

Health First, Inc. and Subsidiaries

Consolidated Financial Report
September 30, 2017

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Independent Auditor's Report

The Board of Trustees
Health First, Inc.

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Health First, Inc. and Subsidiaries (the Company), which comprise the consolidated balance sheets as of September 30, 2017 and 2016, 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 (collectively, the financial statements).

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free 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, the financial statements referred to above present fairly, in all material respects, the financial position of Health First, Inc. and Subsidiaries as of September 30, 2017 and 2016, and the results of their operations and changes in net assets and their cash flows for the years then ended in accordance with the accounting principles generally accepted in the United States of America.

Report on Supplementary Information

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information is presented for purposes of additional analysis rather than to present the financial position, results of operations and cash flows of the individual companies 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 consolidating 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 of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

RSM US LLP

Melbourne, Florida
December 19, 2017

Health First, Inc. and Subsidiaries

Consolidated Balance Sheets
September 30, 2017 and 2016
(Dollars in Thousands)

	2017	2016
Assets		
Current assets:		
Cash and cash equivalents	\$ 182,686	\$ 211,295
Investments	608,145	491,596
Current portion of assets limited as to use	11,149	13,091
Accounts receivable, less allowances for uncollectible accounts of \$54,234 in 2017 and \$90,630 in 2016	113,044	109,629
Inventories	29,822	26,003
Prepaid expenses and other current assets	61,066	56,756
Total current assets	1,005,912	908,370
Assets limited as to use, less current portion	29,845	28,159
Property and equipment, net	733,896	732,429
Goodwill	29,743	29,743
Other assets	41,375	33,837
Total assets	\$ 1,840,771	\$ 1,732,538
Liabilities and Net Assets		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 236,232	\$ 262,674
Current portion of long-term debt and capital lease obligation	23,724	22,605
Total current liabilities	259,956	285,279
Long-term debt and capital lease obligation, less current portion	628,129	608,754
Other noncurrent liabilities	43,505	42,474
Total liabilities	931,590	936,507
Commitments and contingencies		
Net assets:		
Unrestricted:		
Controlling interest	904,384	786,545
Noncontrolling interests in subsidiary	-	3,515
	904,384	790,060
Temporarily restricted – controlling interest	4,797	5,971
Total net assets	909,181	796,031
Total liabilities and net assets	\$ 1,840,771	\$ 1,732,538

See notes to consolidated financial statements.

Health First, Inc. and Subsidiaries

Consolidated Statements of Operations and Changes in Net Assets
Years Ended September 30, 2017 and 2016
(Dollars in Thousands)

	2017	2016
Unrestricted revenues and other support:		
Patient service revenue	\$ 916,644	\$ 923,666
Provision for bad debts	(17,856)	(49,444)
Net patient service revenue	<u>898,788</u>	874,222
Premium revenue	578,206	505,374
Income from joint ventures	1,297	2,260
Other revenue	49,231	39,071
Net assets released from restrictions for operations	579	1,231
Total unrestricted revenues and other support	<u>1,528,101</u>	<u>1,422,158</u>
Expenses:		
Salaries and benefits	617,941	580,753
Supplies and other	490,137	520,885
Medical service	279,166	226,997
Depreciation and amortization	64,276	64,583
Interest	23,614	22,805
Total operating expenses	<u>1,475,134</u>	<u>1,416,023</u>
Income from operations	<u>52,967</u>	<u>6,135</u>
Nonoperating gains (losses):		
Investment income	20,073	15,178
Change in value of interest rate swaps	1,746	(1,951)
Other	(784)	(781)
Total nonoperating gains	<u>21,035</u>	<u>12,446</u>
Excess of revenues, other support and gains over expenses and losses	74,002	18,581
Plus (less): excess of revenues, other support and gains over expenses and losses attributable to noncontrolling interests	<u>(80)</u>	<u>75</u>
Excess of revenues, other support and gains over expenses and losses attributable to controlling interests	<u>\$ 73,922</u>	<u>\$ 18,656</u>

(Continued)

Health First, Inc. and Subsidiaries

Consolidated Statements of Operations and Changes in Net Assets (Continued)
 Years Ended September 30, 2017 and 2016
 (Dollars in Thousands)

	2017	2016
Unrestricted net assets:		
Excess of revenues, other support and gains over expenses and losses attributable to controlling interests	\$ 73,922	\$ 18,656
Excess of revenues, other support and gains over expenses and losses attributable to noncontrolling interests	80	(75)
Net unrealized gains on other-than-trading securities	40,635	29,378
Net assets released from restrictions for purchase of property	1,889	-
Other changes in unrestricted net assets	(2,202)	2,187
Increase in unrestricted net assets	114,324	50,146
Temporarily restricted net assets:		
Contributions	1,212	902
Investment income	82	77
Net assets released from restrictions	(2,468)	(1,231)
Decrease in temporarily restricted net assets	(1,174)	(252)
Increase in net assets	113,150	49,894
Net assets:		
Beginning	796,031	746,137
End	\$ 909,181	\$ 796,031

See notes to consolidated financial statements.

Health First, Inc. and Subsidiaries

Consolidated Statements of Cash Flows
Years Ended September 30, 2017 and 2016
(Dollars in Thousands)

	2017	2016
Operating activities:		
Increase in net assets	\$ 113,150	\$ 49,894
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Net unrealized gains on trading and other-than-trading securities	(40,083)	(30,525)
Realized gains on sales of securities	(5,245)	(609)
Loss on disposal of property and equipment	507	1,454
Change in value of interest rate swaps	1,746	1,951
Restricted contributions and investment income	(1,294)	(979)
Gain on remeasurement of previously held interest	-	(263)
Income from joint ventures	(1,297)	(2,260)
Distributions from joint ventures	1,095	1,902
Depreciation and amortization	64,276	64,583
Provision for bad debts	17,856	49,444
Other	(1,383)	(3,495)
Changes in operating assets and liabilities:		
Accounts receivable	(16,802)	(55,169)
Inventories	(3,819)	1,170
Other operating assets	(11,646)	(18,309)
Accounts payable and accrued liabilities	(31,729)	91,618
Other noncurrent liabilities	(715)	(859)
Net cash provided by operating activities	84,617	149,548
Investing activities:		
Proceeds from the sale of securities – trading	34,000	48,812
Purchases of securities – trading	(64,359)	(55,949)
Proceeds from the sale of non-trading securities	139,786	105,601
Purchases of non-trading securities	(180,914)	(110,809)
Decrease in assets limited as to use	522	488
Purchases of property and equipment	(60,963)	(63,390)
Purchases of physician practices	-	(1,355)
Net cash used in investing activities	(131,928)	(76,602)
Financing activities:		
Proceeds from CMS Contract Deposits	28,006	29,243
Withdrawals from CMS Contract Deposits	(32,475)	(23,533)
Proceeds from issuance of long-term debt	53,000	-
Repayments of long-term debt and capital lease obligation	(31,123)	(21,046)
Restricted contributions and investment income	1,294	979
Net cash provided by (used in) financing activities	18,702	(14,357)
(Decrease) increase in cash and cash equivalents	(28,609)	58,589
Cash and cash equivalents:		
Beginning of year	211,295	152,706
End of year	\$ 182,686	\$ 211,295
Supplemental schedule of noncash investing and financing activities:		
Equipment acquired through the incurrence of a capital lease obligation	\$ -	\$ 2,796

See notes to consolidated financial statements.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 1. Reporting Entity

Health First, Inc. (the Parent) is a not-for-profit parent holding company located in Brevard County, Florida, whose primary purpose is to direct the affairs of a multi-entity health care system, which includes the following affiliates:

- Holmes Regional Medical Center, Inc. (HRMC) – a tax-exempt, 514-bed acute care hospital.
- Palm Bay Hospital (PBH) – a tax-exempt, 120 bed acute care hospital that is a division of HRMC.
- Pro Health Fitness Center (PH) – a tax-exempt division of HRMC with three state-of-the-art health and fitness centers.
- Cape Canaveral Hospital, Inc. (CCH) – a tax-exempt, 150-bed acute care hospital and home health agency.
- Viera Hospital (VH) – a tax-exempt, 84-bed acute care hospital.
- Health First Health Plans, Inc. – a taxable entity providing various health care insurance services to employees of the Parent, other employers, and Medicare Advantage Plans. Effective January 1, 2016, Health First Health Plans, Inc. went through a corporate reorganization and was trifurcated into three separate new entities. The three new entities consist of: Health First Administrative Plans, Inc., Health First Government Plans, Inc. (renamed Health First Health Plans, Inc. on January 7, 2016) and Health First Commercial Plans, Inc.

All administrative business (including third party) of Health First Health Plans, Inc. was assigned and transferred to the Florida for-profit company, Health First Administrative Plans, Inc. The commercial line of business was transferred to the Florida for-profit company, Health First Commercial Plans, Inc. Subsequent to the divestiture of the administrative business and non-marketplace commercial line of business, Health First Health Plans, Inc. novated the residual business into the Florida not-for-profit, Health First Government Plans, Inc. All three entities operate under the fictitious name, "Health First Health Plans." Health First Health Plans, Inc., Health First Administrative Plans, Inc. and Health First Commercial Plans, Inc. are hereinafter collectively referred to as HFHP.

- Health First Medical Group, LLC (HFMG), Health First Physicians, Inc. (HFPI) and Health First Medical Management, Inc. (HFMM) – taxable entities providing a system of primary care centers, specialty and ancillary services, as well as physician practice management services.
- Hospice of Health First, Inc. (HHF) – a tax-exempt entity that provides care for terminally ill individuals.
- Health First Foundation, Inc. (HFF) – a tax-exempt entity that performs philanthropic activities.
- Other affiliated organizations include Cape Health Properties, Inc. (CHP), a subsidiary of CCH; Health First Holding Corp. (HFHC); Holmes Regional Enterprises, Inc. (HRE); Viera Medical Plaza at Viera Health Park (VMOB); Health First Insurance, Inc. (HFII); Health First Family Pharmacy (HFFP), a division of HRMC; Doctor's GI Partnership, LTD. (DGP); Doctor's Surgical Partnership, LTD. (DSP); and taxable entities that manage health care-related and/or other businesses and professional services.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 1. Reporting Entity (Continued)

The Parent is the sole member or owner of each of the above entities except for CHP and controls the multi-entity structure through appointment by the Board of Trustees (Board) and approval of all major transactions.

Consolidation: The accompanying consolidated financial statements (collectively the Financial Statements) include the accounts of the Parent and its controlled affiliates (referred to herein collectively as the Corporation). All significant intercompany accounts and transactions have been eliminated in consolidation.

Note 2. Significant Accounting Policies

Use of estimates: The preparation of these consolidated financial statements in conformity with generally accepted accounting principles (GAAP) in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Financial statement presentation: The Corporation conforms to the requirements of the *Presentation of the Financial Statements—Not-for-Profit Entities* Topic of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC), which establishes standards for external financial reporting by not-for-profit organizations and requires that resources be classified for accounting and reporting purposes into three net asset categories (unrestricted, temporarily restricted, and permanently restricted) according to externally (donor) imposed restrictions.

Cash and cash equivalents: The Corporation classifies all highly liquid investments with an original maturity of 90 days or less when purchased as cash and cash equivalents, excluding amounts limited as to use by Board designation or other arrangements under trust agreements. Cash deposits are federally insured in limited amounts.

Investments and investment income: The Corporation conforms to the requirements of the *Investments—Not-for-Profit Entities* Topic of the FASB ASC. In accordance with those requirements, investments in equity securities with readily determinable fair values and all investments in debt securities are stated at fair value in the consolidated balance sheets. Equity securities are considered other than trading securities.

Investment income or loss, including realized gains and losses on investments and interest and dividends, is included in excess of revenues, other support and gains over expenses and losses unless the income or loss is restricted by donor or law.

Unrealized gains and losses on investments are excluded from excess of revenues, other support, and gains over expenses and losses unless the investments are trading securities. Other-than-temporary impairment of investments represents losses on equity securities for which the decline in the fair value below the cost basis was determined to be other than temporary. There are no material unrealized losses within the Corporation's debt and equity securities at September 30, 2017 and 2016.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 2. Significant Accounting Policies (Continued)

Assets limited as to use: Assets limited as to use primarily include assets held by trustees under bond indenture agreements and designated assets set aside by the Board for malpractice and other obligations, over which the Board retains control and may, at its discretion, subsequently use for other purposes. Amounts required to meet current liabilities of the Corporation are reported as current assets (see Note 4).

Inventories: Inventories, consisting primarily of medical supplies and pharmaceuticals, are stated at the lower of cost (first-in, first-out) or market value.

Property and equipment: Property and equipment are stated at cost or, if donated, at fair value at the date of the gift. Expenditures that materially increase values, change capacities, or extend useful lives are capitalized, as are interest costs during the period of construction for such expenditures. Depreciation is computed utilizing the straight-line method at rates estimated by management to amortize the cost of the various assets within the periods of expected use. Amortization of assets recorded under capital leases is included in depreciation and amortization expense and accumulated depreciation and amortization.

Impairment of long-lived assets: The Corporation reviews long-lived assets to be held and used, including intangible assets, for impairment annually or whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Such evaluation relies on a number of factors, including operating results, future anticipated cash flows, business plans, and certain economic projections. In addition, the Corporation's evaluation considers nonfinancial data, such as changes in operating environment and business relationships. If the sum of the undiscounted expected future cash flows is less than the carrying amount of the asset, the Corporation recognizes an impairment loss. Impairment losses are measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset. When fair values are not available, the Corporation estimates fair value using the expected future cash flows discounted at a rate commensurate with the risks associated with the recovery of the asset. For the years ended September 30, 2017 and 2016, there were no impairments of long-lived assets.

Goodwill: Goodwill represents the excess of the purchase price and related costs over the value assigned to the net tangible and identifiable intangible assets of the businesses acquired. These amounts are evaluated annually for impairment or when there is an indicator of impairment. In accordance with ASC Topic 350, in performing the annual assessment, the Corporation chose to complete a qualitative assessment to determine whether it is more likely than not that the fair value of its reporting unit is less than the carrying amount. Management has determined that it is not more likely than not that the fair value of the Corporation's reporting unit is less than the carrying amount. Therefore, the two-step impairment test under ASC Topic 350 was not required.

Deferred loan costs: Costs incurred in obtaining long-term debt are being amortized by a method approximating the effective interest method over the life of the loan and are included in the consolidated balance sheets within long-term debt and capital lease obligations.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 2. Significant Accounting Policies (Continued)

Collaborative arrangements: The Corporation has a collaborative arrangement with Adventist Health System/Sunbelt, Inc. (Adventist). The agreement is intended to allow Adventist to share in any savings generated through improved efficiencies in the management and coordination of the delivery of health care services rendered to individuals located in counties with Adventist hospitals and covered under a HFHP product. The agreement allows for any deficiency under a CMS awarded contract or health maintenance contract in the central region of Florida to be paid by Adventist to the Corporation. Any overage under a CMS awarded contract or health maintenance contract in the central region of Florida is to be paid by the Corporation to Adventist. For the years ended September 30, 2017 and 2016, the collaborative arrangement with Adventist resulted in deficiencies of \$9,017 and \$9,755, respectively, and it is included in other receivables in the consolidated balance sheets and as a reduction to medical service expense on the consolidated statements of operations and changes in net assets.

Contributions: The Corporation records contributions in accordance with the *Revenue Recognition—Not-for-Profit Entities* Topic of the FASB ASC, which establishes accounting standards for contributions for donees (and donors) and generally requires unconditional promises to give cash and other assets (including multiyear promises) to be recognized at fair value as revenue and expenses in the period made.

Noncash contributions are valued at fair value on the date of the gift. Contributions are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restrictions for operations or capital.

Donor-restricted contributions whose restrictions are met within the same year as the contributions received are reflected as unrestricted contributions in the accompanying consolidated financial statements. Temporarily restricted net assets are primarily available for property and equipment purchases and support of specific programs administered by HRMC, CCH, PBH, VH and HHF.

Excess of revenues, other support and gains over expenses and losses: The consolidated statements of operations and changes in net assets include excess of revenues, other support and gains over expenses and losses. Changes in unrestricted net assets that are excluded from excess of revenues, other support and gains over expenses and losses include changes in unrealized gains and losses on other-than-trading investments, changes in noncontrolling interests and contributions of long-lived assets, including assets acquired using contributions that, by donor restriction, were to be used for the purpose of acquiring such assets.

Net patient service revenue, accounts receivable and allowance for uncollectible accounts: Patient service revenue and accounts receivable are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered. The Corporation recognizes patient service revenue associated with patients who have third-party payor coverage on the basis of contractual rates for the services rendered. For uninsured patients who do not qualify for charity care, revenue is recognized on the basis of discounted rates in accordance with the Corporation's policy.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 2. Significant Accounting Policies (Continued)

Patient service revenue is reduced by the provision for bad debts, and accounts receivable are reduced by an allowance for uncollectible accounts. The provision for bad debts and allowance for uncollectible accounts are based upon management's assessment of historical and expected net collections and historical write-off experience by payor and aging category, trends in health care coverage and other collection indicators. Management regularly reviews collections data by major payor sources in evaluating the sufficiency of the allowance for uncollectible accounts. On the basis of historical experience, a significant portion of the amounts owed by the Corporation's self-pay patients for services rendered will not be paid. As such, the Corporation records a significant provision for bad debts in the period services are rendered related to self-pay patients. The Corporation's allowance for uncollectible accounts for self-pay patients was 91% of self-pay accounts receivable as of September 30, 2017 and 2016. For receivables associated with patients who have third-party coverage, the Corporation analyzes contractually due amounts and provides an allowance for uncollectible accounts and a provision for bad debts, if deemed necessary. Accounts receivable are written off after collection efforts have been followed in accordance with the Corporation's policies. Accounts written off as uncollectible are deducted from the allowance, and subsequent recoveries are added.

The Corporation has determined, based on an assessment at the reporting entity level, that patient service revenue is primarily provided prior to assessing the patient's ability to pay and as such, the entire provision for bad debts is recorded as a deduction from patient service revenue in the accompanying consolidated statements of operations and changes in net assets. Effective for the year ended September 30, 2017, the Corporation changed its policy for the classification and recording of its average general billing reserve. For the year ended September 30, 2016, the average general billing reserve for Self-Pay and Medicaid customers was recorded as an allowance for uncollectible accounts in the accompanying balance sheets and provision for bad debt expense in the accompanying statement of operations. In fiscal year 2017, the Corporation changed its policy to provide a 75% discount to self pay patient accounts. This change in policy resulted in the reclassification from provision for bad debts to a direct reduction of net patient service revenue. This change was made due to the financial assistance requirements of IRS 501R.

Patient service revenue is not recognized for those patients who qualify for charity under the Corporation's policies. For all other patients, patient service revenue, net of contractual allowances and self-pay discounts and before the provision for bad debts, recognized from major payor sources is as follows:

	2017	2016
Gross patient revenue	\$ 3,902,886	\$ 3,628,152
Allowances and discounts	(2,986,242)	(2,704,486)
Total	<u>\$ 916,644</u>	<u>\$ 923,666</u>

The Corporation grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor arrangements. Significant concentrations of patient accounts receivable due from third-party payors at September 30, 2017 and 2016, include 30% and 23% from the Medicare program and 57% and 45% from contracts with other third parties, respectively.

Revenue from the Medicare program represented approximately 44% and 45% of net patient service revenue for the years ended September 30, 2017 and 2016, respectively.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 2. Significant Accounting Policies (Continued)

The Corporation is subject to retroactive revenue adjustments due to audits, reviews and investigations. Included on the consolidated balance sheets are the following amounts in estimated third-party settlements:

	2017		2016
Prepaid expenses and other current assets	\$ 3,814	\$	2,698
Accounts payable and accrued liabilities	7,513		8,506

Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews and investigations. Adjustments to revenue related to prior periods as a result of settled cost reports and changes in estimates increased patient service revenue by \$2,108 and \$3,466, for the years ended September 30, 2017 and 2016, respectively.

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. However, management is not aware of any matters that could have a material effect on recorded estimates.

Charity care: The Corporation provides care without charge or at amounts less than its established rates to patients who meet certain criteria under its charity care policy. Because the Corporation does not pursue collection of amounts determined to qualify as charity care, these amounts are not included in patient service revenue. The Corporation estimates the direct and indirect costs of providing charity care by applying a cost to gross charges ratio to the gross uncompensated charges associated with providing charity care to patients. Funding received to offset or subsidize charity services provided was de minimis for the years ending September 30, 2017 and 2016. The cost of providing charity care was \$48,038 and \$44,662 for the years ended September 30, 2017 and 2016, respectively.

Premium revenue: Commercial membership contracts are written to groups on a yearly basis subject to cancellation by the employer group according to the termination provision of the contract. Medicare membership contracts are written to individuals and may be terminated by the member at any time. Premiums are due monthly and are recognized as revenue during the period in which the Corporation is obligated to provide services to members. Approximately 64% and 67% of total premium revenue was received under the Medicare program, and 36% and 33% was received from contracts with other employer groups during the years ended September 30, 2017 and 2016, respectively.

The Medicare program, administered by the Department of Health and Human Services, Centers for Medicare and Medicaid Services (CMS), uses risk-adjusted rates per member to determine the monthly payments to HFHP and HFII. The CMS risk adjustment model pays more for members with increasing health severity. The monthly risk-adjusted premium per member is determined by CMS based on normalized risk scores of each member from the prior year.

Annually, CMS provides the updated risk scores to HFHP and HFII and revises premium rates prospectively. CMS also calculates the retroactive adjustments to premiums related to the revised risk scores.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 2. Significant Accounting Policies (Continued)

HFHP's stand-alone prescription drug plan and Medicare plan offer prescription drug benefits under Part D of the Medicare federal health insurance program to individuals eligible for benefits under Part A and Part B. Premiums for members are subject to risk corridor provisions. Risk corridor payments due to or from CMS are estimated throughout the year and are recognized as adjustments to premium revenue. After the close of the year, CMS reconciles actual experience to a target amount, and any differences are settled between CMS and HFHP.

Payments received from CMS also include low-income subsidy payments and reinsurance payments. Low-income subsidy payments and reinsurance payments are not included in premium revenue, and related claims incurred are excluded from the medical services expenses.

Because amounts received from CMS are subject to the reconciliation and retroactive adjustment processes described above, it is at least reasonably possible that the premiums and the amounts due from or to CMS in the near term could differ materially from the amounts included in the consolidated financial statements.

Functional expenses: The expenses reported in the consolidated statements of operations and changes in net assets were incurred for the following:

	2017	2016
Health care services	\$ 1,235,696	\$ 1,132,425
General and administrative	215,824	260,793
Interest expense	23,614	22,805
	<u>\$ 1,475,134</u>	<u>\$ 1,416,023</u>

Claims payable: Claims payable are recorded in accounts payable and accrued liabilities in the consolidated balance sheets and represent the amount of payments to be made on individual claims that have been reported to HFHP or HFII, as well as estimates of claims incurred that have not yet been reported as of the consolidated balance sheet dates. Claims payable are estimated using various statistical methods that use both historical financial and operating data. Although considerable variability is inherent in such estimates, management believes that the liabilities for unpaid claims are reasonable. Adjustments to claims payable to reflect actual experience, if any, are reflected in the consolidated statements of operations and changes in net assets in the period in which such adjustments become known to management. Due to uncertainties inherent in the claims estimation process, it is at least reasonably possible that the claims paid in the near term could differ materially from the accrued amounts. Management believes that the recorded liability is adequate.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 2. Significant Accounting Policies (Continued)

The following table provides a reconciliation of the beginning and ending balances of unpaid claims liabilities included in accounts payable and accrued liabilities, net of reinsurance recoverables:

	2017	2016
Unpaid claim liabilities, at beginning of year	\$ 34,109	\$ 31,630
Incurred losses:		
Current period	402,516	334,802
Prior periods	(1,726)	(1,682)
Payments for claims, net of reinsurance:		
Current period	(349,418)	(301,795)
Prior periods	(32,098)	(28,846)
Unpaid claim liabilities, at end of year	<u>\$ 53,383</u>	<u>\$ 34,109</u>

Medical service expense: HFHP and HFII contracts with various health care providers for the provision of certain medical care services to its members. Medical services consist partially of inpatient and outpatient hospital services and pharmacy. Hospital services are paid on a fee-for-service, capitation and fixed-rate basis. The provision for medical services includes estimates of payments to be made on health care services reported as of the consolidated balance sheet dates and estimates of health care services rendered but not reported to HFHP and HFII as of the consolidated balance sheet dates. Medical service liabilities are reviewed and adjusted periodically. As adjustments are made, differences are included in current operations.

Medical loss ratio: Under health care reform, the medical loss ratio (MLR) reporting requirements require the Corporation to submit a report concerning the ratio of the incurred loss to earned premiums as adjusted for various items. This regulation is intended to provide consumers with information needed to better understand how much of the premium paid is used to reimburse providers for covered services, to improve health care quality and to pay for administrative expenses. The Corporation is required to provide an annual rebate to enrollees, if the medical loss ratio falls below the minimum requirements of 85% in the large group market and 80% in the small group or individual markets. The Corporation does not anticipate being required to pay a rebate for the years ended September 30, 2017 or 2016.

Estimated malpractice costs: The provision for estimated medical malpractice claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported, as determined through actuarial analysis.

Income taxes: The Parent and its tax-exempt affiliates are generally exempt from federal and state income taxes applicable under Section 501(a), as organizations described in Section 501(c)(3), of the Internal Revenue Code and Section 220.13 of the Florida Statutes, respectively.

The taxable affiliates, except CHP, file a consolidated income tax return under HFHC for both federal and state income tax purposes. The provision for income taxes and income taxes paid included in these consolidated financial statements is not significant. The consolidated income tax returns for the tax years ended September 30, 2014 through 2016 are still subject to federal and state income tax examination.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 2. Significant Accounting Policies (Continued)

At September 30, 2017 and 2016, HFHC had net deferred tax assets of \$1,503 and \$650, respectively, tax effected at a rate of 37.63%. At September 30, 2017 and 2016, HFHC had \$258,415 and \$220,876, respectively, of net operating loss carryforwards including Separate Return Limitation Year (SRLY) losses of \$16,654 and \$17,594, respectively. These net operating losses will expire between 2018 and 2037. A valuation allowance has been provided to offset the full amount of the deferred tax asset as of September 30, 2017 and 2016, since management determined that it is more likely than not that the benefit of the deferred tax assets will not be realized in future years.

ASC Topic 740, *Income Taxes*, prescribes the accounting for uncertainty in income tax positions recognized in financial statements. ASC Topic 740 provides guidance for recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return.

Other: Other revenue primarily consists of Administrative Service Organization (ASO) fee revenue associated with HFHP, PH membership fees, and Low Income Pool (LIP) payments to the hospital division.

Adoption of new accounting principle: In January 2017, the FASB issued Accounting Standards Update No. (ASU) 2017-04 *Intangibles – Goodwill and Other*. The amendments in ASU 2017-04 provide guidance which simplifies the goodwill impairment test. ASU 2017-04 removes Step 2 from the impairment test as well as the current requirement to perform a qualitative assessment if there is a zero or negative carrying amount. The amendments of ASU 2017-04 are effective for the annual reporting periods beginning after December 15, 2020, with early adoption permitted for periods starting on January 1, 2017. Management has adopted ASU 2017-04 which had no impact on the Corporation's consolidated financial statements.

Recent accounting pronouncements: In January 2017, the FASB issued ASU 2017-01 *Business Combinations*. The amendments in ASU 2017-01 provide clarification on the definition of a business in order to differentiate asset acquisitions from business acquisitions. The amendments of ASU 2017-01 are effective for the annual reporting periods beginning after December 15, 2017, including interim periods within the annual reporting period. Management is currently evaluating the effects of ASU 2017-01 on the Corporation's consolidated financial statements.

In December 2016, the FASB issued ASU 2016-20 *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*. The amendments provide corrections and updates to various topics, which required additional clarification, within ASU 2014-09 Revenue from Contracts with Customers. The amendments of ASU 2016-18 are effective for the annual reporting periods beginning after December 15, 2017, including interim periods within the annual reporting period. Management is currently evaluating the effects of ASU 2016-20 on the Corporation's consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18 *Statement of Cash Flows (Topic 230): Restricted Cash*. The amendments in ASU 2016-18 requires an entity to report, in general, restricted cash and restricted cash equivalents as cash and cash equivalents when reconciling the beginning and ending amounts on the statement of cash flows. The amendments of ASU 2016-18 are effective for the annual reporting periods beginning after December 15, 2017, including interim periods within the annual reporting period. Management is currently evaluating the effects of ASU 2016-18 on the Corporation's consolidated financial statements.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 2. Significant Accounting Policies (Continued)

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230) Classification of Certain Cash Receipts and Cash Payments*. The amendments in ASU 2016-15 provides guidance on the classification and presentation of eight cash flow issues: debt prepayment or debt extinguishment costs, settlements of specific debt instruments, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, proceeds from the settlement of corporate-owned life insurance policies, distributions received from equity method investees, beneficial interests in securitization transactions and separately identifiable cash flows and application of the predominance principle. The amendments of ASU 2016-15 are effective for the annual reporting periods beginning after December 15, 2017, including interim periods within the annual reporting period. Management is currently evaluating the effects of ASU 2016-15 on the Corporation's consolidated financial statements.

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 amendments in ASU 2016-14 provide for improved reporting on the classes of net assets, amounts and purposes of board designations, composition of net assets with donor restrictions, liquidity measures, classification of expenses (functional and natural classification), methods to allocate costs, underwater endowment funds and investment returns. The amendments of ASU 2016-14 are effective for the annual reporting periods beginning after December 15, 2017 and for interim periods after December 18, 2018. Management is currently evaluating the effects of ASU 2016-14 on the Corporation's consolidated financial statements.

In June 2016, the FASB issued ASU 2016-10, *Revenue from Contracts with Customers (Topic 606), Identifying Performance Obligations and Licensing*. The amendments in ASU 2016-10 clarify the following two aspects of Topic 606: identifying performance obligations and the licensing implementation guidance. An entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer. An entity determines whether the nature of its promise in the contract is to transfer each of the goods or services or whether the promise is to transfer a combined item (or items) to which the promised goods and/or services are inputs. The amendments of ASU 2016-10 are effective for annual reporting periods beginning after December 15, 2017, including interim periods within those reporting periods. Management is currently evaluating the effects of ASU 2016-10 on the Corporation's consolidated financial statements.

In June 2016, the FASB issued ASU 2016-08, *Revenue from Contracts with Customers (Topic 606), Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*. The amendments in ASU 2016-08 clarify the implementation guidance on principal versus agent considerations. When another party is involved in providing goods or services to a customer, an entity is required to determine whether the nature of its promise is to provide the specified good or service itself (that is, the entity is a principal) or to arrange for that good or service to be provided by the other party (that is, the entity is an agent). When an entity that is a principal satisfies a performance obligation, the entity recognizes revenue in the gross amount of consideration to which it expects to be entitled in exchange for the specified good or service transferred to the customer. When an entity that is an agent satisfies a performance obligation, the entity recognizes revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the specified good or service to be provided by the other party. The amendments of ASU 2016-08 are effective for annual reporting periods beginning after December 15, 2017, including interim periods within those reporting periods. Management is currently evaluating the effects of ASU 2016-08 on the Corporation's consolidated financial statements.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 2. Significant Accounting Policies (Continued)

In February 2016, the FASB issued ASU 2016-02, *Leases*. ASU 2016-02 introduces a lease accounting model that requires an entity to recognize assets and liabilities arising from most leases, including both financing and operating leases. The recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification as a financing or operating lease and will be in a manner similar to the current accounting guidance. ASU 2016-02 will also require qualitative and quantitative lease disclosures. The amendments of ASU 2016-02 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Management is currently evaluating the effects of ASU 2016-02 on the Corporation's consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments – Overall, Recognition and Measurement of Financial Assets and Financial Liabilities*. The amendments in ASU 2016-01 provide guidance on certain aspects of recognition, measurement, presentation and disclosure of financial instruments. The amendments require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. The amendments simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. The amendments require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes and require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements. The amendments of ASU 2016-01 are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Management is currently evaluating the effects of ASU 2016-01 on the Corporation's consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. The amendments in ASU 2014-09 require an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve this core principle, an entity should apply the following steps: (1) identify the contract with a customer, (2) identify the performance obligations in the contract, (3) determine the transaction price, (4) allocate the transaction price to the performance obligations in the contract, and (5) recognize revenue when (or as) the entity satisfies a performance obligation. An entity should disclose sufficient information to enable the financial statement users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In August 2015, the FASB issued ASU 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*. The amendments of ASU 2015-14 and ASU 2014-09 are effective for annual reporting periods beginning after December 15, 2017, including interim periods within those reporting periods. Management is currently evaluating the effects of ASU 2015-14 and ASU 2014-09 on the Corporation's consolidated financial statements.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 3. Investments

The composition of investments and assets limited as to use is presented below.

	2017	2016
Cash and cash equivalents	\$ 12,769	\$ 14,128
Equity securities	432,203	355,381
U.S. Treasury and agency obligations	67,480	60,290
U.S. corporate bonds	79,677	61,479
Real estate investment trust	30,843	20,939
Asset-backed securities	10,171	13,705
Municipal bonds	6,345	2,969
Government asset-backed securities	6,851	1,528
Other	2,800	2,427
	<u>\$ 649,139</u>	<u>\$ 532,846</u>

Unrestricted investment income comprises the following:

	Years ending September 30,	
	2017	2016
Interest income	\$ 15,380	\$ 13,422
Realized gain on sales of securities	5,245	609
Unrealized gain (loss) on trading securities	(552)	1,147
	<u>\$ 20,073</u>	<u>\$ 15,178</u>

Note 4. Assets Limited as to Use

Assets limited as to use are composed of the following:

	2017	2016
Board designated for malpractice and other obligations	\$ 25,662	\$ 24,998
Cash and investments held by trustee under bond indenture agreements—debt service and project funds	7,539	7,654
Board designated for the HFF	4,797	5,971
Other	2,996	2,627
	<u>40,994</u>	<u>41,250</u>
Less amounts required to meet current obligations	11,149	13,091
	<u>\$ 29,845</u>	<u>\$ 28,159</u>

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 5. Other Assets

The composition of other assets is as follows:

	2017	2016
Collateral assignment split dollar agreement	\$ 16,744	\$ 16,015
Investment in joint ventures	12,862	12,637
Other	11,769	5,185
	<u>\$ 41,375</u>	<u>\$ 33,837</u>

The Corporation has entered into a collateral assignment split-dollar arrangement. The Corporation fully funded the premium on the life insurance policies. The split-dollar insurance agreements are stated at fair value. For the years ended September 30, 2017 and 2016, the Corporation reported \$518 and \$502 in earnings, respectively, which is included in investment income on the consolidated statements of operations and changes in net assets.

The Corporation accounts for its investments in joint ventures in accordance with the *Investments – Equity Method and Joint Ventures* Topic of the FASB ASC. Accordingly, the Corporation records an investment in the net assets of the joint venture at cost and adjusts the carrying amount of the investment to recognize the Corporation's share of the income or losses of the joint venture after the date of acquisition. The Corporation's share of income from joint ventures for the years ended September 30, 2017 and 2016, was \$1,297 and \$2,260, respectively.

HealthSouth of Sea Pines Limited Partnership (HSSP), in which the Corporation has a 25% interest, is the Corporation's significant unconsolidated subsidiary that is accounted for using the equity method of accounting. Summarized financial information for the Corporation's investment in HSSP as of and for the years ended September 30, 2017 and 2016, assuming 100% ownership interest, is as follows:

	2017	2016
Balance sheets		
Current assets	\$ 7,259	\$ 5,016
Noncurrent assets	15,691	16,498
Total assets	<u>\$ 22,950</u>	<u>\$ 21,514</u>
Current liabilities	\$ 3,560	\$ 1,958
Partners' capital	19,390	19,556
Total liabilities and partners' capital	<u>\$ 22,950</u>	<u>\$ 21,514</u>
Statements of operations		
Net operating revenues	\$ 28,864	\$ 28,823
Operating expenses	24,860	24,752
Net income	<u>\$ 4,004</u>	<u>\$ 4,071</u>
Other	-	-
Net income	<u>\$ 4,004</u>	<u>\$ 4,071</u>

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 6. Property and Equipment

A summary of property and equipment is as follows:

	2017	2016	Useful Lives (Years)
Land and improvements	\$ 92,924	\$ 90,577	5-25
Buildings and improvements	867,019	847,054	2-40
Fixed equipment and major movable equipment	699,994	683,221	2-25
	<u>1,659,937</u>	<u>1,620,852</u>	
Less allowances for depreciation and amortization	938,899	912,824	
	<u>721,038</u>	<u>708,028</u>	
Construction-in-progress	12,858	24,401	
	<u>\$ 733,896</u>	<u>\$ 732,429</u>	

Construction-in-progress at September 30, 2017, represents costs incurred to date related to construction and renovation projects expected to be completed over the next five years. At September 30, 2017, the estimated cost to complete construction and renovation projects in progress is approximately \$46,978, which will be funded principally from operations.

The Cape Canaveral Hospital District (District) was created under the laws of the state of Florida on August 18, 1959, and includes a special tax district in Brevard County, Florida. The District was re-created by Chapter 2003-337, Laws of Florida, which codified all special acts related to the District. The District leases the hospital facility and operating assets to CCH. CCH makes payments to the District sufficient to pay the principal and interest on the District's outstanding obligations. The assets and liabilities of CCH revert to the District upon completion of the lease term in 2039. The District may levy taxes upon all real and personal taxable property in the District, not to exceed 2.25 mills annually. The District did not levy taxes for either of the years ended September 30, 2017 or 2016.

The future minimum lease payments at September 30, 2017, under the capital lease obligation with the District are de minimis.

A summary of assets under the capital lease with the District included in property and equipment is as follows:

	2017	2016
Land and improvements	\$ 2,647	\$ 2,591
Buildings and improvements	104,063	101,713
Fixed equipment and major movable equipment	84,362	81,340
	<u>191,072</u>	<u>185,644</u>
Less allowance for amortization	138,703	132,947
	<u>52,369</u>	<u>52,697</u>
Construction-in-progress	2,645	1,741
	<u>\$ 55,014</u>	<u>\$ 54,438</u>

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 7. Goodwill

The changes in the carrying amount of goodwill were as follows:

	2017	2016
Goodwill, at beginning of year	\$ 29,743	\$ 23,696
Acquisitions (see Note 9)	-	6,047
Goodwill, at end of year	<u>\$ 29,743</u>	<u>\$ 29,743</u>

Note 8. Long-Term Debt and Capital Lease Obligation

Long-term debt and capital lease obligation are as follows:

	2017	2016
Term loan with two lenders, secured by certain assets of the Corporation, interest payable monthly at a fixed rate of 4.49%, due March 2038.	\$ 128,997	\$ 132,774
Term loan with a financial institution, secured by revenues of the borrowers, interest payable monthly at a variable rate (2.49% at September 30, 2017), due February 2023.	32,337	33,398
Term loan with a financial institution, secured by revenues of the borrowers, interest payable monthly at a variable rate.	-	9,553
Term loan with a financial institution, secured by revenues of the borrowers, interest payable monthly at a variable rate (2.49% at September 30, 2017), due November 2020.	4,082	5,371
Term loan with a financial institution, secured by revenues of the borrowers, interest payable monthly at a variable rate (2.49% at September 30, 2017), due November 2020.	5,795	7,626
Term loan with a financial institution, secured by certain assets of the corporation, interest payable monthly at a variable rate (2.34% at September 30, 2017), due September 2030.	20,000	20,000
Term loan with a financial institution, secured by certain assets of the Corporation, interest payable monthly at a variable rate (2.34% at September 30, 2017), due November 2026.	53,000	-
Health Facilities Revenue Refunding Bonds, Series 2014, interest payable semi-annually at fixed rates between 3.00% and 5.00%, including a net premium of \$19,437 and \$20,512, due April 2039.	274,506	275,742
Health Facilities Revenue Bonds, Series 2013A, interest payable semi-annually at fixed rates between 3.00% and 5.00%, including a net premium of \$5,686 and \$6,291, due April 2031.	66,531	68,211
Health Facilities Revenue Bonds, Series 2012A, interest payable monthly at a fixed rate of 2.29%, due December 2021.	13,534	16,335
Health First Facilities Revenue Bonds, Series 2009A, interest payable monthly at a fixed rate of 3.79%, due July 2029.	46,375	49,875
Health Facilities Revenue Bonds, Series 2005, interest payable semi-annually at a fixed rate of 5.00%.	-	3,410
Other	10,799	13,464
Issue costs, net	(4,103)	(4,400)
Total long-term debt and capital lease obligation	<u>651,853</u>	<u>631,359</u>
Less current maturities	<u>(23,724)</u>	<u>(22,605)</u>
	<u>\$ 628,129</u>	<u>\$ 608,754</u>

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 8. Long-Term Debt and Capital Lease Obligation (Continued)

Maturities of long-term debt, excluding capital leases, consist of the following:

Years ending September 30:		
2018	\$	22,408
2019		21,639
2020		22,347
2021		20,487
2022		23,494
Thereafter		514,554

Future minimum lease payments under the capital leases, together with the present value of net minimum lease payments, consist of the following:

Years ending September 30:		
2018	\$	1,581
2019		1,611
2020		1,619
2021		403
2022		1,656
		<hr/>
		6,870
Less amount representing interest		966
		<hr/>
Present value of net minimum lease payments		5,904
Current portion		1,316
		<hr/>
Long-term capital lease obligation	\$	<u>4,588</u>

A Master Trust Indenture, dated May 15, 2001, and modified in December 2015, covers all bonds issued and outstanding by the Parent, HRMC, CCH, and VH (collectively, the Obligated Group) at September 30, 2017 and 2016. Under the Master Trust Indenture, all members of the Obligated Group are jointly and severally liable for the obligation covered by the Master Trust Indenture. HRMC has executed a mortgage on a portion of HRMC's property in favor of the Master Trustee to secure the Obligated Group's repayment obligation under the Master Trust Indenture. The mortgaged property has a carrying value of \$246,450 at September 30, 2017. In addition, all revenues of HRMC, PBH, CCH and VH are pledged as security for the payment of the obligations outstanding under the Master Trust Indenture. At September 30, 2017, total debt outstanding related to the Master Trust Indenture is approximately \$491,038.

The Master Trust Indenture provides for specific restrictive covenants, including a debt service coverage requirement. The Corporation was in compliance with all such restrictive covenants at September 30, 2017 and 2016.

In November 2016, the Corporation executed a \$53,000 term loan with a bank. The loan bears interest at one-month London Interbank Offered Rate (LIBOR) plus 1.10% per annum, is due November 2026 and is secured by the revenues of the Obligated Group. The loan proceeds were used by the Corporation to refinance another term loan and to fund capital expenditures.

Interest expense approximates interest paid.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 9. Business Combinations

In February 2016, the Corporation acquired a small family practice that resulted in goodwill of \$1,155.

On April 15, 2016, the Corporation acquired a controlling interest in DSP by acquiring the 1.17% general partner interest. Prior to the acquisition date, the Corporation accounted for its 69.58% limited partner interest as an equity-method investment. The acquisition-date fair value of the previous equity interest was \$5,448. The Corporation recognized a gain of \$263 as a result of remeasuring its prior equity interest held before the business combination. The gain is included in other revenue in the accompanying consolidated statements of operations and changes in net assets. This transaction resulted in goodwill in the amount of \$4,662, which was derived primarily from intangible assets that do not qualify for separate recognition. The fair value of the 29.25% noncontrolling interest was estimated to be \$2,252.

Goodwill recognized as part of the transactions described above is expected to be deductible for tax purposes.

Note 10. Employee Benefit Plans

Retirement plan: The Corporation, excluding HFMG, has a defined contribution plan covering substantially all employees. For the twelve months ended September 30, 2016 and the three months ended December 31, 2016, the Corporation contributed 1% of the eligible employees' gross wages. In addition, the Corporation matched up to 8% of the employees' contribution at a 30% rate. As a result, the maximum contribution made by the Corporation was 3.4%. Effective January 1, 2017, the Corporation no longer contributes 1% of the eligible employee's gross wages, but matches up to 8% of the employees' contribution at a 40% rate. As a result, the maximum contribution made by the corporation for the nine months ending September 30, 2017 is 3.2%. Eligible employees are allowed to contribute up to 100% of the eligible employees' gross wages not to exceed the maximum permissible standard deferral amount. This is in addition to any catch-up deferral amount for qualifying individuals. Retirement plan expense was \$5,893 and \$6,040 for the years ended September 30, 2017 and 2016, respectively, and is included in salaries and benefits within the consolidated statements of operations and changes in net assets.

Employee health plan: The Corporation is self-funded for health benefits for substantially all employees. The self-funded benefits are administered by HFHP. Employee health benefits expense was \$19,316 and \$17,156, for the years ended September 30, 2017 and 2016, respectively, and is included in salaries and benefits within the consolidated statements of operations and changes in net assets.

Note 11. Malpractice Insurance Plan

The Corporation maintained a self-insured revocable trust (Trust) that covers the Corporation's affiliates and their respective employees for claims within a specified level (Self-Insured Retention). Claims above the Self-Insured Retention were insured by claims-made coverage that was placed with a captive insurance company located in the Cayman Islands. A Self-Insured Retention of \$10,000 and \$30,000 per incidence and in aggregate, respectively, was established for the years ended September 30, 2015 through August 1, 2016. Effective August 2016, the Corporation replaced its insurance coverage with a domestic insurance company, in which; the Self-Insured Retention was reduced to \$5,000 and \$15,000 per incidence and in aggregate, respectively.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 11. Malpractice Insurance Plan (Continued)

Management has recorded a liability for estimated losses from reported and unreported claims of the following:

	2017	2016
Accounts payable and accrued liabilities	\$ 3,410	\$ 5,237
Other noncurrent liabilities	20,174	20,906
Total liability	<u>\$ 23,584</u>	<u>\$ 26,143</u>

Management, with the assistance of consulting actuaries, estimates claims liabilities at the present value of future claims payments using a discount rate of 3.74% at September 30, 2017 and 2016, respectively. Medical malpractice expense of \$6,970 and \$6,919 for the years ended September 30, 2017 and 2016, respectively, is included in supplies and other in the accompanying consolidated statements of operations and changes in net assets.

Note 12. Commitments and Contingencies

Litigation: The Corporation is involved in litigation arising in the ordinary course of business. After consultation with legal counsel, management believes that these matters will be resolved without any additional material adverse effect on the Corporation's future consolidated financial position, results of operations or cash flows.

On August 27, 2015, the North Brevard County Hospital District (Parrish) filed a complaint against the Corporation and related entities alleging certain underpayments by Health First Health Plans to Parrish for services rendered to Health First Health Plan members, alleging violation of certain antitrust laws by attempting to monopolize the markets for medical oncology and radiology oncology services through the acquisition of Space Coast Cancer Center, and alleging tortious interference with the contractual relationships between Parrish and Parrish's employed physicians.

The Complaint has nine counts: (1) Breach of Contract; (2) Violation of Section 641.513(5), Florida Statutes, (payment for emergency services); (3) Unjust Enrichment (4) Quantum Meruit; (5) Violation of the Florida Antitrust Act Section 542.23, Florida Statutes (Impermissible Merger in Restraint of Trade); (6) Violation of the Florida Antitrust Act Section 542.19, Florida Statutes (Attempted Monopolization of the Medical Oncology Physician Services and Radiation Oncology Physician Services Market); (7) Violation of the Florida Antitrust Act Section 542.18, Florida Statutes (Contract, Combinations, or Conspiracy in Restraint of Trade); (8) Tortious Interference with a Contract; and (9) Tortious Interference with an Advantageous Business Relationship.

The Complaint seeks damages for the breach of contract claims, an injunction prohibiting the acquisition of Space Coast Cancer Center by HFMG, or alternatively order the divestiture of Space Coast Cancer Center from HFMG, treble damages under Count VII, an injunction prohibiting the Corporation from interfering with Parrish's contractual relationship and from disparaging or making false statements regarding Parrish, and attorneys' fees and costs. Discovery is underway. The Corporation believes the claims to be unfounded and will undertake an aggressive defense. Although it is premature to assess the likely course or outcome of this action, if the outcome of the litigation is adverse to the Health First Group, the Health First Group could incur material liabilities for damages or other adverse financial consequences.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 12. Commitments and Contingencies (Continued)

As of September 30, 2016, amounts relating to various settlements are included in accounts payable and accrued liabilities in the accompanying consolidated balance sheets and supplies and other in the accompanying statements of operations and changes in net assets as of and for the year ended September 30, 2016. The specific terms of the settlements may not be disclosed due to a confidentiality provision in the settlement agreements.

Guarantees: The Corporation has guaranteed the promissory note payments of a certain limited partnership in which the Corporation is a partner. The guaranteed promissory note had a balance as of September 30, 2017 and 2016, of \$1,932 and \$2,033, respectively.

Operating leases: The Corporation leases certain property and equipment under operating leases. Lease and rental expense was approximately \$11,310 and \$12,634 for the years ended September 30, 2017 and 2016, respectively.

Net future minimum lease payments under non-cancelable operating leases as of September 30, 2017, are as follows:

Years ending September 30:		
2018	\$	6,331
2019		5,599
2020		2,356
2021		1,340
2022		974

Note 13. Fair Value of Financial Instruments

As defined in ASC Topic 820, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC Topic 820 establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement).

The three levels of the fair value hierarchy defined by ASC Topic 820 and a description of the valuation methodologies used for instruments measured at fair value are as follows:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities as of the reporting date.

Level 2: Pricing inputs other than quoted prices included in Level 1 that are either directly observable or that can be derived or supported from observable data as of the reporting date.

Level 3: Pricing inputs include those that are significant to the fair value of the financial asset or financial liability and are generally less observable from objective sources. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value. The Corporation has no financial assets or financial liabilities with significant Level 3 inputs.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 13. Fair Value of Financial Instruments (Continued)

The following tables present the fair value of financial assets and financial liabilities that are measured at fair value on a recurring basis at September 30, 2017 and 2016:

	2017			
	Total	Level 1	Level 2	Level 3
Financial assets:				
Cash and cash equivalents	\$ 182,686	\$ 182,686	\$ -	\$ -
Investments:				
Domestic equity securities	206,922	206,922	-	-
International equity securities	223,504	223,504	-	-
U.S. Treasury and agency obligations	55,447	18,133	37,314	-
U.S. corporate bonds	68,070	-	68,070	-
Asset-backed securities	10,163	-	10,163	-
Municipal bonds	6,345	-	6,345	-
Government asset-backed securities	6,851	-	6,851	-
Total investments	577,302	448,559	128,743	-
Assets limited as to use:				
Cash and cash equivalents	12,769	12,769	-	-
Domestic equity securities	1,777	1,777	-	-
U.S. Treasury and agency obligations	12,033	5,753	6,280	-
U.S. corporate bonds	11,607	-	11,607	-
Asset-backed securities	8	-	8	-
Other	2,800	2,324	476	-
Total assets limited as to use	40,994	22,623	18,371	-
	800,982	\$ 653,868	\$ 147,114	\$ -
Investments measured at net asset value[1]:				
Real estate investment trust	30,843			
Total financial assets	\$ 831,825			
Financial liabilities:				
Interest rate swap agreements	\$ 3,286	\$ -	\$ 3,286	\$ -

¹ In accordance with Subtopic 820-10, as amended by ASU 2015-07, certain investments that were measured as net asset value per share (or its equivalent) have not been classified in the fair value hierarchy. The fair value amounts presented in this table are intended to permit reconciliation of the fair value hierarchy to the line items presented in the consolidated balance sheets.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 13. Fair Value of Financial Instruments (Continued)

	2016			
	Total	Level 1	Level 2	Level 3
Financial assets:				
Cash and cash equivalents	\$ 211,295	\$ 211,295	\$ -	\$ -
Investments:				
Domestic equity securities	217,231	217,231	-	-
International equity securities	136,580	136,580	-	-
U.S. Treasury and agency obligations	46,294	18,664	27,630	-
U.S. corporate bonds	52,168	-	52,168	-
Asset-backed securities	13,700	-	13,700	-
Municipal bonds	2,969	-	2,969	-
Government asset-backed securities	1,528	-	1,528	-
Other	187	187	-	-
Total investments	470,657	372,662	97,995	-
Assets limited as to use:				
Cash and cash equivalents	14,128	14,128	-	-
Domestic equity securities	1,570	1,570	-	-
U.S. Treasury and agency obligations	13,996	5,181	8,815	-
U.S. corporate bonds	9,311	9,311	-	-
Asset-backed securities	5	-	5	-
Other	2,240	1,751	489	-
Total assets limited as to use	41,250	31,941	9,309	-
	723,202	\$ 615,898	\$ 107,304	\$ -
Investments measured at net asset value[1]:				
Real estate investment trust	20,939			
Total financial assets	\$ 744,141			
Financial liabilities:				
Interest rate swap agreements	\$ 6,215	\$ -	\$ 6,215	\$ -

Interest rate swap liabilities are included in other noncurrent liabilities in the accompanying consolidated balance sheets.

The fair values of the securities included in Level 1 were determined through quoted market prices. The fair values of Level 2 financial assets and financial liabilities were determined as follows:

Interest rate swaps: The fair value of the interest rate swap agreements was determined through the use of widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative. The analysis reflects the contractual terms of the interest rate swaps, including the period to maturity, and uses observable market-based inputs, such as interest rate curves.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 13. Fair Value of Financial Instruments (Continued)

In addition, credit valuation adjustments are included to reflect both the Corporation's nonperformance risk and the respective counterparty's nonperformance risk. The Corporation pays a fixed rate ranging from 2.29% to 4.41% and receives cash flows based on 65% to 100% of one-month LIBOR, plus a fixed spread.

U.S. corporate bonds, U.S. Treasury and agency obligations, municipal bonds, asset-backed securities and government asset-backed securities: These securities were valued through the use of third-party pricing services and use evaluated bid prices adjusted for specific bond characteristics and market sentiment.

The value of the real estate investment trust is primarily determined using net asset values, which approximate fair value, as determined by an external fund manager based on quoted market prices, operating results, balance sheet stability, growth and other business and market sector fundamentals. The real estate investment trust does not have any unfunded commitments and has a redemption notice period of 90 days. The Corporation does not have any commitments to purchase additional shares of the real estate investment trust. The real estate investment trust adds additional diversification to the Corporation's portfolio while allowing for short-term redemption, as needed.

The carrying values of accounts receivable and accounts payable and accrued liabilities are reasonable estimates of their fair value due to the short-term nature of these financial instruments. The carrying value of the Corporation's variable rate obligations, consisting of term loans and certain other long-term debt, approximates fair value. The fair value of the Corporation's fixed-rate obligations is estimated using Level 2 inputs based on quoted market prices for the same or similar issues. The carrying value and fair value of long-term debt at September 30, 2017, are \$693,004 and \$709,726, respectively. The carrying value and fair value of long-term debt at September 30, 2016, are \$635,756 and \$688,403, respectively.

Note 14. Statutory Compliance

Health First Health Plans, Inc. and Health First Commercial Plans, Inc. (Health Plans)

In compliance with the Application for a Certificate of Authority and Section 624.4085 of the Florida Statutes HFHP must maintain a surplus over the amount produced by the risk-based capital requirements and formula. In addition, the Health Plans must maintain at all times a ratio of premium and risk revenue to capital and surplus not greater than ten to one. The Health Plans were in compliance with these requirements as of September 30, 2017.

The Health Plans are required by Section 641.225(1) of the Florida Statutes to maintain at all times a minimum surplus in an amount that is the greater of \$1,500, 10% of total liabilities, or 2% of total annualized premium revenue. The Health Plans were in compliance with this requirement.

The Health Plans are required by Section 641.35(9) of the Florida Statutes to maintain an amount equal to its required minimum surplus in coin or currency of the United States on hand or in the deposit in any solvent national or state bank, savings, and loan association, or trust company, or in eligible securities or obligations. The Health Plans were in compliance with this requirement.

The Health Plans are required by Title 690-191.076 of the Florida Administrative Code to ensure that income from operations before federal income taxes is no less than 2% of total revenues. For the years ended September 30, 2017 and 2016, the Health Plans were in compliance with this requirement.

Health First, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

Note 14. Statutory Compliance (Continued)

The Office of Insurance Regulation (OIR) limits distributions of earnings or equity transfers to no more than 10% of statutory surplus from accumulated earnings in any one year unless prior approval is received from the Office. In addition to this payment, and to the extent accumulated statutory surplus exceeds the required amount, the Health Plans may make distributions out of their entire preceding fiscal year's net operating profits. The Health Plans issued a \$2,000 dividend to the Corporation in 2017. There were no dividends distributed during 2016.

The State of Florida requires the Health Plans to maintain a deposit with the Department of Financial Services for uncovered claims relating to nonparticipating providers. The Health Plans comply with this requirement by maintaining the required deposit of \$4,126 and \$4,073 as of September 30, 2017 and 2016, respectively, with the Department, which is included in other assets in the accompanying consolidated balance sheets.

Note 15. Subsequent Events

The Corporation evaluated events and transactions occurring subsequent to September 30, 2017 through December 19, 2017, the date the accompanying consolidated financial statements were issued.

Health First, Inc. and Subsidiaries

Consolidating Balance Sheet

September 30, 2017

(Dollars in Thousands)

	Holmes Regional Medical Center, Inc.		Cape Canaveral Hospital, Inc.	Viera Hospital, Inc.	Other	Eliminations	Consolidated Total
	Holmes Regional Medical Center	Palm Bay Hospital					
Assets							
Current assets:							
Cash and cash equivalents	\$ 284,995	\$ 32,298	\$ 81,587	\$ 78,932	\$ (295,126)	\$ -	\$ 182,686
Investments	100,796	-	20,949	-	619,647	(133,247)	608,145
Current portion of assets limited as to use	-	-	-	-	11,149	-	11,149
Accounts receivable, net	70,780	11,522	13,162	10,955	25,381	(18,756)	113,044
Inventories	16,556	2,136	3,243	3,082	4,805	-	29,822
Prepaid expenses and other current assets	4,010	1,591	1,042	1,046	55,589	(2,212)	61,066
Total current assets	477,137	47,547	119,983	94,015	421,445	(154,215)	1,005,912
Assets limited as to use, less current portion	1,580	165	1,230	-	27,889	(1,019)	29,845
Property and equipment, net	188,905	70,640	55,202	103,746	315,403	-	733,896
Goodwill	4,344	-	-	-	25,399	-	29,743
Other assets	8,446	1	2,486	2	254,788	(224,348)	41,375
Total assets	\$ 680,412	\$ 118,353	\$ 178,901	\$ 197,763	\$ 1,044,924	\$ (379,582)	\$ 1,840,771

Health First, Inc. and Subsidiaries

Consolidating Balance Sheet (Continued)

September 30, 2017

(Dollars in Thousands)

	Holmes Regional Medical Center, Inc.						Consolidated Total
	Holmes Regional Medical Center	Palm Bay Hospital	Cape Canaveral Hospital, Inc.	Viera Hospital, Inc.	Other	Eliminations	
Liabilities and Net Assets							
Current liabilities:							
Accounts payable and accrued liabilities	\$ 108,179	\$ 18,810	\$ 24,291	\$ 12,665	\$ 93,255	\$ (20,968)	\$ 236,232
Current portion of long-term debt and capital lease obligation	6,613	2,670	2,346	1,247	10,848	-	23,724
Total current liabilities	114,792	21,480	26,637	13,912	104,103	(20,968)	259,956
Long-term debt and capital lease obligation, less current portion	149,775	55,199	50,487	90,745	416,189	(134,266)	628,129
Other noncurrent liabilities	4,003	594	1,986	552	36,687	(317)	43,505
Total liabilities	268,570	77,273	79,110	105,209	556,979	(155,551)	931,590
Net assets:							
Unrestricted:							
Controlling interest	410,555	40,915	99,034	92,554	485,357	(224,031)	904,384
	410,555	40,915	99,034	92,554	485,357	(224,031)	904,384
Temporarily restricted – controlling interest	1,287	165	757	-	2,588	-	4,797
Total net assets	411,842	41,080	99,791	92,554	487,945	(224,031)	909,181
Total liabilities and net assets	\$ 680,412	\$ 118,353	\$ 178,901	\$ 197,763	\$ 1,044,924	\$ (379,582)	\$ 1,840,771

Health First, Inc. and Subsidiaries

Consolidating Statement of Revenues and Expenses

Year Ended September 30, 2017

(Dollars in Thousands)

	Holmes Regional Medical Center, Inc.						Consolidated Total
	Holmes Regional Medical Center	Palm Bay Hospital	Cape Canaveral Hospital, Inc.	Viera Hospital, Inc.	Other	Eliminations	
Unrestricted revenues and other support:							
Patient service revenue	\$ 510,511	\$ 95,326	\$ 125,805	\$ 101,954	\$ 306,582	\$ (223,534)	\$ 916,644
Provision for bad debts	(2,806)	(1,746)	(1,349)	(1,940)	(10,015)	-	(17,856)
Net patient service revenue	507,705	93,580	124,456	100,014	296,567	(223,534)	898,788
Premium revenue	7,843	1,599	5,831	2,579	578,163	(17,809)	578,206
Income from joint ventures	1,194	-	(291)	-	394	-	1,297
Other revenue	24,002	7,880	2,517	648	264,708	(250,524)	49,231
Net assets released from restrictions for operations	23	-	76	-	480	-	579
Total unrestricted revenues and other support	540,767	103,059	132,589	103,241	1,140,312	(491,867)	1,528,101
Expenses:							
Salaries and benefits	213,321	51,243	69,971	38,523	391,261	(146,378)	617,941
Supplies and other	226,119	35,625	46,364	37,959	262,576	(118,506)	490,137
Medical service	-	-	-	-	485,270	(206,104)	279,166
Depreciation and amortization	24,577	7,281	8,627	9,226	32,366	(17,801)	64,276
Interest	6,769	2,139	2,223	4,293	11,268	(3,078)	23,614
Total operating expenses	470,786	96,288	127,185	90,001	1,182,741	(491,867)	1,475,134
Income (loss) from operations	\$ 69,981	\$ 6,771	\$ 5,404	\$ 13,240	\$ (42,429)	\$ -	\$ 52,967

(continued)

Health First, Inc. and Subsidiaries

Consolidating Statement of Revenues and Expenses (Continued)

Year Ended September 30, 2017

(Dollars in Thousands)

	Holmes Regional Medical Center, Inc.						Consolidated Total
	Holmes Regional Medical Center	Palm Bay Hospital	Cape Canaveral Hospital, Inc.	Viera Hospital, Inc.	Other	Eliminations	
Nonoperating gains (losses):							
Investment income (losses)	\$ 420	\$ -	\$ 87	\$ (1)	\$ 19,567	\$ -	\$ 20,073
Change in value of interest rate swaps	(213)	(501)	(107)	-	2,567	-	1,746
Other	(784)	-	-	-	-	-	(784)
Total nonoperating (losses) gains	(577)	(501)	(20)	(1)	22,134	-	21,035
Excess (deficiency) of revenues, other support and gains over expenses and losses	69,404	6,270	5,384	13,239	(20,295)	-	74,002
Less: excess of revenues, other support and gains over expenses and losses attributable to noncontrolling interests	7	-	-	-	73	-	80
Excess (deficiency) of revenues, other support and gains over expenses and losses attributable to controlling interests	\$ 69,397	\$ 6,270	\$ 5,384	\$ 13,239	\$ (20,368)	\$ -	\$ 73,922