

Consolidated Financial Statements and Report of Independent Certified Public Accountants

Methodist Health System

September 30, 2018 and 2017

Methodist Health System

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REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

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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, 2018 and 2017, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the 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, 2018 and 2017, 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.

A handwritten signature in black ink that reads "Grant Thornton LLP". The signature is written in a cursive, flowing style.

Dallas, Texas
December 13, 2018

Methodist Health System

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

September 30,
(in thousands)

ASSETS	2018	2017
Current assets:		
Cash and cash equivalents	\$ 79,695	\$ 58,550
Short-term investments	998,367	917,494
Patient accounts receivable (net of allowance for uncollectible accounts of \$259,426 and \$260,787 in 2018 and 2017, respectively - Note 2)	229,952	249,519
Health insurance programs reimbursement receivable	-	2,878
Other accounts receivable	31,730	24,066
Other current assets	55,530	47,666
Total current assets	1,395,274	1,300,173
Long-term investments	129,811	82,198
Net property, plant, and equipment - Note 3	918,779	911,945
Assets whose use is limited - Note 1	76,191	73,698
Other assets	18,269	21,187
Total assets	\$2,538,324	\$2,389,201
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable and accrued expenses	\$ 152,750	\$ 127,688
Accrued construction costs	10,184	4,792
Health insurance programs reimbursement payable	1,581	-
Current installments of long-term debt – Note 4	9,063	9,458
Current portion of capital leases- Note 5	2,677	535
Total current liabilities	176,255	142,473
Long-term debt - Note 4	376,775	383,995
Long-term capital leases – Note 5	145,881	144,462
Interest rate swaps liability - Note 4	35,321	49,077
Other liabilities - Notes 8 and 9	42,982	42,828
Total liabilities	777,214	762,835
Commitments and contingencies - Notes 3 and 8		
Net assets – Notes 6 and 7:		
Unrestricted net assets attributable to MHS	1,693,102	1,562,651
Unrestricted net assets attributable to noncontrolling interests	18,599	15,953
Temporarily restricted	43,492	41,968
Permanently restricted	5,917	5,794
Total net assets	1,761,110	1,626,366
Total liabilities and net assets	\$2,538,324	\$2,389,201

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>2018</u>	<u>2017</u>
Net patient service revenue before provision for bad debts	\$1,718,890	\$1,625,485
Provision for bad debts	<u>(150,865)</u>	<u>(143,940)</u>
Net patient service revenue - Notes 1 and 2	1,568,025	1,481,545
Other operating revenue	<u>48,691</u>	<u>55,069</u>
Total operating revenue	1,616,716	1,536,614
Operating expenses - Notes 10 and 12		
Salaries, wages and benefit costs	769,494	739,670
Other operating expenses	634,984	594,944
Depreciation and amortization	<u>104,681</u>	<u>99,168</u>
Total operating expenses	<u>1,509,159</u>	<u>1,433,782</u>
Income from operations	107,557	102,832
Nonoperating gains, net - Note 1	<u>47,019</u>	<u>59,103</u>
Excess of revenue over expenses	154,576	161,935
Excess of revenue over expenses attributable to noncontrolling interests	<u>(27,890)</u>	<u>(29,723)</u>
Excess of revenue over expenses attributable to Methodist Health System	<u>\$ 126,686</u>	<u>\$ 132,212</u>

The accompanying notes are an integral part of these consolidated financial statements, including Page 13, containing information on the unreimbursed cost of charity care of approximately \$150 million and \$156 million provided during 2018 and 2017, respectively.

Methodist Health System

CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS -
CONTINUED

For the years ended September 30,
(in thousands)

	2018	2017
Changes in unrestricted net assets:		
Excess of revenue over expenses	\$ 126,686	\$ 132,212
Other changes in unrestricted net assets:		
Changes attributable to noncontrolling interests	2,646	3,289
Net assets released from restrictions used for capital	3,765	1,533
Increase in unrestricted net assets	133,097	137,034
Changes in temporarily restricted net assets:		
Restricted grants, gifts, and bequests	4,491	10,066
Income from investments	2,557	2,732
Increase in net assets of related foundation	385	412
Transfer from (to) permanently restricted net assets	17	(80)
Net assets released from restrictions	(5,926)	(2,946)
Increase in temporarily restricted net assets	1,524	10,184
Changes in permanently restricted net assets:		
Restricted grants, gifts, and bequests	36	35
Income from investments	104	107
Transfer (to) from temporarily restricted net assets	(17)	80
Increase in permanently restricted net assets	123	222
Increase in net assets	134,744	147,440
Net assets - beginning of year	1,626,366	1,478,926
Net assets - end of year	\$1,761,110	\$1,626,366

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)

	2018	2017
Cash flows from operating activities:		
Increase in net assets	\$ 134,744	\$ 147,440
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Operating depreciation and amortization	104,681	99,168
Nonoperating depreciation and amortization	5,369	4,900
Provision for bad debts	150,865	143,940
Capitalized interest	(767)	(1,265)
Unrealized gain on interest rate swaps	(13,756)	(19,255)
Unrealized and realized gains on investments	(24,426)	(55,592)
Loss from acquisition of hospital net assets	1,021	1,188
Restricted grants, gifts, and bequests and change in interest in the net assets of related foundation	(4,912)	(10,513)
Changes in operating assets and liabilities		
Increase in patient accounts receivable	(127,527)	(183,351)
(Increase) decrease in other accounts receivable	(9,143)	4,807
Increase in other current assets	(8,554)	(5,220)
(Increase) decrease in other assets	(4,208)	5,479
Increase (decrease) in accounts payable and accrued expenses	22,819	(21,700)
Increase (decrease) in health insurance programs reimbursement payable/receivable	4,459	(6,161)
(Decrease) increase in other liabilities	<u>(4,765)</u>	<u>5,221</u>
Net cash provided by operating activities	225,900	109,086
Cash flows from investing activities:		
Purchases of investments	(406,869)	(390,449)
Maturities and sales of investments	302,808	377,175
Purchases of property, plant, and equipment	(98,125)	(98,016)
Cash from acquisition or consolidation of joint ventures	4,256	-
Increase in assets whose use is limited	<u>(2,493)</u>	<u>(10,414)</u>
Net cash used in investing activities	<u>\$(200,423)</u>	<u>\$(121,704)</u>

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)

	2018	2017
Cash flows from financing activities:		
Principal payments on debt	\$(12,242)	\$(10,788)
Principal payments on capital leases	(2,164)	(134)
Issuance of long-term debt	5,162	6,473
Restricted grants, gifts, and bequests and change in interest in the net assets of related foundation	4,912	10,513
Net cash (used in) provided by financing activities	(4,332)	6,064
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	21,145	(6,554)
Cash and cash equivalents, beginning of year	58,550	65,104
Cash and cash equivalents, end of year	\$ 79,695	\$ 58,550
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 31,094	\$ 31,490
Accrued construction costs	\$ 10,184	\$ 4,792
Property acquired under capital leases	\$ 269	\$ -

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

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2018 and 2017

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, Methodist Hospital for Surgery (MHfS), a 32-bed surgical hospital located in Addison, Texas, and Methodist Southlake Hospital (MetSL), 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, Pavilion Properties, MHD-USO Management Company, LP (MHD-USO), and beginning with the year ended September 30, 2018, Methodist Diagnostic Imaging of Texas, LLC (Imaging Center JV) and Methodist-CDI. 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, Methodist-CDI, 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 Tax Cuts and Jobs Act (the Act) was enacted on December 22, 2017. The Act reduced the US federal corporate tax rate from 35% to 21%. For tax exempt entities, effective beginning with the 2018 tax year, the Act also requires organizations to categorize certain fringe benefit expenses as a source of unrelated business income, pay an excise tax on executive remuneration above certain thresholds, and report income or loss from unrelated business activities on an activity by activity basis among other provisions. The tax effects of the Act did not have a material impact on MHS.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

The overall impact of federal income taxes and Texas Margin Taxes to the MHS consolidated financial statements for the years ended September 30, 2018 and 2017 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, 2018 and 2017. MHS is no longer subject to examination by U.S. federal and state taxing authorities for years through September 31, 2014.

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, net is comprised of the following:

	Years ended September 30,	
	2018	2017
	(in thousands)	
Interest and dividend income	\$18,031	\$17,820
Realized gains, net	26,714	14,075
Unrealized gains, net	<u>12,030</u>	<u>41,517</u>
	<u>\$56,775</u>	<u>\$73,412</u>

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Investments are comprised of the following:

	<u>September 30,</u>	
	<u>2018</u>	<u>2017</u>
	(in thousands)	
U.S. government and agency securities	\$ 246,254	\$ 202,221
Corporate bonds	137,363	149,645
Mutual funds	771,681	689,863
Commercial paper	31,304	15,884
Certificates of deposit	<u>344</u>	<u>249</u>
	<u>\$1,186,946</u>	<u>\$1,057,862</u>

Short-term investments total approximately \$1,057,135,000 and \$974,154,000 at September 30, 2018 and 2017, respectively. Long-term investments total approximately \$129,811,000 and \$83,708,000 at September 30, 2018 and 2017, respectively. Short-term investments of approximately \$58,768,000 and \$56,660,000 as of September 30, 2018 and 2017, 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 \$8,423,000 and \$5,921,000 as of September 30, 2018 and 2017, respectively; short-term investments of approximately \$58,768,000 and \$56,660,000 as of September 30, 2018 and 2017, respectively; long-term investments of approximately \$1,510,000 as of September 30, 2017; and other assets, including pledges receivable, of \$9,000,000 and \$9,607,000 at September 30, 2018 and 2017, respectively.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

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, 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 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. At September 30, 2018 unconsolidated companies include North Texas Health Facilities Management, Inc. (NTHFM), formed primarily for operation of properties and provision of services that are not tax exempt; Methodist Transplant Physicians (MTP), provides a mechanism for global billing for transplant services; Physician Associates of Southwest Dallas (PASD), employs physicians providing teaching services in MHS's medical education programs; Associates in Surgical Care (ASAC) provides professional cardiac care services; Methodist Urgent Care (MUC), initially formed to provide urgent care services, holds leases for former urgent care centers; North Central Texas Services d/b/a CareFlite (CareFlite), provides ambulance services; Texas Rehabilitation Hospital of Arlington, LLC (TRHA); and SRP Medica Investors – Addison, LP (SRP Addison), investor in property. Each of these companies was recorded using the equity method. 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, 2018 and 2017

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

The ownership interest, carrying value and equity in earnings of unconsolidated companies at September 30, 2018 and 2017 are as follows (\$ in thousands):

	<u>Ownership Interest</u>		<u>Carrying Value</u>		<u>Equity in Earnings</u>	
	<u>2018</u>	<u>2017</u>	<u>2018</u>	<u>2017</u>	<u>2018</u>	<u>2017</u>
NTHFM	100%	100%	\$ 873	\$ 505	\$ 404	\$ 291
ASAC	100%	100%	171	115	(286)	(468)
MTP	100%	100%	(2,019)	(2,264)	518	407
PASD	100%	100%	(980)	(875)	(224)	(394)
MUC	51%	51%	(559)	(1,467)	647	(61)
CareFlite	25%	25%	3,342	3,671	329	(431)
TRHA	19%	19%	779	823	502	532
SRP Addison	22%	22%	(1,475)	(1,965)	434	416
Imaging	51%	51%	<u>-</u>	<u>4,219</u>	<u>-</u>	<u>(5,928)</u>
			<u>\$ 132</u>	<u>\$ 2,762</u>	<u>\$ 2,324</u>	<u>\$(5,636)</u>

At September 30, 2017 the Imaging Center JV and Methodist-CDI were not consolidated. These two entities are combined as Imaging in the above table

Carrying values of unconsolidated companies are included in other assets in the accompanying statements of financial position. Equity in earnings of unconsolidated companies providing services that MHS does not provide as part of its routine services are included in nonoperating gains (losses) and others are included in operations in the accompanying statements of operations and changes in net assets.

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.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

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 \$150 million and \$156 million in 2018 and 2017, 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.

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 decreased approximately \$459,000 and increased approximately \$559,000 in 2018 and 2017, 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.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

MHS recognized net patient service revenue of approximately \$8,000,000 and \$9,000,000 in its fiscal years 2018 and 2017, 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 \$5,697,000 and \$6,025,000 for the years ended September 30, 2018 and 2017, respectively.

Nonoperating Gains, Net

Nonoperating gains, net primarily include interest expense on MHS debt, gains 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. A summary of nonoperating gains for the years ended September 30, 2018 and 2017 is presented below (in thousands):

	<u>2018</u>	<u>2017</u>
Interest expense, net	\$(29,700)	\$(29,634)
Unrealized gains on interest rate SWAPS	13,756	19,255
Investment income	56,775	73,412
Gains (losses) from unconsolidated companies	1,815	(5,670)
Other, net	2,543	1,103
Unrestricted contributions to MHSF	<u>1,830</u>	<u>637</u>
	<u>\$ 47,019</u>	<u>\$ 59,103</u>

Interest expense presented above is net of amounts capitalized of approximately \$767,000 and \$1,265,000 for the years ended September 30, 2018 and 2017, respectively.

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.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

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, 2018 and 2017 were approximately \$7,220,000 and \$8,317,000, exceeding their discounted present value by approximately \$961,000 and \$1,057,000, respectively. Pledges receivable, included in assets whose use is limited, at September 30, 2018 and 2017 were discounted using rates ranging from .76% to 3.10% and .04% 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>2018</u>	<u>2017</u>
	(in thousands)	
One year or less	\$3,168	\$2,548
Between one and five years	1,707	3,321
Over five years	<u>1,384</u>	<u>1,391</u>
	<u>\$6,259</u>	<u>\$7,260</u>

There was one conditional promise totaling \$99,936 and \$99,905 at September 30, 2018 and 2017, respectively.

Recent Accounting Pronouncements

In May 2014, Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers (Topic 606), which supersedes the current revenue recognition requirements in Topic 605, Revenue Recognition. The ASU is based on the principle that revenue is recognized to depict the transfer of 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. The ASU is effective for MHS's year ending September 30, 2019 and is not expected to have a material impact on the consolidated financial statements.

In February 2016, FASB issued ASU 2016-02, Leases, which will supersede the current lease guidance in current GAAP. The ASU requires lessees to recognize a right of use asset and a related lease liability for all leases, with the limited exception of short-term leases. The main difference with current practice is that lessees will be required to record an asset and liability for what is now considered an operating lease. The ASU is effective for MHS's year ending September 30, 2020 and is not expected to have a material impact on the consolidated statements of operations and changes in net assets. The impact on the consolidated statements of financial position is being evaluated.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

In August 2016, FASB issued ASU 2016-14, Presentation of Financial Statements of Not-for-Profit Entities. The ASU requires significant changes to the financial reporting model, including moving from three classes of net assets down to two classes, net assets with donor restrictions and net assets without donor restrictions and expanded disclosures concerning expenses and liquidity. The ASU will also require changes in the way certain information is aggregated and reported. The ASU is effective for MHS's year ending September 30, 2019. MHS has evaluated the impact of this standard noting it will significantly change the presentation of the financial statements.

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, 2018 and 2017, are as follows:

	September 30,	
	2018	2017
Medicare	29%	26%
Medicaid	4	4
Managed care	57	59
Self-pay and other	<u>10</u>	<u>11</u>
	<u>100%</u>	<u>100%</u>

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 40.8% of gross accounts receivable at September 30, 2018 from 39.2% at September 30, 2017. MHS maintains collection allowances for all major payor categories including governmental, managed care, and all other, which is primarily the uninsured. At September 30, 2018, the collection allowance total is composed of 14.1% for government payors, 20.6% for managed care payors, and 65.3% for all others, primarily 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. Patient accounts receivable are stated at net realizable value. Concentrations of receivables from patients and other payors include:

	September 30,	
	2018	2017
Managed care providers	69%	71%
Government-related programs	7	10
Self-pay patients and other payors	<u>24</u>	<u>19</u>
	<u>100%</u>	<u>100%</u>

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 2 - NET PATIENT SERVICE REVENUE AND PATIENT ACCOUNTS RECEIVABLE - Continued

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.

NOTE 3 - PROPERTY, PLANT AND EQUIPMENT

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

	September 30,			
	2018		2017	
	Cost	Accumulated depreciation	Cost	Accumulated depreciation
	(in thousands)			
Land	\$ 53,889	\$ -	\$ 50,458	\$ -
Land improvements	44,409	26,700	41,418	24,670
Buildings	919,468	467,623	886,449	423,445
Fixed equipment	107,660	81,657	89,047	68,089
Movable equipment	646,042	457,529	617,515	410,239
Buildings and equipment under capital lease	153,256	36,899	145,902	26,511
Construction in progress	<u>64,463</u>	<u>-</u>	<u>34,110</u>	<u>-</u>
	<u>\$1,989,187</u>	<u>\$1,070,408</u>	<u>\$1,864,899</u>	<u>\$952,954</u>
Net book value	<u>\$ 918,779</u>		<u>\$ 911,945</u>	

MHS has several construction and renovation projects in progress for which it has commitments of approximately \$55 million at September 30, 2018, which are expected to be utilized in the next fiscal year.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 4 - LONG-TERM DEBT

Long-term debt is as follows:

	September 30,	
	2018	2017
	(in thousands)	
Tarrant County Cultural Education Facilities Finance Corporation Hospital Revenue Bonds Series 2013 – fixed rate term bonds at rates ranging from 4.00% to 5.25%, payable semi-annually, principal payable annually through 2044	\$173,370	\$178,580
Tarrant County Cultural Education Facilities Finance Corporation Hospital Revenue Bonds Series 2008 - variable rate demand notes payable monthly with an average interest rate of 3.53% and 3.66% for the years ended September 30, 2018 and 2017, respectively, principal payable annually through 2042	167,600	169,000
Methodist McKinney Hospital Property - Real Estate Loan with an interest rate of 4.2%, payable monthly through 2035	27,372	28,509
Methodist McKinney Hospital – Promissory and Equipment Notes with interest rates of 4.25% to 5.0%, payable monthly through 2023	<u>9,008</u>	<u>8,337</u>
	377,350	384,426
Unamortized premium	8,488	9,027
Less current installments	<u>(9,063)</u>	<u>(9,458)</u>
Total	<u>\$376,775</u>	<u>\$383,995</u>

The aggregate long-term debt maturing during the years following fiscal 2019 is as follows: 2020 - \$10,320,000; 2021 - \$10,824,000; 2022 - \$11,454,000; 2023 - \$10,742,000; 2024 - \$11,049,000; thereafter - \$313,898,000.

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, 2020 and the other expires October 31, 2021.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 4 - LONG-TERM DEBT - Continued

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%.

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 \$83,800,000 and 3.8% per annum on a notional amount of \$83,800,000, 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 \$35.3 million and \$49.1 million at September 30, 2018 and 2017, respectively, and the amount included in nonoperating gains (losses) related to the change in value of the swaps is a gain of approximately \$13.8 million and \$19.3 million for the years ended September 30, 2018 and 2017, respectively. 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, 2018 and 2017.

NOTE 5 - CAPITAL LEASES

MHS is the lessee in several real estate and equipment capital leases. At September 30, 2018 future rental payments applicable to capital leases are as follows (in thousands):

<u>Year</u>	<u>Amount</u>
2019	\$ 17,389
2020	17,677
2021	17,643
2022	17,588
2023	17,872
2024-2037	<u>217,006</u>
Total payments	305,175
Less interest	(156,617)
Less current portion of capital leases	<u>(2,677)</u>
Long-term capital leases	<u>\$ 145,881</u>

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 5 - CAPITAL LEASES - Continued

Because initial rent payments do not exceed imputed interest on certain capital leases, the amount owed under the agreements increases during the first several years. These increases, totaling \$4,775,000 and \$4,826,000 at September 30, 2018 and 2017, respectively, are recorded as deferred interest and included in other liabilities on the consolidated statements of financial position.

NOTE 6 - TEMPORARILY AND PERMANENTLY RESTRICTED NET ASSETS

Temporarily restricted net assets are available for the following:

	September 30,	
	2018	2017
	(in thousands)	
Golden Cross Indigent Care Program	\$ 7,692	\$ 6,758
Specific Purpose Funds:		
Capital Projects & Equipment	8,267	6,907
Women and Children Services	1,143	2,415
Trauma/Emergency Department	741	847
Indigent Care Programs	1,513	1,452
Pastoral Care	928	1,018
Research	71	71
Transplant	369	325
Oncology	264	350
Education and Training	5,142	5,324
Cardiology/Neurology	50	1,193
Other	1,728	1,470
Nursing Scholarships	1,450	1,352
Future Fund	29	37
General Endowment	1,173	1,173
Specific Purpose Endowments	<u>10,188</u>	<u>8,917</u>
	40,748	39,609
Interest in net assets of MRMC Foundation	<u>2,744</u>	<u>2,359</u>
	<u>\$43,492</u>	<u>\$41,968</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).

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 6 - TEMPORARILY AND PERMANENTLY RESTRICTED NET ASSETS - Continued

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.

Net assets released from restrictions for operations were approximately \$2,161,000 and \$1,413,000 for the years ended September 30, 2018 and 2017, respectively. Net assets released from restrictions for capital were approximately \$3,765,000 and \$1,533,000 for the years ended September 30, 2018 and 2017, respectively.

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

	<u>September 30,</u>	
	<u>2018</u>	<u>2017</u>
	(in thousands)	
Golden Cross Endowment	\$4,334	\$4,221
General Endowment	441	441
Nursing Scholarships	615	605
Specific Purpose Endowments	<u>527</u>	<u>527</u>
	<u>\$5,917</u>	<u>\$5,794</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 7 - ENDOWMENT

Endowments consists of individual endowment funds established for a variety of purposes including both donor-restricted endowment funds and funds designated by the board of directors to function as endowments. Net assets associated with endowment funds, including funds designated to function as endowments, are classified and reported based on the existence or absence of donor-imposed restrictions.

Interpretation of Relevant Law

Under UPMIFA, the assets in an endowment fund are donor-restricted until appropriated for expenditure by the Foundation. UPMIFA eliminates the concept of historical dollar value. MHS interprets UPMIFA as allowing the board of directors, absent donor stipulations to the contrary as stated in the gift instrument, to appropriate so much of a donor-restricted endowment fund as MHS determines is prudent for the uses, benefits, purposes, and duration for which the endowment is established. The assets in the endowment fund remain restricted until appropriated for expenditure.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 7 - ENDOWMENT - Continued

In determining whether to appropriate or accumulate fund assets, MHS must act in good faith with the care that an ordinarily prudent person in a like position would exercise under similar circumstances. The following factors are considered in making a determination to appropriate or accumulate donor restricted endowment funds: 1) the duration and preservation of the fund; 2) the purposes of MHS and the donor restricted endowment fund; 3) general economic conditions; 4) the possible effect of inflation and deflation; 5) the expected total return from income and the appreciation of investments; 6) other resources of MHS; and 7) the investment policies of MHS.

Endowment net asset composition by type of fund is as follows (in thousands):

	September 30, 2018			
	<u>Unrestricted</u>	Temporarily <u>Restricted</u>	Permanently <u>Restricted</u>	<u>Total</u>
Donor-restricted endowment funds	\$ -	\$1,899	\$5,917	\$ 7,816
Board-designated endowment funds	<u>81,004</u>	<u>-</u>	<u>-</u>	<u>81,004</u>
Total endowment net assets	<u>\$81,004</u>	<u>\$1,899</u>	<u>\$5,917</u>	<u>\$88,820</u>
		September 30, 2017		
	<u>Unrestricted</u>	Temporarily <u>Restricted</u>	Permanently <u>Restricted</u>	<u>Total</u>
Donor-restricted endowment funds	\$ -	\$1,377	\$5,794	\$ 7,171
Board-designated endowment funds	<u>74,572</u>	<u>-</u>	<u>-</u>	<u>74,572</u>
Total endowment net assets	<u>\$74,572</u>	<u>\$1,377</u>	<u>\$5,794</u>	<u>\$81,743</u>

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 7 - ENDOWMENT - Continued

Changes in endowment net assets are as follows (in thousands):

	Year Ended September 30, 2018			<u>Total</u>
	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	
Endowment net assets, beginning of year	<u>\$74,572</u>	<u>\$1,377</u>	<u>\$5,794</u>	<u>\$81,743</u>
Contributions	-	-	36	36
Dividends and interest	1,113	122	-	1,235
Net realized and unrealized gains	7,436	400	77	7,913
Appropriation of endowment assets for expenditure	(2,117)	-	-	(2,117)
Transfers	<u>-</u>	<u>-</u>	<u>10</u>	<u>10</u>
Endowment net assets, end of year	<u>\$81,004</u>	<u>\$1,899</u>	<u>\$5,917</u>	<u>\$88,820</u>
	Year Ended September 30, 2017			
	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$65,273	\$ 785	\$5,572	\$71,630
Contributions	-	-	35	35
Dividends and interest	1,048	119	7	1,174
Net realized and unrealized gains	10,264	473	76	10,813
Appropriation of endowment assets for expenditure	(2,013)	-	-	(2,013)
Transfers	<u>-</u>	<u>-</u>	<u>104</u>	<u>104</u>
Endowment net assets, end of year	<u>\$74,572</u>	<u>\$1,377</u>	<u>\$5,794</u>	<u>\$81,743</u>

Return Objective and Risk Parameters

Investment and spending policies have been adopted for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of the endowment assets. Endowments include those assets of donor restricted funds that MHS must hold in perpetuity or for a donor specified period as well as board designated funds.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 7 - ENDOWMENT - Continued

Strategies Employed for Achieving Objectives

To satisfy its long-term rate-of-return objectives, the organization relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). MHS targets a diversified asset allocation that places emphasis on the investment choices necessary to achieve each fund's objectives within prudent risk constraints. The asset allocation is reviewed at least annually.

Spending Policy and How the Investment Objectives Relate to Spending Policy

The primary long-term management objective of the endowment is to preserve the real purchasing power of the endowment, while providing a predictable, stable, and constant (in real terms) stream of earnings consistent with the MHS's spending needs. Spending policies limit each fund's annual distribution to a percentage of its endowment fund's average fair value over the prior twelve quarters through the fiscal year-end preceding the fiscal year in which the distribution is planned. Spending limits vary between 4% and 5% for each fund. In the event actual returns in any given year are negative, a distribution may not be made from an endowment fund when such distribution would cause the market value of the fund to fall below the fund's historic dollar value without the approval of the board of directors or the donor who established the fund.

Funds with Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or UPMIFA requires MHS to retain as a fund of perpetual duration. No funds have fallen below their original gift value as of September 30, 2018 and 2017.

NOTE 8 - 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 liability for claims was approximately \$20,138,000 and \$17,919,000 at September 30, 2018 and 2017, respectively, and is recorded in other liabilities in the accompanying consolidated statements of financial position. 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, 2018 and 2017

NOTE 9 - 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. Through September 30, 2017, funds for MHS's RHPs were 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. However, 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. In August 2018, CMS was successful in obtaining a ruling that disallowed matching funds for the quarter ended December 31, 2015. The resolution of this issue did not have a material impact on the consolidated financial statements through September 30, 2018.

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. In June 2017, Texas Legislature approved legislation that authorized Dallas County Hospital District and Tarrant County Hospital District to create and operate health care provider participation programs (Local Provider Participation Funds or LPPF). Each program requires a mandatory payment fee from every hospital in its respective county that provides inpatient care, which is then used to fund intergovernmental transfers that allow access to federal matching funds for Medicaid Supplemental programs. During 2018, the Medicaid Supplemental programs funded by this financing mechanism were UC pool and the Uniform Hospital Rate Increase Program (UHRIP), which began March 1, 2018. As a result of this agreement and the LPPF program, MHS has recognized net patient service revenue of \$60.1 million and \$47.5 million in 2018 and 2017, respectively.

During 2018 and 2017, MHS recognized a total of \$14.7 million and \$14.8 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.

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 10 - 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 \$20,715,000 and \$18,801,000 for the years ended September 30, 2018 and 2017, respectively. The total accrued pension asset, which represents the funded status of the defined benefit feature of the Plan, was \$623,356 and \$488,529 as of September 30, 2018 and 2017, respectively.

NOTE 11 - 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, 2018 and 2017

NOTE 11 - 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 (in thousands):

		<u>Fair Value Measurements at September 30, 2018</u>		
<u>Description</u>	<u>2018</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	\$ 246,254	\$129,605	\$116,649	\$ -
Certificates of deposit	344	344	-	-
Corporate bonds	137,363	-	137,363	-
Commercial paper	31,304	-	31,304	-
Mutual funds	<u>771,681</u>	<u>771,681</u>	<u>-</u>	<u>-</u>
Total investments	<u>\$1,186,946</u>	<u>\$901,630</u>	<u>\$285,316</u>	<u>\$ -</u>
Liabilities:				
Interest rate swaps	<u>\$ 35,321</u>	<u>\$ -</u>	<u>\$ 35,321</u>	<u>\$ -</u>
		<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>

Methodist Health System

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2018 and 2017

NOTE 12 - 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>2018</u>	<u>2017</u>
	(in thousands)	
Patient care	\$ 999,767	\$ 947,724
General and administrative	382,460	365,345
Depreciation and amortization	104,681	99,168
Medical education	21,061	20,585
Other	<u>1,190</u>	<u>960</u>
	<u>\$1,509,159</u>	<u>\$1,433,782</u>

NOTE 13 - SUBSEQUENT EVENTS

MHS evaluated its financial statements through December 13, 2018, the date that the financial statements are issued, and concludes that no additional disclosures are required.