

Jennie Stuart Medical Center, Inc.

Independent Auditor's Report and
Consolidated Financial Statements

December 31, 2017 and 2016

Jennie Stuart Medical Center, Inc.
December 31, 2017 and 2016

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Independent Auditor's Report

Board of Trustees
Jennie Stuart Medical Center, Inc.
Hopkinsville, Kentucky

We have audited the accompanying consolidated financial statements of Jennie Stuart Medical Center, Inc. (Medical Center), which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of operations, changes in net assets and cash flows for the years then ended and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated 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 consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 consolidated financial statements.

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

Board of Trustees
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Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Medical Center as of December 31, 2017 and 2016, and the results of its operations, the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

BKD, LLP

Louisville, Kentucky
April 26, 2018

Jennie Stuart Medical Center, Inc.
Consolidated Balance Sheets
December 31, 2017 and 2016

Assets

	<u>2017</u>	<u>2016</u>
Current Assets		
Cash and cash equivalents	\$ 8,154,291	\$ 9,998,629
Short-term investments	46,082,962	38,354,677
Assets limited as to use – current	1,873,744	1,381,385
Patient accounts receivable, less allowance for uncollectible accounts; 2017 – \$14,300,000; 2016 – \$16,200,000	11,719,503	13,207,948
Supplies	1,485,458	1,574,695
Prepaid expenses and other	1,032,886	941,284
	<u>70,348,844</u>	<u>65,458,618</u>
Assets Limited As To Use		
Internally designated for self-funded malpractice claims	11,161,093	9,477,540
Held by trustee	17,021,485	16,478,097
Externally restricted by donors	1,296,306	1,167,465
	<u>29,478,884</u>	<u>27,123,102</u>
Less amount required to meet current obligations	1,873,744	1,381,385
	<u>27,605,140</u>	<u>25,741,717</u>
Property and Equipment, At Cost		
Land and land improvements	7,721,688	7,342,870
Buildings and improvements	95,679,088	95,759,144
Equipment	59,567,698	77,664,057
Construction in progress	1,479,612	202,887
	<u>164,448,086</u>	<u>180,968,958</u>
Less accumulated depreciation	102,350,022	117,114,773
	<u>62,098,064</u>	<u>63,854,185</u>
Other Assets		
Physician receivables	268,750	37,991
Other	7,167,779	5,316,663
	<u>7,436,529</u>	<u>5,354,654</u>
Total assets	<u>\$ 167,488,577</u>	<u>\$ 160,409,174</u>

Liabilities and Net Assets

	<u>2017</u>	<u>2016</u>
Current Liabilities		
Current maturities of long-term debt	\$ 1,293,072	\$ 663,033
Accounts payable	5,032,478	5,350,765
Accrued expenses	7,633,337	5,739,234
Deferred revenue	518,925	640,511
Estimated settlement due to third-party payers	<u>2,045,473</u>	<u>4,696,571</u>
Total current liabilities	16,523,285	17,090,114
Long-Term Debt	68,506,210	68,811,386
Other	<u>9,064,854</u>	<u>6,660,116</u>
Total liabilities	<u>94,094,349</u>	<u>92,561,616</u>
Net Assets		
Unrestricted	71,966,758	66,566,334
Temporarily restricted	181,741	181,710
Permanently restricted	<u>1,245,729</u>	<u>1,099,514</u>
Total net assets	<u>73,394,228</u>	<u>67,847,558</u>
Total liabilities and net assets	<u>\$ 167,488,577</u>	<u>\$ 160,409,174</u>

Jennie Stuart Medical Center, Inc.
Consolidated Statements of Operations
Years Ended December 31, 2017 and 2016

	2017	2016
Unrestricted Revenues, Gains and Other Support		
Patient service revenue (net of contractual discounts and allowances)	\$ 129,537,253	\$ 126,045,416
Provision for uncollectible accounts	4,409,856	5,354,768
Net patient service revenue less provision for uncollectible accounts	125,127,397	120,690,648
Other	1,422,459	1,654,218
Total unrestricted revenues, gains and other support	126,549,856	122,344,866
Expenses		
Salaries and wages	50,813,136	49,520,674
Employee benefits	10,626,022	8,481,039
Purchased services and professional fees	15,560,295	18,120,498
Supplies and drugs	22,185,679	22,064,786
Utilities	2,781,192	2,867,097
Repairs and maintenance	5,932,570	5,467,773
Leases and rentals	3,275,539	3,403,185
Provider tax	1,908,934	1,856,405
Depreciation	6,699,393	6,988,693
Interest	3,916,299	2,959,814
Other	4,768,939	4,534,154
Total expenses	128,467,998	126,264,118
Operating Loss	(1,918,142)	(3,919,252)
Other Income (Expense)		
Investment return	7,184,616	5,090,447
Gain on investment in equity investee	133,950	127,566
Loss on extinguishment of debt	-	(5,794,872)
Change in fair value of interest rate swap agreement	-	(577)
Total other income (expense)	7,318,566	(577,436)
Excess (Deficiency) of Revenues Over Expenses and Increase (Decrease) in Unrestricted Net Assets	\$ 5,400,424	\$ (4,496,688)

Jennie Stuart Medical Center, Inc.
Consolidated Statements of Changes in Net Assets
Years Ended December 31, 2017 and 2016

	2017	2016
Unrestricted Net Assets		
Excess (deficiency) of revenues over expenses	\$ 5,400,424	\$ (4,496,688)
Temporarily Restricted Net Assets		
Net realized and unrealized gains (losses) on investments	31	(6,590)
Permanently Restricted Net Assets		
Net realized and unrealized gains (losses) on investments	146,215	46,766
Increase (Decrease) in Net Assets	5,546,670	(4,456,512)
Net Assets, Beginning of Year	67,847,558	72,304,070
Net Assets, End of Year	\$ 73,394,228	\$ 67,847,558

Jennie Stuart Medical Center, Inc.
Consolidated Statements of Cash Flows
Years Ended December 31, 2017 and 2016

	2017	2016
Operating Activities		
Change in net assets	\$ 5,546,670	\$ (4,456,512)
Items not requiring cash		
Depreciation	6,699,393	6,988,693
Amortization of deferred issuance costs and bond discount	114,391	135,331
Net gain on investments	(5,655,666)	(3,832,566)
Provision for uncollectible accounts	4,409,856	5,354,768
Loss on extinguishment of debt	-	5,794,872
Gain on investment in equity investee	(133,950)	(127,566)
Change in fair value of interest rate swap agreement	-	577
(Gain) loss on sale of property and equipment	131,279	(125,124)
Changes in		
Patient accounts receivable, net	(2,921,411)	(4,483,369)
Other current assets	(2,365)	1,941,677
Other assets	(2,081,875)	76,551
Estimated settlements due to third-party payers	(2,651,098)	785,509
Accounts payable, accrued expenses, deferred revenue and other noncurrent liabilities	3,787,059	97,359
Net cash provided by operating activities	7,242,283	8,150,200
Investing Activities		
Purchase of investments	(16,790,403)	(29,160,406)
Proceeds from disposition of investments	12,362,002	19,762,635
Purchase of property and equipment	(4,391,683)	(4,942,348)
Proceeds from sale of property and equipment	263,884	313,184
Purchase of physical therapy practice	-	(900,000)
Distribution from equity investee	133,950	127,566
Net cash used in investing activities	(8,422,250)	(14,799,369)
Financing Activities		
Principal payments on long-term debt	(664,371)	(63,434,046)
Proceeds from issuance of debt	-	68,281,218
Payment of debt issuance costs	-	(1,216,036)
Proceeds from termination interest swap agreement	-	2,217,000
Net cash provided by (used in) financing activities	(664,371)	5,848,136
Decrease in Cash and Cash Equivalents	(1,844,338)	(801,033)
Cash and Cash Equivalents, Beginning of Year	9,998,629	10,799,662
Cash and Cash Equivalents, End of Year	\$ 8,154,291	\$ 9,998,629
Supplemental Cash Flows Information		
Interest paid (net of amount capitalized)	\$ 2,593,474	\$ 4,216,804
Property and equipment included in accounts payable	\$ 386,197	\$ 314,288
Capital lease obligation incurred for property and equipment	\$ 874,843	\$ -

Jennie Stuart Medical Center, Inc.
Notes to Consolidated Financial Statements
December 31, 2017 and 2016

Note 1: Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

The accompanying consolidated financial statements include the operations of Jennie Stuart Medical Center, Inc. (Medical Center) and Fairview Physicians Network, LLC d/b/a Jennie Stuart Medical Group (Medical Group). The Medical Center is located in Hopkinsville, Kentucky, primarily earns revenues by providing inpatient, outpatient and emergency care services to patients in Western Kentucky. The Medical Group primarily earns revenue as a multi-specialty physician group providing primary care and other clinical services to patients in Western Kentucky. The Medical Center also operates a home health agency in the same geographic area.

Principles of Consolidation

The consolidated financial statements include the accounts of the Medical Center and Medical Group. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

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

Cash and Cash Equivalents

The Medical Center considers all liquid investments, other than those limited as to use, with original maturities of three months or less to be cash equivalents. At December 31, 2017 and 2016, cash equivalents consisted primarily of money market accounts with brokers and certificates of deposit.

At December 31, 2017, the Medical Center's cash accounts exceeded federally insured limits by approximately \$7,112,000.

Included in cash and cash equivalents at December 31, 2017, are approximately \$1,832,000 of money market mutual funds that are not insured by the Federal Deposit Insurance Corporation.

Jennie Stuart Medical Center, Inc.
Notes to Consolidated Financial Statements
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Investments and Investment Return

Investments in equity securities having a readily determinable fair value and all debt securities are carried at fair value. The investment in equity investee is reported on the equity method of accounting. Other investments are valued at the lower of cost (or fair value at time of donation, if acquired by contribution) or fair value. Certificates of deposit are stated at cost, plus accrued interest, which approximates market value. Investment return includes dividends, interest and other investment income, realized and unrealized gains and losses on investments carried at fair value and realized gains and losses on other investments.

Investment return that is initially restricted by donor stipulation and for which the restriction will be satisfied in the same year is included in unrestricted net assets. Other investment return is reflected in the consolidated statements of operations and changes in net assets as unrestricted, temporarily restricted or permanently restricted based upon the existence and nature of any donor or legally imposed restrictions.

Assets Limited As To Use

Assets limited as to use include: (1) assets held by trustees relating to tax exempt revenue bond obligations, (2) assets restricted by donors and (3) assets set aside by the board of trustees (Board) for self-funded portions of medical malpractice claims. Amounts required to meet current liabilities of the Medical Center are included in current assets.

Patient Accounts Receivable

Accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectability of accounts receivable, the Medical Center analyzes its past history and identifies trends for each of its major payer sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for uncollectible accounts. Management regularly reviews data about these major payer sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts.

For receivables associated with services provided to patients who have third-party coverage, the Medical Center analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for uncollectible accounts, if necessary.

For receivables associated with self-pay patients, which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill, the Medical Center records a significant provision for uncollectible accounts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates or the discounted rates if negotiated or provided by policy and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

Jennie Stuart Medical Center, Inc.
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The Medical Center's allowance for doubtful accounts for self-pay patients was consistent at 89% of self-pay accounts receivable at December 31, 2016, and December 31, 2017. In addition, the Medical Center's write-offs increased approximately \$1,866,000 from approximately \$4,600,000 for the year ended December 31, 2016, to approximately \$6,466,000 for the year ended December 31, 2017. The increase in write-offs was due to efforts by the Medical Center to write-off older accounts.

Supplies

The Medical Center states supply inventories at the lower of cost, determined using the first-in, first-out method (FIFO), or net realizable value for 2017 and at the lower of cost or market for 2016.

Property and Equipment

Property and equipment acquisitions are recorded at cost and are depreciated using the straight-line method over the estimated useful life of each asset. Leasehold improvements are depreciated over the shorter of the lease term or their respective estimated useful lives.

The estimated useful lives for each major depreciable classification of property and equipment are as follows:

Buildings and improvements	5–40 years
Leasehold improvements	5–20 years
Equipment	3–20 years

Long-Lived Asset Impairment

The Medical Center evaluates the recoverability of the carrying value of long-lived assets whenever events or circumstances indicate the carrying amount may not be recoverable. If a long-lived asset is tested for recoverability and the undiscounted estimated future cash flows expected to result from the use and eventual disposition of the asset is less than the carrying amount of the asset, the asset cost is adjusted to fair value and an impairment loss is recognized as the amount by which the carrying amount of a long-lived asset exceeds its fair value. No asset impairment was recognized during the years ended December 31, 2017 and 2016.

Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are those whose use by the Medical Center has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the Medical Center in perpetuity.

Jennie Stuart Medical Center, Inc.
Notes to Consolidated Financial Statements
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Net Patient Service Revenue

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

Charity Care

The Medical Center provides care without charge or at amounts less than its established rates to patients meeting certain criteria under its charity care policy. Because the Medical Center does not pursue collection of amounts determined to qualify as charity care, these amounts are not reported as net patient service revenue. The Medical Center's direct and indirect costs for services furnished under its charity care policy aggregated approximately \$312,000 and \$183,000 for the years ended December 31, 2017 and 2016, respectively. The Medical Center has received approximately \$955,000 and \$1,006,000 in 2017 and 2016 from an uncompensated care fund to subsidize charity services provided under its charity policy, respectively.

Contributions

Unconditional promises to give cash and other assets are accrued at estimated fair value at the date each promise is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, *i.e.*, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported as an increase in unrestricted net assets. Donor-restricted contributions, whose restrictions are met within the same year as received, are reported as unrestricted contributions. Receipt of contributions which are conditional is reported as liabilities until the condition is eliminated or the contributed assets are returned to the donor.

Estimated Malpractice Costs

An annual estimated provision is accrued for the self-insured portion of medical malpractice claims and includes an estimate of the ultimate costs for both reported claims and claims incurred but not reported.

Self-Insurance

The Medical Center maintains a partially self-insured health insurance program covering substantially all full-time employees. Contributions are made to a third-party administrator as health care claims are incurred. The Medical Center has purchased insurance that limits its exposure for individual claims and limits its aggregate exposure to \$150,000. The Medical Center has a provision recorded for incurred but not reported claims.

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Income Taxes

The Medical Center has been recognized as exempt from income taxes under Section 501 of the Internal Revenue Code and a similar provision of state law. However, the Medical Center is subject to federal income tax on any unrelated business taxable income. The Medical Center files tax returns in the U.S. federal jurisdictions. With a few exceptions, the Medical Center is no longer subject to U.S. federal examinations by tax authorities for years before 2013.

Subsequent Events

Subsequent events have been evaluated through April 26, 2018, which is the date the consolidated financial statements were issued.

Note 2: Net Patient Service Revenue

The Medical Center recognizes patient service revenue associated with services provided to patients who have third-party payer coverage on the basis of contractual rates for the services rendered. For uninsured patients that do not qualify for charity care, the Medical Center recognizes revenue on the basis of its standard rates for services provided. On the basis of historical experience, a significant portion of the Medical Center's uninsured patients will be unable or unwilling to pay for the services provided. Thus, the Medical Center records a significant provision for uncollectible accounts related to uninsured patients in the period the services are provided. This provision for uncollectible accounts is presented on the consolidated statements of operations as a component of net patient service revenue.

The Medical Center has agreements with third-party payers that provide for payments to the Medical Center at amounts different from its established rates. These payment arrangements include:

Medicare: Inpatient acute care services and substantially all outpatient services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Inpatient skilled nursing services are paid at prospectively determined per diem rates that are based on the patients' acuity. Certain inpatient nonacute services and defined medical education costs are paid based on a cost reimbursement methodology. The Medical Center is reimbursed for certain services at tentative rates with final settlement determined after submission of annual cost reports by the Medical Center and audits thereof by the Medicare administrative contractor.

Medicaid: Inpatient acute care services rendered to Medicaid program beneficiaries are paid at a prospectively determined per diem rate. Medicaid reimburses the Medical Center for inpatient care rendered to its beneficiaries based on a prospectively determined rate per discharge, which is similar to the Medicare program. Outpatient services rendered are

Jennie Stuart Medical Center, Inc.
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reimbursed based on a combination of fee schedules and a cost reimbursement methodology. The Medical Center is reimbursed at a tentative rate with final settlement determined after submission of annual cost reports by the Medical Center and audits thereof by the Department of Medicaid Services.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation and change. As a result, it is reasonably possible that recorded estimates will change materially in the near term.

The Medical Center has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations and preferred provider organizations. The basis for payment to the Medical Center under these agreements include prospectively determined rates per discharge, discounts from established charges and prospectively determined daily rates.

Patient service revenue, net of contractual allowances and discounts (before the provision for uncollectible accounts), recognized in the years ended December 31, 2017 and 2016, respectively, was approximately:

	<u>2017</u>	<u>2016</u>
Medicare	\$ 46,670,873	\$ 45,834,515
Medicaid	17,818,027	16,446,471
Other third-party payers	53,810,237	50,271,992
Patient	<u>11,238,116</u>	<u>13,492,438</u>
Total	<u>\$129,537,253</u>	<u>\$126,045,416</u>

The 2017 and 2016 net patient service revenue increased approximately \$1,632,000 and \$544,000, respectively, due to the removal of previously estimated amounts that are no longer necessary as a result of final settlements in previous years.

Jennie Stuart Medical Center, Inc.
Notes to Consolidated Financial Statements
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Note 3: Concentrations of Credit Risk

Accounts Receivable

The Medical Center grants credit without collateral to its patients, most of who are area residents and are insured under third-party payer agreements. The mix of net receivables from patients and third-party payers at December 31, 2017 and 2016, was:

	<u>2017</u>	<u>2016</u>
Medicare	23%	22%
Medicaid	11%	16%
Other third-party payers	47%	48%
Patients	19%	14%
	<u>100%</u>	<u>100%</u>

Note 4: Functional Expenses

The Medical Center provides general health care services to residents within its geographic location. Expenses related to providing these services were as follows:

	<u>2017</u>	<u>2016</u>
Health care services	\$112,935,721	\$110,455,788
General and administrative services	15,532,277	15,808,330
	<u>\$128,467,998</u>	<u>\$126,264,118</u>

Note 5: Temporarily and Permanently Restricted Net Assets

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

	<u>2017</u>	<u>2016</u>
Health care services		
Purchase of equipment	\$ 61,231	\$ 61,200
Cancer center	120,510	120,510
	<u>\$ 181,741</u>	<u>\$ 181,710</u>

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Permanently restricted net assets are restricted to:

	2017	2016
Investments to be held in perpetuity, the income of which is temporarily restricted for operations of the Medical Center	<u>\$ 1,245,729</u>	<u>\$ 1,099,514</u>

Note 6: Investments and Investment Return

Assets Limited As To Use

Assets limited as to use include:

	2017	2016
Internally designated for self-funded malpractice claims		
Cash and cash equivalents	\$ 567,016	\$ 698,205
U.S. Treasury and Government agency obligations	4,027,748	2,859,469
Corporate bonds	223,873	344,277
Mutual funds – large cap U.S. companies	307,616	286,302
Mutual funds – mid and small cap U.S. companies	572,114	624,701
Mutual funds – emerging markets and international equities	389,330	316,523
Mutual funds – exchange traded funds	4,078,109	3,297,225
Mutual funds – fixed income	44,880	40,440
Certificates of deposit	950,407	1,010,398
	<u>\$ 11,161,093</u>	<u>\$ 9,477,540</u>
Held by trustee		
Cash and cash equivalents	\$ 11,948,912	\$ 11,483,385
Guaranteed investment contract	5,072,573	4,994,712
	<u>\$ 17,021,485</u>	<u>\$ 16,478,097</u>

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	<u>2017</u>	<u>2016</u>
Externally restricted by donors		
Cash and cash equivalents	\$ 105,183	\$ 100,273
U.S. Treasury and Government agency obligations	260,288	196,168
Marketable equity securities	298,114	242,289
Mutual funds – large cap U.S. companies	45,320	36,965
Mutual funds – mid and small cap U.S. companies	30,475	27,331
Mutual funds – emerging markets and international equities	71,353	59,054
Mutual funds – exchange traded funds	316,540	269,774
Certificates of deposit	169,033	235,611
	<u>\$ 1,296,306</u>	<u>\$ 1,167,465</u>

Short-Term Investments

Short-term investments, stated at fair value, include:

	<u>2017</u>	<u>2016</u>
U.S. Treasury and Government agency obligations	\$ 11,817,090	\$ 8,138,807
Marketable equity securities	25,684,384	21,841,593
Corporate bonds	933,623	1,020,224
Mutual funds – large cap U.S. companies	582,578	621,758
Mutual funds – mid and small cap U.S. companies	1,707,211	1,493,233
Mutual funds – emerging markets and international equities	560,674	464,645
Mutual funds – exchange traded funds	1,900,135	1,609,916
Mutual funds – fixed income	127,151	110,582
Certificates of deposit	2,770,116	3,053,919
	<u>\$ 46,082,962</u>	<u>\$ 38,354,677</u>

Total investment return is comprised of the following for the years ended December 31, 2017 and 2016:

	<u>2017</u>	<u>2016</u>
Interest and dividend income	\$ 1,675,196	\$ 1,298,057
Unrealized gains on trading securities	5,003,002	3,422,502
Realized gains on trading securities	652,664	410,064
	<u>\$ 7,330,862</u>	<u>\$ 5,130,623</u>

Jennie Stuart Medical Center, Inc.
Notes to Consolidated Financial Statements
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Total investment return is reflected in the consolidated statements of operations and changes in net assets as follows for the years ended December 31, 2017 and 2016:

	2017	2016
Unrestricted net assets		
Other nonoperating income (expense)	\$ 7,184,616	\$ 5,090,447
Temporarily restricted net assets	31	(6,590)
Permanently restricted net assets	146,215	46,766
	\$ 7,330,862	\$ 5,130,623

The Medical Center's investments are exposed to various risks, such as interest rate, market and credit. Due to the level of risk associated with certain investments and the level of uncertainty related to changes in the value of investments, it is at least reasonably possible that changes in these risks in the near term could materially affect the amounts reported in the consolidated balance sheets and statements of operations and changes in net assets. While the Medical Center does not directly invest in derivative securities, it may through investment holdings with a manager of hedge funds, indirectly hold these securities.

Note 7: Investment in and Advances to Equity Investees

During 2008, the Medical Center entered into a joint venture, Physician Holding, LLC, to operate an outpatient diagnostic imaging center. The Medical Center had a 57% ownership percentage in the joint venture as of December 31, 2017 and 2016, respectively. The Medical Center is accounting for this joint venture under the equity method of accounting.

In 2008, the Medical Center entered into a lease agreement with Physician Holding, LLC to lease office space through April 2029. The lease agreement is payable in monthly installments of \$46,590. Rent expense related to this lease was approximately \$559,000 in 2017 and 2016. The lease is included in the future minimum lease payment disclosure in Note 12.

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Notes to Consolidated Financial Statements
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Note 8: Management Agreement

The Medical Center contracts with Quorum Health Resources, LLC (Quorum) to provide management services, recruit or provide a hospital administrator and a chief financial officer who are Quorum employees, provide discounts through preferred vendor contacts and provide various other consulting services, including operational and strategic advice, under an agreement which expires October 29, 2021. The Medical Center's expense for these services, including the salaries and benefits for the hospital administrator and chief financial officer, approximated \$1,240,000 and \$1,153,000 for the years ended December 31, 2017 and 2016, respectively.

Note 9: Medical Malpractice Claims

The Medical Center is self-insured for the first \$1,000,000 per occurrence and \$5,000,000 in aggregate of medical malpractice risks for claims occurring after June 1, 2008, and at various limits for claims occurring prior to June 1, 2008. The Medical Center purchases commercial insurance coverage above the self-insurance limits. Losses from asserted and unasserted claims identified under the Medical Center's incident reporting system are accrued based on estimates that incorporate the Medical Center's past experience, as well as other considerations, including the nature of each claim or incident and relevant trend factors. In connection with the retention amounts, the Board established a trust account to fund potential losses. The Medical Center engages an actuary to project the medical malpractice liability. Based upon the Medical Center's claim experience, an accrual of approximately \$9,065,000 and \$7,160,000 was established as of December 31, 2017 and 2016, respectively, of which \$0 and \$500,000 is included in accrued expenses and \$9,065,000 and \$6,600,000 is included in other long-term liabilities in the consolidated balance sheets, respectively. The Medical Center has recorded receivables for insurance recoveries of approximately \$4,761,000 and \$2,910,000, which are included in other assets in the consolidated balance sheets at December 31, 2017 and 2016, respectively.

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Note 10: Long-Term Debt

	<u>2017</u>	<u>2016</u>
Series 2016 County of Christian, Kentucky Hospital Revenue and Refunding Bonds (A)	\$ 62,900,000	\$ 62,900,000
Installment note payable (B)	1,998,352	2,407,912
Installment note payable (C)	5,975,491	6,228,925
Capital lease obligation (D)	874,843	-
	<u>71,748,686</u>	<u>71,536,837</u>
Less unamortized bond discount	801,121	846,508
Less unamortized deferred debt issuance costs	1,148,283	1,215,910
Less current maturities	<u>1,293,072</u>	<u>663,033</u>
	<u><u>\$ 68,506,210</u></u>	<u><u>\$ 68,811,386</u></u>

- (A) In December 2016, the Medical Center issued \$62,900,000 of County of Christian, Kentucky Hospital Revenue Bonds (2016 Bonds). The 2016 Bonds incur interest at a fixed rate ranging from 5.00% to 5.50% and are subject to retirement in varying annual principal payments of \$510,000 to \$4,860,000 through 2044. The 2016 Bonds are secured by substantially all of the property and gross revenues of the Medical Center. The 2016 Bonds were used to finance the costs of refunding the 2006 Bonds and for certain capital projects and acquisition of equipment.

Unamortized debt issuance costs were \$1,083,930 and \$1,145,960 at December 31, 2017 and 2016, respectively. The effective interest rate was 5.60% and 5.40% for the years ended December 31, 2017 and 2016, respectively.

Under the terms of the 2016 Bonds master trust indenture, the Medical Center is required to maintain certain deposits with the trustee. These deposits are included with assets limited as to use in the consolidated financial statements. The master trust indenture also places limits on the incurrence of additional borrowings and require that certain measures of financial performance be maintained so long as the debt is outstanding.

- (B) In 2012, the Medical Center entered into a note payable with monthly principal and interest payments of \$42,108 (interest at 4.25%), due through the note's maturity of April 27, 2022. The note is secured by certain real property.
- (C) In 2016, the Medical Center entered into a note payable with monthly principal and interest payments of \$49,814 (interest at 5.02%) due through the note's maturity of December 1, 2031. The note is secured by certain real property. Unamortized debt issuance costs were \$64,353 and \$68,950 at December 31, 2017 and 2016, respectively. The effective interest rate was 5.09% for the years ended December 31, 2017 and 2016. The loan agreement also requires that certain measures of financial performance be maintained so long as the debt is outstanding.

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- (D) Capital lease obligation at an imputed interest 3.90% due in 2025; collateralized by certain property and equipment. The property and equipment of approximately \$875,000 is included construction in progress within property and equipment at December 31, 2017. There is an additional \$281,000 in equipment that will be delivered in 2018. The monthly payments for the capital lease obligation is set to begin in July 2018 once all the equipment has been placed into service.

Aggregate annual maturities of long-term debt and payments on the capital lease obligation at December 31, 2017, are:

	Long-Term Debt (Exc. Capital Lease Obligation)	Capital Lease Obligation
2018	\$ 1,238,182	\$ 71,510
2019	1,302,834	143,020
2020	1,363,043	143,020
2021	1,431,720	143,020
2022	682,536	143,020
Thereafter	64,855,528	357,550
	<u>\$ 70,873,843</u>	1,001,140
Less amount representing interest		<u>126,297</u>
Present value of future minimum lease payments		874,843
Less current maturities		<u>54,890</u>
Noncurrent portion		<u>\$ 819,953</u>

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Note 11: Derivative Financial Instrument

Cash Flow Hedge

As a strategy to reduce interest expense over the life of the 2006 Bonds, the Medical Center entered into an interest rate swap agreement for a portion of its fixed rate debt as follows:

The Medical Center entered into an interest rate swap agreement in 2008 in connection with the 2006 Bonds, which was effective February 1, 2009. The swap agreement provided for the Medical Center to receive interest from the counterparty at 67% of one-month London Interbank Offered Rate, plus 0.7068%, and to pay interest to the counterparty at Securities Industry and Financial Markets Association on a notional amount of \$60,100,000 as of December 31, 2016. The swap agreement is to expire on February 1, 2036. Under the agreement, the Medical Center paid or received the net interest amount quarterly with quarterly settlements included in interest expense.

Management had not designated the swap agreement as a cash flow hedging instrument. As a result, the swap agreement was recorded at its fair value with subsequent changes in fair value included in excess of revenues over expenses. The fair value of the interest rate swap agreement was \$0 at December 31, 2017 and 2016.

In 2016, the Medical Center terminated the interest rate swap agreement and received approximately \$2,217,000 as a termination payment from the counterparty.

Note 12: Operating Leases

The Medical Center leases various equipment and real estate under noncancellable operating leases expiring at various dates through 2029.

Future minimum lease payments at December 31, 2017, were:

2018	\$ 1,571,666
2019	1,489,908
2020	1,198,632
2021	1,198,632
2022	694,385
Thereafter	<u>3,789,077</u>
Future minimum lease payments	<u><u>\$ 9,942,300</u></u>

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Note 13: Disclosures About Fair Value of Assets and Liabilities

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. Fair value measurements must maximize the use of observable inputs and minimize the use of unobservable inputs. There is a hierarchy of three levels of inputs that may be used to measure fair value:

- Level 1** Quoted prices in active markets for identical assets or liabilities
- Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities
- Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

Recurring Measurements

The following tables present the fair value measurements of assets and liabilities recognized in the accompanying consolidated balance sheets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at December 31, 2017 and 2016:

	2017			
	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market mutual funds	\$ 14,453,484	\$ 14,453,484	\$ -	\$ -
Marketable equity securities	\$ 25,982,498	\$ 25,982,498	\$ -	\$ -
Mutual funds – large cap U.S. companies	\$ 935,514	\$ 935,514	\$ -	\$ -
Mutual funds – mid and small cap U.S. companies	\$ 2,309,800	\$ 2,309,800	\$ -	\$ -
Mutual funds – emerging markets and international equities	\$ 1,021,357	\$ 1,021,357	\$ -	\$ -
Mutual funds – exchange traded funds	\$ 6,294,784	\$ 6,294,784	\$ -	\$ -
Mutual funds – fixed income	\$ 172,031	\$ 172,031	\$ -	\$ -
Corporate bonds	\$ 1,157,496	\$ -	\$ 1,157,496	\$ -
U.S. Treasury and Government agency obligations	\$ 16,105,126	\$ -	\$ 16,105,126	\$ -

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	2016			
	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market mutual funds	\$ 15,950,728	\$ 15,950,728	\$ -	\$ -
Marketable equity securities	\$ 22,083,882	\$ 22,083,882	\$ -	\$ -
Mutual funds – large cap				
U.S. companies	\$ 945,025	\$ 945,025	\$ -	\$ -
Mutual funds – mid and small cap U.S. companies	\$ 2,145,265	\$ 2,145,265	\$ -	\$ -
Mutual funds – emerging markets and international equities	\$ 840,222	\$ 840,222	\$ -	\$ -
Mutual funds – exchange traded funds	\$ 5,176,915	\$ 5,176,915	\$ -	\$ -
Mutual funds – fixed income	\$ 151,022	\$ 151,022		
Corporate bonds	\$ 1,364,501	\$ -	\$ 1,364,501	\$ -
U.S. Treasury and Government agency obligations	\$ 11,194,444	\$ -	\$ 11,194,444	\$ -

Following is a description of the valuation methodologies and inputs used for assets and liabilities measured at fair value on a recurring basis and recognized in the accompanying consolidated balance sheets, as well as the general classification of such assets and liabilities pursuant to the valuation hierarchy. There have been no significant changes in the valuation techniques during the year ended December 31, 2017.

Investments

Where quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities include money market mutual funds, common and preferred stock and mutual funds. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics or discounted cash flows. The inputs used by the pricing service to determine fair value may include one or a combination of, observable inputs such as benchmark securities, bid offers and reference data market research publications and are classified within Level 2 of the valuation hierarchy. Level 2 securities include corporate bonds and United States Treasury and Government agency obligations.

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Note 14: Pension Plan

The Medical Center has a defined contribution pension plan covering substantially all employees. The Board annually determines the amount, if any, of the Medical Center's contributions to the plan. Pension expense associated with the plan was approximately \$638,000 and \$625,000 for December 31, 2017 and 2016, respectively.

Note 15: Significant Estimates and Concentrations

Accounting principles generally accepted in the United States of America require disclosure of certain significant estimates and current vulnerabilities due to certain concentrations. These matters include the following:

Allowances for Net Patient Service Revenue Adjustments

Estimates of allowances for adjustments included in net patient service revenue are described in Note 2.

Litigation

In the normal course of business, the Medical Center is, from time to time, subject to allegations that may or do result in litigation. Some of these allegations are in areas not covered by the Medical Center's commercial insurance, *e.g.*, allegations regarding breach of contracts. The Medical Center evaluates such allegations by conducting investigations to determine the validity of each potential claim. Based upon the advice of counsel, management records an estimate of the amount of ultimate expected loss, if any, for each of these matters. Events could occur that would cause the estimate of ultimate loss to differ materially in the near term.

Medical Malpractice Claims

Estimates related to the accrual for medical malpractice claims are described in Notes 1 and 9.

Incurred, But Not Reported, Employee Health Insurance Claims

Estimates of incurred, but not reported, health insurance claims are described in Note 1.

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Note 16: Future Changes in Accounting Principles

Revenue Recognition

The Financial Accounting Standards Board (FASB) amended its standards related to revenue recognition. This amendment replaces all existing revenue recognition guidance and provides a single, comprehensive revenue recognition model for all contracts with customers. The guidance provides a five-step analysis of transactions to determine when and how revenue is recognized. Other major provisions include capitalization of certain contract costs, consideration of the time value of money in the transaction price and allowing estimates of variable consideration to be recognized before contingencies are resolved in certain circumstances. The amendment also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in those judgments and assets recognized from costs incurred to fulfill a contract. The standard allows either full or modified retrospective adoption effective for conduit debt obligors for annual periods beginning after December 15, 2017, including any interim periods within the fiscal year ended December 31, 2018. The Medical Center is in the process of evaluating the impact the amendment will have on the consolidated financial statements.

Leases

The FASB amended its standard related to the accounting for leases. Under the new standard, lessees will now be required to recognize substantially all leases on the balance sheet as both a right-of-use asset and a liability. The standard has two types of leases for income statement recognition purposes: operating leases and finance leases. Operating leases will result in the recognition of a single lease expense on a straight-line basis over the lease term similar to the treatment for operating leases under existing standards. Finance leases will result in an accelerated expense similar to the accounting for capital leases under existing standards. The determination of lease classification as operating or finance will be done in a manner similar to existing standards. The new standard also contains amended guidance regarding the identification of embedded leases in service contracts and the identification of lease and nonlease components in an arrangement. The new standard is effective for conduit debt obligors for annual periods beginning after December 15, 2018, including any interim periods within the fiscal year ended December 31, 2019. The Medical Center is evaluating the impact the standard will have on the consolidated financial statements; however, the standard is not expected to have a material impact on the consolidated financial statements.