

Consolidated Financial Statements and Report of Independent Certified Public Accountants

**Methodist Health System**

September 30, 2019 and 2018

## Methodist Health System

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**REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS**

Board of Directors  
Methodist Hospitals of Dallas  
d/b/a Methodist Health System

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, 2019 and 2018 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, 2019 and 2018, 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 12, 2019

## Methodist Health System

### CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

As of September 30,  
(in thousands)

ASSETS	<u>2019</u>	<u>2018</u>
Current assets:		
Cash and cash equivalents	\$ 102,418	\$ 79,695
Short-term investments - Note 1	1,073,887	998,367
Patient accounts receivable - Note 2	201,898	229,952
Other accounts receivable	22,276	31,730
Other current assets	<u>73,701</u>	<u>55,530</u>
Total current assets	1,474,180	1,395,274
Long-term investments	153,787	129,811
Net property, plant, and equipment - Note 3	967,342	918,779
Assets whose use is limited - Note 1	84,105	76,191
Other assets	<u>21,198</u>	<u>18,269</u>
Total assets	<u>\$2,700,612</u>	<u>\$2,538,324</u>
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable and accrued expenses	\$ 174,465	\$ 152,750
Accrued construction costs	19,319	10,184
Health insurance programs reimbursement payable	1,473	1,581
Current installments of long-term debt - Note 4	9,129	9,063
Current portion of capital leases - Note 5	<u>3,238</u>	<u>2,677</u>
Total current liabilities	207,624	176,255
Long-term debt - Note 4	340,012	376,775
Long-term capital leases - Note 5	186,757	145,881
Interest rate swaps liability - Note 4	61,827	35,321
Other liabilities - Notes 8 and 9	<u>70,140</u>	<u>42,982</u>
Total liabilities	<u>866,360</u>	<u>777,214</u>
Commitments and contingencies - Notes 3 and 8		
Net assets - Notes 6 and 7:		
Net assets without donor restrictions		
Attributable to MHS	1,786,403	1,693,102
Attributable to noncontrolling interests	(745)	18,599
Net assets with donor restrictions	<u>48,594</u>	<u>49,409</u>
Total net assets	<u>1,834,252</u>	<u>1,761,110</u>
Total liabilities and net assets	<u>\$2,700,612</u>	<u>\$2,538,324</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>2019</u>	<u>2018</u>
Net patient service revenue - Notes 1 and 2	\$1,678,082	\$1,568,025
Other operating revenue	<u>54,767</u>	<u>48,691</u>
Total operating revenue	1,732,849	1,616,716
Operating expenses - Notes 10 and 13		
Salaries, wages and benefit costs	827,706	769,494
Other operating expenses	664,357	634,984
Interest expense	29,715	29,700
Depreciation and amortization	<u>105,254</u>	<u>104,681</u>
Total operating expenses	<u>1,627,032</u>	<u>1,538,859</u>
Income from operations	105,817	77,857
Nonoperating gains, net - Note 1	<u>5,006</u>	<u>76,719</u>
Excess of revenue over expenses	110,823	154,576
Excess of revenue over expenses attributable to noncontrolling interests	<u>(22,301)</u>	<u>(27,890)</u>
Excess of revenue over expenses attributable to Methodist Health System	<u>\$ 88,522</u>	<u>\$ 126,686</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 \$170 million and \$185 million provided during 2019 and 2018, respectively.

**Methodist Health System**

CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS -  
CONTINUED

For the years ended September 30,  
(in thousands)

	2019	2018
Changes in net assets without donor restrictions:		
Excess of revenue over expenses	\$ 88,522	\$ 126,686
Other changes in unrestricted net assets:		
Changes attributable to noncontrolling interests	(19,344)	2,646
Other	80	-
Net assets released from restrictions used for capital	4,699	3,765
Increase in net assets without donor restrictions	73,957	133,097
Changes in net assets with donor restrictions:		
Restricted grants, gifts, and bequests	7,566	4,527
Income from investments	598	2,661
Increase in net assets of related foundation	349	385
Net assets released from restrictions	(9,328)	(5,926)
(Decrease) increase in net assets with donor restrictions	(815)	1,647
Increase in net assets	73,142	134,744
Net assets - beginning of year	1,761,110	1,626,366
Net assets - end of year	\$1,834,252	\$1,761,110

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)

	2019	2018
Cash flows from operating activities:		
Increase in net assets	\$ 73,142	\$ 134,744
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Operating depreciation and amortization	105,254	104,681
Nonoperating depreciation and amortization	5,576	5,369
Capitalized interest	(2,236)	(767)
Unrealized loss (gain) on interest rate swaps	26,506	(13,756)
Unrealized and realized losses (gains) on investments	18,995	(24,426)
Loss from acquisition of hospital net assets	-	1,021
Restricted grants, gifts, and bequests and change in interest in the net assets of related foundation	(7,915)	(4,912)
Changes in operating assets and liabilities		
Decrease in patient accounts receivable	28,054	23,338
Decrease (increase) in other accounts receivable	9,454	(9,143)
Increase in other current assets	(18,171)	(8,554)
Increase in other assets	(3,047)	(4,208)
Increase in accounts payable and accrued expenses	21,715	22,819
(Decrease) increase in health insurance programs reimbursement payable	(108)	4,459
Increase (decrease) in other liabilities	<u>27,158</u>	<u>(4,765)</u>
Net cash provided by operating activities	284,377	225,900
Cash flows from investing activities:		
Purchases of investments	(445,709)	(406,869)
Maturities and sales of investments	327,218	302,808
Purchases of property, plant, and equipment	(104,503)	(98,125)
Cash from acquisition or consolidation of joint ventures	-	4,256
Increase in assets whose use is limited	<u>(7,914)</u>	<u>(2,493)</u>
Net cash used in investing activities	(230,908)	(200,423)

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>2019</u>	<u>2018</u>
Cash flows from financing activities:		
Principal payments on debt	\$ (36,150)	\$(12,242)
Principal payments on capital leases	(2,553)	(2,164)
Issuance of long-term debt	42	5,162
Restricted grants, gifts, and bequests and change in interest in the net assets of related foundation	<u>7,915</u>	<u>4,912</u>
Net cash used in financing activities	<u>(30,746)</u>	<u>(4,332)</u>
 NET INCREASE IN CASH AND CASH EQUIVALENTS	 22,723	 21,145
 Cash and cash equivalents, beginning of year	 <u>79,695</u>	 <u>58,550</u>
 Cash and cash equivalents, end of year	 <u>\$ 102,418</u>	 <u>\$ 79,695</u>
 Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 32,419	\$ 31,094
Accrued construction costs	\$ 19,319	\$ 10,184
Property acquired under capital leases - Note 4	\$ 43,990	\$ 269

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

## Methodist Health System

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2019 and 2018

#### 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 564-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 50-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”), Methodist Diagnostic Imaging of Texas, LLC (“Imaging Center JV”) and Methodist-CDI, Methodist Community Pharmacy, LLC (“MHS Pharmacy”), and Methodist Mansfield Ambulatory Surgery Center, LLC (“Mansfield ASC”). 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.

## Methodist Health System

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

#### **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, 2019 and 2018 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 consolidated 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, 2019 and 2018. MHS is no longer subject to examination by U.S. federal and state taxing authorities for years through September 30, 2016.

##### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ("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. Significant items subject to such estimates include the determination of variable consideration of patient accounts receivable, reserves for employee healthcare claims, accrued professional liability costs, interest rate swaps, and estimated third-party payor settlements. As a result, there is at least a reasonable possibility that recorded estimates related to these programs will change by a material amount in the near term.

##### 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.

**Methodist Health System**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued**

Investment income, included in nonoperating gains, net is comprised of the following:

	Years ended September 30,	
	2019	2018
	(in thousands)	
Interest and dividend income	\$ 26,145	\$18,031
Realized gains, net	20,475	26,714
Unrealized gains, net	<u>(23,313)</u>	<u>12,030</u>
	<u>\$ 23,307</u>	<u>\$56,775</u>

Investments are comprised of the following:

	September 30,	
	2019	2018
	(in thousands)	
U.S. government and agency securities	\$ 305,543	\$ 246,254
Corporate bonds	152,805	137,363
Mutual funds	810,742	771,681
Commercial paper	13,888	31,304
Certificates of deposit	<u>498</u>	<u>344</u>
	<u>\$1,283,476</u>	<u>\$1,186,946</u>

Short-term investments total approximately \$1,126,576,000 and \$1,057,135,000 at September 30, 2019 and 2018, respectively. Long-term investments total approximately \$156,900,000 and \$129,811,000 at September 30, 2019 and 2018, respectively. Short-term investments of approximately \$52,689,000 and \$58,768,000 as of September 30, 2019 and 2018, respectively, and long-term investments of approximately \$3,113,000 as of September 30, 2019 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.

## Methodist Health System

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

#### **NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued**

##### 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 \$18,817,000 and \$8,423,000 as of September 30, 2019 and 2018, respectively; short-term investments of approximately \$52,689,000 and \$58,768,000 as of September 30, 2019 and 2018, respectively; long-term investments of approximately \$3,113,000 as of September 30, 2019; and other assets, including pledges receivable, of \$9,486,000 and \$9,000,000 at September 30, 2019 and 2018, respectively.

##### 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.

## Methodist Health System

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

#### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

##### Investments in Unconsolidated Companies

MHS has investments in subsidiaries, affiliates, and joint ventures which are not consolidated. At September 30, 2019 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; Methodist Puerto Rico Transplant Administration Corporation (“PRT”), formed to operate clinics located in Puerto Rico that perform pre- and post-transplant services in support of MHS’s transplant program; 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.

The ownership interest, carrying value and equity in earnings of unconsolidated companies at September 30, 2019 and 2018 are as follows (\$ in thousands):

	<u>Ownership Interest</u>		<u>Carrying Value</u>		<u>Equity in Earnings</u>	
	<u>2019</u>	<u>2018</u>	<u>2019</u>	<u>2018</u>	<u>2019</u>	<u>2018</u>
NTHFM	100%	100%	\$ 1,128	\$ 873	\$ 590	\$ 404
ASAC	100%	100%	65	171	(797)	(286)
MTP	100%	100%	(1,524)	(2,019)	788	518
PRT	100%	-	(379)	-	(379)	-
PASD	100%	100%	(1,279)	(980)	(209)	(224)
MUC	51%	51%	(559)	(559)	-	647
CareFlite	25%	25%	3,895	3,342	224	329
TRHA	19%	19%	599	779	751	502
SRP Addison	22%	22%	(1,156)	(1,475)	488	434
			<u>\$ 790</u>	<u>\$ 132</u>	<u>\$1,456</u>	<u>\$2,324</u>

## Methodist Health System

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

#### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

Carrying values of unconsolidated companies are included in other assets in the accompanying consolidated 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 consolidated statements of operations and changes in net assets.

##### Net Assets with Donor Restrictions

Net assets with donor restrictions represent amounts that are subject to donor imposed restrictions which either expire with the passage of time, will be fulfilled for the intended purpose pursuant to those provisions, or are perpetual in nature.

##### Net Patient Service Revenue

Effective October 1, 2018, MHS adopted the new revenue recognition standard, Accounting Standards Update ("ASU") No. 2014-09, "*Revenue from Contracts with Customers (Topic 606)*", using the retrospective method of adoption. With the adoption of the new standard, net patient service revenue is reported at the amounts that MHS expects to be entitled in exchange for providing healthcare services. These amounts are due from patients and third-party payors for services rendered, including variable consideration for estimated retroactive adjustments under reimbursement agreements with third-party payors. Healthcare services provided to a patient represent a bundle of goods and (or) services that is distinct and accounted for as a single-performance obligation. For inpatient acute services, MHS generally measures performance obligations from admission to the point when there are no further services required for the patient, which is generally the time of discharge. Revenue is recognized as the performance obligation is satisfied over the period of time the patient is receiving treatment. For outpatient services, the performance obligation is generally satisfied on the day services are provided.

The transaction price for healthcare services is estimated by reducing standard charges by variable price concessions. This includes terms provided by or negotiated with third-party payors, discounts, and implicit price concessions. Implicit price concessions primarily relate to self-pay patients who do not qualify for financial assistance and co-pays and deductibles owed by patients with insurance; the implicit price concession is estimated based on historical collection data. Differences between original estimates in transaction price and subsequent revisions, including final settlements, represent changes in the estimate of variable consideration and are included in the period in which the revisions are made.

Under the provisions of ASU 2014-09, implicit price concessions are recorded as a direct reduction to net patient service revenue.

## Methodist Health System

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

#### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

##### 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 \$170 million and \$185 million in 2019 and 2018, 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 increased by approximately \$4,702,000 and decreased approximately \$459,000 in 2019 and 2018, 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 \$8,200,000 and \$8,000,000 in its fiscal years 2019 and 2018, 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.

## Methodist Health System

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

#### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

##### Advertising Costs

Advertising costs are expensed as incurred and were approximately \$5,865,000 and \$5,697,000 for the years ended September 30, 2019 and 2018, respectively.

##### Nonoperating Gains, Net

Nonoperating gains, net primarily include gains (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. A summary of nonoperating gains for the years ended September 30, 2019 and 2018 is presented below (in thousands):

	<u>2019</u>	<u>2018</u>
Unrealized (losses) gains on interest rate swaps	\$(26,506)	\$ 13,756
Investment income	23,307	56,775
Gains from unconsolidated companies	1,302	1,815
Other, net	6,563	2,543
Contributions without donor restrictions to MHSF	<u>340</u>	<u>1,830</u>
	<u>\$ 5,006</u>	<u>\$ 76,719</u>

##### Contributions

Contributions are recorded as net assets with donor restrictions 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 or time restrictions expire, net assets with donor restrictions are reclassified as net assets without donor restrictions and reported in the consolidated statements of operations and changes in net assets as net assets released from donor 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. If all eligibility requirements have been satisfied, pledges 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, 2019 and 2018 were approximately \$7,378,000 and \$7,220,000, exceeding their discounted present value by approximately \$979,000 and \$961,000, respectively. Pledges receivable, included in assets whose use is limited, at September 30, 2019 and 2018 were discounted using rates ranging from 1.26% to 3.10% and 0.76% to 3.10%, respectively. All pledges receivable are deemed collectible by management; thus, no allowance is required.

## Methodist Health System

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

#### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

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>2019</u>	<u>2018</u>
	(in thousands)	
One year or less	\$1,814	\$3,168
Between one and five years	3,263	1,707
Over five years	<u>1,322</u>	<u>1,384</u>
	<u>\$6,399</u>	<u>\$6,259</u>

There was one conditional promise totaling \$87,445 and \$99,936 at September 30, 2019 and 2018, respectively.

#### Recent Accounting Pronouncements

Effective October 1, 2018, MHS adopted ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)* using the retrospective method of adoption. 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. In accordance with the standard, MHS now recognizes its previously reported provision for bad debts, primarily related to its self-pay patients and co-pays and deductibles owed by patients with insurance, as a direct reduction to revenues as an implicit price concession, instead of separately as a discrete deduction to arrive at net patient service revenue. The patient accounts receivable allowance for uncollectible accounts was treated similarly.

For the fiscal year ending September 30, 2019 MHS adopted ASU 2016-14, "*Presentation of Financial Statements of Not-for-Profit Entities*". The new pronouncement amends certain financial reporting requirements for not-for-profit entities. MHS's consolidated financial statements for fiscal year 2019 and 2018 has been modified from the previous reporting of three net asset classes (unrestricted, temporarily restricted, and permanently restricted) to reporting two net asset classes (net assets with donor restrictions and net assets without donor restrictions). In addition to classification changes in net assets, additional disclosures regarding liquidity and availability of resources (Note 12), and expenses by both their natural and functional classification (Note 13) are required and presented with these notes to the consolidated financial statements. However, MHS has elected the permitted option to omit disclosures about liquidity and availability of resources and analysis of expenses separately for both natural and functional classification for the year ended September 30, 2018.

**Methodist Health System**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued**

In February 2016, Financial Accounting Standards Board (“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.

Reclassifications

Certain reclassifications have been made to the September 30, 2018 financial statements to conform to the current year presentation. The reclassifications had no effect on excess of revenue over expenses or net assets as previously reported. Previously, interest expense was classified as nonoperating gains, net, but are now presented as a separate line in operating expenses.

**NOTE 2 - PATIENT SERVICE REVENUE AND PATIENT ACCOUNTS RECEIVABLE**

Patient service revenue, net of all price concessions for the years ended September 30, 2019 and 2018, respectively, by major payor source are as follows:

	September 30,	
	2019	2018
Medicare	32%	30%
Medicaid	7	7
Managed care	57	59
Self-pay and other	4	4
	<u>100%</u>	<u>100%</u>

The estimated percentage of patient revenue, net of all price concessions for the years ended September 30, 2019 and 2018, respectively, by major service line, is as follows:

	September 30,	
	2019	2018
Inpatient	60%	61%
Outpatient	40	39
	<u>100%</u>	<u>100%</u>

## Methodist Health System

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

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

MHS provides health care services to patients regardless of their ability to pay. MHS records an implicit price concession in the period services are provided for services provided to the uninsured and under-insured, including patient accounts for which the primary insurance company has paid but the patient responsibility remains outstanding. The implicit price concession is based on historical write-offs and expected collections based on health care coverage and other collection indicators; management continually monitors and adjusts the implicit price concession. Accounts are written off when routine billing and communication with the patient are not expected to result in payment. MHS collection efforts continue, and recoveries of accounts written off are accounted for as reductions in the implicit price concession. Estimated implicit price concessions of \$287,987,000 were recorded as reductions to patient accounts receivable at September 30, 2019 on the consolidated statements of financial position.

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,			
	2019		2018	
	Cost	Accumulated depreciation	Cost	Accumulated depreciation
	(in thousands)			
Land	\$ 49,682	\$ -	\$ 53,889	\$ -
Land improvements	44,601	28,757	44,409	26,700
Buildings	968,330	501,433	919,468	467,623
Fixed equipment	117,133	93,427	107,660	81,657
Movable equipment	671,634	499,626	646,042	457,529
Buildings and equipment under capital lease	153,257	43,802	153,256	36,899
Construction in progress	<u>129,750</u>	<u>-</u>	<u>64,463</u>	<u>-</u>
	<u>2,134,387</u>	<u>1,167,045</u>	<u>1,989,187</u>	<u>1,070,408</u>
Net book value	<u>\$ 967,342</u>		<u>\$ 918,779</u>	

Depreciation expense related to property, plant and equipment was approximately \$111 million and \$110 million for the years ended September 30, 2019 and 2018, respectively. MHS has several construction and renovation projects in progress for which it has commitments of approximately \$65 million at September 30, 2019, which are expected to be utilized in the next fiscal year.

**Methodist Health System**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

**NOTE 4 - LONG-TERM DEBT**

Long-term debt is as follows:

	September 30,	
	2019	2018
	(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	\$167,870	\$173,370
Tarrant County Cultural Education Facilities Finance Corporation Hospital Revenue Bonds Series 2008 - variable rate demand notes payable monthly with an average interest rate of 3.52% and 3.53% for the years ended September 30, 2019 and 2018, respectively, principal payable annually through 2042	166,200	167,600
Methodist McKinney Hospital Property - Real Estate Loan with an interest rate of 4.2%, payable monthly through 2035	-	27,372
Methodist McKinney Hospital – Promissory and Equipment Notes with interest rates of 4.0% to 4.5%, payable monthly through 2023	<u>7,172</u>	<u>9,008</u>
	341,242	377,350
Unamortized premium	7,899	8,488
Less current installments	<u>(9,129)</u>	<u>(9,063)</u>
Total	<u>\$340,012</u>	<u>\$376,775</u>

The aggregate long-term debt maturing during the years following fiscal 2020 is as follows: 2021 - \$9,472,000; 2022 - \$9,926,000; 2023 - \$9,613,000; 2024 - \$8,816,000; 2025 - \$9,200,000; thereafter - \$285,086,000.

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, 2019 and 2018

#### **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 was 59.02%. This debt was paid off during FY19 when the McKinney hospital building and underlying real estate were sold to a third party. Concurrent with the sale, McKinney entered into a long-term lease with the property’s new owner, incurring a capital lease liability of approximately \$43,983,000.

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 \$83,100,000 and 3.8% per annum on a notional amount of \$83,100,000, 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 \$61.8 million and \$35.3 million at September 30, 2019 and 2018, respectively, and the amount included in nonoperating gains (losses) related to the change in value of the swaps is a loss of approximately \$26.5 million for the year ended September 30, 2019 and a gain of \$13.8 million for the year ended September 30, 2018. 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, 2019 and 2018.

## Methodist Health System

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

#### NOTE 5 - CAPITAL LEASES

MHS is the lessee in several real estate and equipment capital leases. At September 30, 2019 future rental payments applicable to capital leases are as follows (in thousands):

<u>Year</u>	<u>Amount</u>
2020	\$ 22,053
2021	22,107
2022	22,141
2023	22,516
2024	23,017
2025-2038	<u>283,884</u>
Total payments	395,718
Less interest	(205,723)
Less current portion of capital leases	<u>(3,238)</u>
Long-term capital leases	<u>\$ 186,757</u>

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 \$4,336,000 and \$4,775,000 at September 30, 2019 and 2018, respectively, are 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, 2019 and 2018

**NOTE 6 - NET ASSETS WITH DONOR RESTRICTIONS**

Net assets with donor restrictions are available for the following purposes:

	September 30,	
	2019	2018
	(in thousands)	
Golden Cross Indigent Care Program	\$12,418	\$12,027
Specific Purpose Funds:		
Capital Projects & Equipment	8,176	8,267
Women and Children Services	1,090	1,143
Trauma/Emergency Department	418	741
Indigent Care Programs	137	1,513
Pastoral Care	1,120	928
Research	93	71
Transplant	247	369
Oncology	244	264
Education and Training	7,194	5,142
Cardiology/Neurology	51	50
Other	1,756	1,728
Nursing Scholarships	2,067	2,064
Future Fund	-	29
General Endowment	1,614	1,614
Specific Purpose Endowments	<u>8,876</u>	<u>10,715</u>
	45,501	46,665
Interest in net assets of MRMC Foundation	<u>3,093</u>	<u>2,744</u>
	<u>\$48,594</u>	<u>\$49,409</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.

Net assets released from donor restrictions for operations were approximately \$4,629,000 and \$2,161,000 for the years ended September 30, 2019 and 2018, respectively. Net assets released from restrictions for capital were approximately \$4,699,000 and \$3,765,000 for the years ended September 30, 2019 and 2018, respectively.

**Methodist Health System**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

**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 the Uniform Prudent Management of Institutional Funds Act (“UPMIFA”), the assets in an endowment fund are donor restricted until appropriated for expenditure. 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.

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, 2019		
	Without Donor Restrictions	With Donor Restrictions	Total
Donor restricted endowment funds	\$ -	\$8,113	\$ 8,113
Board designated endowment funds	<u>79,853</u>	<u>-</u>	<u>79,853</u>
Total endowment net assets	<u>\$79,853</u>	<u>\$8,113</u>	<u>\$87,966</u>
	September 30, 2018		
	Without Donor Restrictions	With Donor Restrictions	Total
Donor restricted endowment funds	\$ -	\$7,816	\$ 7,816
Board designated endowment funds	<u>81,004</u>	<u>-</u>	<u>81,004</u>
Total endowment net assets	<u>\$81,004</u>	<u>\$7,816</u>	<u>\$88,820</u>

**Methodist Health System**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

**NOTE 7 - ENDOWMENT - Continued**

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

	Year ended September 30, 2019		
	Without Donor Restrictions	With Donor Restrictions	Total
Endowment net assets, beginning of year	\$81,004	\$7,816	\$88,820
Contributions	1	37	38
Dividends and interest	1,418	114	1,532
Net realized and unrealized gains	85	116	201
Appropriation of endowment assets for expenditure	(2,655)	-	(2,655)
Transfers	-	29	29
Endowment net assets, end of year	<u>\$79,853</u>	<u>\$8,112</u>	<u>\$87,965</u>
	Year ended September 30, 2018		
	Without Donor Restrictions	With Donor Restrictions	Total
Endowment net assets, beginning of year	\$74,572	\$7,171	\$81,743
Contributions	-	36	36
Dividends and interest	1,113	122	1,235
Net realized and unrealized gains	7,436	477	7,913
Appropriation of endowment assets for expenditure	(2,117)	-	(2,117)
Transfers	-	10	10
Endowment net assets, end of year	<u>\$81,004</u>	<u>\$7,816</u>	<u>\$88,820</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, 2019 and 2018

#### 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 funds' 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, 2019 and 2018.

#### 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 \$18,842,000 and \$20,138,000 at September 30, 2019 and 2018, 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, 2019 and 2018

#### **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. Both the UC pool and DSRIP pool have been extended through September 30, 2022 and September 30, 2021, respectively.

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. HHSC requested the Departmental Appeals Board (“DAB”) reconsider and reverse the decision, but the request was denied in an October 2, 2019 ruling. The resolution of this issue did not have a material impact on the consolidated financial statements through September 30, 2019. Management does not have adequate information at this time to predict the outcome of the matter nor its possible impact on MHS.

## Methodist Health System

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

#### **NOTE 9 - MEDICAID WAIVER PROGRAM - Continued**

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. The mandatory payment fee must be consistent with CMS rules regarding provider taxes, and in a letter to HHSC dated December 20, 2018, CMS opined the mandatory payment fee met the related requirements. During 2019 and 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 \$60.2 million and \$60.1 million in 2019 and 2018, respectively. MHS recorded expenses of \$24.6 million and \$30.2 million in 2019 and 2018, respectively, for the programs described above, which are included in other operating expenses in the consolidated statements of operations and changes in net assets.

During 2019 and 2018, MHS recognized a total of \$10.3 million and \$14.7 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.

#### **NOTE 10 - RETIREMENT PLAN**

The Methodist Health System Employees Retirement Plan (the “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 3.0% 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 \$22,885,000 and \$20,715,000 for the years ended September 30, 2019 and 2018, respectively. The total accrued pension asset, which represents the funded status of the defined benefit feature of the Plan, was \$541,647 and \$623,356 as of September 30, 2019 and 2018, respectively.

## Methodist Health System

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

#### 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, 2019 and 2018

**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, 2019</u>		
<u>Description</u>	<u>2019</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	\$ 305,543	\$212,890	\$92,653	\$ -
Certificates of deposit	498	498	-	-
Corporate bonds	152,805	-	152,805	-
Commercial paper	13,888	-	13,888	-
Mutual funds	<u>810,742</u>	<u>810,742</u>	<u>-</u>	<u>-</u>
Total investments	<u>\$1,283,476</u>	<u>\$1,024,130</u>	<u>\$259,346</u>	<u>\$ -</u>
Liabilities:				
Interest rate swaps	<u>\$ 61,827</u>	<u>\$ -</u>	<u>\$ 61,827</u>	<u>\$ -</u>
		<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>

**Methodist Health System**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

September 30, 2019 and 2018

**NOTE 12 - LIQUIDITY AND AVAILABILITY OF RESOURCES**

MHS's financial assets available for general expenditure within one year of September 30, 2019 are as follows:

	2019
	(in thousands)
Cash and cash equivalents	\$ 102,418
Short-term investments	1,073,887
Patient accounts receivable	201,898
Other accounts receivable	22,276
	<b><u>\$1,400,479</u></b>

MHS structures its financial assets to be available for general operating expenses, current liabilities, and other obligations as they become due.

**NOTE 13 - FUNCTIONAL EXPENSES**

MHS provides general health care services. The financial statements report certain expenses that can be attributable to more than one function. Expenses not directly attributable to a function, including interest and depreciation, are allocated based on an appropriate metric such as percentage of property and equipment basis, percentage of revenue, percentage of insured value, or loss history. Functional classification of expenses related to providing these services are as follows (in thousands):

	Patient Care	General and Administrative	Medical Education	Other	2019 Total Expenses	2018 Total Expenses
Salaries, wages and benefit costs	\$ 575,743	\$230,473	\$21,142	\$ 348	\$ 827,706	\$ 769,494
Other operating expenses	472,407	189,352	1,889	709	664,357	634,984
Interest	27,978	1,737	-	-	29,715	29,700
Depreciation and amortization	91,971	13,192	-	91	105,254	104,681
Total	<b><u>\$1,168,099</u></b>	<b><u>\$434,754</u></b>	<b><u>\$23,031</u></b>	<b><u>\$1,148</u></b>	<b><u>\$1,627,032</u></b>	<b><u>\$1,538,859</u></b>

**NOTE 14 - SUBSEQUENT EVENTS**

MHS evaluated its consolidated financial statements through December 12, 2019, the date that the consolidated financial statements are issued, and concludes that no additional disclosures are required.