of employee earnings. Base contributions continue for employees with 5 to 10 years of service at 0.5% and 1.0% for employees with over 10 years of service. The System's contribution for base matching and transition credits totaled \$5,791 and \$6,407 for fiscal years 2019 and 2018, 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 \$422 and \$449 for the years ended June 30, 2019 and 2018, 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>2019</u>	<u>2018</u>
Medicare	28%	29%
Medicaid	18	18
Blue Cross	15	13
HMOs and PPOs	15	17
Commercial insurance and other third-party payors	7	7
Patients	17	16
	<u>100%</u>	<u>100%</u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

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:

	Program	General and Administrative	Total
Year ended June 30, 2019			
Salaries and wages	\$ 144,180	\$ 24,053	\$ 168,233
Employee benefits	31,335	4,300	35,635
Professional fees	10,258	4,335	14,593
Cost of goods sold	70,231	146	70,377
Supplies	10,913	589	11,502
Contract services	62,108	12,069	74,177
Other	10,121	3,100	13,221
Utilities	3,707	944	4,651
Insurance	921	1,842	2,763
Depreciation	21,566	1,282	22,848
Interest	5,465	382	5,847
	<u>\$ 370,805</u>	<u>\$ 53,042</u>	<u>\$ 423,847</u>
Year ended June 30, 2018			
Salaries and wages	\$ 138,160	\$ 20,632	\$ 158,792
Employee benefits	29,470	4,191	33,661
Professional fees	11,389	4,755	16,144
Cost of goods sold	61,419	122	61,541
Supplies	10,518	703	11,221
Contract services	61,006	14,538	75,544
Other	9,567	3,702	13,269
Utilities	3,627	898	4,525
Insurance	1,001	2,435	3,436
Depreciation	23,350	1,778	25,128
Interest	4,858	366	5,224
	<u>\$ 354,365</u>	<u>\$ 54,120</u>	<u>\$ 408,485</u>

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

14. Net Assets

Net assets with temporary donor restrictions are available for the following purposes or periods at June 30:

	<u>2019</u>	<u>2018</u>
Health care services:		
Buildings and equipment	\$ 4,681	\$ 5,075
Restricted by time only	1,094	1,294
Education programs	605	510
Indigent care and research	440	412
	<u>\$ 6,820</u>	<u>\$ 7,291</u>

Net assets with permanent donor restrictions consist of investments to be held in perpetuity, the income from which is expendable for:

	<u>2019</u>	<u>2018</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 2019 and 2018, net assets were released from donor restrictions by incurring expenses or capital expenditures satisfying the restricted purposes in the amounts of \$1,220 and \$2,503, 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, 2019 and 2018, the System has recorded a liability for claims incurred but not reported of \$2,027 and \$1,685, 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 provided 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 through to the 2017/2018 policy year. Effective for the 2018/2019 policy year, MIL provides FMH with Primary Medical Professional Liability (MPL) and Primary General Liability (GL) coverage with policy limits of liability of \$1,000 per claim/per occurrence for both MPL and GL separately, with a \$4,000 aggregate for both MPL and GL combined. The Company also issued a Buffer Medical Professional Liability and General Liability policy providing limits of liability of \$1,000 each and every medical incident with a \$2,000 aggregate, for Medical Professional Liability and General Liability combined. 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.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

15. Contingencies (continued)

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. 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.

Effective September 1, 2017, MIL issued a Cyber Deductible Liability Policy to the System at a per claim limit of liability of \$100 and an annual aggregate limit of \$200. The policy funding is retrospectively rated.

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. Through MIL, a wholly owned subsidiary, the System maintains reserves, including excess coverage, in the amount of \$16,042 and \$15,186 at June 30, 2019 and 2018, respectively, and a related reinsurance receivable of \$6,410 and \$6,605 at June 30, 2019 and 2018, 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, 2019 and 2018. 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.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

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 \$4,142 and \$4,489 for 2019 and 2018, respectively. Future minimum payments under noncancelable operating leases are as follows:

Years ending June 30:	
2020	\$ 3,361
2021	3,162
2022	3,210
2023	3,136
2024	2,666
Thereafter	14,528
	<u>\$ 30,063</u>

Workers' Compensation

The System is self-insured against workers' compensation claims, currently up to \$600 per occurrence. Excess insurance attaches at \$600 and has unlimited liability above this amount. Expenses include claims paid, reserves on known claims, and reserves on unreported 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.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

17. Liquidity and Availability

Financial assets available for general expenditure within one year of the balance sheet date comprise the following at June 30, 2019:

Cash and cash equivalents	\$ 42,063
Patient accounts receivable, net	48,170
Promises to give, net	817
Other receivables	3,435
Investments with daily and weekly liquidity	154,737
Total	<u>\$ 249,222</u>

The System's most restrictive bond covenant requires the obligated group to maintain unrestricted cash and marketable securities on hand to meet 75 days of normal operating expenses, which would be \$80,802 as of June 30, 2019.

18. 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)*

18. Regulatory Environment (continued)

In 1983, Congress approved a Medicare prospective payment plan for most inpatient services as part of the Social Security Amendments 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 the Commission's requirements.

Through June 2019, 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 CMS 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, CMS 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.

Starting in January 2019, Maryland's hospitals began operating under a new 10-year contract with the federal government entitled Maryland Total Cost of Care Model (TCOC). TCOC is designed to test whether the improvements hospitals have made under the previous modernized waiver can be expanded to all health care providers. The GBR methodology will remain in place for hospital rate setting under the TCOC model. In addition, programs aimed to measure and reduce total health care spending for attributed Medicare patients, including pre- and post-acute care by all providers, are being introduced and will be further defined in the next fiscal year.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

18. Regulatory Environment (continued)

Beginning in fiscal year 2014, the System entered into an agreement with 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.

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 System. The actual average unit charge for each service center is compared to the approved rate monthly 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 \$117 and \$1,616 for the years ended June 30, 2019 and 2018, respectively, which are both within the allowable variance threshold of 0.5%, and no immediate corrective action is required for either year.

The timing of 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 System recognizes unbilled revenue for in-house patients.

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 \$19 and \$490 for the years ended June 30, 2019 and 2018, respectively.

Frederick Regional Health System, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

19. Subsequent Events

The System has evaluated subsequent events through September 30, 2019, the date of issuance of these consolidated financial statements.

The System is unaware of any significant subsequent events 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, 2019

	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	\$ 25,542	\$ 967	\$ 1,049	\$ 2,383	\$ 340	\$ -	\$ 30,310
Patient receivables	-	42,212	-	5,328	630	-	-	48,170
Other receivables	-	3,338	-	96	-	-	-	3,434
Inventory	-	4,508	-	937	-	-	-	5,445
Prepaid expenses	-	3,325	6	-	178	-	-	3,509
Assets limited as to use	-	3,151	92	-	-	-	-	3,243
Promises to give, net	-	817	-	-	-	-	-	817
Total current assets	29	82,893	1,065	7,410	3,191	340	-	94,928
Net property and equipment		225,980	-	2,644	4,531			233,155
Other assets:								
Assets limited as to use	-	1,175	-	-	-	-	-	1,175
Investments – donor restricted	-	3,057	-	-	-	-	-	3,057
Promises to give, net	-	3,922	-	-	-	-	-	3,922
Long-term investments	-	171,801	14,076	-	-	-	-	185,877
Other investments	275,858	19,544	-	-	5,256		(292,145)	8,513
Other assets	-	14,567	6,333	-	555		(14,899)	6,556
Intercompany receivables	-	5,089	-	-	-		(5,089)	-
Total other assets	275,858	219,155	20,409	-	5,811		(312,133)	209,100
Total assets	\$ 275,887	\$ 528,028	\$ 21,474	\$ 10,054	\$ 13,533	\$ 340	\$ (312,133)	\$ 537,183

Frederick Regional Health System, Inc. and Subsidiaries

Supplementary Consolidating Balance Sheet (continued)

(Dollars in Thousands)

June 30, 2019

	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	\$ -	\$ 5,223	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 5,223
Accounts payable	-	22,726	-	31	258	104	-	23,119
Accrued expenses	-	21,449	100	4,007	849	-	-	26,405
Advances from third-party payors	-	7,722	-	-	-	-	-	7,722
Loans payable, affiliates	-	-	-	-	4,445	-	(4,445)	-
Other current liabilities	-	1,728	8,513	888	-	-	(8,513)	2,616
Total current liabilities	-	58,848	8,613	4,926	5,552	104	(12,958)	65,085
Long-term liabilities, net of current portion:								
Long-term debt and capital lease obligations	-	168,386	-	-	-	-	-	168,386
Interest rate swap contract	-	8,365	-	-	-	-	-	8,365
Accrued pension expense	-	14,373	-	-	-	-	-	14,373
Other long-term liabilities	-	8,925	12,741	347	1,417	-	(1,941)	21,489
Intercompany liabilities	72	-	-	4,781	-	236	(5,089)	-
Total long-term liabilities, net of current portion	72	200,049	12,741	5,128	1,417	236	(7,030)	212,613
Total liabilities	72	258,897	21,354	10,054	6,969	340	(19,988)	277,698
Net assets:								
Without donor restrictions	275,815	261,335	120	-	6,564	-	(292,145)	251,689
With donor restrictions	-	7,796	-	-	-	-	-	7,796
Total net assets	275,815	269,131	120	-	6,564	-	(292,145)	259,485
Total liabilities and net assets	\$ 275,887	\$ 528,028	\$ 21,474	\$ 10,054	\$ 13,533	\$ 340	\$ (312,133)	\$ 537,183

Frederick Regional Health System, Inc. and Subsidiaries

Supplementary Consolidating Statements of Operations and Changes In Net Assets (Dollars in Thousands)

Year Ended June 30, 2019

	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	\$ -	\$ 358,906	\$ -	\$ 59,604	\$ 5,707	\$ -	\$ (218)	\$ 423,999
Other	-	9,523	3,374	1,285	2,711	562	(7,499)	9,956
Total unrestricted revenues	-	368,429	3,374	60,889	8,418	562	(7,717)	433,955
Operating expenses:								
Salaries and contract labor	-	131,365	-	31,310	4,494	1,064	-	168,233
Employee benefits	-	28,863	-	5,633	1,175	219	(255)	35,635
Professional fees	-	14,628	158	227	17	307	(744)	14,593
Cost of goods sold	-	39,266	-	30,294	817	-	-	70,377
Supplies	-	10,936	-	556	-	10	-	11,502
Contract services	-	71,051	-	4,151	419	112	(1,556)	74,177
Other	-	10,509	119	3,274	1,097	6	(1,784)	13,221
Utilities	-	4,342	-	165	129	15	-	4,651
Insurance	-	1,180	4,044	819	96	-	(3,376)	2,763
Depreciation and amortization	-	22,030	-	520	298	-	-	22,848
Interest	-	5,836	-	-	238	-	(227)	5,847
Total operating expenses	-	340,006	4,321	76,949	8,780	1,733	(7,942)	423,847
Operating income (loss)	-	28,423	(947)	(16,060)	(362)	(1,171)	225	10,108

Frederick Regional Health System, Inc. and Subsidiaries

Supplementary Consolidating Statements of Operations and Changes In Net Assets (continued) (Dollars in Thousands)

Year Ended June 30, 2019

	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, net:								
Gain on sale of assets	\$ -	\$ 20	\$ -	\$ (34)	\$ -	\$ -	\$ -	\$ (14)
Loss on extinguishment of debt	-	-	-	-	-	-	-	-
Investment income (loss)	19,948	4,980	25	1	653	-	(20,173)	5,434
Change in unrealized losses on trading securities, net	-	7,167	922	-	-	-	-	8,089
Realized and unrealized gains (losses)								
on interest rate swap contract, net	-	(2,861)	-	-	-	-	-	(2,861)
Periodic pension expense	-	(1,231)	-	(168)	-	-	-	(1,399)
Pension settlement expense	-	-	-	-	-	-	-	-
Other nonoperating income (loss)	-	-	-	-	108	-	-	108
Total other income, net	19,948	8,075	947	(201)	761	-	(20,173)	9,357
Excess of revenue over expenses	19,948	36,498	-	(16,261)	399	(1,171)	(19,948)	19,465
Other changes in net assets without donor restrictions:								
Pension adjustment	-	(2,500)	-	-	-	-	-	(2,500)
Other changes in unrestricted net assets*	332	(75,082)	-	74,081	-	3,517	-	2,848
Released from restriction used to purchase capital	-	938	-	-	-	-	-	938
Total other changes in net assets without donor restrictions	332	(76,644)	-	74,081	-	3,517	-	1,286
Increase (decrease) in net assets without donor restrictions	20,280	(40,146)	-	57,820	399	2,346	(19,948)	20,751
Net assets with donor restrictions:								
Released from restriction used to purchase capital	-	(938)	-	-	-	-	-	(938)
Assets released from restrictions	-	(282)	-	-	-	-	-	(282)
Restricted gifts, bequests, and contributions	-	749	-	-	-	-	-	749
Decrease in net assets with donor restrictions	-	(471)	-	-	-	-	-	(471)
Increase in net assets	20,280	(40,617)	-	57,820	399	2,346	(19,948)	20,280
Net assets, beginning of year	255,535	309,748	120	(57,820)	6,165	(2,346)	(272,197)	239,205
Net assets, end of year	\$ 275,815	\$ 269,131	\$ 120	\$ -	\$ 6,564	\$ -	\$ (292,145)	\$ 259,485

* Includes the effects of the adoption of ASU 2016-01 Recognition and Measurement of Financial Assets and Financial Liabilities and the board resolution to cancel intercompany liabilities exceeding subsidiaries' net assets.

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