

# **Health First, Inc. and Subsidiaries**

Consolidated Financial Report  
September 30, 2018

## Contents

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Independent auditor's report	1-2
<hr/>	
Financial statements	
Consolidated balance sheets	3
Consolidated statements of operations and changes in net assets	4-5
Consolidated statements of cash flows	6
Notes to consolidated financial statements	7-29
Supplementary information	
Consolidating balance sheet	30-31
Consolidating statement of operations	32-33

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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, 2018 and 2017, 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 from material misstatement.

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

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

### Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Health First, Inc. and Subsidiaries as of September 30, 2018 and 2017, 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*

Miami, Florida  
December 19, 2018

**Health First, Inc. and Subsidiaries**

**Consolidated Balance Sheets  
September 30, 2018 and 2017  
(Dollars in Thousands)**

	2018	2017
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 196,966	\$ 182,686
Investments	676,499	608,145
Current portion of assets limited as to use	11,413	11,149
Accounts receivable, less allowances for uncollectible accounts of \$51,246 in 2018 and \$54,234 in 2017	111,806	113,044
Inventories	30,595	29,822
Prepaid expenses and other current assets	63,188	61,066
<b>Total current assets</b>	<b>1,090,467</b>	<b>1,005,912</b>
Assets limited as to use, less current portion	30,659	29,845
Property and equipment, net	723,405	733,896
Goodwill	29,743	29,743
Other assets	46,047	41,375
<b>Total assets</b>	<b>\$ 1,920,321</b>	<b>\$ 1,840,771</b>
<b>Liabilities and Net Assets</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 224,026	\$ 236,232
Current portion of long-term debt and capital lease obligation	28,033	23,724
<b>Total current liabilities</b>	<b>252,059</b>	<b>259,956</b>
Long-term debt and capital lease obligation, less current portion	600,788	628,129
Other noncurrent liabilities	49,818	43,505
<b>Total liabilities</b>	<b>902,665</b>	<b>931,590</b>
Commitments and contingencies		
Net assets:		
Unrestricted	1,012,588	904,384
Temporarily restricted	5,068	4,797
<b>Total net assets</b>	<b>1,017,656</b>	<b>909,181</b>
<b>Total liabilities and net assets</b>	<b>\$ 1,920,321</b>	<b>\$ 1,840,771</b>

See notes to consolidated financial statements.

**Health First, Inc. and Subsidiaries**

**Consolidated Statements of Operations and Changes in Net Assets  
Years Ended September 30, 2018 and 2017  
(Dollars in Thousands)**

	2018	2017
Unrestricted revenues and other support:		
Patient service revenue	\$ 982,268	\$ 916,644
Provision for bad debts	(15,037)	(17,856)
Net patient service revenue	<u>967,231</u>	898,788
Premium revenue	644,762	578,206
Income from joint ventures	2,041	1,297
Other revenue	43,235	49,231
Net assets released from restrictions for operations	818	579
<b>Total unrestricted revenues and other support</b>	<b><u>1,658,087</u></b>	<b>1,528,101</b>
Expenses:		
Salaries and benefits	654,402	617,941
Supplies and other	534,305	490,137
Medical service	323,193	279,166
Depreciation and amortization	67,273	64,276
Interest	24,312	23,614
<b>Total operating expenses</b>	<b><u>1,603,485</u></b>	<b>1,475,134</b>
<b>Income from operations</b>	<b><u>54,602</u></b>	<b>52,967</b>
Nonoperating gains (losses):		
Investment income	18,883	20,073
Change in value of interest rate swaps	1,425	1,746
Other	(634)	(784)
<b>Total nonoperating gains</b>	<b><u>19,674</u></b>	<b>21,035</b>
Excess of revenues, other support and gains over expenses and losses	<b>74,276</b>	74,002
Less: excess of revenues, other support and gains over expenses and losses attributable to noncontrolling interests	<u>-</u>	<u>(80)</u>
<b>Excess of revenues, other support and gains over expenses and losses attributable to controlling interests</b>	<b><u>74,276</u></b>	<b>73,922</b>

(Continued)

**Health First, Inc. and Subsidiaries**

**Consolidated Statements of Operations and Changes in Net Assets (Continued)**  
**Years Ended September 30, 2018 and 2017**  
**(Dollars in Thousands)**

	2018	2017
Unrestricted net assets:		
Excess of revenues, other support and gains over expenses and losses attributable to controlling interests	\$ 74,276	\$ 73,922
Excess of revenues, other support and gains over expenses and losses attributable to noncontrolling interests	-	80
Net unrealized gains on other-than-trading securities	33,853	40,635
Net assets released from restrictions for purchase of property	93	1,889
Other changes in unrestricted net assets	(18)	(2,202)
<b>Increase in unrestricted net assets</b>	<b>108,204</b>	<b>114,324</b>
Temporarily restricted net assets:		
Contributions	1,113	1,212
Investment income	69	82
Net assets released from restrictions	(911)	(2,468)
<b>Increase (decrease) in temporarily restricted net assets</b>	<b>271</b>	<b>(1,174)</b>
<b>Increase in net assets</b>	<b>108,475</b>	<b>113,150</b>
Net assets:		
Beginning of year	909,181	796,031
End of year	\$ 1,017,656	\$ 909,181

See notes to consolidated financial statements.

**Health First, Inc. and Subsidiaries**

**Consolidated Statements of Cash Flows**  
**Years Ended September 30, 2018 and 2017**  
**(Dollars in Thousands)**

	2018	2017
Cash flows from operating activities:		
Increase in net assets	\$ 108,475	\$ 113,150
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Net unrealized gains on trading and other-than-trading securities	(29,630)	(40,083)
Realized gains on sales of securities	(1,286)	(5,245)
Loss on disposal of property and equipment	183	507
Change in value of interest rate swaps	(1,425)	1,746
Restricted contributions and investment income	(1,182)	(1,294)
Income from joint ventures	(2,041)	(1,297)
Distributions from joint ventures	1,621	1,095
Depreciation and amortization	67,273	64,276
Provision for bad debts	15,037	17,856
Other	(1,325)	(1,383)
Changes in operating assets and liabilities:		
Accounts receivable	(10,952)	(16,802)
Inventories	(773)	(3,819)
Other operating assets	(6,374)	(11,646)
Accounts payable and accrued liabilities	(19,556)	(31,729)
Other noncurrent liabilities	7,738	(715)
<b>Net cash provided by operating activities</b>	<b>125,783</b>	<b>84,617</b>
Cash flows from investing activities:		
Proceeds from the sale of non-trading securities	4,000	34,000
Purchases of non-trading securities	(17,645)	(64,359)
Proceeds from the sale of securities – trading	103,375	139,786
Purchases of securities – trading	(127,085)	(180,914)
(Increase) decrease in assets limited as to use	(1,161)	522
Purchases of property and equipment	(49,615)	(60,963)
<b>Net cash used in investing activities</b>	<b>(88,131)</b>	<b>(131,928)</b>
Cash flows from financing activities:		
Proceeds from CMS contract deposits	25,690	28,006
Withdrawals from CMS contract deposits	(28,537)	(32,475)
Proceeds from issuance of long-term debt	-	53,000
Repayments of long-term debt and capital lease obligation	(21,707)	(31,123)
Restricted contributions and investment income	1,182	1,294
<b>Net cash (used in) provided by financing activities</b>	<b>(23,372)</b>	<b>18,702</b>
<b>Increase (decrease) in cash and cash equivalents</b>	<b>14,280</b>	<b>(28,609)</b>
Cash and cash equivalents:		
Beginning of year	182,686	211,295
End of year	\$ 196,966	\$ 182,686
Supplemental schedule of noncash investing and financing activities:		
Equipment acquired through the incurrence of a capital lease obligation	\$ 1,026	\$ -

See notes to consolidated financial statements.

## Health First, Inc. and Subsidiaries

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

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#### 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., Health First Administrative Plans, Inc., and Health First Commercial Plans, Inc., all tax-exempt entities, collectively doing business as Health First Health Plans (HFHP). HFHP provides various health insurance services to employees of the Parent, other employers, and Medicare Advantage plans.
- 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.

The Parent is the sole member or owner of each of the above entities except for CHP and DGP 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.

## Health First, Inc. and Subsidiaries

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

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#### 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 and debt securities are considered trading.

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 other than trading 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 equity securities at September 30, 2018 and 2017.

**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.

## Health First, Inc. and Subsidiaries

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

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#### Note 2. Significant Accounting Policies (Continued)

**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, 2018 and 2017, 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.

**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 contract awarded by the Department of Health and Human Services, Centers for Medicare and Medicaid Services (CMS) 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, 2018 and 2017, the collaborative arrangement with Adventist resulted in deficiencies of \$7,273 and \$9,017, respectively. Due to the collaborative arrangement, \$5,940 and \$9,157 at September 30, 2018 and 2017, respectively is included in prepaid expenses and other current assets in the consolidated balance sheets.

**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.

## Health First, Inc. and Subsidiaries

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

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#### Note 2. Significant Accounting Policies (Continued)

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.

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 88% and 91% of self-pay accounts receivable as of September 30, 2018 and 2017, respectively. 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 statement of operations and changes in net assets. In accordance with the financial assistance requirements of Internal Revenue Code Section 501R, the Corporation provides a 75% discount to self-pay patient accounts, which is a direct reduction of net patient service revenue.

## Health First, Inc. and Subsidiaries

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

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#### Note 2. Significant Accounting Policies (Continued)

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:

	2018	2017
Gross patient revenue	\$ 4,274,312	\$ 3,902,886
Allowances and discounts	(3,292,044)	(2,986,242)
Total	<u>\$ 982,268</u>	<u>\$ 916,644</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, 2018 and 2017, include 31% and 30% from the Medicare program and 58% and 57% from contracts with other third parties, respectively.

Revenue from the Medicare program represented approximately 43% and 44% of net patient service revenue for the years ended September 30, 2018 and 2017, respectively.

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

	2018	2017
Prepaid expenses and other current assets	\$ 3,361	\$ 3,814
Accounts payable and accrued liabilities	14,538	7,513

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 \$3,964 and \$2,108 for the years ended September 30, 2018 and 2017, 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, 2018 and 2017. The cost of providing charity care was \$61,447 and \$48,038 for the years ended September 30, 2018 and 2017, respectively.

## Health First, Inc. and Subsidiaries

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

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#### Note 2. Significant Accounting Policies (Continued)

**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 61% and 64% of total premium revenue was received under the Medicare program, and 39% and 36% was received from contracts with other employer groups during the years ended September 30, 2018 and 2017, respectively.

The Medicare program, administered by CMS, uses risk-adjusted rates per member to determine the monthly payments to HFHP. 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 revises premium rates prospectively. CMS also calculates the retroactive adjustments to premiums related to the revised risk scores. Risk adjustment payments due to or from CMS are estimated throughout the year and are recognized as adjustments to premium revenue.

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. HFHP had a payable for estimated Part D risk corridor payments of \$872 and \$2,680 at September 30, 2018 and 2017, respectively.

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.

As of September 30, 2018 and 2017, HFHP and HFII had estimated receivables of \$8,303 and \$2,141, respectively, related to the Affordable Care Act risk adjustment program. The risk adjustment program transfers premiums from insurers that enroll members with relatively lower health risks to insurers that enroll members with relatively higher health risks and therefore are recorded as premium revenue in operations.

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

	2018	2017
Health care services	\$ 1,322,144	\$ 1,205,001
General and administrative	257,029	246,519
Interest expense	24,312	23,614
	<u>\$ 1,603,485</u>	<u>\$ 1,475,134</u>

## Health First, Inc. and Subsidiaries

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

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#### Note 2. Significant Accounting Policies (Continued)

**Advertising:** The Corporation incurs advertising and marketing expense in the normal course of business. These expenses are expensed when incurred. For the years ended September 30, 2018 and 2017, advertising expense was \$10,465 and \$7,214, respectively, and is included in other operating expenses in the accompanying consolidated statements of operations and changes in net assets.

**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.

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:

	2018	2017
Unpaid claim liabilities, at beginning of year	\$ 53,383	\$ 34,109
Incurred losses:		
Current period	459,212	402,516
Prior periods	(9,745)	(1,726)
Payments for claims, net of reinsurance:		
Current period	(404,282)	(349,418)
Prior periods	(42,982)	(32,098)
Unpaid claim liabilities, at end of year	<u>\$ 55,586</u>	<u>\$ 53,383</u>

Incurred losses decreased in 2018 and 2017 by \$9,745 and \$1,726, respectively, due to lower than expected claims experience related to the individual and commercial lines of business.

The lower than expected claims experience was driven by external factors, such as Hurricane Irma, that affected the Corporation's service area during September 2017, and expectation regarding development. Medical services after the hurricane resumed at a slower pace in the area, which resulted in lower claims activity.

## Health First, Inc. and Subsidiaries

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

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#### Note 2. Significant Accounting Policies (Continued)

Medical costs payable included incurred but not recorded (IBNR) of \$38,520 and \$43,877 at September 30, 2018 and 2017, respectively. Substantially all of the IBNR balance as of September 30, 2018 relates to the current year. The following is information about incurred and paid medical cost development as of September 30, 2018:

Year	Net Incurred Medical Costs Years Ended September 30,	
	2017	2018
2017	\$ 402,516	\$ 392,771
2018		459,212
Total		<u>\$ 851,983</u>

  

Year	Net Incurred Medical Payments Years Ended September 30,	
	2017	2018
2017	\$ (349,418)	\$ (392,115)
2018		(404,282)
Total		<u>\$ (796,397)</u>
Net remaining outstanding liabilities prior to 2017		-
Total medical costs payable		<u>\$ 55,586</u>

**Medical service expense:** HFHP and HFII contract 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, 2018 or 2017.

**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.

## Health First, Inc. and Subsidiaries

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

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#### Note 2. Significant Accounting Policies (Continued)

**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.

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, 2015 through 2017 are still subject to federal and state income tax examination.

At September 30, 2018 and 2017, HFHC had net deferred tax assets of \$62,903 and \$98,763, respectively, tax effected at a rate of 23.63% and 37.63%, respectively. At September 30, 2018 and 2017, HFHC had \$254,312 and \$258,415, respectively, of net operating loss carryforwards including Separate Return Limitation Year (SRLY) losses of \$17,594 and \$16,654, respectively. These net operating losses will expire between 2019 and 2037. A valuation allowance has been provided to offset the full amount of the deferred tax assets as of September 30, 2018 and 2017, 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 on a tax return.

On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the TCJA). The TCJA makes broad and complex changes to the U.S. tax code, including a reduction to the U.S. federal corporate tax rate from 35% to 21%. GAAP requires companies to recognize the effect of tax law changes in the period of enactment. As of September 30th, 2018, the Corporation has not yet completed its accounting for all tax effects related to the enactment of the TCJA. The Corporation will continue to refine these calculations prior to the filing of the September 30, 2018 federal 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.

**Recent accounting pronouncements:** In June 2018, the FASB issued Accounting Standards Update (ASU) 2018-08 *Not-for-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*. The amendments in ASU 2018-08 provide clarification and improve upon the scope and accounting guidance around contributions of cash and other assets received and made by not-for-profit organizations and business enterprises. The amendments of ASU 2018-08, related to contributions received, are effective for annual reporting periods beginning after June 15, 2018, including interim periods within the annual reporting period. Management is currently evaluating the effects of ASU 2018-08 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 in ASU 2016-18 are effective for the annual reporting periods beginning after December 15, 2017, including interim periods within annual reporting period. The adoption of ASU 2016-18 is not expected to be material to the Corporation's consolidated financial statements.

## Health First, Inc. and Subsidiaries

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

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#### 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 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 in ASU 2016-14 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 2016-14 on the Corporation's consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases*. ASU 2016-12 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. In July 2018, the FASB issued ASU 2018-10, *Codification Improvements to Topic 842, Leases*, and ASU 2018-11, *Leases (Topic 842): Targeted Improvements*. ASU 2018-10 affects specific aspects of the amendments issued in ASU 2016-02. ASU 2018-11 intends to reduce costs and ease implementation of the leases standard for financial statement preparers. The amendments of ASU 2016-02, ASU 2018-10, and ASU 2018-11 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Management is currently evaluating the effects of these ASU's on the Corporation's consolidated financial statements.

## Health First, Inc. and Subsidiaries

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

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#### Note 2. Significant Accounting Policies (Continued)

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. In February 2018, the FASB issued ASU 2018-03, *Technical Corrections and Improvements to Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*, that clarifies the guidance in ASU 2016-01, *Financial Instruments – Overall*. The amendments in ASU 2016-01 and ASU 2018-03 are effective for fiscal years beginning after December 15, 2018. Management has evaluated the effects of ASU 2016-01 on the Corporation's consolidated financial statements and it expects there to be a classification impact as the changes in fair value of the Corporation's equity investments will be presented in the Corporation's excess of revenues, other support and gains over expenses and losses.

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 in 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 has evaluated the effects of ASU 2015-14 and ASU 2014-09 on the Corporation's consolidated financial statements. Upon adoption using the modified approach, the majority of what is currently classified as provision for bad debts and presented as a reduction to patient service revenue on the consolidated statements of operations and changes in net assets is treated as a price concession that reduces the transaction price, which is reported as net patient service revenue. The new standard also requires enhanced disclosures related to the disaggregation of revenue and significant judgments made in measurement and recognition. The impact of adopting ASU 2014-09 is not material to total unrestricted revenues, excess of revenues over expenses or unrestricted net assets

**Reclassifications:** Certain reclassifications were made to the 2017 consolidated financial statements to conform to the classifications used in 2018. These reclassifications had no impact on the consolidated excess of revenue, other support and gains over expenses and losses, changes in net assets or cash flows previously reported.

## Health First, Inc. and Subsidiaries

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

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#### Note 3. Investments

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

	2018	2017
Cash and cash equivalents	\$ 12,778	\$ 12,769
Equity securities	311,130	227,100
U.S. Treasury and agency obligations	119,799	101,175
U.S. corporate bonds	113,684	119,061
International equity securities	83,420	119,813
Real estate investment trust	37,572	30,843
Asset-backed securities	9,687	10,171
Municipal bonds	6,263	6,345
Government asset-backed securities	7,682	6,851
International bonds	12,870	12,211
Other	3,686	2,800
	<u>\$ 718,571</u>	<u>\$ 649,139</u>

Unrestricted investment income comprises the following:

	For the Years Ended September 30	
	2018	2017
Interest income	\$ 21,820	\$ 15,380
Realized gain on sales of securities	1,286	5,245
Unrealized loss on trading securities	(4,223)	(552)
	<u>\$ 18,883</u>	<u>\$ 20,073</u>

#### Note 4. Assets Limited as to Use

Assets limited as to use are composed of the following:

	2018	2017
Board designated for malpractice and other obligations	\$ 25,701	\$ 25,662
Cash and investments held by trustee under bond indenture agreements – debt service and project funds	7,418	7,539
Board designated for the HFF	5,068	4,797
Other	3,885	2,996
	<u>42,072</u>	<u>40,994</u>
Less amounts required to meet current obligations	11,413	11,149
	<u>\$ 30,659</u>	<u>\$ 29,845</u>

## Health First, Inc. and Subsidiaries

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

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#### Note 5. Other Assets

The composition of other assets is as follows:

	2018	2017
Collateral assignment split-dollar agreement	\$ 18,190	\$ 16,744
Investment in joint ventures	13,282	12,862
Other	14,575	11,769
	<u>\$ 46,047</u>	<u>\$ 41,375</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, 2018 and 2017, the Corporation reported \$532 and \$518 in earnings, respectively, which is included in investment income in 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, 2018 and 2017 was \$2,041 and \$1,297, respectively.

HealthSouth of Sea Pines Limited Partnership (HSSP), doing business as Encompass Health Corporation (EHC) 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, 2018 and 2017, assuming 100% ownership interest, is as follows:

	2018	2017
Balance sheets		
Current assets	\$ 8,138	\$ 7,259
Noncurrent assets	14,908	15,691
Total assets	<u>\$ 23,046</u>	<u>\$ 22,950</u>
Current liabilities	\$ 3,951	\$ 3,560
Partners' capital	19,095	19,390
Total liabilities and partners' capital	<u>\$ 23,046</u>	<u>\$ 22,950</u>
Statements of operations		
Net operating revenues	\$ 28,767	\$ 28,864
Operating expenses	24,378	24,860
Net income	<u>\$ 4,389</u>	<u>\$ 4,004</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:

	2018	2017	Useful Lives (Years)
Land and improvements	\$ 93,014	\$ 92,924	5-25
Buildings and improvements	882,985	867,019	2-40
Fixed equipment and major movable equipment	733,955	699,994	2-25
	<u>1,709,954</u>	<u>1,659,937</u>	
Less allowances for depreciation and amortization	1,001,144	938,899	
	<u>708,810</u>	<u>721,038</u>	
Construction-in-progress	14,595	12,858	
	<u>\$ 723,405</u>	<u>\$ 733,896</u>	

Construction-in-progress at September 30, 2018, represents costs incurred to date related to construction and renovation projects expected to be completed over the next five years. At September 30, 2018, the estimated cost to complete construction and renovation projects in progress is approximately \$49,522, 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, 2018 or 2017.

The future minimum lease payments at September 30, 2018, 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:

	2018	2017
Land and improvements	\$ 2,655	\$ 2,647
Buildings and improvements	107,802	104,063
Fixed equipment and major movable equipment	85,823	84,362
	<u>196,280</u>	<u>191,072</u>
Less allowance for amortization	144,635	138,703
	<u>51,645</u>	<u>52,369</u>
Construction-in-progress	1,272	2,645
	<u>\$ 52,917</u>	<u>\$ 55,014</u>

## Health First, Inc. and Subsidiaries

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

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#### Note 7. Long-Term Debt and Capital Lease Obligation

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

	2018	2017
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.	\$ 125,047	\$ 128,997
Term loan with a financial institution, secured by revenues of the borrowers, interest payable monthly at a variable rate (3.44% at September 30, 2018), due February 2023.	31,243	32,337
Term loan with a financial institution, secured by revenues of the borrowers, interest payable monthly at a variable rate (3.44% at September 30, 2018), due November 2020.	2,793	4,082
Term loan with a financial institution, secured by revenues of the borrowers, interest payable monthly at a variable rate (3.41% at September 30, 2018), due November 2020.	3,965	5,795
Term loan with a financial institution, secured by certain assets of the Corporation, interest payable monthly at a variable rate (3.31% at September 30, 2018), due September 2030.	18,920	20,000
Term loan with a financial institution, secured by certain assets of the Corporation, interest payable monthly at a variable rate (3.38% at September 30, 2018), due November 2026.	53,000	53,000
Health Facilities Revenue Refunding Bonds, Series 2014, interest payable semiannually at fixed rates between 3.00% and 5.00%, including a net premium of \$18,336 and \$19,437, due April 2039.	269,711	274,506
Health Facilities Revenue Bonds, Series 2013A, interest payable semiannually at fixed rates between 3.00% and 5.00%, including a net premium of \$5,076 and \$5,686, due April 2031.	64,781	66,531
Health Facilities Revenue Bonds, Series 2012A, interest payable monthly at a fixed rate of 2.29%, due December 2021.	10,598	13,534
Health First Facilities Revenue Bonds, Series 2009A, interest payable monthly at a fixed rate of 3.79%, due July 2029.	42,875	46,375
Other	9,605	10,799
Issue costs, net	(3,717)	(4,103)
Total long-term debt and capital lease obligation	628,821	651,853
Less current maturities	(28,033)	(23,724)
	<u>\$ 600,788</u>	<u>\$ 628,129</u>

## Health First, Inc. and Subsidiaries

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

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#### Note 7. Long-Term Debt and Capital Lease Obligation (Continued)

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

Years ending September 30:		
2019	\$	26,426
2020		21,947
2021		20,087
2022		23,094
2023		48,663
Thereafter		463,428

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:		
2019	\$	1,893
2020		1,900
2021		682
2022		575
2023		1,302
		<hr/>
		6,352
Less amount representing interest		871
		<hr/>
Present value of net minimum lease payments		5,481
Current portion		1,606
		<hr/>
Long-term capital lease obligation	\$	<u>3,875</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, 2018 and 2017. 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 \$251,905 at September 30, 2018. 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, 2018, total debt outstanding related to the Master Trust Indenture is approximately \$474,474.

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, 2018 and 2017.

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)

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#### Note 8. Employee Benefit Plans

**Retirement plan:** The Corporation, excluding HFMG, has a defined contribution plan covering substantially all employees. For 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 was 3.2%. Eligible employees are allowed to contribute up to 75% 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 \$6,392 and \$5,893 for the years ended September 30, 2018 and 2017, 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 \$20,629 and \$19,316 for the years ended September 30, 2018 and 2017, respectively, and is included in salaries and benefits within the consolidated statements of operations and changes in net assets.

#### Note 9. 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 are insured by claims-made coverage that was placed with a domestic insurance company, in which for the ten months ended July 31 the Self-Insured Retention was \$5,000 and \$15,000 per incidence and in aggregate, respectively. The Self-Insured Retention decreased, as of August 1, 2018 to \$3,000 and \$15,000 per incidence and in aggregate, respectively.

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

	2018	2017
Accounts payable and accrued liabilities	\$ 3,795	\$ 3,410
Other noncurrent liabilities	19,840	20,174
Total liability	<u>\$ 23,635</u>	<u>\$ 23,584</u>

Management, with the assistance of consulting actuaries, estimates claims liabilities at the present value of future claims payments using a discount rate of 3.39% and 3.74% at September 30, 2018 and 2017, respectively. Medical malpractice expense of \$5,372 and \$6,970 for the years ended September 30, 2018 and 2017, respectively, is included in supplies and other in the accompanying consolidated statements of operations and changes in net assets.

## Health First, Inc. and Subsidiaries

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

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#### Note 10. 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.

The Florida Agency for Health Care Administration (AHCA) is engaged in state-wide audits of Hospital Medicaid Cost Reports for SFY11-15. While these audits are on-going and subject to challenge including potential litigation, the Corporation has estimated a potential exposure of up to \$8 million for the year ended September 30, 2018. The estimate is included in accounts payable and accrued liabilities in the consolidated balance sheets.

**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, 2018 and 2017, of \$1,831 and \$1,932, respectively, and is due December 2020.

**Operating leases:** The Corporation leases certain property and equipment under operating leases. Lease and rental expense was approximately \$9,939 and \$11,310 for the years ended September 30, 2018 and 2017, respectively.

## Health First, Inc. and Subsidiaries

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

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#### Note 10. Commitments and Contingencies (Continued)

Net future minimum lease payments under non-cancelable operating leases as of September 30, 2018, are as follows:

Years ending September 30:		
2019	\$	6,586
2020		2,955
2021		1,998
2022		1,676
2023		1,570

#### Note 11. 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 11. 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, 2018 and 2017:

	2018			
	Total	Level 1	Level 2	Level 3
Financial assets:				
Cash and cash equivalents	\$ 196,966	\$ 196,966	\$ -	\$ -
Investments:				
Domestic equity securities	309,226	309,226	-	-
US Treasury and agency obligations	108,071	69,094	38,977	-
US corporate bonds	101,708	39,603	62,105	-
International equity securities	83,420	83,420	-	-
International bonds	12,870	11,959	911	-
Asset-backed securities	9,687	-	9,687	-
Municipal bonds	6,263	-	6,263	-
Government asset-backed securities	7,682	-	7,682	-
Other	-	-	-	-
Total investments	638,927	513,302	125,625	-
Assets limited as to use:				
Cash and cash equivalents	12,778	12,778	-	-
Domestic equity securities	1,904	1,904	-	-
U.S. Treasury and agency obligations	11,728	7,566	4,162	-
U.S. corporate bonds	11,976	-	11,976	-
Asset-backed securities	-	-	-	-
Other	3,686	3,055	631	-
Total assets limited as to use	42,072	25,303	16,769	-
	877,965	\$ 735,571	\$ 142,394	\$ -
Investments measured at net asset value [1]:				
Real estate investment trust	37,572			
Total financial assets	\$ 915,537			
Financial liabilities:				
Interest rate swap agreements	\$ 1,247	\$ -	\$ 1,247	\$ -

<sup>1</sup> In accordance with Subtopic 820-10, as amended by ASU 2015-07, certain investments that are 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 11. Fair Value of Financial Instruments (Continued)**

	2017			
	Total	Level 1	Level 2	Level 3
Financial assets:				
Cash and cash equivalents	\$ 182,686	\$ 182,686	\$ -	\$ -
Investments:				
Domestic equity securities	225,323	225,323	-	-
U.S. Treasury and agency obligations	89,142	51,828	37,314	-
U.S. corporate bonds	107,454	39,384	68,070	-
International equity securities	119,813	119,813	-	-
International bonds	12,211	12,211	-	-
Asset-backed securities	10,163	-	10,163	-
Municipal bonds	6,345	-	6,345	-
Government asset-backed securities	6,851	-	6,851	-
Other	-	-	-	-
Total investments	<u>577,302</u>	<u>448,559</u>	<u>128,743</u>	<u>-</u>
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	<u>40,994</u>	<u>22,623</u>	<u>18,371</u>	<u>-</u>
	<u>800,982</u>	<u>\$ 653,868</u>	<u>\$ 147,114</u>	<u>\$ -</u>
Investments measured at net asset value [1]:				
Real estate investment trust	<u>30,843</u>			
Total financial assets	<u>\$ 831,825</u>			
Financial liabilities:				
Interest rate swap agreements	<u>\$ 3,286</u>	<u>\$ -</u>	<u>\$ 3,286</u>	<u>\$ -</u>

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)

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#### Note 11. 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 the 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 of 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, 2018, are \$632,538 and \$661,031, respectively. The carrying value and fair value of long-term debt at September 30, 2017, were \$655,956 and \$693,004, respectively.

#### Note 12. 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, the Health Plans 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, 2018 and 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 as of September 30, 2018 and 2017.

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 as of September 30, 2018 and 2017.

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 periods ended September 30, 2018 and September 30, 2017, the Health Plans were in compliance with this requirement.

## Health First, Inc. and Subsidiaries

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

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#### **Note 12 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 OIR. 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. On December 15, 2017, a property dividend was issued to the Corporation with an approximate value of \$8,089. These dividends are eliminated in consolidation.

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 \$4,492 and \$4,126 as of September 30, 2018 and September 30, 2017, respectively, with the Department, which is included in other assets in the accompanying consolidated balance sheets.

#### **Note 13. Subsequent Events**

The Corporation has signed a letter of intent to formally explore a business agreement that would permit Adventist to purchase a minority share of the Corporation.

The Corporation evaluated events and transactions occurring subsequent to September 30, 2018 through December 19, 2018, the date the accompanying consolidated financial statements were issued.

**Health First, Inc. and Subsidiaries**

**Consolidating Balance Sheet  
September 30, 2018  
(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	
<b>Assets</b>							
Current assets:							
Cash and cash equivalents	\$ 322,923	\$ 33,641	\$ 88,355	\$ 90,583	\$ (338,536)	\$ -	\$ 196,966
Investments	101,765	-	21,151	-	688,151	(134,568)	676,499
Current portion of assets limited as to use	-	-	-	-	11,413	-	11,413
Accounts receivable, net	66,768	11,639	14,560	11,477	24,344	(16,982)	111,806
Inventories	16,183	2,191	3,508	3,618	5,095	-	30,595
Prepaid expenses and other current assets	5,705	963	1,035	911	60,744	(6,170)	63,188
<b>Total current assets</b>	<b>513,344</b>	<b>48,434</b>	<b>128,609</b>	<b>106,589</b>	<b>451,211</b>	<b>(157,720)</b>	<b>1,090,467</b>
Assets limited as to use, less current portion	1,607	54	1,220	-	28,807	(1,029)	30,659
Property and equipment, net	190,485	66,200	52,916	99,327	314,477	-	723,405
Goodwill	4,343	-	-	-	25,400	-	29,743
Other assets	8,442	-	2,822	2	250,989	(216,208)	46,047
<b>Total assets</b>	<b>\$ 718,221</b>	<b>\$ 114,688</b>	<b>\$ 185,567</b>	<b>\$ 205,918</b>	<b>\$ 1,070,884</b>	<b>\$ (374,957)</b>	<b>\$ 1,920,321</b>

(Continued)

**Health First, Inc. and Subsidiaries**

**Consolidating Balance Sheet (Continued)**

**September 30, 2018**

**(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	
<b>Liabilities and Net Assets</b>							
Current liabilities:							
Accounts payable and accrued liabilities	\$ 118,241	\$ 15,726	\$ 26,678	\$ 18,746	\$ 67,787	\$ (23,152)	\$ 224,026
Current portion of long-term debt and capital lease obligation	10,595	2,693	2,495	1,314	10,936	-	28,033
<b>Total current liabilities</b>	<b>128,836</b>	<b>18,419</b>	<b>29,173</b>	<b>20,060</b>	<b>78,723</b>	<b>(23,152)</b>	<b>252,059</b>
Long-term debt and capital lease obligation, less current portion	138,838	53,030	47,787	89,089	407,641	(135,597)	600,788
Other noncurrent liabilities	7,403	1,133	2,344	654	38,550	(266)	49,818
<b>Total liabilities</b>	<b>275,077</b>	<b>72,582</b>	<b>79,304</b>	<b>109,803</b>	<b>524,914</b>	<b>(159,015)</b>	<b>902,665</b>
Net assets:							
Unrestricted	441,832	42,053	105,523	96,115	543,007	(215,942)	1,012,588
Temporarily restricted	1,312	53	740	-	2,963	-	5,068
<b>Total net assets</b>	<b>443,144</b>	<b>42,106</b>	<b>106,263</b>	<b>96,115</b>	<b>545,970</b>	<b>(215,942)</b>	<b>1,017,656</b>
<b>Total liabilities and net assets</b>	<b>\$ 718,221</b>	<b>\$ 114,688</b>	<b>\$ 185,567</b>	<b>\$ 205,918</b>	<b>\$ 1,070,884</b>	<b>\$ (374,957)</b>	<b>\$ 1,920,321</b>

**Health First, Inc. and Subsidiaries**

**Consolidating Statement of Operations  
Year Ended September 30, 2018  
(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	\$ 526,001	\$ 108,129	\$ 139,414	\$ 110,313	\$ 322,338	\$ (223,927)	\$ 982,268
Provision for bad debts	(4,877)	(2,054)	(1,479)	(1,485)	(5,142)	-	(15,037)
Net patient service revenue	521,124	106,075	137,935	108,828	317,196	(223,927)	967,231
Premium revenue	7,299	1,555	5,804	3,141	644,709	(17,746)	644,762
Income from joint ventures	1,452	-	337	-	252	-	2,041
Other revenue	28,824	2,497	3,999	912	264,680	(257,677)	43,235
Net assets released from restrictions for operations	13	111	20	-	674	-	818
<b>Total unrestricted revenues and other support</b>	<b>558,712</b>	<b>110,238</b>	<b>148,095</b>	<b>112,881</b>	<b>1,227,511</b>	<b>(499,350)</b>	<b>1,658,087</b>
Expenses:							
Salaries and benefits	216,815	53,635	74,367	40,867	416,108	(147,390)	654,402
Supplies and other	246,539	41,845	49,142	42,420	272,820	(118,461)	534,305
Medical service	-	-	-	-	532,944	(209,751)	323,193
Depreciation and amortization	25,883	8,176	9,192	8,943	35,259	(20,180)	67,273
Interest	7,227	2,329	2,365	4,334	11,625	(3,568)	24,312
<b>Total operating expenses</b>	<b>496,464</b>	<b>105,985</b>	<b>135,066</b>	<b>96,564</b>	<b>1,268,756</b>	<b>(499,350)</b>	<b>1,603,485</b>
<b>Income (loss) from operations</b>	<b>62,248</b>	<b>4,253</b>	<b>13,029</b>	<b>16,317</b>	<b>(41,245)</b>	<b>-</b>	<b>54,602</b>

(Continued)

**Health First, Inc. and Subsidiaries**

**Consolidating Statement of Operations (Continued)**

**Year Ended September 30, 2018**

**(Dollars in Thousands)**

	Holmes Regional Medical Center, Inc.						Consolidated
	Holmes Regional Medical Center	Palm Bay Hospital	Cape Canaveral Hospital, Inc.	Viera Hospital, Inc.	Other	Eliminations	Total
Nonoperating gains (losses):							
Investment income	969	-	201	-	17,713	-	18,883
Change in value of interest rate swaps	(113)	(336)	(53)	-	1,927	-	1,425
Other	(611)	-	(21)	-	(2)	-	(634)
<b>Total nonoperating gains (losses)</b>	<b>245</b>	<b>(336)</b>	<b>127</b>	<b>-</b>	<b>19,638</b>	<b>-</b>	<b>19,674</b>
<b>Excess (deficiency) of revenues, other support and gains over expenses and losses</b>	<b>\$ 62,493</b>	<b>\$ 3,917</b>	<b>\$ 13,156</b>	<b>\$ 16,317</b>	<b>\$ (21,607)</b>	<b>\$ -</b>	<b>\$ 74,276</b>