



**MCLEOD HEALTH**

Consolidated Financial Statements

September 30, 2017 and 2016

(With Independent Auditors' Report Thereon)

## MCLEOD HEALTH

### Table of Contents

	<b>Page(s)</b>
Independent Auditors' Report	1
Consolidated Financial Statements as of and for the years ended September 30, 2017 and 2016:	
Consolidated Balance Sheets	2
Consolidated Statements of Operations	3
Consolidated Statements of Changes in Net Assets	4
Consolidated Statements of Cash Flows	5
Notes to Consolidated Financial Statements	6–29



KPMG LLP  
Suite 260  
40 West Broad Street  
Greenville, SC 29601-2610

## Independent Auditors' Report

The Board of Trustees  
McLeod Health  
Florence, South Carolina

We have audited the accompanying consolidated financial statements of McLeod Health and subsidiaries, which comprise the consolidated balance sheets as of September 30, 2017 and 2016, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

### Management's Responsibility for the Financial Statements

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

### Auditors' 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 auditors' 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.

### Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of McLeod Health and subsidiaries as of September 30, 2017 and 2016, and the results of their operations and their cash flows for the years then ended, in accordance with U.S. generally accepted accounting principles.

**KPMG LLP**

Greenville, South Carolina  
December 14, 2017

**MCLEOD HEALTH**

Consolidated Balance Sheets

September 30, 2017 and 2016

(In thousands)

<b>Assets</b>	<b>2017</b>	<b>2016</b>
Current assets:		
Cash and cash equivalents	\$ 26,591	22,400
Investments	4,449	3,484
Receivables:		
Patient – net of allowances for doubtful accounts of \$139,270 and \$179,708 in 2017 and 2016, respectively	131,341	113,856
Other	5,558	4,193
Inventories	15,338	12,812
Prepaid expenses	17,093	14,624
Total current assets	<u>200,370</u>	<u>171,369</u>
Assets limited as to use	931,384	893,853
Property and equipment – net	723,536	646,071
Other assets:		
Goodwill	3,262	3,262
Other assets	14,030	12,127
Total other assets	<u>17,292</u>	<u>15,389</u>
Total assets	<u>\$ 1,872,582</u>	<u>1,726,682</u>
<b>Liabilities and Net Assets</b>		
Current liabilities:		
Current portion of long-term debt	\$ 7,056	6,826
Accounts payable	47,298	41,699
Accrued expenses and other liabilities	70,601	60,483
Estimated third-party settlements	46,483	56,440
Total current liabilities	<u>171,438</u>	<u>165,448</u>
Long-term debt – net of current portion	<u>286,701</u>	<u>293,637</u>
Total liabilities	<u>458,139</u>	<u>459,085</u>
Net assets:		
Unrestricted	1,404,950	1,258,373
Temporarily restricted	6,225	6,349
Permanently restricted	742	742
Total net assets attributable to McLeod Health	<u>1,411,917</u>	<u>1,265,464</u>
Noncontrolling interest in MMP	2,526	2,133
Total net assets	<u>1,414,443</u>	<u>1,267,597</u>
Commitments and contingencies (notes 5, 6, 7, 10, and 12)		
Total liabilities and net assets	<u>\$ 1,872,582</u>	<u>1,726,682</u>

See accompanying notes to consolidated financial statements.

**MCLEOD HEALTH**

Consolidated Statements of Operations

Years ended September 30, 2017 and 2016

(In thousands)

	<u>2017</u>	<u>2016</u>
Unrestricted revenues, gains, and other support:		
Patient service revenue – net of contractual and other adjustments	\$ 1,274,103	1,259,269
Provision for bad debts	<u>(227,494)</u>	<u>(296,787)</u>
Net patient service revenue	1,046,609	962,482
Other operating revenue	51,775	47,073
Net assets released from restrictions	<u>4,645</u>	<u>4,089</u>
Total unrestricted revenues, gains, and other support	<u>1,103,029</u>	<u>1,013,644</u>
Expenses:		
Personnel	610,049	532,244
Professional fees	37,800	37,437
Supplies	199,186	174,807
Purchased services	72,910	69,837
Facility-related costs	21,038	20,186
Insurance	8,141	7,690
Other	34,631	32,665
Interest	14,073	14,167
Depreciation and amortization	59,486	54,481
Loss on disposal of property	<u>2,365</u>	<u>286</u>
Total expenses	<u>1,059,679</u>	<u>943,800</u>
Income from operations	43,350	69,844
Other nonoperating revenues, net	<u>102,194</u>	<u>62,112</u>
Excess of revenues over expenses before noncontrolling interest	145,544	131,956
Less income attributable to noncontrolling interest	<u>(746)</u>	<u>(518)</u>
Excess of revenues over expenses attributable to McLeod Health	144,798	131,438
Net assets released from restrictions for purchases of property and equipment	1,779	2,922
Escrow transfer	<u>—</u>	<u>1,000</u>
Increase in unrestricted net assets attributable to McLeod Health	\$ <u><u>146,577</u></u>	\$ <u><u>135,360</u></u>

See accompanying notes to consolidated financial statements.

**MCLEOD HEALTH**

Consolidated Statements of Changes in Net Assets

Years ended September 30, 2017 and 2016

(In thousands)

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Noncontrolling Interest</u>	<u>Total</u>
Net assets – September 30, 2016	\$ 1,123,013	5,978	742	1,904	1,131,637
Excess of revenues over expenses	131,438	—	—	518	131,956
Restricted donations and investment income	—	7,382	—	—	7,382
Distributions to noncontrolling interest	—	—	—	(289)	(289)
Contribution of equipment	1,000	—	—	—	1,000
Net assets released from restrictions for operations	—	(4,089)	—	—	(4,089)
Net assets released from restrictions for property and equipment	<u>2,922</u>	<u>(2,922)</u>	<u>—</u>	<u>—</u>	<u>—</u>
Change in net assets	<u>135,360</u>	<u>371</u>	<u>—</u>	<u>229</u>	<u>135,960</u>
Net assets – September 30, 2017	<u>1,258,373</u>	<u>6,349</u>	<u>742</u>	<u>2,133</u>	<u>1,267,597</u>
Excess of revenues over expenses	144,798	—	—	746	145,544
Restricted donations and investment income	—	6,300	—	—	6,300
Distributions to noncontrolling interest	—	—	—	(353)	(353)
Net assets released from restrictions for operations	—	(4,645)	—	—	(4,645)
Net assets released from restrictions for property and equipment	<u>1,779</u>	<u>(1,779)</u>	<u>—</u>	<u>—</u>	<u>—</u>
Change in net assets	<u>146,577</u>	<u>(124)</u>	<u>—</u>	<u>393</u>	<u>146,846</u>
Net assets – September 30, 2017	\$ <u>1,404,950</u>	<u>6,225</u>	<u>742</u>	<u>2,526</u>	<u>1,414,443</u>

See accompanying notes to consolidated financial statements.

**MCLEOD HEALTH**

Consolidated Statements of Cash Flows

Years ended September 30, 2017 and 2016

(In thousands)

	<u>2017</u>	<u>2016</u>
Cash flows from operating activities:		
Change in net assets	\$ 146,846	135,960
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	59,486	54,481
Provision for bad debts – net	227,494	296,787
Change in fair market value of interest rate swap agreement	(584)	(12)
Loss on disposal of property	2,365	286
Loss on acquisition	—	1,483
Loss on debt refunding	—	6,282
Unrealized and realized gains on investments	(94,610)	(59,501)
Noncontrolling interest distributions	353	289
Changes in operating assets and liabilities:		
Patient receivables	(244,979)	(297,840)
Other receivables	(1,365)	(597)
Inventories	(2,526)	(1,520)
Prepaid expenses	(2,469)	(1,640)
Other assets	(1,903)	(1,587)
Accounts payable	5,599	(7,833)
Accrued expenses and other liabilities	9,238	7,341
Estir s	(9,957)	11,064
Net cash provided by operating activities	<u>92,988</u>	<u>143,443</u>
Cash flows from investing activities:		
Proceeds from sales of trading securities	540,947	347,187
Purchases of trading securities	(482,661)	(346,705)
Acquisition of Clarendon, net of cash acquired	—	1,588
Purchase of property and equipment	(139,020)	(110,123)
Other investing activities	227	8,095
Net cash used in investing activities	<u>(80,507)</u>	<u>(99,958)</u>
Cash flows from financing activities:		
Repayments of long-term debt	(6,706)	(41,861)
Funds limited as to use for debt service	(1,231)	(1,380)
Noncontrolling interest distributions	(353)	(289)
Net cash used in financing activities	<u>(8,290)</u>	<u>(43,530)</u>
Net increase (decrease) in cash and cash equivalents	4,191	(45)
Cash and cash equivalents – beginning of year	<u>22,400</u>	<u>22,445</u>
Cash and cash equivalents – end of year	\$ <u>26,591</u>	<u>22,400</u>
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$ 14,071	14,261
Liabilities accrued for the purchase of property and equipment – net	4,358	4,062

See accompanying notes to consolidated financial statements.

## MCLEOD HEALTH

Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

### (1) Organization and Summary of Significant Accounting Policies

#### (a) Organization

McLeod Health is a South Carolina nonprofit corporation and is also an organization as described under Sections 501(c)(3) and 509(a)(3) of the Internal Revenue Code (IRC). McLeod Health serves as the parent corporation and sole member of McLeod Regional Medical Center of the Pee Dee, Inc. (McLeod Regional Medical Center or MRMC), McLeod Medical Center – Dillon, McLeod Health Foundation (the Foundation), McLeod Physician Associates II, McLeod Loris Seacoast Hospital (MLSH), McLeod Health Cheraw (MHC), and McLeod Health Clarendon (MHCI) and is the sole shareholder of McLeod Physician Associates, Inc. (MPA).

McLeod Health serves the healthcare needs of a 12-county region in eastern South Carolina. The activities of the principal entities comprising McLeod Health are summarized as follows:

*McLeod Regional Medical Center* is a 461-bed teaching hospital and tertiary care referral center located in Florence, South Carolina.

*McLeod Medical Center – Dillon* is a 79-bed community hospital located in Dillon, South Carolina.

*McLeod Medical Center – Darlington* is a division of MRMC and operates a 49-bed community hospital located in Darlington, South Carolina.

*McLeod Behavioral Health* is a division of MRMC and operates a 23-bed psychiatric facility located in Darlington, South Carolina.

*McLeod Hospice House* is a division of MRMC and operates a 24-bed inpatient hospice facility located in Florence, South Carolina.

*McLeod Home Health* is a division of MRMC that provides home healthcare services.

*McLeod Health Foundation* is a not-for-profit foundation organized to solicit funds for facilities, research, and general support of McLeod Health.

*McLeod Health and Fitness Center* is a division of MRMC that operates a health and fitness center.

*McLeod Physician Associates, Inc. (MPA)* is a for-profit corporation that was composed of approximately 30 medical practices located throughout the Pee Dee region prior to October 1, 2006. Effective October 1, 2006, substantially all assets and operations were transferred to McLeod Physician Associates II, which is a not-for-profit corporation (see discussion below).

*McLeod Physician Associates II* is a not-for-profit corporation that comprises approximately 95 medical practices throughout 15 counties in South and North Carolina.

*McLeod Medical Partners, LLC (MMP)* is a for-profit corporation that owns and operates three medical office buildings adjacent to MRMC. MRMC owns approximately a 60% controlling share in the equity of MMP.

## MCLEOD HEALTH

Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

*McLeod Loris Seacoast Hospital (MLSH)* provides care for residents of northern Horry County in South Carolina and southern Brunswick and Columbus Counties in North Carolina.

*McLeod Loris* is a division of MLSH and operates a 105-bed community hospital located in Loris, South Carolina.

*McLeod Seacoast* is a division of MLSH and operates a 50-bed community hospital located in Little River, South Carolina.

*McLeod Health Cheraw (MHC)* (formerly Chesterfield General Hospital) is a 59-bed community hospital with operations that began in June 2015.

*McLeod Health Clarendon (MHCI)* (formerly Clarendon Health System) is an 81-bed community hospital with operations that began in July 2016.

### **(b) Principles of Consolidation**

The consolidated financial statements include the accounts of McLeod Health and all wholly owned or controlled subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. The Obligated Group consists of McLeod Health, MRMC, McLeod Medical Center – Dillon, McLeod Physician Associates II, MHC, and MHCI. The Nonobligated Group consists of the Foundation, MPA, MMP, and MLSH.

### **(c) Use of Estimates**

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles (U.S. GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, 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. Significant estimates and assumptions are used for, but not limited to, net patient service revenue; valuation of patient accounts receivable, including contractual allowances and allowances for doubtful accounts; estimated third-party settlements; and accounting for business combinations. Future events and their effects cannot be predicted with certainty; accordingly, management's accounting estimates require the exercise of judgment. The accounting estimates used in the preparation of the accompanying consolidated financial statements will change as new events occur, as more experience is acquired, as additional information is obtained, and as the operating environment changes. Management regularly evaluates the accounting policies and estimates it uses. In general, management relies on historical experience and on other assumptions believed to be reasonable under the circumstances and may employ outside experts to assist in the evaluation, as considered necessary. Although management believes all adjustments considered necessary for fair presentation have been included, actual results may vary from those estimates.

### **(d) Cash and Cash Equivalents**

Cash and cash equivalents include highly liquid investments with original maturities of three months or less at the time of purchase, which have not been designated as limited as to use.

## MCLEOD HEALTH

Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

### **(e) Patient Receivables and Allowance for Doubtful Accounts**

Patient receivables are reported at the net realizable amounts due from patients and third-party payors for services rendered, including estimated retroactive adjustments under reimbursement agreements. 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. Collection of these patient receivables is McLeod Health's primary source of cash and is critical to operating performance. The process of estimating the allowance for doubtful accounts requires McLeod Health to estimate the collectibility of patient receivables, which is primarily based on McLeod Health's collection history, adjusted for expected recoveries. Collections are impacted by the economic ability of patients to pay and the effectiveness of collection efforts. Significant changes in payor mix, business office operations, economic conditions, or trends in federal and state governmental healthcare coverage could affect the collection of patient receivables. McLeod Health also continually reviews overall reserve adequacy by monitoring historical cash collections as a percentage of trailing net revenue, as well as by analyzing current-period gross revenue and admissions by payor classification, aged accounts receivable by payor, and days revenue outstanding.

McLeod Health collects substantially all of its third-party insured receivables, which include receivables from governmental agencies, resulting in a significant portion of the allowance for doubtful accounts relating to self-pay patients, as well as co-payments and deductibles owed by patients with insurance. The allowance for doubtful accounts was \$139,270 and \$179,708 for the years ended September 30, 2017 and 2016, respectively. The decrease from the prior year was primarily the result of the implementation of the 501(r) Self Pay Charity write-off program. Whereas in 2016, self-pay accounts were aged at gross (full charge value of claim), in 2017 the 501(r) program reduced the self-pay claim to 25% (75% direct charity deduction from revenue) at the time of billing. This reduced the total of self-pay patient receivable aging from \$100,300 at September 30, 2016 to \$55,600 at September 30, 2017.

### **(f) Investments, Assets Limited as to Use, and Investment Income**

Investments, including those recorded as assets limited as to use, are stated at fair value in the accompanying consolidated balance sheets. Investment income or loss, including realized and unrealized gains and losses, is included in excess of revenues over expenses, unless the income or loss is restricted by donor or law.

Assets limited as to use include investments designated by the Board of Trustees of McLeod Health (Board of Trustees) for future capital improvements (over which the Board of Trustees retains control and may, at its discretion, subsequently use for other purposes) and funds held by trustees under bond indenture agreements. Assets limited as to use, if required for settlement of current liabilities, are reported within current assets in the accompanying consolidated balance sheets.

### **(g) Inventories**

Inventories are stated at the lower of cost (first-in, first-out method) or market.

## MCLEOD HEALTH

Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

### **(h) Property and Equipment**

Property and equipment are recorded at cost, except for donated assets, which are recorded at fair value at the date of receipt. Assets under capital lease obligations are initially recorded at the lesser of fair value or the present value of the minimum lease payments at the inception of the lease. Depreciation is provided on a straight-line basis over the estimated useful lives of the assets, which range from 3 to 40 years. Equipment under capital lease obligations is amortized using the straight-line method over the shorter of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the accompanying consolidated financial statements.

Expenditures that materially extend the useful lives of the related assets are capitalized. Routine maintenance and repair costs are charged to expense.

Interest costs incurred during the construction period for significant qualifying construction projects are capitalized as part of the cost of the constructed asset and amortized over the applicable useful lives.

### **(i) Bond Issue Costs and Bond Discounts and Premiums**

Bond issue costs are amortized over the term of the respective obligation utilizing the straight-line method, which approximates the effective-interest method. Bond discounts and premiums are also amortized over the terms of the outstanding obligations using the straight-line method. Amortization of bond issue costs, discounts, and premiums is included as a component of depreciation and amortization in the accompanying consolidated financial statements.

### **(j) Goodwill**

McLeod Health applies the provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 958-805, *Business Combinations*, relating to goodwill. Prior to the adoption of ASC 958-805, goodwill associated with the purchase of McLeod Medical Center – Dillon was amortized over a 20-year period using a straight-line method. Beginning October 1, 2010 and upon adoption of ASC 958-805, the goodwill associated with the purchase of McLeod Medical Center – Dillon is no longer amortized. The remaining unamortized balance of goodwill of approximately \$3,262 is now subject to an annual assessment for impairment or more frequently if events or circumstances indicate that assets might be impaired by applying a fair-value-based test. There was no impairment of goodwill during the year ended September 30, 2017 or 2016.

## MCLEOD HEALTH

Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

### **(k) Interest Rate Swap Agreement**

In May 2005, MMP entered into a nine-year interest rate swap agreement related to its note payable. As part of the refinancing of the associated note payable, the interest rate swap agreement was amended and restated in February 2012. The agreement terminates in February 2022. The terms of the amended and restated agreement do not differ significantly from the terms of the original agreement. The notional amount of the agreement as of September 30, 2017 and 2016 was \$9,872 and \$10,304, respectively. The agreement requires MMP to pay the counterparty a 4.66% fixed rate of interest on the notional amount. In return, the counterparty will pay MMP interest at a variable rate based on the published London Interbank Offered Rate (LIBOR) index in accordance with the swap agreement. MMP did not designate the derivative as a hedge instrument. The net settlement between the fixed and variable rates is included as a component of interest expense in the accompanying consolidated statements of operations. The fair value of this derivative, which was estimated using Level 2 observable inputs, of \$(663) and \$(1,247) as of September 30, 2017 and 2016, respectively, is reported in the accompanying consolidated balance sheets as a component of accrued expenses and other liabilities. Changes in the fair value of the derivative are reflected in other nonoperating revenues, net in the accompanying consolidated statements of operations.

### **(l) Noncontrolling Interest**

Noncontrolling interest represents the minority stockholders' proportionate share of the net assets of MMP. Revenues in excess of expenses is allocated to the noncontrolling interest of MMP in proportion to their ownership percentage and are reflected as income attributable to noncontrolling interest in the consolidated statements of operations.

### **(m) Temporarily and Permanently Restricted Net Assets**

Temporarily restricted net assets are those assets whose use has been limited by a donor to a specific time period or purpose. Temporarily restricted net assets as of September 30, 2017 and 2016, of \$6,225 and \$6,349, respectively, are available for scholarships, continuing education, and various other health-related programs. Temporarily restricted net assets are transferred to unrestricted net assets when the donor restrictions as to time or purpose have been met and are reflected as net assets released from restrictions in the accompanying consolidated financial statements. Net assets released from restrictions in fiscal years 2017 and 2016 of \$6,424 and \$7,011, respectively, included \$1,779 and \$2,922 for the purchase of property and equipment, respectively, and \$4,645 and \$4,089 for operating activities, respectively.

Permanently restricted net assets of \$742 at both September 30, 2017 and 2016 have been restricted by the donors to be maintained by McLeod Health in perpetuity. The income from permanently restricted net assets is recorded as temporarily restricted net assets and is expendable for scholarships, continuing education, and various other health-related programs.

## MCLEOD HEALTH

Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

### **(n) Net Patient Service Revenues**

McLeod Health recognizes a significant amount of patient service revenues at the time the services are rendered even though McLeod Health does not assess the patient's ability to pay at that time. As a result, the provision for bad debts is presented as a deduction from patient service revenue (net of contractual and other allowances). Net patient service revenues is reported at the estimated net realizable amounts received, or to be received, from patients, third-party payors, and others for the specific services and supplies rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and are adjusted in future periods as estimates change or final settlements are determined.

### **(o) Charity Care**

McLeod Health provides care without charge, or at amounts less than its established rates, to patients who meet certain criteria under its charity care policy. Because McLeod Health does not pursue collection of patient accounts determined to qualify as charity care, they are not reported as net patient service revenues. McLeod Health estimates the direct and indirect costs of providing charity care using a calculated ratio of costs to gross charges for each facility. During 2017, McLeod Health amended their charity care policy to conform to the regulations surrounding the IRS 501(r) code, whereby McLeod provides a 75% discount for all uninsured patients. This discount is applied at the beginning of the billing process. See 1(e) for related facts.

### **(p) Electronic Health Records (EHR) Incentives**

The American Recovery and Reinvestment Act of 2009 established incentive payments under Medicare and Medicaid programs for certain professionals and hospitals that meaningfully use certified EHR technology. The EHR incentive payments to hospitals include a base amount, plus a discharge-related portion, which is calculated by the Centers for Medicare and Medicaid Services (CMS) based on the hospital's most recently filed cost report, and are subject to adjustment upon settlement of the cost report for the hospital's fiscal year that begins after the beginning of the payment year. A hospital may receive incentive payments for up to four years, provided that it successfully demonstrates meaningful use for each applicable EHR reporting period. McLeod Health recognizes revenue for EHR incentive payments in the period in which it is reasonably assured that it will comply with the applicable EHR meaningful use requirements. EHR incentive revenues is recognized ratably over the applicable meaningful use reporting period and is included in other operating revenues in the consolidated statements of operations. McLeod Health recognized EHR incentive revenues of \$815 and \$3,680 for the years ended September 30, 2017 and 2016, respectively. McLeod Health's attestations regarding the meaningful use of EHR technology are subject to audit by the federal government or its designee.

## MCLEOD HEALTH

Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

### **(q) Contributions**

Unconditional promises by donors to give cash or other assets are reported at fair value at the date the promises are received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gifts are received or at the time conditions are substantially met. Gifts are reported as either temporarily or permanently restricted support if they are received with donor restrictions 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 financial statements as net assets released from restrictions. Donor-restricted contributions, whose restrictions are met within the same year that they are received, are reported as unrestricted contributions in the accompanying consolidated financial statements. Contributions of property and equipment are recorded as unrestricted support in the absence of donor stipulations regarding how long the assets are to be used.

### **(r) Income Taxes**

McLeod Health and its not-for-profit subsidiaries have been recognized by the Internal Revenue Service as exempt from tax under the provisions of IRC Section 501(a) as entities described under IRC Section 501(c)(3). Accordingly, no provision for income taxes on related income has been recorded in the accompanying consolidated financial statements.

### **(s) Excess of Revenues over Expenses**

The accompanying consolidated financial statements reflect an excess of revenues over expenses. Changes in unrestricted net assets resulting from permanent transfers of assets to and from affiliates for other than goods and services and contributions of long-lived assets (including assets acquired using contributions, which, by donor restriction, were to be used for the purposes of acquiring such assets) are excluded from excess of revenues over expenses.

### **(t) Subsequent Events**

McLeod Health has evaluated events and transactions occurring after September 30, 2017 for potential recognition or disclosure in its consolidated financial statements through December 14, 2017, the date that the consolidated financial statements were issued.

### **(u) New Accounting Pronouncements**

In May 2015, the FASB issued Accounting Standards Update (ASU) 2015-07, *Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*. This ASU removes the requirement to categorize within fair value hierarchy all investments for which fair value is measured using the net asset value (NAV) per share as a practical expedient. ASU 2015-07 is effective for fiscal year 2017.

In April 2015, the FASB issued ASU 2015-03, *Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*. This ASU requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts, and that the amortization of debt issuance costs be reported as interest expense. ASU 2015-03 is effective for fiscal year 2017.

## MCLEOD HEALTH

### Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

In January 2016, the FASB issued ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*. This ASU removes the requirement to disclose the fair value of financial instruments that are measured at amortized cost. ASU 2016-01 is effective for fiscal year 2018.

In February 2016, the FASB issued ASU-2016-02, *Leases (Topic 842)*. This ASU requires the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous U.S. GAAP which have terms of greater than 12 months. This ASU defines a lease as a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. This ASU retains a distinction between finance leases and operating leases. The result of retaining a distinction between finance leases and operating leases in the statement of operations and the statement of cash flows is largely unchanged from previous U.S. GAAP. ASU 2016-02 is effective for fiscal year 2021.

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958)*. This ASU changes certain presentation requirements for not-for-profit entities' financial statements in an effort to make information more meaningful for users. This ASU removes the requirement to distinguish between resources with temporary and permanent restrictions on the face of the financial statements and replaces this with a requirement to present two classes of net assets—with and without donor restrictions. Additionally, the ASU requires expenses to be presented by their natural and functional classifications. The guidance also requires that investment returns be presented net of external and direct internal investment expenses and eliminates the requirements for disclosures of the components of investment return. ASU 2016-14 is effective for fiscal year 2019.

#### **(v) Fair Value Measurements**

Under U.S. GAAP, fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. GAAP also prioritizes, for the measurement of fair value, the use of market-based information over entity-specific information and establishes a three-level hierarchy for fair value based on the transparency of inputs used in the valuation of an asset or liability as of the measurement date. The fair value hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements).

Financial instruments measured and reported at fair value are classified and disclosed within one of the following categories:

*Level 1* – Valuations for financial instruments traded in active exchange markets as of the reporting date. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

*Level 2* – Valuations for financial instruments as determined through direct or indirect observations other than quoted market prices

## MCLEOD HEALTH

### Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

*Level 3* – Valuations for financial instruments that are derived from other valuation methodologies including discounted cash flow models and similar techniques, and not based on market exchange, dealer or broker traded transactions. These valuation methodologies are based on unobservable inputs in situations where there is little or no market activity for the asset or liability. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities

*NAV* – Certain investments that are measured at fair value using NAV per share (or its equivalent) as a practical expedient have not been categorized in the fair value hierarchy. The fair value amounts presented in the table below are intended to permit reconciliation of the fair value hierarchy to the amounts presented in the accompanying consolidated balance sheets.

The following methods and assumptions were used in estimating the fair value of financial instruments:

*Cash Equivalents* – The carrying amount reported in the accompanying consolidated balance sheets for cash and cash equivalents approximates its fair value.

*Investments and Assets Limited as to Use* – The carrying amounts reported in the accompanying consolidated balance sheets are based on quoted market prices, if available, or estimated using quoted market prices for similar securities (see notes 3 and 4 for additional information).

*Receivables* – The carrying amounts reported in the accompanying consolidated balance sheets for receivables approximate their fair value.

*Accounts Payable and Accrued Expenses and Other Liabilities* – The carrying amounts reported in the accompanying consolidated balance sheets for accounts payable and accrued expenses and other liabilities approximate their fair value.

*Estimated Third-Party Settlements* – The carrying amount reported in the accompanying consolidated balance sheets for estimated third-party settlements approximates its fair value.

*Long-Term Debt* – The carrying amount reported in the accompanying consolidated balance sheets for long-term debt approximates its fair value.

**MCLEOD HEALTH**

Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

**(2) Net Patient Service Revenues**

Patient service revenues – net of contractual and other allowances for the years ended September 30, 2017 and 2016 is summarized as follows:

	<u>Year ended September 30, 2017</u>		
	<u>Third-party payors</u>	<u>Self-pay</u>	<u>Total</u>
Patient service revenue	\$ 4,069,708	402,898	4,472,606
Contractual and other adjustments	(3,035,774)	(162,729)	(3,198,503)
Provision for bad debts	—	(227,494)	(227,494)
Net patient service revenue	<u>\$ 1,033,934</u>	<u>12,675</u>	<u>1,046,609</u>

	<u>Year ended September 30, 2016</u>		
	<u>Third-party payors</u>	<u>Self-pay</u>	<u>Total</u>
Patient service revenue	\$ 3,628,295	306,427	3,934,722
Contractual and other adjustments	(2,675,453)	—	(2,675,453)
Provision for bad debts	—	(296,787)	(296,787)
Net patient service revenue	<u>\$ 952,842</u>	<u>9,640</u>	<u>962,482</u>

McLeod Health has agreements with third-party payors that provide for payments to McLeod Health at amounts different from its established rates. A summary of the payment arrangements with certain third-party payors is as follows:

*Medicare* – Inpatient acute care services rendered to Medicare program beneficiaries are generally paid at prospectively determined rates per discharge, which vary according to a patient classification system based on clinical, diagnostic, and other factors. McLeod Health’s classification of Medicare patients and the appropriateness of their admissions are subject to review by a Medicare-contracted independent organization. Most outpatient services are also reimbursed at prospectively determined rates. However, final Medicare reimbursement is determined based upon the submission of annual cost reports by McLeod Health and audits thereof by the Medicare Audit Contractor (MAC).

McLeod Health’s Medicare cost reports have been audited by Palmetto GBA, the MAC, through September 30, 2013. Final settlements for all acute care hospitals had been delayed by the CMS for fiscal years ending on or after September 30, 2010, due to issues related to the computation of the Supplemental Security Income fraction, a key component in the calculation of Medicare Disproportionate Share reimbursement. In September 2017, the results of the MAC settlement for the years 2011–2013 were final

## MCLEOD HEALTH

### Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

settled and the associated amounts were recorded. As of September 30, 2017, McLeod Health's Medicare cost reports have been settled through fiscal year ended September 30, 2013.

*Medicaid* – Inpatient and outpatient Medicaid services are reimbursed on a reasonable cost basis. Interim payments are made by the state based on each facility's historical costs trended forward. Tentative settlements are made based on actual costs reported on hospital cost reports, but these are subject to further adjustment based on subsequent audits. As of September 30, 2017, final settlements have been determined by the State of South Carolina for fiscal years through 2011. Management has established reserves for potential Medicaid cost settlements and settlement adjustments for fiscal years 2009–2017.

In the state of South Carolina, providers are assessed a quarterly tax and receive periodic Medicaid disproportionate share and upper payment limit funds from the State of South Carolina. The tax assessment was \$16,962 and \$15,800 for the years ended September 30, 2017 and 2016, respectively, and is recorded as other operating expense in the accompanying consolidated statements of operations. McLeod Health received approximately \$25,979 and \$30,613 of disproportionate share funds from the state for the years ended September 30, 2017 and 2016, respectively, and recorded the funds as net patient service revenues in the accompanying consolidated statements of operations. Effective January 1, 2003, funds received under the upper payment limit program may be subject to a retroactive settlement process. McLeod Health continues to evaluate the settlement process related to the upper payment limit program and believes that it has recorded adequate provisions at September 30, 2017 and 2016 in estimated third-party settlements in the accompanying consolidated balance sheets. Funds received under these programs may be subject to a retroactive settlement process and future receipts of funds are not guaranteed. Beginning in fiscal year 2012, states are required to perform audits of hospital disproportionate share data and make adjustments to payments if over or underpayments have occurred based on the results of these audits.

Since final determination of amounts due from or to the Medicare and Medicaid programs is subject to audit and subsequent adjustments, changes resulting from final determinations are reflected as changes in estimates, generally in the year of determination. In the opinion of management, adequate provision has been made for adjustments, if any, that may result from such reviews. Net patient service revenue increased approximately \$9,518 and decreased approximately \$2,011 for the years ended September 30, 2017 and 2016, respectively, due to changes in third-party estimates and the settlement of third-party cost reports for fiscal years ended September 30, 2012 through September 30, 2016.

*Charity Care* – In accordance with McLeod Health's mission to improve the health of its communities, McLeod Health facilities accept patients regardless of their ability to pay. McLeod Health offers financial assistance to patients who meet established financial assistance guidelines. Because McLeod Health does not pursue collection of patient accounts determined to qualify as charity care, they are not reported as net patient service revenues. McLeod Health estimates the direct and indirect costs of providing charity care using a calculated ratio of costs to gross charges for each facility. The estimated cost of charity care provided by McLeod Health under its charity care policy was \$65,338 and \$28,028 for the years ended September 30, 2017 and 2016, respectively.

**MCLEOD HEALTH**

Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

**(3) Investments**

Investments at September 30, 2017 and 2016 are composed of Level 1 investments held by the Foundation and are recorded as follows:

	<u>2017</u>	<u>2016</u>
Investments held by the Foundation	\$ 7,920	6,660
Less amounts included in assets limited to use	<u>(3,471)</u>	<u>(3,176)</u>
Total investments held as certificates of deposit and money market funds	\$ <u>4,449</u>	<u>3,484</u>

McLeod Health has segregated assets limited as to use maintained by the Foundation into the most appropriate level within the fair value hierarchy based on the inputs used to determine the fair value as of September 30, 2017 and 2016, as follows:

<u>Fair value measurement as of September 30, 2017</u>				
	<u>Total</u>	<u>Quoted prices in active markets for identical assets (Level 1)</u>	<u>Significant other observable inputs (Level 2)</u>	<u>Significant unobservable inputs (Level 3)</u>
Common stocks	\$ —	—	—	—
Mutual funds	1,558	1,558	—	—
Corporate bond funds	1,106	1,106	—	—
Government bonds	411	—	411	—
Other	<u>396</u>	<u>—</u>	<u>396</u>	<u>—</u>
Total	\$ <u>3,471</u>	<u>2,664</u>	<u>807</u>	<u>—</u>

**MCLEOD HEALTH**

Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

**Fair value measurement as of September 30, 2016**

	<b>Total</b>	<b>Quoted prices in active markets for identical assets (Level 1)</b>	<b>Significant other observable inputs (Level 2)</b>	<b>Significant unobservable inputs (Level 3)</b>
Common stocks	\$ 1,344	1,344	—	—
Mutual funds	1,054	1,054	—	—
Corporate bond funds	390	390	—	—
Government bonds	354	—	354	—
Other	34	—	34	—
<b>Total</b>	<b>\$ 3,176</b>	<b>2,788</b>	<b>388</b>	<b>—</b>

**(4) Assets Limited as to Use**

McLeod Health combines its investments in a systemwide investment pool, which includes investments and assets whose use is limited. Assets whose use is limited primarily include assets held by trustees under a master trust indenture agreement and assets designated by the Board of Trustees for future capital improvements, over which the board retains control and may, at its discretion, subsequently use for other purposes.

Assets limited as to use are stated at fair value at September 30, 2017 and 2016 and have been designated as follows:

	<b>2017</b>	<b>2016</b>
By the Board of Trustees for future expansion, purchase of property and equipment, and repayment of debt	\$ 918,937	882,934
Held by trustee for escrow	1,002	1,000
Held by the Foundation	3,471	3,176
MRF Trust Fund (note 7)	7,974	6,743
<b>Total</b>	<b>\$ 931,384</b>	<b>893,853</b>

The classification of investments in the fair value hierarchy is not necessarily an indication of the risks, liquidity, or degree of difficulty in estimating the fair value of each investment's underlying assets and liabilities. In general, for Level 2, Level 3, and NAV investments, McLeod Health utilizes the investment manager of the asset to provide a valuation estimate based on disclosed techniques and processes, which have been reviewed by McLeod Health's management for propriety and consistency with consideration given to type and investment strategy.

## MCLEOD HEALTH

### Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

McLeod Health has segregated its investments and assets limited as to use into the most appropriate level within the fair value hierarchy based on the inputs used to determine the fair value as of September 30, 2017 and 2016, as follows:

	Fair value measurement as of September 30, 2017				Investments reported at NAV
	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	
Cash, cash equivalents, and money market funds	\$ 6,930	6,930	—	—	—
Mutual funds	152,685	152,685	—	—	—
Domestic equities	85,519	85,519	—	—	—
Fixed income:					
Government bonds and government-backed securities	37,718	—	37,718	—	—
Corporate bonds	23,283	—	23,283	—	—
Mortgage-backed securities	33,900	—	33,900	—	—
Other	2,739	—	2,739	—	—
Large-cap commingled funds:					
State Street Global Advisors S&P 500 Index Funds	40,595	40,595	—	—	—
JPMorgan U.S. Large Cap 130/30 Fund LLC	61,594	—	—	—	61,594
International equity commingled funds:					
Blackrock Global ex-US Tilts B	88,762	—	—	—	88,762
State Street Global Advisors MSCI Index Fund	89,169	89,169	—	—	—
Alternative investments:					
Acadian Global Managed Fund	75,806	—	—	—	75,806
Credit Suisse	36,518	—	—	—	36,518
Blackstone Partners Offshore Fund Ltd.	95,000	—	—	—	95,000
Winton Futures Fund Ltd.	22,232	—	—	—	22,232
Standard Life	22,627	—	—	—	22,627
Real Estate (PRISA)	44,862	—	—	—	44,862
MRF Trust Fund (note 7)	7,974	7,974	—	—	—
Investments held by the Foundation (note 3)	3,471	2,664	807	—	—
<b>Total</b>	<b>\$ 931,384</b>	<b>385,536</b>	<b>98,447</b>	<b>—</b>	<b>447,401</b>

## MCLEOD HEALTH

### Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

Fair value measurement as of September 30, 2016					
	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Investments reported at NAV
Cash, cash equivalents, and money market funds	\$ 7,605	7,605	—	—	—
Mutual funds	139,536	139,536	—	—	—
Domestic equities	89,608	89,608	—	—	—
Fixed income:					
Government bonds and government-backed securities	21,689	—	21,689	—	—
Corporate bonds	32,400	—	32,400	—	—
Mortgage-backed securities	34,882	—	34,882	—	—
Other	17,160	—	17,160	—	—
Large-cap commingled funds:					
State Street Global Advisors S&P 500 Index Funds	47,045	—	47,045	—	—
JPMorgan U.S. Large Cap 130/30 Fund LLC	62,002	—	—	—	62,002
International equity commingled funds:					
Blackrock Global ex-US Tilts B	79,267	—	—	—	79,267
State Street Global Advisors MSCI Index Fund	80,509	—	80,509	—	—
Alternative investments:					
Acadian Global Managed Fund	72,328	—	—	—	72,328
Credit Suisse	33,742	—	—	—	33,742
Blackstone Partners Offshore Fund Ltd.	88,546	—	—	—	88,546
Winton Futures Fund Ltd.	22,639	—	—	—	22,639
Standard Life	21,858	—	—	—	21,858
Real Estate (PRISA)	33,118	—	—	—	33,118
MRF Trust Fund (note 7)	6,743	6,743	—	—	—
Investments held by the Foundation (note 3)	3,176	2,788	388	—	—
Total	\$ 893,853	246,280	234,073	—	413,500

The fair value of fixed-income securities shown in Level 2 above are measured using inputs other than quoted prices that are observable for the assets, including the stated interest rate, maturity, and credit risk.

## MCLEOD HEALTH

### Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

McLeod Health's commingled funds and alternative investments include the following funds that do not have readily determinable fair values:

*JPMorgan U.S. Large Cap 130/30 Fund LLC* – A privately held fund that invests primarily in equity securities that trade on a national stock exchange, utilizes an active stock selection with a systematic valuation process, and seeks to invest in a diversified portfolio of U.S. large-cap equities with a target average exposure of 130% long and 30% short. The notification periods required for redemption are 15 days.

*Acadian Global Managed Fund* – A global large-cap blend equity that aims to achieve a return similar to or better than that of the MSCI World Index but with lower volatility over a full market cycle. The notification periods required for redemption or other limits on redemption is 30 days.

*Blackrock Global ex-US Tilts B* – A privately held fund that invests primarily in international equity securities that trade on global stock exchanges. This fund provides for redemptions on any dealing day provided that written notice is received three days prior to the relevant dealing date.

*Blackstone Partners Offshore Fund Ltd.* – A privately held fund that invests primarily in other funds that are not publicly traded and is a fund of funds constructed through a multimanager framework of strategies that collectively are not highly correlated to traditional asset classes. This fund provides for redemptions on a semiannual basis with 95 days' prior written notice.

*Winton Futures Fund Ltd.* – A privately held fund that seeks to achieve long-term capital appreciation of assets in a variety of changing market conditions using a diversified futures trading program focused on quantitative technical analysis. The fund trades a portfolio of more than 100 international futures, options, and forward contracts. This fund provides for redemptions on any dealing day provided that written notice is received two days prior to the relevant dealing date (first business day of each month).

*Real Estate (PRISA)* – A domestic commingled property fund that pools investor money to build and invest into commercial, industrial, and residential real estate. The fund seeks to generate a return from property appreciation, as well as lease and rental revenue. The notification periods required for redemption or other limits on redemption is 90 days.

*Credit Suisse Dollar Senior Loan Fund Ltd.* – A privately held fund that invests primarily in senior secured debt of high yield companies. Bottom-up analysis drives the selection of individual investments and a high level of diversity with strict quality, issuer, and industry concentration criteria. This fund provides for redemptions on the first business day of the following month after a 20-day written notice is provided.

## MCLEOD HEALTH

### Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

*Standard Life* – The Feeder Fund an exempted company incorporated with limited liability in the Cayman Islands as an open-ended investment company. The Feeder Fund's investment objective is to invest substantially all its assets in Standard Life Investments Global Absolute Return Strategies Master Fund Ltd. (the Master Fund). The Master Fund's investment objective is to deliver a positive absolute return in the form of capital growth over the medium to long term in all market conditions. The benchmark is U.S. one-month The London Interbank Bid Rate and the target is to outperform the benchmark by 5% per annum, on a three-year rolling basis. The Master Fund seeks to maintain a diversified portfolio consisting primarily of listed equity; derivatives; equity-related and debt securities, including exchange-traded funds; other securities; and other pooled investment vehicles whose managers may be affiliated with the investment adviser. The notification period required for redemption or other limits on redemption is five business days.

The commingled funds and alternative investments may contain elements of both credit and market risk. Such risks could include, but are not limited to, limited liquidity, absence of oversight, dependence upon key individuals, emphasis on speculative investments (both derivatives and nonmarketable investments), and nondisclosure of portfolio composition. McLeod Health reviews and evaluates the values provided by the investment managers for commingled funds and alternative investments and agrees with the valuation methods and assumptions used in determining the fair value of commingled funds and alternative investments. U.S. GAAP permits, as a practical expedient, a reporting entity to measure the fair value of certain investments without readily determinable fair values by using the reported NAV per share (or its equivalent) of the investment without further adjustment if the investment is in an entity that meets the description of an investment company whose underlying investments are measured at fair value as set forth in the ASC. Accordingly, McLeod Health generally estimates the fair value of its alternative investments using this approach based on information reported by the respective fund managers or the general partners. Financial instruments, which involve varying degrees of off-balance-sheet risk for the various limited partnerships, limited liability corporations, and offshore investment funds included within alternative investments, may result in a loss due to changes in the market (market risk). Because alternative investments are not readily marketable, their estimated value is subject to uncertainty and, therefore, may differ from the value that would have been used had a ready market for such investments existed. Such differences could be material.

There were no significant reclassifications between Level 1, Level 2, or Level 3 during the year ended September 30, 2017 or 2016.

## MCLEOD HEALTH

### Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

Other nonoperating revenue, net for the years ended September 30, 2017 and 2016 are as follows:

	<u>2017</u>	<u>2016</u>
Unrealized gains on investments	\$ 52,834	47,823
Realized gains on sales of investments	41,776	11,678
Dividends and interest – net of management fees	7,000	10,364
Loss on acquisition	—	(1,483)
Change in fair market value of interest rate swap	584	12
Loss on debt refunding	—	(6,282)
Total	<u>\$ 102,194</u>	<u>62,112</u>

#### (5) Property and Equipment

Property and equipment as of September 30, 2017 and 2016 consist of the following:

	<u>2017</u>	<u>2016</u>
Land and land improvements	\$ 76,931	71,413
Buildings	841,761	789,889
Fixed and moveable equipment	354,220	361,452
Leasehold improvements	20,038	19,792
Construction in progress	108,984	64,314
	1,401,934	1,306,860
Less accumulated depreciation	<u>(678,398)</u>	<u>(660,789)</u>
Total	<u>\$ 723,536</u>	<u>646,071</u>

Depreciation expense for the years ended September 30, 2017 and 2016 was \$59,694 and \$54,481, respectively.

Construction in progress at September 30, 2017 is principally related to projects for facility enhancements and clinical equipment. These projects are expected to be completed during fiscal year 2018 at an estimated total remaining cost to complete of approximately \$61,913 to be funded from operations. McLeod Health capitalized no interest during 2017 or 2016.

#### (6) Short-Term Borrowings

McLeod Health has a \$20,000 unsecured line of credit with a local financial institution. The line of credit bears interest at LIBOR, plus 1.25% (LIBOR was 1.23% as of September 30, 2017). Interest is assessed at a variable interest rate adjusted daily and is payable monthly. There were no outstanding borrowings as of September 30, 2017 or 2016.

**MCLEOD HEALTH**

Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

**(7) Long-Term Debt**

Long-term debt as of September 30, 2017 and 2016 consists of the following:

	<u>2017</u>	<u>2016</u>
2010 Series A bonds, plus unamortized premium, due in various installments ranging from \$2,420 to \$15,215, beginning in 2011 and extending to 2037. Interest is paid semiannually at rates ranging from 3.00% to 5.00%.	\$ 105,787	109,978
2010 Series B bonds, plus unamortized premium, due in annual installments of \$15,375 to \$15,805, beginning in 2038 and extending to 2040. Interest is paid monthly based on a variable rate (1.37% at September 30, 2017).	46,770	46,770
Series 2014 bonds plus unamortized premium, due in various installments of \$395 to \$6,950, beginning in 2017 and extending to 2034. Interest is paid semiannually at rates ranging from 2.00% to 5.00%.	68,872	69,569
Note payable, due in monthly installments ranging from \$32 to \$44, with the remaining outstanding balance of \$7.8 million to be paid in February 2022. Interest is paid monthly according to a swap agreement described in note 1. Collateralized by MMP's land and buildings	9,908	10,303
Mortgage payable, due in monthly installments of approximately \$522, with the outstanding balance to be paid in November 2036. Interest is paid monthly based on a fixed interest rate of 7.25%.	<u>64,674</u>	<u>66,191</u>
	296,011	302,811
Less current portion of long-term debt	(7,056)	(6,826)
Less unamortized bond issuance costs	<u>(2,254)</u>	<u>(2,348)</u>
Total	\$ <u>286,701</u>	<u>293,637</u>

McLeod Health's Series 2014, 2010 A, and 2010 B bonds were issued through the governmental municipality of Florence County, South Carolina. Each member of the Obligated Group is jointly and severally liable for the repayment of the principal and interest as they become due on the bonds under a master indenture agreement. All accounts receivable of the Obligated Group, now owned or hereafter acquired, and all proceeds thereof are pledged as collateral for the bonds. Also, under the master indenture agreement, McLeod Health is subject to various restrictions as a part of debt covenants for the bonds and other debt. As of September 30, 2017, management believes that McLeod Health was in compliance with its restrictive financial debt covenants under the master indenture agreement.

## MCLEOD HEALTH

### Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

As part of the acquisition of Loris Hospital System (LHS), McLeod Health assumed a secured mortgage fully insured by the U.S. Department of Housing and Urban Development Federal Housing Administration pursuant to Section 242 of the National Housing Act, as amended, related to construction projects, refunding of other long-term debt, and other projects and equipment purchases of LHS. At the date of acquisition, the outstanding principal balance of the mortgage of approximately \$71,567 was assigned to the newly formed MLSH. The mortgage calls for monthly installments of approximately \$522, which includes interest at 7.25% with the final payment expected in November 2036. The mortgage is secured by all current or future properties and revenues of MLSH.

As part of the agreement to the assigned mortgage (the Agreement), MLSH was required to establish a mortgage reserve fund (MRF) with a trustee to provide reserve funds related to the mortgage. MLSH is required to make monthly payments to the MRF, which, when coupled with an assumed investment rate of return of 4%, will equal approximately 12 months and 24 months of mortgage debt service at 5 and 10 years, respectively. Such deposits held by the trustee are included in assets limited to use in the consolidated financial statements. The Agreement also places limits on the incurrence of additional borrowings and distribution of assets, including cash, and requires that certain financial performance measures be satisfied as long as the mortgage is outstanding.

Future aggregate annual principal payments applicable to long-term debt as of September 30, 2017, are as follows:

Year ending September 30:	
2018	\$ 7,056
2019	7,445
2020	7,819
2021	8,244
2022	14,055
Thereafter	<u>249,138</u>
Total	<u>\$ 293,757</u>

#### (8) Employee Benefit Plans

McLeod Health sponsors a 401(k) plan covering substantially all employees of McLeod Health. Annual contributions are based upon a matching of the participant's elective deferrals and amounted to \$9,982 and \$8,554 in fiscal years 2017 and 2016, respectively.

#### (9) Concentrations of Credit Risk

McLeod Health provides acute and nonacute healthcare services to residents of the Pee Dee region of South Carolina. While the majority of patient receivables are due from the Medicare and Medicaid programs and various insurance companies, the collectibility of receivable balances is affected by the economic stability of the area. Accordingly, receivables are reflected in the consolidated balance sheet net of valuation allowances based on the anticipated collectibility of the related gross receivables.

## MCLEOD HEALTH

### Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

The mix of gross receivables from patients and third-party payors as of September 30, 2017 and 2016 is as follows:

	<u>2017</u>	<u>2016</u>
Medicare	43 %	36 %
Medicaid	18	13
Managed care and other commercial insurers	29	29
Self-pay patients	<u>10</u>	<u>22</u>
Total	<u>100 %</u>	<u>100 %</u>

#### (10) Commitments and Contingencies

McLeod Health has leased a portion of its land for its physical plant through 2076, at which time McLeod Health has the option to purchase the property for a nominal cost. McLeod Health is also contingently responsible for any debt service cost of the landlord, plus any expenses incurred by the landlord in connection with the ownership of the premises. For the year ended September 30, 2017 or 2016, the landlord had incurred no debt service costs or other expenses in connection with the land.

MHC entered an agreement in June 2015 to lease a 59-bed hospital in Cheraw, as well as a hospital in Bennettsville that is currently unoccupied. The initial lease expires in June 2025, but McLeod Health has the option to renew the agreement three times for 5 years per renewal. Lease payments total \$1,000 per year. The payments are prorated and paid on a monthly basis. A credit of \$2,000 in lease payments was granted by the lessor to fund necessary repairs in order to achieve compliance with the joint commission and other governmental agencies. McLeod Health has the option to purchase the leased facilities after the initial 10-year lease expires. The sales price is prearranged and ranges from \$10,000 to \$17,750 based on an earnings multiple; any extraordinary renovations or expansions/additions of buildings, structures or other improvements paid for by McLeod Health will be credited at book value against the optional purchase price.

McLeod Health has a claims-made professional liability insurance policy to cover medical malpractice claims in accordance with state-mandated limits for both hospital operations and its physicians. The South Carolina Charitable Immunity Statute allows for recovery against a charitable organization of only the actual damages sustained in an amount not exceeding the limitations of liability imposed in the South Carolina Tort Claims Act (the Tort Claims Act). The Tort Claims Act provides that no person shall recover in any action or claim brought hereunder a sum exceeding \$300 per person, per occurrence or a total of \$600 per occurrence, except that both the per person and per occurrence amounts are raised to \$1,200 for the tort of a licensed physician or dentist employed by such facility. No award for damages under the Tort Claims Act shall include punitive or exemplary damages or interest prior to judgment. While any medical malpractice claims contain an element of uncertainty, management believes that the outcome of any pending lawsuit or claim is covered by insurance and the related claim liability and anticipated insurance recoveries are not material due to the limitations of liability imposed in the Tort Claims Act.

McLeod Health is self-insured with respect to employee health benefits and workers' compensation.

## MCLEOD HEALTH

### Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

McLeod Health is involved in various litigation, regulatory matters, and administrative proceedings arising in the ordinary course of business, including personnel- and employment-related matters. While any litigation contains an element of uncertainty, management believes that the outcome of any pending lawsuit or claim is covered by insurance and/or has been adequately reflected as accrued expenses and other liabilities in the accompanying consolidated financial statements. McLeod Health believes that the ultimate resolution of these matters will not have a material adverse effect on future financial position, results from consolidated operations, or its cash flows.

The healthcare industry is subject to numerous laws and regulations of federal, state, and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement for patient care services, and Medicare and Medicaid fraud and abuse. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time. Violations of these laws and regulations could result in expulsion from government health care programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed.

The health care industry continues to attract much legislative interest and public attention. In March of 2010, the President signed into law H.R. 3590, *The Patient Protection and Affordable Care Act*, and companion bill H.R. 4872, *The Health Care and Education Reconciliation Act of 2010*. The reform will be effective over a 10-year period through 2020 and contains an individual insurance mandate, low-income subsidies, insurance reforms, and the creation of state-based health insurance exchanges. It is unclear at this time what the net impact of this legislation will be on McLeod Health. Such effects may include material and adverse changes to the amounts of reimbursement received by McLeod Health's facilities.

McLeod Health has committed to contracts with outside parties for various construction projects and equipment purchases with approximately \$68,068 remaining to be paid subsequent to September 30, 2017.

Investment securities, in general, are exposed to various risks, such as interest rate, credit, and overall market volatility. Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the consolidated financial statements.

#### **(11) Related-Party Transactions**

Total expenditures for related-party transactions during fiscal years 2017 and 2016 were approximately \$9,421 and \$4,492, respectively. Such transactions primarily consist of payments to Pee Dee Pathology, where a member of the Foundation Board and Board of Trustees practices, as well as medical director and chief of staff fees for several members of the Board of Trustees and community board. In addition, a Board of Trustees member is a key employee of an anesthesiology group that has an exclusive arrangement with McLeod Health for provision of anesthesiology services.

In fiscal years 2017 and 2016, McLeod Health purchased insurance coverage from third-party insurance companies involving premiums totaling approximately \$6,150 and \$1,836, respectively. This coverage was placed by an insurance broker who serves on the Board of Trustees of the Foundation.

## MCLEOD HEALTH

### Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

#### (12) Leases

McLeod Health leases office space to outside parties under lease agreements with varying expiration dates through fiscal year 2028. Portions of the buildings below are used by McLeod Health, and accordingly, no rental income is recognized for that space. The cost and carrying amounts of property covered by these leases as of September 30, 2017 are as follows:

Buildings	\$	9,722
Less accumulated depreciation		<u>(5,298)</u>
Total	\$	<u><u>4,424</u></u>

Aggregate annual rental payments to be received during the remaining terms of these agreements as of September 30, 2017 are as follows:

Year ending September 30:		
2018	\$	1,575
2019		1,113
2020		948
2021		878
2022		687
Thereafter		<u>2,196</u>
Total	\$	<u><u>7,397</u></u>

Rental income for the years ended September 30, 2017 and 2016 totaled \$2,012 and \$2,821, respectively.

McLeod Health leases certain equipment and office space used in its operations. Generally, the leases provide for renewal for various periods at stipulated rates. Aggregate future minimum lease payments under noncancelable operating leases as of September 30, 2017 are as follows:

Year ending September 30:		
2018	\$	591
2019		221
2020		<u>3</u>
Total	\$	<u><u>815</u></u>

## MCLEOD HEALTH

### Notes to Consolidated Financial Statements

September 30, 2017 and 2016

(In thousands)

Rent expense related to office space for the years ended September 30, 2017 and 2016 was \$1,951 and \$1,823, respectively. Rent expense related to equipment for the years ended September 30, 2017 and 2016 was \$5,702 and \$6,076, respectively.

McLeod Health is obligated under a capital lease covering land and buildings for MHCI entered into on July 12, 2016. The gross amount of the land and buildings under capital lease was \$23,170 and \$23,170 at September 30, 2017 and 2016, respectively. Accumulated amortization related to this capital lease was \$3,130 and \$846 at September 30, 2017 and 2016, respectively.

### (13) Functional Expenses

McLeod Health primarily provides various healthcare services to its patients. Expenses related to providing these services during fiscal years 2017 and 2016 are summarized as follows:

	<u>2017</u>	<u>2016</u>
Healthcare services	\$ 954,464	840,419
General and administrative	<u>105,215</u>	<u>103,381</u>
Total	<u>\$ 1,059,679</u>	<u>943,800</u>