

Consolidated Financial Statements and Report of Independent Certified Public Accountants

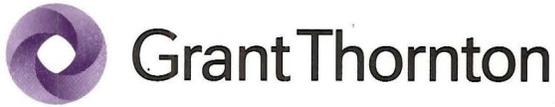
Methodist Health System

September 30, 2017 and 2016

Methodist Health System

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REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors
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d/b/a Methodist Health System

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We have audited the accompanying consolidated financial statements of Methodist Hospitals of Dallas and subsidiaries d/b/a Methodist Health System, which comprise the consolidated statements of financial position as of September 30, 2017 and 2016, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the financial statements.

Management's responsibility for the financial statements

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

Auditor's responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Methodist Health System 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 accounting principles generally accepted in the United States of America.

Grant Thornton LLP

Dallas, Texas
December 20, 2017

Methodist Health System

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

September 30,
(in thousands)

ASSETS	<u>2017</u>	<u>2016</u>
Current assets:		
Cash and cash equivalents	\$ 58,550	\$ 65,104
Short-term investments	917,494	821,159
Patient accounts receivable (net of allowance for uncollectible accounts of \$260,787 and \$230,175 in 2017 and 2016, respectively - Note 2)	249,519	210,108
Health insurance programs reimbursement receivable	2,878	
Other accounts receivable	24,066	28,873
Other current assets	<u>47,666</u>	<u>43,634</u>
Total current assets	1,300,173	1,168,878
Long-term investments	82,198	109,666
Net property, plant, and equipment - Note 3	911,945	914,773
Assets whose use is limited - Note 1	73,698	63,284
Other assets	<u>21,187</u>	<u>26,793</u>
Total assets	<u>\$2,389,201</u>	<u>\$2,283,394</u>
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable and accrued expenses	\$ 127,688	\$ 149,387
Accrued construction costs	4,792	2,416
Health insurance programs reimbursement payable	-	3,283
Current installments of long-term debt - Note 4	<u>9,993</u>	<u>10,265</u>
Total current liabilities	142,473	165,351
Long-term debt - Note 4	528,457	533,178
Interest rate swaps liability - Note 4	49,077	68,332
Other liabilities - Notes 6 and 8	<u>42,828</u>	<u>37,607</u>
Total liabilities	762,835	804,468
Commitments and contingencies - Notes 3 and 6		
Net assets - Note 5:		
Unrestricted net assets attributable to MHS	1,562,651	1,428,907
Unrestricted net assets attributable to noncontrolling interests	15,953	12,663
Temporarily restricted	41,968	31,784
Permanently restricted	<u>5,794</u>	<u>5,572</u>
Total net assets	<u>1,626,366</u>	<u>1,478,926</u>
Total liabilities and net assets	<u>\$2,389,201</u>	<u>\$2,283,394</u>

The accompanying notes are an integral part of these consolidated financial statements.

Methodist Health System

CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS

For the years ended September 30,
(in thousands)

	<u>2017</u>	<u>2016</u>
Net patient service revenue before provision for bad debts	\$1,625,485	\$1,484,921
Provision for bad debts	<u>(143,940)</u>	<u>(115,283)</u>
Net patient service revenue - Notes 1 and 2	1,481,545	1,369,638
Other operating revenue – Note 11	<u>55,069</u>	<u>71,861</u>
Total operating revenue	1,536,614	1,441,499
Operating expenses - Notes 8 and 10		
Salaries, wages and benefit costs	739,670	673,671
Other operating expenses	594,944	549,818
Depreciation and amortization	<u>99,168</u>	<u>90,062</u>
Total operating expenses	<u>1,433,782</u>	<u>1,313,551</u>
Income from operations	102,832	127,948
Nonoperating gains (losses), net - Note 1	<u>59,103</u>	<u>2,106</u>
Excess of revenue over expenses	161,935	130,054
Excess of revenue over expenses attributable to noncontrolling interests	<u>(29,723)</u>	<u>(21,085)</u>
Excess of revenue over expenses attributable to Methodist Health System	<u>\$ 132,212</u>	<u>\$ 108,969</u>

The accompanying notes are an integral part of these consolidated financial statements, including Page 12, containing information on the unreimbursed cost of charity care of approximately \$156 million and \$150 million provided during 2017 and 2016, respectively.

Methodist Health System

CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS -
CONTINUED

For the years ended September 30,
(in thousands)

	2017	2016
Changes in unrestricted net assets:		
Excess of revenue over expenses	\$ 132,212	\$ 108,969
Other changes in unrestricted net assets:		
Changes attributable to noncontrolling interests	3,289	6,807
Net assets released from restrictions used for capital	1,533	3,069
Increase in unrestricted net assets	137,034	118,845
Changes in temporarily restricted net assets:		
Restricted grants, gifts, and bequests	10,066	4,134
Income from investments	2,732	1,925
Increase (decrease) in net assets of related foundation	412	(264)
Transfer to permanently restricted net assets	(80)	(1,199)
Net assets released from restrictions	(2,946)	(4,783)
Decrease in temporarily restricted net assets	10,184	(187)
Changes in permanently restricted net assets:		
Restricted grants, gifts, and bequests	35	34
Income from investments	107	69
Transfer from temporarily restricted net assets	80	1,199
Increase in permanently restricted net assets	222	1,302
Increase in net assets	147,440	119,960
Net assets - beginning of year	1,478,926	1,358,966
Net assets - end of year	<u>\$1,626,366</u>	<u>\$1,478,926</u>

The accompanying notes are an integral part of these consolidated financial statements.

Methodist Health System

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended September 30,
(in thousands)

	2017	2016
Cash flows from operating activities:		
Increase in net assets	\$ 147,440	\$ 119,960
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Operating depreciation and amortization	99,168	90,062
Nonoperating depreciation and amortization	4,900	5,367
Provision for bad debts	143,940	115,283
Capitalized interest	(1,265)	(1,734)
Unrealized (gain) loss on interest rate swaps	(19,255)	13,153
Unrealized and realized gains on investments	(55,592)	(29,176)
Loss (gain) from acquisition of hospital net assets	1,188	(7,774)
Restricted grants, gifts, and bequests and change in interest in the net assets of related foundation	(10,513)	(3,904)
Changes in operating assets and liabilities:		
Increase in patient accounts receivable	(183,351)	(133,336)
Decrease in other accounts receivable	4,807	53,717
Increase in other current assets	(5,220)	(3,351)
Decrease in other assets	5,479	2,015
(Decrease) increase in accounts payable and accrued expenses	(21,700)	19,477
Decrease in health insurance programs reimbursement receivable/payable	(6,161)	(815)
Increase in other liabilities	5,221	7,793
Net cash provided by operating activities	109,086	246,737
Cash flows from investing activities:		
Purchases of investments	(390,449)	(528,783)
Maturities and sales of investments	377,175	454,322
Purchases of property, plant, and equipment	(98,016)	(127,750)
Investment in hospital	-	(17,278)
(Increase) decrease in assets whose use is limited	(10,414)	1,445
Net cash used in investing activities	(121,704)	(218,044)

The accompanying notes are an integral part of these consolidated financial statements.

Methodist Health System

CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED

For the years ended September 30,
(in thousands)

	<u>2017</u>	<u>2016</u>
Cash flows from financing activities:		
Principal payments on debt	\$ (10,922)	\$ (11,503)
Issuance of long-term debt	6,473	404
Restricted grants, gifts, and bequests and change in interest in the net assets of related foundation	<u>10,513</u>	<u>3,904</u>
Net cash provided by (used in) financing activities	<u>6,064</u>	<u>(7,195)</u>
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(6,554)	21,498
Cash and cash equivalents, beginning of year	<u>65,104</u>	<u>43,606</u>
Cash and cash equivalents, end of year	<u>\$ 58,550</u>	<u>\$ 65,104</u>
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 31,490	\$ 26,863
Accrued construction costs	\$ 4,792	\$ 2,416
Property acquired under capital lease	\$ -	\$ 87,000

The accompanying notes are an integral part of these consolidated financial statements.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2017 and 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Methodist Hospitals of Dallas, a 501(c)(3) tax-exempt corporation doing business as Methodist Health System (MHS), owns and operates four acute care hospitals. Two of the hospitals, Methodist Dallas Medical Center, a 585-licensed-bed tertiary care hospital, and Methodist Charlton Medical Center, a 317-licensed-bed community hospital, are located in Dallas, Texas. The third hospital, Methodist Mansfield Medical Center, a 254-licensed-bed community hospital is located in Mansfield, Texas. The remaining hospital, Methodist Richardson Medical Center, is a general acute care hospital with two campuses and a total of 394 licensed beds located in Richardson, Texas. In addition, MHS is the majority owner of Methodist Rehabilitation Hospital, LLC (MRH), a 40-bed post-acute hospital located in Dallas, Texas that is a joint venture with Kindred Healthcare. MHS is also the majority owner of Methodist McKinney Hospital, LLC (McKinney), a 21-bed surgical hospital located in McKinney, Texas, and Methodist Hospital for Surgery (MHfS), a 32-bed surgical hospital located in Addison, Texas. During 2016 Methodist Southlake Hospital (MetSL) was established to lease and operate a 54-bed surgical hospital located in Southlake, Texas. McKinney, MHfS, and MetSL are joint ventures with physicians. MHS's interest in MetSL is owned by North Texas Health Facilities Management, Inc. (NTHFM) a taxable Texas for-profit corporation that is wholly owned by MHS.

The consolidated financial statements include accounts of MHS, MRH, MHfS, MetSL, McKinney, Methodist McKinney Hospital Property, LLC, Methodist Health System Foundation (Foundation), Methodist Medical Group (MMG) formerly named MedHealth, and Pavilion Properties. The Foundation is a 501(c)(3) tax-exempt corporation that was established to raise funds to support the operations of MHS. MMG is a 501(c)(3) physician organization which operates the Family Health Centers and provides surgery coverage for MHS's trauma services. Pavilion Properties is a 501(c)(2) tax-exempt title-holding corporation. All significant intercompany items are eliminated in consolidation.

U.S. Income Tax Status

MHS, MMG, and the Foundation are exempt from federal income taxes under Section 501(a) of the Internal Revenue Code (IRC), as an organization described in IRC Section 501(c)(3). They each have been classified as an organization that is not a private foundation under either IRC Section 509(a)(1) or 509(a)(3), and as such, contributions to them qualify for deduction as charitable contributions.

Due to their organization structure, certain of the consolidated entities are taxable under the IRC and some entities are tax exempt but are required to pay income taxes for income generated from activities unrelated to their exempt purpose under IRC Section 511. In addition, certain of the consolidated entities file U.S. partnership income tax returns. The Texas Margin Tax applies to certain partnerships and taxable entities included in the consolidated financial statements. The overall impact of federal income taxes and Texas Margin Taxes to the MHS consolidated financial statements for the years ended September 30, 2017 and 2016 is not significant.

MHS has concluded that it does not have any unrecognized tax benefits resulting from current or prior period tax positions. Accordingly, no additional disclosures have been made in the financial statements. MHS does not have any outstanding interest or penalties, and none have been recorded in the consolidated statements of operations and changes in net assets for the years ended September 30, 2017 and 2016.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States (US GAAP) requires estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses for the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash equivalents include commercial paper, corporate notes, and U.S. government securities having original maturities, at time of purchase, of 90 days or less. Cash is placed in high credit quality financial institutions. At times such investments may be in excess of the Federal Deposit Insurance Corporation insurance limit. The carrying amounts approximate fair value because of the short maturity of these instruments.

Investments

Investments include those held by the Foundation. Short-term investments include mutual funds and investments having maturities, measured at balance sheet dates, of less than one year. Long-term investments have maturities greater than one year.

Investment income, included in nonoperating gains (losses), is comprised of the following:

	Years ended September 30,	
	<u>2017</u>	<u>2016</u>
	(in thousands)	
Interest and dividend income	\$17,820	\$ 9,748
Realized gains, net	14,075	11,140
Unrealized gains (losses), net	<u>41,517</u>	<u>18,036</u>
	<u>\$73,412</u>	<u>\$38,924</u>

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Investments are comprised of the following:

	<u>September 30,</u>	
	<u>2017</u>	<u>2016</u>
	(in thousands)	
U.S. government and agency securities	\$ 202,221	\$200,897
Corporate bonds	149,645	177,252
Mutual funds	689,863	580,317
Commercial paper	15,884	27,844
Certificates of deposit	<u>249</u>	<u>250</u>
	<u>\$1,057,862</u>	<u>\$986,560</u>

Short-term investments total approximately \$974,154,000 and \$876,894,000 at September 30, 2017 and 2016, respectively. Long-term investments total approximately \$83,708,000 and \$109,666,000 at September 30, 2017 and 2016, respectively. Short-term investments of approximately \$56,664,000 and \$55,735,000 as of September 30, 2017 and 2016, respectively, and long-term investments of approximately \$1,510,000 as of September 30, 2017 are included in assets whose use is limited.

The carrying amounts of corporate bonds, mutual funds, marketable securities and government agency funds approximate fair value based on quoted market prices or that of identical or similar assets in active markets.

Inventory

Inventories are valued at the lower of net realizable value or cost, determined using average cost.

Property, Plant and Equipment

Property, plant and equipment are stated at cost. Depreciation is provided on the straight-line method using the estimated economic lives of depreciable assets, ranging from 3 to 40 years. Expenditures that materially increase values, change capacities, or extend useful lives are capitalized. Routine maintenance and repair items are charged to current operations.

Assets Whose Use Is Limited

Assets whose use is limited include cash and cash equivalents of approximately \$5,917,000 and \$2,308,000 as of September 30, 2017 and 2016, respectively; short-term investments of approximately \$56,664,000 and \$55,735,000 as of September 30, 2017 and 2016, respectively; long-term investments of approximately \$1,510,000 as of September 30, 2017; and other assets, including pledges receivable, of \$9,607,000 and \$5,241,000 at September 30, 2017 and 2016, respectively.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Disclosures About Fair Value of Financial Instruments

US GAAP requires that investments held in equity securities with readily determinable fair values and all investments in debt securities be reported at fair value.

Adjustments for amortization of premium and accretion of discount are included in interest income, which is included in nonoperating gains (losses), net on the accompanying consolidated statements of operations and changes in net assets. Gains or losses on the sale of securities are recognized upon realization using the specific identification method.

All investments with readily determinable fair values are recorded at fair values based on quoted market prices. Investments are considered trading securities. Unrealized gains and losses on investments recorded at fair value are included in the consolidated statements of operations and changes in net assets as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor stipulations or law.

Fair value of fixed rate long-term debt is estimated based on quoted market prices for the same or similar issues. Variable rate long-term debt carrying values approximate fair value because of the frequency with which the interest rates are reset.

Derivative Instruments and Hedging

US GAAP requires that derivative instruments be recorded on the consolidated statements of financial position as either an asset or liability, be measured at their fair value, and that changes in the derivative's fair value be recognized currently in earnings, unless specific hedge accounting criteria are met. MHS utilized six interest rate swap agreements to minimize the risks and costs associated with its financing activities (see Note 4). The interest rate swaps were not designated as hedging instruments. Unrealized gains and losses on interest rate swaps are recorded in nonoperating (losses) gains, net on the consolidated statements of operations and changes in net assets.

Investments in Unconsolidated Companies

MHS has investments in subsidiaries, affiliates, and joint ventures which are not consolidated. Investments in unconsolidated companies owned 20 percent or more are recorded using the equity method and are included in other assets in the accompanying consolidated statements of financial position. Investments in companies less than 20 percent owned, and for which MHS does not exercise significant influence, are recorded at cost. While certain of these companies meet the criteria for consolidation, management believes such presentation is not material to the consolidated financial statements.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Temporarily and Permanently Restricted Net Assets

Temporarily and permanently restricted net assets represent those net assets whose use has been limited by donors to a specific purpose. Permanently restricted net assets have been restricted by donors to be maintained in perpetuity and the income to be used for specific purposes.

Assets in an endowment fund are donor-restricted assets until appropriated for expenditure by MHS. The portion of a donor-restricted endowment that is not permanently restricted has a time restriction until appropriated and is classified as temporarily restricted net assets.

Net Patient Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from patients and third-party payors for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors.

Charity Care

MHS provides care to patients who meet certain criteria under its charity care policy, without charge or for amounts less than its established rates. The amount by which established rates exceed the amount, if any, expected to be collected from patients receiving charity care is not reported as net patient service revenue.

MHS maintains records to identify and monitor the level of charity care it provides under its charity care policy. The unreimbursed cost of charity services provided, including the unreimbursed cost of Medicaid services, was approximately \$156 million and \$150 million in 2017 and 2016, respectively. The unreimbursed cost estimate is derived from applying the ratio of costs to charges to serve all patients to charity patient charges and subtracting payments received that are associated with the charity care.

Medicare and Medicaid Program Reimbursement

Net patient service revenue before provision for uncollectible accounts includes amounts reimbursable by the Medicare and Medicaid programs. Reimbursement for Medicare inpatient services is based on a combination of prospectively determined amounts for operating costs, capital costs, and medical education, and retrospective reimbursement for other costs. Reimbursement for Medicaid inpatient services is based on prospectively determined amounts. Reimbursement for Medicare and Medicaid outpatient services is based on either the hospitals' operating costs, as defined, prospectively determined amounts, or a blend of the operating costs and prospectively determined amounts, depending on the services provided. The commercial managed Medicare and Medicaid inpatient and outpatient business is paid on negotiated rates.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Those payments that are not prospectively determined under the Medicare and Medicaid programs are reimbursed at tentative rates with final settlement determined after submission of annual cost reports, and audits thereof by the Medicare and Medicaid fiscal intermediary. The difference between final determination after audit and the estimated amount accrued is included in net patient service revenue in the year of determination. Net patient service revenue increased approximately \$559,000 and decreased approximately \$178,000 in 2017 and 2016, respectively, due to changes in allowances required as a result of final settlement and current estimates based on the status of audits that are in process or completed but not final.

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. MHS believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing.

MHS recognized net patient service revenue of approximately \$9,000,000 and \$12,000,000 in its fiscal years 2017 and 2016, respectively, from the Texas Health and Human Services' Medicaid Disproportionate Share program. The program obtains funding from intra-governmental transfers of Texas Region 9 and 10 public hospital funds that are matched by U.S. government federal funds and distributed to Texas Region 9 and 10 hospitals that serve a disproportionately large share of uninsured and Medicaid program patients. The distribution received by MHS is based upon the percentage of low-income patients served.

Advertising Costs

Advertising costs are expensed as incurred and were approximately \$6,025,000 and \$6,295,000 for the years ended September 30, 2017 and 2016, respectively.

Nonoperating Gains (Losses), Net

Nonoperating gains (losses), net primarily include interest expense on MHS debt, losses on interest rate swaps, and all investment income. MHS classifies its investments as trading securities and reports investment income, including unrealized gains and losses, within the performance indicator. Interest expense, net of amounts capitalized, was approximately \$29,634,000 and \$24,700,000 for 2017 and 2016, respectively. Interest paid was approximately \$31,490,000 and \$26,863,000 for 2017 and 2016, respectively. Interest of approximately \$1,265,000 and \$1,734,000 was capitalized for each of 2017 and 2016. Unrealized gains (losses) on interest rate swaps were approximately \$19,255,000 and (\$13,153,000) for 2017 and 2016, respectively. Nonoperating gains (losses), net also include losses from operations of unconsolidated companies of \$5,670,000 and \$2,549,000 for 2017 and 2016, respectively; and unrestricted contributions to MHSF of approximately \$637,000 and \$181,000 for 2017 and 2016, respectively.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Contributions

Contributions are recorded as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When expenditures are made that meet the donor specified purpose, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restrictions. The carrying amount of pledges receivable approximates fair value as determined by discounting pledges at an appropriate discount rate commensurate with the risks involved.

Unconditional promises to give cash and other assets to MHS or the Foundation are reported at fair value when the eligibility requirements established by the donor have been satisfied. Pledges are written unconditional promises to make future contributions which, if all eligibility requirements have been satisfied, are recognized as pledges receivable and contribution income at their discounted present value based on future expected collections. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received or becomes an unconditional promise. Undiscounted pledges receivable at September 30, 2017 and 2016 were approximately \$8,317,000 and \$4,339,000, exceeding their discounted present value by approximately \$1,057,000 and \$1,040,000, respectively. Pledges receivable, included in assets whose use is limited, at September 30, 2017 and 2016 were discounted using rates ranging from .04% to 3.40% and .59% to 3.40%, respectively. All pledges receivable are deemed collectible by management; thus, no allowance is required.

Pledges receivable are a component of assets whose use is limited. Pledges outstanding are expected to be collected in the following periods:

	<u>September 30,</u>	
	<u>2017</u>	<u>2016</u>
	(in thousands)	
One year or less	\$2,548	\$ 674
Between one and five years	3,321	1,198
Over five years	<u>1,391</u>	<u>1,427</u>
	<u>\$7,260</u>	<u>\$3,299</u>

There was one conditional promise totaling \$99,905 and \$88,304 at September 30, 2017 and 2016, respectively.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 2 - NET PATIENT SERVICE REVENUE AND PATIENT ACCOUNTS RECEIVABLE

Net patient service revenue before the provision for uncollectible accounts by major payor source for the years ended September 30, 2017 and 2016, are as follows:

	September 30,	
	2017	2016
Medicare	26%	27%
Medicaid	4	4
Managed care	59	58
Self-pay and other	11	11
	100%	100%

MHS provides health care services to patients regardless of their ability to pay. MHS maintains an allowance for uncollectible accounts for estimated losses resulting from a payor's inability to make payments on accounts. The allowance is based on historical write-offs and the aging of the accounts; management continually monitors and adjusts the allowance for uncollectible accounts receivable. Accounts are written off when routine billing and communication with the payor are not expected to result in payment. MHS collection efforts continue, and recoveries of accounts written off are accounted for as reductions in the provision for bad debts. The allowance for uncollectible accounts increased to 39.2% of gross accounts receivable at September 30, 2017 from 36.2% at September 30, 2016. The system maintains collection allowances for all major payor categories including governmental, managed care, and all other, which is primarily the uninsured. At September 30, 2017, the collection allowance total is composed of 12.7% for government payors, 24.9% for managed care payors, and 62.3% for all others, primarily uninsured. At September 30, 2016, the collection allowance total is comprised of 12.4% for government payors, 22.6% for managed care payors, and 65.0% for all others, primarily uninsured. Patient accounts receivable are stated at net realizable value. Concentrations of receivables from patients and other payors include:

	September 30,	
	2017	2016
Managed care providers	71%	78%
Government-related programs	10	9
Self-pay patients and other payors	19	13
	100%	100%

Receivables from government programs (primarily Medicare and Medicaid) represent the only concentrated group of credit risk for MHS, and management does not believe that there are any significant credit risks associated with these government agencies. Managed care and other receivables consist of receivables from various payors involved in diverse activities and subject to differing economic conditions and do not represent any significant concentrated credit risks to MHS.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 3 - PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment and the related accumulated depreciation are as follows:

	September 30,			
	2017		2016	
	Cost	Accumulated depreciation	Cost	Accumulated depreciation
	(in thousands)			
Land	\$ 50,458	\$ -	\$ 50,458	\$ -
Land improvements	41,418	24,670	40,291	22,682
Buildings	1,031,725	449,361	1,021,393	398,016
Fixed equipment	89,047	68,089	84,586	65,764
Movable equipment	618,141	410,834	527,926	369,525
Construction in progress	34,110	-	46,106	-
	<u>\$1,864,899</u>	<u>\$952,954</u>	<u>\$1,770,760</u>	<u>\$855,987</u>
Net book value	<u>\$ 911,945</u>		<u>\$ 914,773</u>	

MHS has several construction and renovation projects in progress for which it has commitments of approximately \$5 million at September 30, 2017, which are expected to be utilized in the next fiscal year.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 4 - LONG-TERM DEBT

Long-term debt is as follows:

	September 30,	
	2017	2016
	(in thousands)	
Tarrant County Cultural Education Facilities Finance Corporation Hospital Revenue Bonds Series 2013 – fixed rate term bonds at rates ranging from 3.00% to 5.25%, payable semi-annually, principal payable annually through 2044	\$178,580	\$183,710
Tarrant County Cultural Education Facilities Finance Corporation Hospital Revenue Bonds Series 2008 - variable rate demand notes payable monthly with an average interest rate of 3.66% and 3.53% for the years ended September 30, 2017 and 2016, respectively, principal payable annually through 2042	169,000	170,200
Capital Lease Obligation at imputed interest rate of 4% payable monthly through 2017	46	179
Methodist McKinney Hospital Property - Real Estate Loan with an interest rate of 4.2%, payable monthly through 2035	28,509	29,599
Methodist McKinney Hospital – Promissory and Equipment Notes with interest rates of 4.25% to 5.0%, payable monthly through 2023	8,337	5,160
Methodist Hospital for Surgery - Related-party capital lease	57,951	58,023
Methodist Southlake Hospital – Building capital lease at an imputed interest rate of 6.14% payable monthly through 2037	<u>87,000</u>	<u>87,000</u>
	529,423	533,871
Unamortized premium	9,027	9,572
Less current installments	<u>(9,993)</u>	<u>(10,265)</u>
Total	<u>\$528,457</u>	<u>\$533,178</u>

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 4 - LONG-TERM DEBT - Continued

The aggregate long-term debt maturing during the years following fiscal 2018 is as follows: 2019 - \$10,441,000; 2020 - \$11,059,000; 2021 - \$11,984,000; 2022 - \$13,769,000; thereafter - \$472,177,000.

In September 2008, MHS borrowed the proceeds of the Tarrant County Cultural Education Facilities Finance Corporation Hospital Revenue Bonds Series 2008 ("Series 2008 Bonds"). The proceeds were used to refund a prior series of bonds. The Series 2008 Bonds consist of Series 2008A Bonds and 2008B Bonds both of which are currently remarketed in a daily mode. Remarketing agents selected by MHS determine the interest rates and market each series of bonds. Additional security for payment of the principal and interest of any Series 2008 Bonds tendered and not remarketed is provided under two irrevocable Letters of Credit issued by a bank. One letter of credit expires October 31, 2018 and the other expires October 31, 2020.

In 2013, MHS borrowed the proceeds of the Tarrant County Cultural Education Facilities Finance Corporation Hospital Revenue Bonds Series 2013 ("Series 2013 Bonds"). The proceeds were used to finance and reimburse the costs of constructing and equipping health facilities.

Methodist McKinney Hospital Property, LLC (MMHP JV), is a joint venture limited liability company established to own and construct a surgical hospital that is leased to McKinney. The loan to MMHP JV is irrevocably and unconditionally guaranteed by its members. MHS's portion of the guarantee is 59.02%.

McKinney has equipment loans, some of which are guaranteed by its members. MHS's portion of those guarantees is 50.5%.

MHfS has a building lease with MHSS-Addison L.P., a related party, for an initial 20 year period through 2030 with an option to extend for three periods of ten years each. MHSS-Addison L.P. is a joint venture which was formed as a financing vehicle in which MHS holds a minority interest. The lease payments escalate throughout the lease each subsequent year based on 3% of the initial year. Because initial rent payments do not exceed the imputed interest on the lease, the amount owed under this agreement increases through 2016. The increase, totaling \$1,834,000 and \$2,126,000 at September 30, 2017 and 2016, respectively, is recorded as deferred interest and included in other liabilities on the consolidated statements of financial position.

MetSL is leasing a building for a 21 year period through 2037 with an option to purchase. The lease payments escalate each year throughout the lease at a rate of 2% with special escalation in years six, eleven, and sixteen based on net patient revenue for the immediately preceding twelve month period. Because initial rent payments do not exceed the imputed interest on the lease, the amount owed under this agreement increases through 2022. The increase, totaling \$2,992,000 and \$2,315,000 at September 30, 2017 and 2016, respectively, is recorded as deferred interest and included in other liabilities on the consolidated statements of financial position.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 4 - LONG-TERM DEBT - Continued

Property, plant, and equipment include the following property under capital lease:

	September 30,	
	2017	2016
	(in thousands)	
Land	\$ 10,450	\$ 10,450
Buildings	134,826	134,826
Equipment	626	626
	145,902	145,902
Less accumulated depreciation	(26,511)	(19,694)
	\$119,391	\$126,208

Aggregate scheduled annual payments on capital lease obligations at September 30, 2017 are as follows: 2018 - \$15,126,000; 2019 - \$15,303,000; 2020 - \$15,520,000; 2021 - \$15,728,000; 2022 - \$16,600,000; thereafter - \$234,833,000. The amount representing interest is \$168,545,000, and the principal balance at year end is \$144,565,000.

In 2007, MHS entered into six interest rate swap transactions in order to substantially fix the expected net interest expenses associated with its bonds. MHS is obligated to make payments to the related swap counterparties at fixed rates of 3.7% per annum on a notional amount of \$84,500,000 and 3.8% per annum on a notional amount of \$84,500,000, and the related swap counterparties are obligated to make reciprocal floating rate payments at a rate equal to 64% of the U.S. dollar one-month LIBOR rate reset weekly, plus 0.2%. The instruments' fair value and changes therein must be measured in MHS's consolidated financial statements. The market value of the swaps, included in noncurrent liabilities, is approximately \$49.1 million and \$68.3 million at September 30, 2017 and 2016, respectively, and the amount included in nonoperating gains (losses) related to the change in value of the swaps is a gain of approximately \$19.3 million for the year ended September 30 2017, and a loss of approximately \$13.1 million for the year ended September 30, 2016. The fair value of the interest rate swaps is estimated based on quotes from the market makers of these investments and represents the estimated amounts MHS could expect to receive or pay to terminate the agreements.

MHS is in compliance with all debt covenants as of September 30, 2017 and 2016.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 5 - TEMPORARILY AND PERMANENTLY RESTRICTED NET ASSETS

Temporarily restricted net assets are available for the following:

	September 30,	
	2017	2016
	(in thousands)	
Golden Cross Indigent Care Program	\$ 6,758	\$ 6,025
Specific Purpose Funds:		
Capital Projects & Equipment	6,907	2,213
Women and Children Services	2,415	1,274
Trauma/Emergency Department	847	1,121
Indigent Care Programs	1,452	1,356
Pastoral Care	1,018	835
Research	71	71
Transplant	325	197
Oncology	350	294
Education and Training	5,324	3,675
Cardiology/Neurology	1,193	1,407
Other	1,470	1,233
Nursing Scholarships	1,352	1,248
Future Fund	37	138
General Endowment	1,173	1,173
Specific Purpose Endowments	<u>8,917</u>	<u>7,576</u>
	39,609	29,836
Interest in net assets of MRMC Foundation	<u>2,359</u>	<u>1,948</u>
	<u>\$41,968</u>	<u>\$31,784</u>

Methodist Richardson Medical Center Foundation, Inc. (MRMC Foundation) was organized as a Texas non-profit corporation established to operate (i) exclusively for the benefit of MRMC and all of its campuses and health care facilities and programs, (ii) for the support of the community as needed for the benefit of MRMC consistent with historical practices, and (iii) consistent with the intent of the donors making grants or charitable contributions pursuing charitable, benevolent, educational and scientific purposes. MRMC Foundation is exempt from federal income taxes under Section 501(a) of the IRC, as an organization described in Section 501(c)(3).

US GAAP requires MHS to record its interest in the net assets of MRMC Foundation and to adjust that interest for changes in its share of the net assets of the MRMC Foundation. The assets of MRMC Foundation are managed solely by its board of directors. MRMC Foundation's board determines the timing of transfers to MHS (dba MRMC). MHS (dba MRMC) maintains an economic interest in MRMC Foundation.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 5 - TEMPORARILY AND PERMANENTLY RESTRICTED NET ASSETS - Continued

Net assets released from restrictions for operations were approximately \$1,413,000 and \$1,714,000 for the years ended September 30, 2017 and 2016, respectively. Net assets released from restrictions for capital were approximately \$1,533,000 and \$3,069,000 for the years ended September 30, 2017 and 2016, respectively.

Permanently restricted net assets, the income from which is restricted to the purposes below, are as follows:

	<u>September 30,</u>	
	<u>2017</u>	<u>2016</u>
	(in thousands)	
Golden Cross Endowment	\$4,221	\$4,099
General Endowment	441	441
Nursing Scholarships	605	506
Specific Purpose Endowments	<u>27</u>	<u>526</u>
	<u>\$5,794</u>	<u>\$5,572</u>

Permanently restricted net assets consist of donor restricted endowment funds that require the principal be invested in perpetuity and only earnings be expended.

NOTE 6 - CONTINGENCIES

MHS is a defendant in various legal proceedings arising in the ordinary course of business. Although the results of litigation cannot be predicted with certainty, management believes the outcome of pending litigation will not have a material adverse effect on MHS's financial statements.

MHS covers its professional and general liability risks through a program of self-insurance and commercial claims-made insurance policies from unrelated companies. The primary self-insurance coverage has a \$5,000,000 retention per claim for all claims incurred after August 31, 2003. Additionally, the coverage has had an aggregate limit capping MHS' self-insurance retention at \$15,000,000 since September 1, 2011. The self-insurance program is funded in MHS's irrevocable self-insurance trust based upon a third-party actuarial study with projected future payments discounted at a 2% discount rate. Under the trust agreement, trust assets, which are included in assets whose use is limited, can only be used for certain payments, primarily claim indemnity payments, expenses and the cost of administering the trust. MHS has limited its liability for losses incurred prior to September 1, 2002 to \$1,000,000 per claim and \$5,000,000 in the aggregate through purchase of a tail insurance option in the expiring policy.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 7 - MEDICAID WAIVER PROGRAM

During 2012, the Texas Health and Human Services Commission (HHSC) implemented a five-year Section 1115 Waiver, Texas Healthcare Transformation and Quality Improvement Program: Medicaid 1115 Waiver (Waiver Program), which was approved by the Centers for Medicare and Medicaid Services (CMS) in December of 2011 to replace the Private Hospital Medicaid Supplemental Payment Program authorized by Medicaid State Plan Amendment TX-05-011 (UPL Program). The Waiver Program replaced the UPL Program with two new pools of funding, the uncompensated care pool (UC pool), and the delivery system reform incentive payment pool (DSRIP pool). The UC pool reimburses hospitals for a portion of the cost of care for Medicaid and uninsured patients for which the hospital does not receive payment. The DSRIP pool provides payments to hospitals and other providers upon their achieving certain goals that are intended to improve the quality and lower the cost of care.

In order to implement the Waiver Program, the State created 20 regional health plan (RHP) areas. MHS has hospitals located in RHP 9, which includes Dallas, Kaufman and Denton Counties, and RHP 10, which includes Tarrant, Hood, Erath, Johnson, Parker, Somervell, and Ellis Counties. Funds for MHS's RHPs will be allocated by Parkland Hospital, acting as the RHP 9 anchor hospital in Dallas, and John Peter Smith Hospital, acting as the RHP 10 anchor hospital in Ft. Worth, in collaboration with area health care providers under protocols approved by the State and CMS.

MHS has Indigent Care Affiliation Agreements with Dallas County Hospital District and Tarrant County Hospital District, and other private hospitals, as a requirement of participation in the Waiver Program. The private hospitals and health care systems who are parties to the Indigent Care Affiliation Agreement are referred to herein as the affiliated hospitals. As a result of this agreement, MHS has recognized net patient service revenue of \$47.5 million and \$53.5 million in 2017 and 2016, respectively.

During 2017 and 2016, MHS recognized a total of \$14.8 million and \$13.1 million, respectively, of DSRIP payments in net patient service revenue for participation in regional health initiatives and to assist patients with chronic health care needs.

CMS has previously stated that it had concerns regarding financial funding arrangements in Texas and the possible effect on the local governmental entity's ability to make intergovernmental transfers on behalf of some private hospitals. HHSC and CMS continue to have frequent discussions on the issue. Management believes that the resolution of this issue will not have a material impact on revenues recorded in the financial statements through September 30, 2017.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 8 - RETIREMENT PLAN

The Methodist Health System Employees Retirement Plan (Plan) has both defined benefit and defined contribution features. The Plan's defined benefit feature was frozen effective January 1, 1993 and replaced with an enhanced defined contribution feature. Plan participants are required to contribute 2.5% of compensation, which is matched by MHS at amounts ranging from 2.5% to 6.25% of the participant's compensation depending on the participant's length of service. The plan includes an additional 1% match for employees making additional voluntary contributions of at least 1% of compensation to the employee 403b plan. Contributions are invested in tax-sheltered annuities in each participant's name. The participant becomes fully vested in the MHS matching contribution after three years of service. Substantially all Plan assets are invested in fixed income and equity mutual funds managed by open-end investment companies. MHS's contributions for the defined contribution feature of the Plan, reflected in salaries, wages and benefit costs in the accompanying consolidated statements of operations and changes in net assets, totaled approximately \$18,801,000 and \$17,277,000 for the years ended September 30, 2017 and 2016, respectively. The total accrued pension asset, which represents the funded status of the defined benefit feature of the Plan, was \$488,529 and \$421,080 as of September 30, 2017 and 2016, respectively.

NOTE 9 - FAIR VALUE OF FINANCIAL INSTRUMENTS

US GAAP emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, US GAAP establishes a three-tier hierarchy to distinguish between various types of inputs used in determining the value of the MHS's investments and liabilities. The inputs are summarized in three levels as outlined below:

Level 1 Inputs - Quoted prices (unadjusted) in active markets for identical assets and liabilities. Assets include publicly traded securities, certificates of deposit, money market funds, government agency funds, and mutual funds. Valuations of these instruments do not require a high degree of judgment as the valuations are based on quoted prices in active markets that are readily available.

Level 2 Inputs - Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities that are not active; and inputs other than quoted prices that are observable, such as models or other valuation methodologies. Assets in this category generally include corporate bonds, commercial paper, and government agency funds. Liabilities in this category include interest rate swaps. Valuations in this category are inherently less reliable than quoted market prices due to the degree of subjectivity involved in determining appropriate methodologies and the applicable underlying assumptions.

Level 3 Inputs - Unobservable inputs for the valuation of the asset or liability. Assets include investments for which there is little, if any, market activity. These inputs require significant management judgment or estimation. MHS has no level 3 assets or liabilities.

MHS's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the financial instrument.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 9 - FAIR VALUE OF FINANCIAL INSTRUMENTS - Continued

The schedule below classifies MHS's assets and liabilities carried at fair value at September 30 based upon the three-tier hierarchy:

		<u>Fair Value Measurements at September 30, 2017</u>		
<u>Description</u>	<u>2017</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>
Assets:				
U.S. government and agency securities	\$ 202,221	\$ 88,799	\$113,422	\$ -
Certificates of deposit	249	249		-
Corporate bonds	149,645		149,645	-
Commercial paper	15,884		15,884	-
Mutual funds	<u>689,863</u>	<u>689,863</u>	<u>-</u>	<u>-</u>
Total investments	<u>\$1,057,862</u>	<u>\$778,911</u>	<u>\$278,951</u>	<u>\$ -</u>
Liabilities:				
Interest rate swaps	<u>\$ 49,077</u>	<u>\$ -</u>	<u>\$ 49,077</u>	<u>\$ -</u>

		<u>Fair Value Measurements at September 30, 2016</u>		
<u>Description</u>	<u>2016</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>
Assets:				
U.S. government and agency securities	\$200,897	\$127,086	\$ 73,811	\$ -
Certificates of deposit	250	250	-	-
Corporate bonds	177,252	-	177,252	-
Commercial paper	27,844	-	27,844	-
Mutual funds	<u>580,317</u>	<u>580,317</u>	<u>-</u>	<u>-</u>
Total investments	<u>\$986,560</u>	<u>\$707,653</u>	<u>\$278,907</u>	<u>\$ -</u>
Liabilities:				
Interest rate swaps	<u>\$ 68,332</u>	<u>\$ -</u>	<u>\$ 68,332</u>	<u>\$ -</u>

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2017 and 2016

NOTE 10 - FUNCTIONAL EXPENSES

MHS provides general health care services. Functional classification of expenses related to providing these services are as follows:

	Years ended	
	September 30,	
	<u>2017</u>	<u>2016</u>
	(in thousands)	
Patient care	\$ 947,724	\$ 858,985
General and administrative	365,345	343,804
Depreciation and amortization	99,168	90,062
Medical education	20,585	19,778
Other	<u>960</u>	<u>922</u>
	<u>\$1,433,782</u>	<u>\$1,313,551</u>

NOTE 11 - METHODIST SOUTHLAKE HOSPITAL

In May of 2016 MetSL Holdings LLC (MetSL Holdings), a majority owned subsidiary of NTHFM, purchased certain assets and assumed certain liabilities of a surgical hospital at their respective fair values as shown below to establish an entity, MetSL, to lease and operate a hospital in Southlake, Texas.

Accounts receivable	\$ 387,000
Inventory	2,492,000
Equipment	23,000,000
Accounts payable and accrued expenses	827,000

This transaction required cash of approximately \$17,278,000 and resulted in a gain of approximately \$7,774,000 which is included in nonoperating gains (losses), net on the accompanying consolidated statements of operations and changes in net assets. In 2017, the gain was reduced by approximately \$1,200,000.

MetSL entered into a lease with a separate entity for the hospital building, which had a fair market value of \$87,000,000. This lease was recorded as a capital lease in the accompanying consolidated financial statements.

In July of 2016, MetSL Holdings sold 47% of its interest in MetSL to a group of physicians.

NOTE 12 - SUBSEQUENT EVENTS

MHS evaluated its financial statements through December 20, 2017, the date that the financial statements are issued, and concludes that no additional disclosures are required.