



MCLEOD HEALTH

Consolidated Financial Statements

September 30, 2018 and 2017

(With Independent Auditors' Report Thereon)

MCLEOD HEALTH

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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 its subsidiaries, which comprise the consolidated balance sheets as of September 30, 2018 and 2017, 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 Consolidated 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 its subsidiaries as of September 30, 2018 and 2017, 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 13, 2018

MCLEOD HEALTH

Consolidated Balance Sheets

September 30, 2018 and 2017

(In thousands)

Assets	2018	2017
Current assets:		
Cash and cash equivalents	\$ 22,951	26,591
Investments	4,947	4,449
Receivables:		
Patient – net of allowances for doubtful accounts of \$139,943 and \$139,270 in 2018 and 2017, respectively	138,244	131,341
Other	8,265	5,558
Inventories	18,766	15,338
Prepaid expenses	14,537	17,093
Total current assets	207,710	200,370
Assets limited as to use	1,039,850	931,384
Property and equipment – net	773,533	723,536
Other assets:		
Goodwill	3,262	3,262
Other assets	15,866	14,030
Total other assets	19,128	17,292
Total assets	\$ 2,040,221	1,872,582
Liabilities and Net Assets		
Current liabilities:		
Current portion of long-term debt	\$ 8,792	7,056
Accounts payable	44,238	47,298
Accrued expenses and other liabilities	78,952	70,601
Estimated third-party settlements	39,767	46,483
Total current liabilities	171,749	171,438
Long-term debt – net of current portion	373,721	286,701
Total liabilities	545,470	458,139
Net assets:		
Unrestricted	1,485,013	1,404,950
Temporarily restricted	6,221	6,225
Permanently restricted	742	742
Total net assets attributable to McLeod Health	1,491,976	1,411,917
Noncontrolling interest in MMP	2,775	2,526
Total net assets	1,494,751	1,414,443
Commitments and contingencies (notes 5, 6, 7, 10, and 12)		
Total liabilities and net assets	\$ 2,040,221	1,872,582

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Operations

Years ended September 30, 2018 and 2017

(In thousands)

	<u>2018</u>	<u>2017</u>
Unrestricted revenues, gains, and other support:		
Patient service revenue – net of contractual and other adjustments	\$ 1,256,707	1,274,103
Provision for bad debts	<u>(165,966)</u>	<u>(227,494)</u>
Net patient service revenue	1,090,741	1,046,609
Other operating revenue	50,364	51,775
Net assets released from restrictions	<u>7,655</u>	<u>4,645</u>
Total unrestricted revenues, gains, and other support	<u>1,148,760</u>	<u>1,103,029</u>
Expenses:		
Personnel	633,326	610,049
Professional fees	39,770	37,800
Supplies	209,303	199,186
Purchased services	89,241	72,910
Facility-related costs	22,396	21,038
Insurance	8,844	8,141
Other	33,449	34,631
Interest	13,661	14,073
Depreciation and amortization	64,265	59,486
Loss on disposal of property	<u>284</u>	<u>2,365</u>
Total expenses	<u>1,114,539</u>	<u>1,059,679</u>
Income from operations	34,221	43,350
Other nonoperating revenues, net	<u>43,185</u>	<u>102,194</u>
Excess of revenues over expenses before noncontrolling interest	77,406	145,544
Less income attributable to noncontrolling interest	<u>(572)</u>	<u>(746)</u>
Excess of revenues over expenses attributable to McLeod Health	76,834	144,798
Net assets released from restrictions for purchases of property and equipment	<u>3,229</u>	<u>1,779</u>
Increase in unrestricted net assets attributable to McLeod Health	\$ <u><u>80,063</u></u>	\$ <u><u>146,577</u></u>

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Changes in Net Assets

Years ended September 30, 2018 and 2017

(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	\$ 1,258,373	6,349	742	2,133	1,267,597
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>
Excess of revenues over expenses	76,834	—	—	572	77,406
Restricted donations and investment income	—	10,880	—	—	10,880
Distributions to noncontrolling interest	—	—	—	(323)	(323)
Net assets released from restrictions for operations	—	(7,655)	—	—	(7,655)
Net assets released from restrictions for property and equipment	<u>3,229</u>	<u>(3,229)</u>	<u>—</u>	<u>—</u>	<u>—</u>
Change in net assets	<u>80,063</u>	<u>(4)</u>	<u>—</u>	<u>249</u>	<u>80,308</u>
Net assets – September 30, 2018	\$ <u>1,485,013</u>	<u>6,221</u>	<u>742</u>	<u>2,775</u>	<u>1,494,751</u>

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Cash Flows

Years ended September 30, 2018 and 2017

(In thousands)

	<u>2018</u>	<u>2017</u>
Cash flows from operating activities:		
Change in net assets	\$ 80,308	146,846
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation	64,596	59,694
Amortization of bond issuance costs and bond premium	(331)	(208)
Provision for bad debts	165,966	227,494
Change in fair value of interest rate swap agreement	(470)	(584)
Loss on disposal of property	284	2,365
Loss on extinguishment of debt	10,299	—
Unrealized and realized gains on investments	(44,909)	(94,610)
Restricted donations and investment income	(10,880)	(6,300)
Noncontrolling interest distributions	323	353
Changes in operating assets and liabilities:		
Patient receivables	(172,869)	(244,979)
Other receivables	(3,626)	(715)
Inventories	(3,428)	(2,526)
Prepaid expenses	2,556	(2,469)
Other assets	(1,836)	(1,903)
Accounts payable	(3,060)	5,599
Accrued expenses and other liabilities	7,956	9,238
Estimated third-party settlements	(6,716)	(9,957)
Net cash provided by operating activities	<u>84,163</u>	<u>87,338</u>
Cash flows from investing activities:		
Proceeds from sales of trading securities	349,711	540,947
Purchases of trading securities	(339,520)	(482,661)
Purchase of property and equipment	(114,012)	(139,020)
Other investing activities	(498)	227
Net cash used in investing activities	<u>(104,319)</u>	<u>(80,507)</u>
Cash flows from financing activities:		
Borrowings of long-term debt	150,837	—
Repayments of long-term debt	(72,049)	(6,706)
Funds limited as to use	(73,748)	(1,231)
Restricted donations and investment income	11,799	5,650
Noncontrolling interest distributions	(323)	(353)
Net cash provided by (used in) financing activities	<u>16,516</u>	<u>(2,640)</u>
Net (decrease) increase in cash and cash equivalents	(3,640)	4,191
Cash and cash equivalents – beginning of year	<u>26,591</u>	<u>22,400</u>
Cash and cash equivalents – end of year	\$ <u>22,951</u>	\$ <u>26,591</u>
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$ 13,660	14,071
Liabilities accrued for the purchase of property and equipment	722	4,358

See accompanying notes to consolidated financial statements.

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Notes to Consolidated Financial Statements

September 30, 2018 and 2017

(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.

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 509-bed teaching hospital and tertiary care referral center located in Florence, South Carolina.

McLeod Medical Center – Dillon is a 66-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. 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 85 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.

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(In thousands)

McLeod Loris Seacoast Hospital 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 50-bed community hospital located in Loris, South Carolina.

McLeod Seacoast is a division of MLSH and operates a 105-bed community hospital located in Little River, South Carolina.

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

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

McLeod Healthcare Network (MHN) is a South Carolina limited liability company that was formed in 2017 and operates a Clinically Integrated Network. There are currently over 400 providers participating in the McLeod Healthcare Network.

(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, MLSH, MHC, and MHCI. The Nonobligated Group consists of MMP, the Foundation, and MHN.

(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.

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(In thousands)

(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.

(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 collectability 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 \$139,943 and \$139,270 as of September 30, 2018 and 2017, respectively.

(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 average cost.

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Notes to Consolidated Financial Statements

September 30, 2018 and 2017

(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) Subtopic 958-805, *Business Combinations*, relating to goodwill. Prior to the adoption of ASC Subtopic 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 Subtopic 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 years ended September 30, 2018 and 2017.

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Notes to Consolidated Financial Statements

September 30, 2018 and 2017

(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, 2018 and 2017 was \$9,420 and \$9,872, 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 \$(193) and \$(663) as of September 30, 2018 and 2017, 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 whose use has been limited by a donor to a specific time period or purpose. Temporarily restricted net assets as of September 30, 2018 and 2017, of \$6,221 and \$6,225, 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 2018 and 2017 of \$10,884 and \$6,424, respectively, included \$3,229 and \$1,779 for the purchase of property and equipment, respectively, and \$7,655 and \$4,645 for operating activities, respectively.

Permanently restricted net assets of \$742 at both September 30, 2018 and 2017 have been restricted by 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.

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Notes to Consolidated Financial Statements

September 30, 2018 and 2017

(In thousands)

(n) 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 2018, McLeod Health continued with its charity care policy to conform to the regulations surrounding the Internal Revenue Service (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).

(o) 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.

(p) 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 Internal Revenue Code (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.

(q) 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.

(r) Subsequent Events

McLeod Health has evaluated events and transactions occurring after September 30, 2018 for potential recognition or disclosure in its consolidated financial statements through December 13, 2018, the date that the consolidated financial statements were issued.

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Notes to Consolidated Financial Statements

September 30, 2018 and 2017

(In thousands)

(s) New Accounting Pronouncements

In February 2016, the FASB issued ASU No. 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 No. 2016-02 is effective for fiscal year 2020.

In August 2016, the FASB issued ASU No. 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 No. 2016-14 is effective for fiscal year 2019.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This ASU establishes principles for reporting useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from the entity's contracts with customers. Particularly, that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU No. 2014-09 is effective for fiscal year 2019.

(t) 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).

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Notes to Consolidated Financial Statements

September 30, 2018 and 2017

(In thousands)

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

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.

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Notes to Consolidated Financial Statements

September 30, 2018 and 2017

(In thousands)

(2) Net Patient Service Revenue

Patient service revenue – net of contractual and other allowances for the years ended September 30, 2018 and 2017 is summarized as follows:

	Year ended September 30, 2018		
	Third-party payors	Self-pay	Total
Patient service revenue	\$ 4,363,140	509,761	4,872,901
Contractual and other adjustments	(3,288,847)	(327,347)	(3,616,194)
Provision for bad debts	—	(165,966)	(165,966)
Net patient service revenue	<u>\$ 1,074,293</u>	<u>16,448</u>	<u>1,090,741</u>

	Year ended September 30, 2017		
	Third-party payors	Self-pay	Total
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>

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 2018, the results of the MAC settlement for the years 2011–2013 were final settled and the associated amounts were recorded. As of September 30, 2018, McLeod Health’s Medicare cost reports have been settled through fiscal year ended September 30, 2013.

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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, 2018, final settlements have been determined by the State of South Carolina for fiscal years through 2012. Management has established reserves for potential Medicaid cost settlements and settlement adjustments for fiscal years 2013–2018.

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 \$17,235 and \$16,962 for the years ended September 30, 2018 and 2017, respectively, and is recorded as other operating expense in the accompanying consolidated statements of operations. McLeod Health accrued approximately \$35,744 and \$25,979 of disproportionate share funds from the state for the years ended September 30, 2018 and 2017, respectively, and recorded the funds as net patient service revenues in the accompanying consolidated statements of operations. McLeod Health continues to evaluate the settlement process related to the South Carolina DSH limit program and believes that it has recorded adequate provisions at September 30, 2018 and 2017 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 \$1,632 and \$9,518 for the years ended September 30, 2018 and 2017, respectively, due to changes in third-party estimates and the settlement of third-party cost reports for fiscal years ended September 30, 2013 through September 30, 2017.

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 \$98,929 and \$65,338 for the years ended September 30, 2018 and 2017, respectively.

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(3) Investments

Investments at September 30, 2018 and 2017 are composed of Level 1 investments held by the Foundation and are recorded as follows:

	<u>2018</u>	<u>2017</u>
Investments held by the Foundation	\$ 9,285	7,920
Less amounts included in assets limited to use	<u>(4,338)</u>	<u>(3,471)</u>
Total investments held as certificates of deposit and money market funds	\$ <u>4,947</u>	<u>4,449</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, 2018 and 2017, as follows:

<u>Fair value measurement as of September 30, 2018</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>
Mutual funds	\$ 3,173	3,173	—	—
Corporate bond funds	461	461	—	—
Government bonds	298	—	298	—
Other	<u>406</u>	<u>—</u>	<u>406</u>	<u>—</u>
Total	\$ <u>4,338</u>	<u>3,634</u>	<u>704</u>	<u>—</u>

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Fair value measurement as of September 30, 2017

	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Mutual funds	\$ 1,558	1,558	—	—
Corporate bond funds	1,106	1,106	—	—
Government bonds	411	—	411	—
Other	396	—	396	—
Total	\$ 3,471	2,664	807	—

(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, 2018 and 2017 and have been designated as follows:

	2018	2017
By the Board of Trustees for future expansion, purchase of property and equipment, and repayment of debt	\$ 1,034,714	918,937
Held by trustee for escrow	789	1,002
Held by the Foundation	4,338	3,471
MRF Trust Fund (note 7)	9	7,974
Total	\$ 1,039,850	931,384

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.

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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, 2018 and 2017, as follows:

Fair value measurement as of September 30, 2018					
	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	\$ 87,002	87,002	—	—	—
Mutual funds	179,332	179,332	—	—	—
Domestic equities	92,470	92,470	—	—	—
Fixed income:					
Government bonds and government-backed securities	39,428	—	39,428	—	—
Corporate bonds	23,469	—	23,469	—	—
Mortgage-backed securities	26,926	—	26,926	—	—
Other	733	—	733	—	—
Large-cap commingled funds:					
State Street Global Advisors S&P 500 Index Funds	65,569	65,569	—	—	—
JPMorgan U.S. Large Cap 130/30 Fund LLC	62,986	—	—	—	62,986
International equity commingled funds:					
Blackrock Global ex-US Tilts B	74,556	—	—	—	74,556
State Street Global Advisors MSCI Index Fund	80,740	80,740	—	—	—
Alternative investments:					
Acadian Global Managed Fund	73,876	—	—	—	73,876
Credit Suisse Dollar Senior Loan Fund Ltd.	37,324	—	—	—	37,324
Blackstone Partners Offshore Fund Ltd.	93,775	—	—	—	93,775
Winton Futures Fund Ltd.	23,370	—	—	—	23,370
Standard Life	23,194	—	—	—	23,194
Real Estate (PRISA)	48,334	—	—	—	48,334
Mercer Private Equity	2,419	—	—	—	2,419
MRF Trust Fund (note 7)	9	9	—	—	—
Investments held by the Foundation (note 3)	4,338	3,634	704	—	—
Total	\$ 1,039,850	508,756	91,260	—	439,834

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Fair value measurement as of September 30, 2017					
	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	\$ 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 Dollar Senior Loan Fund Ltd.	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	—	—
Total	\$ 931,384	385,536	98,447	—	447,401

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.

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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.

Standard Life – The Feeder Fund is 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;

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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.

Private Equity – Mercer Private Investment Partners V, LP was formed to invest in a diversified portfolio of private equity, private debt, and real assets investment funds, which invest in a broad range of private equity, private debt, infrastructure, real estate, energy and other hard-asset oriented investments. This fund selectively targets underlying funds that, in the Investment Manager's opinion, have above average prospects for generating quality investment performance through investing in equity, equity-related, debt, and debt-related securities of private and public companies in negotiated transactions, or through investing in infrastructure, real estate, natural resources or other hard assets. This fund seeks to assemble a portfolio of underlying funds and investments that present a mix of investment strategies, industries, and geographic locations. This fund invests its assets in underlying funds focused on US and non-US investments. The investment objective of this fund is to achieve a rate of return greater than the performance achievable through investing in listed public markets. Another important feature of this fund is a commitment to return cash, rather than securities, to this fund's investors. The Investment Manager will manage the in-kind distributions from portfolio partnerships to preserve and enhance value for this fund's investors. After provision for Partnership expenses, sufficient working capital consistent with good fiscal operating policy and management, taxes payable, and such other needs as the General Partner, in its sole discretion, shall deem appropriate, the General Partner may determine the amount, timing and form of the distribution of all funds received by the Partnership. Subject to the Investment Manager's entitlement to a Performance Fee, as discussed below, distributions will be apportioned and distributed among the Limited Partners in respect of each Class in proportion to their relative commitments.

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 ASU No. 2015-07. 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, 2018 or 2017.

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Other nonoperating revenue, net for the years ended September 30, 2018 and 2017 are as follows:

	<u>2018</u>	<u>2017</u>
Unrealized gains on investments	\$ 6,605	52,834
Realized gains on sales of investments	38,304	41,776
Dividends and interest – net of management fees	8,105	7,000
Change in fair market value of interest rate swap	470	584
Loss on extinguishment of debt	<u>(10,299)</u>	<u>—</u>
Total	<u>\$ 43,185</u>	<u>102,194</u>

(5) Property and Equipment

Property and equipment as of September 30, 2018 and 2017 consist of the following:

	<u>2018</u>	<u>2017</u>
Land and land improvements	\$ 80,272	76,931
Buildings	928,047	841,761
Fixed and moveable equipment	369,895	354,220
Leasehold improvements	33,626	20,038
Construction in progress	<u>77,279</u>	<u>108,984</u>
	1,489,119	1,401,934
Less accumulated depreciation	<u>(715,586)</u>	<u>(678,398)</u>
Total	<u>\$ 773,533</u>	<u>723,536</u>

Depreciation expense for the years ended September 30, 2018 and 2017 was \$64,596 and \$59,694 respectively.

Construction in progress at September 30, 2018 is principally related to projects for facility enhancements and clinical equipment. These projects are expected to be completed during fiscal year 2019 at an estimated total remaining cost to complete of approximately \$97,090 to be funded from operations and bond proceeds. McLeod Health capitalized interest for the years ended September 30, 2018 and 2017 was \$846 and \$0, respectively.

(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 2.26% as of September 30, 2018). Interest is assessed at a variable interest rate adjusted daily and is payable monthly. There were no outstanding borrowings as of September 30, 2018 or 2017.

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(In thousands)

(7) Long-Term Debt

Long-term debt as of September 30, 2018 and 2017 consists of the following:

	<u>2018</u>	<u>2017</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%.	\$ 101,415	105,787
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 (2.41% at September 30, 2018).	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%.	68,166	68,872
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	9,455	9,908
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%. Paid in full in June 2018.	—	64,674
2018 Series bonds, plus unamortized premium, due in annual installments of \$200 to \$12,160, beginning in 2018 and extending to 2048. Interest is paid semiannually at rates ranging from 4.00% to 5.00%.	158,989	—
	<u>384,795</u>	<u>296,011</u>
Less current portion of long-term debt	(8,792)	(7,056)
Less unamortized bond issuance costs	<u>(2,282)</u>	<u>(2,254)</u>
Total	\$ <u><u>373,721</u></u>	<u><u>286,701</u></u>

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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, 2018, management believes that McLeod Health was in compliance with its restrictive financial debt covenants under the master indenture agreement.

On June 28, 2018, the South Carolina Jobs-Economic Development Authority issued its \$144,275 Hospital Refunding and Improvement Revenue Bonds, Series 2018 Bonds and loaned the proceeds thereof to McLeod Regional and McLeod Loris Seacoast Hospital. In connection with the issuance of the 2018 Bonds, McLeod Loris Seacoast Hospital became a Member of the Obligated Group. 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. McLeod Health is subject to various restrictions as a part of debt covenants for the bonds and other debt. As of September 30, 2018, management believes that McLeod Health was in compliance with its restrictive financial debt covenants under the master indenture agreement.

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 called for monthly installments of approximately \$522, which included interest at 7.25%. The final payment was originally due in November 2036. However, the mortgage was paid in full in June 2018.

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 was required to make monthly payments to the MRF, which, when coupled with an assumed investment rate of return of 4%, equaled approximately 12 months and 24 months of mortgage debt service at 5 and 10 years, respectively. Such deposits held by the trustee were included in assets limited to use in the consolidated financial statements. The Agreement also placed limits on the incurrence of additional borrowings and distribution of assets, including cash, and required that certain financial performance measures be satisfied as long as the mortgage is outstanding. The mortgage was paid in full in June 2018.

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Future aggregate annual principal payments applicable to long-term debt as of September 30, 2018, are as follows:

Year ending September 30:		
2019		\$ 8,792
2020		6,436
2021		6,720
2022		12,381
2023		4,513
Thereafter		<u>345,953</u>
Total		<u>\$ 384,795</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 \$10,166 and \$9,982 in fiscal years 2018 and 2017, 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.

The mix of gross receivables from patients and third-party payors as of September 30, 2018 and 2017 is as follows:

	<u>2018</u>	<u>2017</u>
Medicare	43 %	43 %
Medicaid	17	18
Managed care and other commercial insurers	30	29
Self-pay patients	<u>10</u>	<u>10</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

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connection with the ownership of the premises. For the year ended September 30, 2018 or 2017, the landlord had incurred no debt service costs or other expenses in connection with the land.

MHC entered into 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 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.

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September 30, 2018 and 2017

(In thousands)

The health care industry continues to attract much legislative interest and public attention. In March of 2010, 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* was signed into law. The reform will be effective over a 10-year period through 2020 and contains an individual insurance mandate through 2018, 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 \$92,420 remaining to be paid subsequent to September 30, 2018.

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 2018 and 2017 were approximately \$12,727 and \$14,660, respectively. Such transactions primarily consist of payments to Rivers Plumbing and Electric, Inc, where a senior vice president's brother serves as director of operations; Pee Dee Pathology, where a member of the Foundation Board and Board of Trustees practices; Santee Cooper, where a member of the Board is employed; and 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 an employee of an anesthesiology group that has an exclusive arrangement with McLeod Health for provision of anesthesiology services.

In fiscal years 2018 and 2017, McLeod Health purchased insurance coverage from third-party insurance companies involving premiums totaling approximately \$4,142 and \$6,150, respectively. This coverage was placed by an insurance broker who serves on the Board of Trustees of the Foundation.

(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, 2018 are as follows:

Buildings	\$	8,852
Less accumulated depreciation		<u>(3,281)</u>
Total	\$	<u>5,571</u>

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(In thousands)

Aggregate annual rental payments to be received during the remaining terms of these agreements as of September 30, 2018 are as follows:

Year ending September 30:	
2019	\$ 1,291
2020	1,020
2021	1,016
2022	754
2023	520
Thereafter	<u>1,729</u>
Total	<u>\$ 6,330</u>

Rental income for the years ended September 30, 2018 and 2017 totaled \$2,147 and \$2,012, 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, 2018 are as follows:

Year ending September 30:	
2019	\$ 931
2020	916
2021	845
2022	7
Thereafter	<u>3</u>
Total	<u>\$ 2,702</u>

Rent expense related to office space for the years ended September 30, 2018 and 2017 was \$2,147 and \$1,951, respectively. Rent expense related to equipment for the years ended September 30, 2018 and 2017 was \$5,939 and \$5,702, 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 at September 30, 2018 and 2017. Accumulated amortization related to this capital lease was \$5,301 and \$3,130 at September 30, 2018 and 2017, respectively.

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(13) Functional Expenses

McLeod Health primarily provides various healthcare services to its patients. Expenses related to providing these services during fiscal years 2018 and 2017 are summarized as follows:

	<u>2018</u>	<u>2017</u>
Healthcare services	\$ 991,343	954,464
General and administrative	<u>123,196</u>	<u>105,215</u>
Total	<u>\$ 1,114,539</u>	<u>1,059,679</u>