



OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES
Consolidated Financial Statements and Supplemental Schedules
May 31, 2018 and 2017
(With Independent Auditors' Report Thereon)

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

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KPMG LLP
Suite 1000
401 Commerce Street
Nashville, TN 37219-2422

Independent Auditors' Report

The Board of Directors
Owensboro Health, Inc.:

We have audited the accompanying consolidated financial statements of Owensboro Health, Inc. and affiliated entities, which comprise the consolidated balance sheets as of May 31, 2018 and 2017, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Managements' Responsibility for the Consolidated Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Owensboro Health, Inc. and affiliated entities as of May 31, 2018 and 2017, and the results of their operations and their cash flows for the years then ended, in accordance with U.S. generally accepted accounting principles.



Other Matters

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary information included in schedules 1 through 4 is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole. The supplementary information included in schedule 5 is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the consolidated financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

KPMG LLP

Nashville, Tennessee
August 28, 2018

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Consolidated Balance Sheets

May 31, 2018 and 2017

(In thousands)

Assets	2018	2017
Current assets:		
Cash and cash equivalents	\$ 54,890	49,663
Investments	180,910	169,488
Patient accounts receivable, net of estimated uncollectibles of \$50,597 and \$55,480, respectively	94,519	87,527
Inventories	14,045	12,555
Prepaid expenses and other current assets	9,912	11,920
Assets limited as to use, current portion	<u>22,864</u>	<u>24,016</u>
Total current assets	377,140	355,169
Assets limited as to use, less current portion	8,310	38,121
Property and equipment, net	606,043	599,429
Deferred compensation plan assets	12,277	10,112
Other assets	<u>13,654</u>	<u>13,747</u>
Total assets	<u>\$ 1,017,424</u>	<u>1,016,578</u>
Liabilities and Net Assets		
Current liabilities:		
Current maturities of long-term debt costs	\$ 8,755	6,816
Accounts payable	19,992	20,495
Accrued payroll and related liabilities	29,585	25,483
Other current liabilities	34,656	36,879
Due to third-party payors	<u>21,076</u>	<u>23,585</u>
Total current liabilities	114,064	113,258
Deferred compensation plan obligations	12,277	10,112
Long-term debt, less current maturities and debt issuance costs	590,170	600,419
Accrued pension cost	55,525	70,363
Contractual lease obligation	2,683	3,340
Other long-term liabilities	<u>164</u>	<u>253</u>
Total liabilities	<u>774,883</u>	<u>797,745</u>
Net assets:		
Unrestricted	239,885	217,611
Temporarily restricted	<u>1,518</u>	<u>1,404</u>
Total net assets attributable to Owensboro Health, Inc.	241,403	219,015
Noncontrolling interests	<u>1,138</u>	<u>(182)</u>
Total net assets	<u>242,541</u>	<u>218,833</u>
Commitments and contingencies		
Total liabilities and net assets	<u>\$ 1,017,424</u>	<u>1,016,578</u>

See accompanying notes to consolidated financial statements.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Consolidated Statements of Operations

Years ended May 31, 2018 and 2017

(In thousands)

	<u>2018</u>	<u>2017</u>
Unrestricted revenue:		
Net patient service revenue	\$ 645,606	634,420
Provision for bad debts	<u>(29,831)</u>	<u>(37,628)</u>
Net patient service revenue less provision for bad debts	615,775	596,792
Other operating revenue	<u>10,562</u>	<u>12,909</u>
Total unrestricted revenue	<u>626,337</u>	<u>609,701</u>
Patient service and other expenses:		
Personnel	342,682	336,374
Professional fees	22,988	30,196
Drugs and supplies	120,995	116,162
Plant maintenance and operation	20,647	20,888
Kentucky provider tax	5,009	4,868
Other expenses	39,815	40,322
Depreciation and amortization	41,726	41,098
Interest expense	27,168	31,711
Loss on bond defeasance	—	83,073
Total patient service and other expenses	<u>621,030</u>	<u>704,692</u>
Operating income (loss)	<u>5,307</u>	<u>(94,991)</u>
Nonoperating gains (losses):		
Investment income, net	11,181	13,183
Contributions and other	<u>(1,766)</u>	<u>68</u>
Nonoperating gains, net	<u>9,415</u>	<u>13,251</u>
Excess (deficiency) of revenue and gains over expenses and losses before noncontrolling interests	14,722	(81,740)
Noncontrolling interests	<u>(722)</u>	<u>(650)</u>
Excess (deficiency) of revenue and gains over expenses and losses	14,000	(82,390)
Accrued pension cost adjustment	<u>8,274</u>	<u>9,351</u>
Change in unrestricted net assets	\$ <u>22,274</u>	\$ <u>(73,039)</u>

See accompanying notes to consolidated financial statements.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Consolidated Statements of Changes in Net Assets

Years ended May 31, 2018 and 2017

(In thousands)

	<u>2018</u>	<u>2017</u>
Unrestricted net assets:		
Excess (deficiency) of revenue and gains over expenses and losses: \$	14,000	(82,390)
Accrued pension cost adjustment	8,274	9,351
Change in unrestricted net assets	<u>22,274</u>	<u>(73,039)</u>
Temporarily restricted net assets:		
Contributions	275	305
Net assets released from restrictions used for operations	(161)	(175)
Change in temporarily restricted net assets	<u>114</u>	<u>130</u>
Noncontrolling interests:		
Excess of revenue and gains over expenses and losses	722	650
Partnership investment	1,206	(158)
Distributions to noncontrolling interests	(608)	(520)
Change in noncontrolling interests	<u>1,320</u>	<u>(28)</u>
Change in total net assets	23,708	(72,937)
Net assets, beginning of year	<u>218,833</u>	<u>291,770</u>
Net assets, end of year	<u>\$ 242,541</u>	<u>218,833</u>

See accompanying notes to consolidated financial statements.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Consolidated Statements of Cash Flows

Years ended May 31, 2018 and 2017

(In thousands)

	<u>2018</u>	<u>2017</u>
Cash flows from operating activities:		
Change in total net assets	\$ 23,708	(72,937)
Adjustments to reconcile change in total net assets to net cash provided by operating activities:		
Depreciation and amortization	41,726	41,098
Provision for bad debts	29,831	37,628
Loss on defeasance of bonds	—	83,073
Amortization of debt issuance costs and premiums included in interest expense	(1,515)	230
Distributions to noncontrolling interests	608	520
Net realized and unrealized (gains) losses on investments	(8,132)	(9,444)
Loss (gain) on disposal of property and equipment	33	(194)
Accrued pension cost adjustments	(8,274)	(9,351)
Increase (decrease) in cash due to changes in:		
Patient accounts receivable	(36,823)	(34,587)
Inventories	(1,490)	(502)
Prepaid expenses and other current assets	2,008	4,842
Other assets	(2,072)	(4,024)
Accounts payable	(129)	(6,832)
Accrued payroll and related liabilities	4,102	3,215
Accrued pension cost	(6,564)	10,542
Other liabilities	(804)	17,119
Due to third-party payors	(2,509)	601
Net cash provided by operating activities	<u>33,704</u>	<u>60,997</u>
Cash flows from investing activities:		
Acquisition and construction of property and equipment	(48,747)	(36,270)
Purchases of investment securities	(103,945)	(102,826)
Proceeds from sales and maturities of investment securities	100,655	98,852
Change in assets limited as to use	30,963	(11,285)
Net cash used in investing activities	<u>(21,074)</u>	<u>(51,529)</u>
Cash flows from financing activities:		
Payments on long-term debt	(6,795)	(6,550)
Proceeds from issuance of debt	—	501,227
Bond Defeasance	—	(453,810)
Payment for deferred financing costs	—	(9,526)
Distributions to noncontrolling interests	(608)	(520)
Net cash (used in) provided by financing activities	<u>(7,403)</u>	<u>30,821</u>
Net increase in cash and cash equivalents	5,227	40,289
Cash and cash equivalents, beginning of year	49,663	9,374
Cash and cash equivalents, end of year	\$ <u>54,890</u>	<u>49,663</u>
Supplemental disclosures of cash flow information:		
Cash paid during the year for:		
Interest	\$ 17,909	19,606
Noncash activities:		
Accrued but unpaid costs of property and equipment additions	374	57

See accompanying notes to consolidated financial statements.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

(1) Organization and Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Owensboro Health, Inc. (Owensboro Health), a Kentucky nonstock, nonprofit corporation, and its affiliated entities (the System). Owensboro Health's wholly owned and controlled affiliated entities include Owensboro Health Medical Group, Inc. (OHMG), Owensboro Health Muhlenberg Community Hospital (OHMCH), Owensboro Medical Center Laboratory, Inc. (OMCL), The Foundation for Health, Inc., The Health Network of Western Kentucky, LLC (HNWK), and Commonwealth Medical Management, LLC (CMM). Owensboro Ambulatory Surgical Facility Ltd. (OASF), a 65.7% owned affiliated entity, is also included in the consolidated financial statements.

(2) Summary of Significant Accounting Policies

(a) Use of Estimates

The preparation of the consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management of the System to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

(b) Cash and Cash Equivalents

Cash and cash equivalents include certain investments in highly liquid debt investments with maturities of three months or less at date of purchase.

(c) Investments

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value at the consolidated balance sheet date. Investment income or loss (including both unrealized and realized gains and losses on investments, interest, and dividends) is included in the excess (deficiency) of revenue and gains over expenses and losses, unless the income or loss is restricted by donor or law, as all investments are considered trading securities.

(d) Inventories

Inventories, consisting primarily of medical supplies and pharmaceuticals, are stated at the lower of cost and net realizable value.

(e) Assets Limited as to Use

Assets limited as to use include assets held by trustees under indenture and other funding agreements. Amounts required to meet current liabilities of the System are classified as current assets in the accompanying consolidated balance sheets.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

(f) Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Equipment under capital lease obligations is amortized on the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the accompanying consolidated financial statements. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets.

Gifts of long-lived assets, such as land, buildings, or equipment, are reported as unrestricted support and are excluded from the excess (deficiency) of revenue and gains over expenses and losses, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long these long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

(g) Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed of

Long-lived assets, goodwill, and certain identifiable intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value, less estimated costs to sell.

(h) Other Assets

Other assets consist primarily of goodwill, which represents the excess of the purchase price over the actual fair value of assets acquired and other assets. Goodwill was approximately \$13,195 at May 31, 2018 and 2017.

(i) Basis of Accounting

Net assets and revenue, expenses, gains, and losses are classified based on the existence or absence of donor-imposed restrictions. Accordingly, the net assets of the System and changes therein are classified and reported as follows:

Unrestricted net assets – Net assets that are not subject to donor-imposed stipulations.

Temporarily restricted net assets – Net assets subject to donor-imposed stipulations. Such stipulations may be met either by actions of the System and/or by the passage of time.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

Revenue is reported as increases in unrestricted net assets unless use of the related assets is limited by donor-imposed restrictions. Expenses are reported as decreases in unrestricted net assets. Gains and losses on investments and other assets or liabilities are reported as increases or decreases in unrestricted net assets unless their use is restricted by explicit donor stipulation or by law. Expirations of temporary restrictions on net assets (i.e., the donor-stipulated purpose has been fulfilled and/or the stipulated time period has elapsed) are reported as reclassifications between the applicable classes of net assets. Donor-restricted net assets whose restrictions are met within the same year as received are reported as unrestricted net assets and as net assets released from restrictions in the accompanying consolidated financial statements.

(j) Excess (Deficiency) of Revenue and Gains over Expenses and Losses

The accompanying consolidated statements of operations include excess (deficiency) of revenue and gains over expenses and losses. Changes in unrestricted net assets, which are excluded from excess (deficiency) of revenue and gains over expenses and losses, consistent with industry practice, include the recognition of pension liability adjustments arising during the current period, the cumulative effect of accounting principle changes, permanent transfers of assets to and from nonconsolidated affiliates for other than goods and services, and contributions of long-lived assets (including assets acquired using contributions that were restricted for the purposes of acquiring such assets).

(k) Net Patient Service Revenue

The System has agreements with third-party payors that provide for payments to the System at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

(l) Charity Care

The System provides care to patients who meet certain criteria under its charity care policy at amounts less than its established rates or without charge. Because the System does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue.

(m) Income Taxes

Owensboro Health and its affiliated entities, OHMG, OHMCH, and the Foundation for Health, Inc., are nonprofit corporations and have been recognized as tax-exempt under Section 501(a) of the Internal Revenue Code (IRC) as entities described in Section 501(c)(3) of the IRC. HNWK is a single-member LLC with 100% of its profits and losses attributable to Owensboro Health. For OASF, a partnership, the liability for any income taxes is the responsibility of the OASF partners.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

The System applies Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 740, *Accounting for Uncertainty in Income Taxes*. ASC Topic 740 provides guidance on when tax positions are recognized in an entity's financial statements and how the values of these positions are determined. There is currently no impact on the System's consolidated financial statements as a result of the application of ASC Topic 740.

(n) Computer Software Costs

Certain costs related to the development or purchase of internal-use software are capitalized and amortized over the estimated life of the software. In addition, costs related to the preliminary project stage and the postimplementation/operations stage in an internal-use computer software development project are expensed as incurred. The System capitalized approximately \$2,773 and \$4,215 in 2018 and 2017, respectively, of costs related to its development of new system software.

(o) Pension Accounting Standard

The System follows the recognition and disclosure provisions of FASB ASC Subtopic 715-20, *Defined Benefit Plans*. ASC Subtopic 715-20 (among other things) requires that the System recognize the unfunded status of its defined-benefit pension plan on its consolidated balance sheets. The System measures the plan at May 31 each year.

ASC Subtopic 715-20 also requires that the System provide enhanced disclosures related to pension plan assets, including disclosures related to the fair value of the plan assets. These enhanced disclosures are included in these consolidated financial statements at note 12.

(p) Fair Value Measurements

The System follows the following financial accounting and reporting literature regarding fair value measurements:

- FASB ASC Topic 820, *Fair Value Measurement*, which defines fair value, establishes an enhanced framework for measuring fair value, and expands disclosures about fair value measurements;

(q) Noncontrolling Interests

The System follows ASC Topic 958, *Not-for-Profit Entities*. The guidance requires that noncontrolling ownership interests in subsidiaries held by parties other than the parent be clearly identified, labeled, and presented in the consolidated balance sheets within net assets but separate from the parent's net assets. In addition, the standard requires that a consolidated schedule of changes in net assets attributable to the parent and noncontrolling interests be provided for each class of net assets for which a noncontrolling interest exists during the reporting period.

(r) Reclassifications

Certain reclassifications have been made to the 2017 consolidated financial statements in order for them to conform to the 2018 presentation.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

(3) Charity Care

Self-pay revenue is primarily derived from patients who do not have any form of healthcare coverage and from patient responsibility after insurances have paid their obligations. The revenue associated with self-pay patients is generally reported at the System's gross charges. The System evaluates these patients, after the patient's medical condition is determined to be stable, for their ability to pay based upon federal and state poverty guidelines, qualifications for Medicaid, or other government assistance programs, as well as the System's policy for charity care. The System provides assistance in applying for Medicaid and/or other government assistance programs if the evaluation determines they may be eligible for such a program.

The System provides care without charge to patients that qualify under the System's charity care policy. The policy takes into consideration family size, income, and medical indigence in determining eligibility. Patients at 225% and below the Federal Poverty Income Level are eligible for 100% financial assistance with a sliding scale up to 375% of Federal Poverty Guidelines for eligibility of 70% financial assistance.

The System's management estimates its costs of care provided under its charity care programs utilizing a calculated ratio of total costs (less bad debt expense) to gross charges multiplied by the System's gross charity care charges provided to charity patients for the period. The System's gross charity care charges include only services provided to patients who are unable to pay and qualify under the charity care policy. The System does not report a charity care patient's charges in net patient service revenue or in the estimated uncollectibles as it is the System's policy not to pursue collection of amounts related to these patients.

The following information measures the level of charity care provided during the years ended May 31, 2018 and 2017:

	<u>2018</u>	<u>2017</u>
Charges forgone, based on established rates	\$ 14,131	11,594
Estimated costs and expenses incurred to provide charity care	4,780	4,788
Equivalent percentage of charity care charges to all charges	0.8 %	0.8 %

The System received approximately \$2,387 and \$2,867 in 2018 and 2017, respectively, from the Commonwealth of Kentucky as a Disproportionate Share Hospital payment for the provision of care to indigent citizens.

(4) Business and Credit Concentration

The System provides healthcare service through its inpatient and outpatient care facilities located primarily in Owensboro, Kentucky. The System grants credit to its patients and generally does not require collateral or other security in extending credit to patients. However, the System routinely obtains assignment of (or is otherwise entitled to receive) patients' benefits payable under their health insurance programs, plans, or policies (e.g., Medicare, Medicaid, Blue Cross, health maintenance organizations, and commercial insurance policies).

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

Patient accounts receivable include net receivables from the federal government (Medicare), the Commonwealth of Kentucky (Medicaid), and Blue Cross at May 31, 2018 and 2017 as follows:

	<u>2018</u>	<u>2017</u>
Medicare	\$ 33,203	28,062
Medicaid	15,508	15,170
Blue Cross	<u>26,411</u>	<u>27,167</u>
Total	\$ <u>75,122</u>	<u>70,399</u>

At May 31, 2018 and 2017, the System had deposits at financial institutions of approximately \$52,948 and \$46,953, respectively, in excess of the Federal Deposit Insurance Corporation limits. Further, investments in U.S. government and U.S. government agency securities are not guaranteed by the U.S. government or otherwise insured.

(5) Investments and Assets Limited as to Use

In accordance with ASC Topic 820, the System has categorized its financial instruments, based on the priority of inputs used in related valuation techniques, into a three-level fair value hierarchy. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure the financial instruments fall within different levels of the hierarchy, the categorization is based on the lowest-level input that is significant to the fair value measurement of the instrument.

When available, the System generally uses quoted market prices to determine fair value and classifies such items as Level 1. The System's Level 2 securities are bonds whose fair values are determined by independent vendors. The vendors compile prices from various sources and may apply matrix pricing for similar bonds or loans where no price is observable in an actively traded market. If available, the vendor may also use quoted prices for recent trading activity of assets with similar characteristics to the bond being valued.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

The System's Level 3 securities comprise alternative investments that have less liquidity, a stale quoted price, or varying price from independent sources. The System's Level 3 alternative investments' prices are obtained from the related fund manager. For the System's funds of funds, the manager receives account statements directly from independent administrators or the underlying hedge fund managers, who are responsible for the pricing of these funds. Before relying on these valuations, the System evaluates the fair value estimation processes and control environment, the investee fund's policies and procedures in estimating the fair value of underlying investments, the investee fund's use of independent third-party valuation experts, the portion (approximately 100% for the System) of the underlying securities traded on active markets, and the professional reputation and standing of the investee fund's auditor.

Investments stated at fair value at May 31, 2018 and 2017 include the following:

	<u>2018</u>	<u>2017</u>
Cash and cash equivalents	\$ 6,346	3,607
U.S. Treasury obligations	17,730	14,218
Federal mortgage-backed securities	1,934	2,003
Corporate bonds	45,426	35,617
Equity securities	15,996	24,383
Mutual funds	87,703	84,011
Certificates of deposit	5,356	5,354
Accrued interest receivable	419	295
Total	<u>\$ 180,910</u>	<u>169,488</u>

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

The fair value hierarchy of investments is as follows:

	2018			Total
	Level 1	Level 2	Level 3	
Cash and cash equivalents	\$ 6,346	—	—	6,346
U.S. Treasury obligations	17,730	—	—	17,730
Federal mortgage-backed securities:				
Residential	—	1,934	—	1,934
Corporate bonds:				
Domestic	—	29,374	—	29,374
International	—	16,052	—	16,052
Equity securities:				
Consumer discretionary	993	—	—	993
Energy	2,164	—	—	2,164
Financial	5,341	—	—	5,341
Healthcare	2,618	—	—	2,618
Industrials	1,394	—	—	1,394
Information technology	2,088	—	—	2,088
Materials	923	—	—	923
Telecommunication services	376	—	—	376
Utilities	99	—	—	99
Mutual funds:				
Large-cap equity securities	18,319	—	—	18,319
Small- and mid-cap equity securities	17,533	—	—	17,533
International equity securities	16,342	—	—	16,342
Bond funds	35,509	—	—	35,509
Certificates of deposit	5,356	—	—	5,356
Accrued interest receivable	419	—	—	419
	<u>\$ 133,550</u>	<u>47,360</u>	<u>—</u>	<u>180,910</u>

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

	2017			Total
	Level 1	Level 2	Level 3	
Cash and cash equivalents	\$ 3,607	—	—	3,607
U.S. Treasury obligations	14,218	—	—	14,218
Federal mortgage-backed securities:				
Residential	—	2,003	—	2,003
Corporate bonds:				
Domestic	—	24,031	—	24,031
International	—	11,586	—	11,586
Equity securities:				
Consumer discretionary	2,509	—	—	2,509
Consumer staples	—	—	—	—
Energy	2,139	—	—	2,139
Financial	6,763	—	—	6,763
Healthcare	4,012	—	—	4,012
Industrials	2,199	—	—	2,199
Information technology	4,729	—	—	4,729
Materials	1,524	—	—	1,524
Telecommunication services	361	—	—	361
Utilities	147	—	—	147
Mutual funds:				
Large-cap equity securities	16,064	—	—	16,064
Small- and mid-cap equity securities	15,416	—	—	15,416
International equity securities	23,713	—	—	23,713
Bond funds	28,818	—	—	28,818
Certificates of deposit	5,354	—	—	5,354
Accrued interest receivable	295	—	—	295
	<u>\$ 131,868</u>	<u>37,620</u>	<u>—</u>	<u>169,488</u>

The System had no investments classified as Level 3 investments during 2018 or 2017.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

Assets limited as to use stated at fair value at May 31, 2018 and 2017 include the following:

	<u>2018</u>	<u>2017</u>
Cash and cash equivalents	\$ 31,162	62,115
Accrued interest receivable	12	22
	<hr/>	<hr/>
Total assets limited as to use	31,174	62,137
Less amounts required to meet current obligations	<hr/>	<hr/>
	22,864	24,016
	<hr/>	<hr/>
	\$ 8,310	38,121
	<hr/>	<hr/>

As of May 31, 2018 and 2017, all of assets limited as to use were considered Level 1 investments.

Assets limited as to use in the accompanying consolidated balance sheets were established in accordance with the requirements of the indentures related to the various revenue bond issues discussed in note 9, which require the following funds:

	<u>2018</u>	<u>2017</u>
Principal and interest funds	\$ 22,874	24,017
Construction funds	8,300	37,950
Expense funds	<hr/>	<hr/>
	—	170
	<hr/>	<hr/>
	\$ 31,174	62,137
	<hr/>	<hr/>

The interest funds are used to pay interest on the various bond issues. Expense funds are used to pay for expenses related to the issuance of the bonds.

(6) Investment Income

Investment income comprised the following for the years ended May 31, 2018 and 2017:

	<u>2018</u>	<u>2017</u>
Investment income (loss):		
Interest and dividend income	\$ 3,416	4,140
Net realized gains on sales of securities	7,932	1,464
Net unrealized gains on trading securities	200	7,980
Management fees and other	<hr/>	<hr/>
	(367)	(401)
	<hr/>	<hr/>
Investment income, net	\$ 11,181	13,183
	<hr/>	<hr/>

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

(7) Property and Equipment

A summary of property and equipment at May 31, 2018 and 2017 is as follows:

	<u>2018</u>	<u>2017</u>
Land	\$ 20,280	16,415
Land improvements	4,457	3,710
Buildings	677,129	618,389
Fixed equipment	46,631	41,777
Major movable equipment and capitalized software costs	<u>267,763</u>	<u>247,914</u>
	1,016,260	928,205
Less accumulated depreciation and amortization	<u>415,879</u>	<u>372,063</u>
	600,381	556,142
Construction in progress	<u>5,662</u>	<u>43,287</u>
	<u>\$ 606,043</u>	<u>599,429</u>

Construction in progress at May 31, 2018 consists primarily of costs incurred for new Healthplexes and improvements related to various buildings. The Healthplex projects are expected to be completed in the last quarter of 2018. At May 31, 2018, the remaining commitments on construction contracts approximated \$6,450 for the system.

Capitalized interest expenses for 2018 was approximately \$2,089. Capitalized interest expenses for 2017 was approximately \$3,457.

OHMCH is committed to a lease, which requires \$600 of annual rent and to fund capital expenditure of \$2,200 per year; however, this amount can be renegotiated annually as expenditures are needed. The System has estimated the present value of this capital expenditure obligation at \$4,600 as of July 1, 2015. This amount is being accreted over the seven-year noncancelable lease term. Accretion was \$657 for the years ended May 31, 2018 and 2017. The lease is for a period of 20 years with an option for the System to cancel after 7 years.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

(8) Net Patient Service Revenue

The System participates in the Medicare and Medicaid programs (the Programs). The Programs reimburse the System at amounts different from the established billing rates. Contractual adjustments under the Programs represent the difference between the System's billings at established rates for services and amounts reimbursed by third-party payors. A summary of the basis of reimbursement with major third-party payors is as follows:

Medicare – The System is paid for substantially all services rendered to inpatient Medicare Program beneficiaries under prospectively determined rates per discharge. Those rates vary according to a classification system that is based on clinical, diagnostic, and other factors. The Medicare Program reimburses the System on a prospective payment system for hospital outpatient services known as the Ambulatory Payment Classification (APC) system. Under the APC system, outpatient services are classified into an APC category based on the Current Procedural Terminology-4 code for the service provided, and payment for the APC category is determined using prospectively determined federal payment rates adjusted for regional wage differences. Depreciation and other defined capital costs are reimbursed under a capital prospective payment system. Reimbursement is calculated based on a federal capital payment rate per discharge. The System receives cash payments at a tentative rate with final settlement determined after the System's submission of annual cost reports and audits thereof by the Medicare fiscal intermediary. The System's classification of patients under the Medicare Prospective Payment System and the appropriateness of the patients' admissions are subject to validation reviews by the Medicare peer review organization with which the System is required by law to contract for the performance of such reviews. Revenue from the Medicare program totals approximately 38.8% and 39.2% of the System's net patient service revenue for the years ended May 31, 2018 and 2017, respectively.

Medicaid – The System is paid for substantially all services rendered to inpatient Medicaid Program beneficiaries under prospectively determined rates per discharge. Those rates vary according to a classification system that is based on clinical, diagnostic, and other factors. Outpatient services, except for lab services, are reimbursed by the Medicaid program based upon a cost-reimbursement methodology. Final reimbursement rates are determined after submission of annual cost reports by the System and audits by third-party intermediaries. Lab services are reimbursed on a predetermined fee schedule based upon the CPT-4 code for the service provided. Revenue from the Medicaid program totals approximately 14.0% and 14.9% of the System's net patient service revenue for the years ended May 31, 2018 and 2017, respectively. Kentucky Medicaid began to contract with managed care organizations in late 2011. Approximately 90.0% of Kentucky Medicaid enrollees are in a managed care plan.

Other – The System has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred-provider organizations. The bases for payment to the System under these agreements include prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

The Kentucky General Assembly enacted a temporary tax on all healthcare providers beginning July 1, 1993. The tax on hospitals is 2.5% of net patient service revenue and contributions received. The tax expense recognized was approximately \$6,664 and \$6,605 at 2018 and 2017, respectively. The legislation also provided payments to qualifying hospitals for the care of indigent patients. The System's tax was reduced by approximately \$1,655 and \$1,737 of such payments for 2018 and 2017, respectively.

Amounts due to third-party payors represent the excess of interim payments received or receivable over estimated final payment rates. Provision has been made in the accompanying consolidated financial statements for the effects of estimated final settlements on open years. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Net patient service revenue increased approximately \$2,706 and \$1,713 for the years ended May 31, 2018 and 2017, respectively, as a result of prior year final settlements in excess of amounts previously estimated and the removal of liabilities related to prior years that are no longer necessary as such years are no longer subject to audits, reviews, and investigations. The increase for the year ended May 31, 2018 consisted of third-party estimates that were above actual amounts paid.

The composition of net patient service revenue is as follows:

	<u>2018</u>	<u>2017</u>
Gross patient service revenue	\$ 1,836,029	1,726,414
Less provision for contractual and other adjustments	<u>1,190,423</u>	<u>1,091,994</u>
Net patient service revenue	<u>\$ 645,606</u>	<u>634,420</u>

Patient accounts receivable are reduced by an allowance for bad debts. In evaluating the collectibility of accounts receivable, the System analyzes historical collections and write-offs and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for bad debts and provision for bad debts. Management regularly reviews data about these major payor sources of revenue in evaluation of the sufficiency of the allowance for bad debts. For receivables associated with services provided to patients who have third-party coverage, the System analyzes contractually due amounts and provides an allowance for bad debts, allowance for contractual adjustments, provision for bad debts, and contractual adjustments on accounts for which the third-party payor has not yet paid or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely. For receivables associated with self-pay patients or with balances remaining after the third-party coverage has already been paid, the System records a significant provision for bad debts in the period of service on the basis of its historical collections, which indicates that many patients decline to pay the portion of their bill for which they are financially responsible. The difference between the discounted rate and the amounts collected after all reasonable collection efforts have been exhausted is written off against the allowance for bad debts. The System's self-pay write-offs decreased from approximately \$37,628 for fiscal year 2017 to approximately \$29,831 for fiscal year 2018. The System has changed its charity care during fiscal year 2018 to meet the new requirements as described in Section 501(r) of the IRC and has adjusted the write-off percentages to comply with the Section 501(r) regulations. The System maintains an allowance for estimated uncollectible accounts from other third-party payors, which is not material.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

(9) Long-Term Debt

A summary of long-term debt and current maturities of long-term debt at May 31, 2018 and 2017 is as follows (in thousands):

	<u>2018</u>	<u>2017</u>
2010 revenue bonds, Series A, under a Master Trust Indenture, interest from 5.00% to 6.50%, through March 2045	\$ 18,515	24,095
2015 revenue bonds, Series A, under a Master Trust Indenture, interest from 4.50% to 5.25%, through June 2050	67,585	67,585
2015 revenue bonds, Series B, under a Master Trust Indenture, interest from 3.00% to 5.00%, through June 2031	22,515	23,730
2017 revenue bonds, Series A, under a Master Trust Indenture, interest from 4.00% to 5.25%, through June 2045	433,620	433,620
2017 revenue bonds, Series B, under a Master Trust Indenture, interest from 3.75% to 5.00%, through June 2040	<u>39,015</u>	<u>39,015</u>
Total contractual debt	581,250	588,045
Unamortized premiums, net	26,768	28,817
Unamortized debt issuance costs, net	<u>(9,093)</u>	<u>(9,627)</u>
Total debt	598,925	607,235
Less current portion	<u>8,755</u>	<u>6,816</u>
	<u>\$ 590,170</u>	<u>600,419</u>

In May 2017, the System, through the Kentucky Economic Development Finance Authority, issued Hospital Revenue Refunding Bonds, Series 2017A and Hospital Revenue Refunding Bonds, Series 2017B (collectively, 2017 revenue bonds) in the amount of \$433,620 and \$39,015, totaling \$472,635. The proceeds from the issuance were used to partially advance refund the Series 2010A and to fully advance refund the Series 2010B. The portion of the Series 2010A Bonds maturing prior to June 1, 2021 were not refunded in the principal amount of approximately \$24,095. As a result of the issuance of the Series 2017 Bonds and the defeasance of the Refunded 2010 Bonds, in FY2017, OHI recorded a noncash loss on bond defeasance of approximately \$83,073 primarily from the difference between the purchase prices and the par values of the purchased securities of approximately \$63,727 and write-off of the unamortized bond discounts and issuance costs of approximately \$19,346. The remaining net proceeds were used to pay the premium for the Surety Bond, to fund the Debt Service Reserve Requirement, pay the premium for the Policy insuring payment, and pay certain expenses incurred in connection with the issuance.

In July 2015, the System, through the Kentucky Economic Development Finance Authority, issued Hospital Revenue Bonds, Series 2015A and Hospital Revenue Refunding Bonds, Series 2015B (collectively, 2015 revenue bonds) in the amount of \$67,585 and \$24,885, totaling \$92,470. The proceeds from the issuance were used to provide funding to finance the cost of acquiring, constructing, and equipping the Healthplexes

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

project, refund \$26,758 for portion of the Series 2010B bonds, fund a portion of the interest on the 2015 Series A bonds, and pay certain expenses incurred in connection with the issuance.

In March 2010, the System, through the Kentucky Economic Development Finance Authority, issued Hospital Revenue Bonds, Series 2010A and Hospital Revenue Refunding Bonds, Series 2010B (collectively, 2010 revenue bonds) in the amount of \$460,645 and \$66,695, totaling \$527,340. The proceeds from the issuance were used to provide funding to finance the cost of acquiring, constructing, and equipping a new nine-story replacement acute care hospital and related service buildings, refund \$152,000 in aggregate principal amount of the 2001 revenue bonds, fund a debt service reserve fund to be used to pay down future debt service, fund a portion of the interest on the 2010 Series A bonds, and pay certain expenses incurred in connection with the issuance. In May 2017, the 2010 Series A bonds was partially refunded by 2017 Series A bonds with current outstanding amount of \$24,095 and 2010 Series B bonds outstanding balance of \$66,695 was fully advanced refunded through the use of proceeds of the 2017 Series B bonds described above.

In June 2001, the System, through the City of Owensboro, Kentucky, issued Health System Variable Revenue Bonds Auction Rate Securities, 2001 Series A, B, and C (collectively, 2001 revenue bonds) in the amount of \$70,400, \$65,500, and \$65,525, respectively, totaling \$201,425. The funds were designated to reimburse the System for the cost of certain capital expenditures, certain future capital expenditures, certain advance refunding, and principal payments of the Series 1992 and 1996 bonds, and to pay the costs of issuance of the 2001 revenue bonds. The 2001 revenue bonds had interest at a variable rate following a 35-day auction period. The outstanding balance of \$152,000 was refunded in March 2010 through the use of proceeds of the 2010 revenue bonds described above.

The 2010, 2015, and 2017 revenue bonds are collateralized by related bond trust funds and pledged revenue. The System has also agreed under the Master Trust Indenture to subject the Obligated Group to various operational and financial covenants typical of such agreements. The Obligated Group includes Owensboro Health and OHMG, excluding its subsidiary, OMCL. In addition, the System has granted to the Master Trustee, a deed of trust lien on the land and buildings owned by Owensboro Health and a security interest in Owensboro Health's accounts receivable to secure payment of the outstanding revenue bonds.

Scheduled principal repayments on long-term debt are as follows (in thousands):

	Long-term debt
Year ending May 31:	
2019	\$ 8,755
2020	9,205
2021	9,685
2022	10,190
2023	10,710
Thereafter	<u>532,705</u>
	<u>\$ 581,250</u>

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

Debt issuance costs, net of approximately \$9,093 and \$9,627 at May 31, 2018 and 2017, respectively, are being amortized over the term of the bonds using the effective-interest method. Amortization was approximately \$534 and \$456 at May 31, 2018 and 2017, respectively.

(10) Operating Leases

The System leases certain buildings and equipment under noncancelable operating leases with terms ranging from 2 to 4 years. Rent expense under these leases approximated \$1,002 and \$1,186 for the years ended May 31, 2018 and 2017, respectively. Rental expense, including short-term cancelable rentals was \$2,203 and \$2,358 for the years ended May 31, 2018 and 2017, respectively.

Future minimum lease payments under these noncancelable operating leases with initial or remaining terms in excess of one year are as follows:

Year ending May 31:		
2019	\$	887
2020		826
2021		600
2022		600
2023		—
Thereafter		—
		—
Total minimum lease payments	\$	2,913

(11) Temporarily Restricted Net Assets

Temporarily restricted net assets at May 31, 2018 and 2017 are available for use as follows (in thousands):

	2018	2017
Breast cancer	\$ 75	54
Cancer center	322	324
Cancer Center Transportation	20	20
Gains Scholarship	25	24
HOPE fund	439	345
Hospitality House	112	118
Kuhlin Endowment Fund	25	22
Lifespring	10	28
McAuley Clinic	196	195
Medicus	73	73
NICU	20	50
Other	201	151
	201	151
Total temporarily restricted net assets	\$ 1,518	1,404

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

(12) Retirement Plan

The System has a defined-benefit pension plan, the Owensboro Health Retirement Plan (the Plan), a single-employer pension trust fund. The Plan is available to employees age 21 or older who have completed one year of continuous service and have 1,000 hours of annual service. The benefits are based upon years of service and the employee's average monthly earnings.

The funding policy of the System is to contribute amounts to the Plan at least equal to the minimum funding requirements of the Employee Retirement Income Security Act of 1974 and subsequent amendments. The System expects to contribute approximately \$11,192 to the Plan during fiscal year 2019.

The following table summarizes the allocation of the assets available for plan benefits at May 31:

	<u>2018</u>	<u>2017</u>
Cash and cash equivalents	— %	— %
Equities	—	—
Mutual Funds	100	100

The Plan utilizes an investment strategy that focuses on maximizing total return and places limited emphasis on generating income. The Plan's average asset allocation target is 60% equities, 38% fixed income, and 2% cash. The Plan's diversification offers the expectation of higher and more stable returns that will meet the obligations of the Plan.

The actuarially computed net periodic pension cost for 2018 and 2017 included the following components (in thousands):

	<u>2018</u>	<u>2017</u>
Service cost – benefits earned during the year	\$ 9,179	\$ 9,519
Interest cost on projected benefit obligation	5,589	5,415
Expected return on plan assets	(5,338)	(4,697)
Net amortization and deferral	<u>2,601</u>	<u>3,432</u>
Net periodic pension cost	<u>\$ 12,031</u>	<u>\$ 13,669</u>

The following are the estimated amounts that will be amortized from unrestricted net assets over the next fiscal year (in thousands):

Amortization of loss	\$ 1,853
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OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

The following tables set forth the Plan's funded status (measured at May 31, 2018 and 2017) and amounts recognized in the System's accompanying consolidated financial statements at May 31, 2018 and 2017 (in thousands):

	<u>2018</u>	<u>2017</u>
Accumulated benefit obligation	\$ (131,245)	(124,302)
Change in projected benefit obligation:		
Projected benefit obligation at the beginning of measurement year	\$ (166,925)	(162,475)
Service cost	(9,179)	(9,519)
Interest cost	(5,589)	(5,415)
Actuarial gain (loss)	4,930	(226)
Benefits paid	<u>8,082</u>	<u>10,710</u>
Projected benefit obligation at the end of measurement year	\$ <u>(168,681)</u>	<u>(166,925)</u>
	<u>2018</u>	<u>2017</u>
Change in plan assets:		
Fair value of plan assets at the beginning of measurement year	\$ 96,562	93,303
Actual return on plan assets	6,081	10,842
Employer contributions	18,595	3,127
Benefits paid	<u>(8,082)</u>	<u>(10,710)</u>
Fair value of plan assets at the end of measurement year	\$ <u>113,156</u>	<u>96,562</u>
Funded status	\$ (55,525)	(70,363)
Unrecognized net actuarial loss	—	—
Unrecognized prior service cost	—	—
Accrued pension cost	\$ <u>(55,525)</u>	<u>(70,363)</u>
	<u>2018</u>	<u>2017</u>
Amounts recognized in unrestricted net assets:		
Net actuarial loss	\$ <u>35,624</u>	<u>43,898</u>
	\$ <u>35,624</u>	<u>43,898</u>

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

	<u>2018</u>	<u>2017</u>
Employer contributions	\$ 18,595	3,127
Plan participants' contributions	—	—
Benefits paid	8,082	10,710

The benefits expected to be paid from the Plan in each year from 2019 to 2023 are approximately \$27,798, \$13,254, \$12,072, \$11,759, and \$12,284, respectively. The aggregate expected benefits to be paid in the five years from 2024 to 2028 are approximately \$72,698. The expected benefits to be paid are based on the same assumptions used to measure the Plan's benefit obligation at May 31 and include estimated future employee service.

Weighted average assumptions used to determine benefit obligation at May 31, 2018 and 2017 were as follows:

	<u>2018</u>	<u>2017</u>
Discount rate	3.96 %	3.65 %
Rate of compensation increase	4.00	4.00

Weighted average assumptions used to determine net periodic pension cost for the years ended May 31, 2018 and 2017 were as follows:

	<u>2018</u>	<u>2017</u>
Discount rate	3.65 %	3.63 %
Expected long-term rate of return on plan assets	5.75	5.75
Rate of compensation increase	4.00	4.00

The expected long-term rate of return is based on the portfolio as a whole and not on the sum of the returns on individual asset categories. This assumption is based on historical returns of the Plan. Unrecognized gains and losses in excess of 10% of the greater of the projected benefit obligation or market-related value of plan assets are amortized on a straight-line basis over the average remaining service period of participants expected to receive benefits under the Plan, which is 10 years at May 31, 2018 and 2017.

In accordance with ASC Subtopic 715-20, the System has categorized its plan assets, based on ASC Topic 820 and the priority of inputs used in related valuation techniques, into a three-level fair value

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

hierarchy, as explained in note 5. All plan assets at May 31, 2018 and 2017 include the following (in thousands):

	2018	2017
Mutual funds	\$ 113,156	96,562
Total	\$ 113,156	96,562

The fair value hierarchy of plan assets is as follows:

		2018			
		Level 1	Level 2	Level 3	Total
Mutual funds:					
Large-cap equity securities	\$	21,845	—	—	21,845
Small- and mid-cap equity securities		17,071	—	—	17,071
International equity securities		21,733	—	—	21,733
Debt securities		37,222	15,285	—	52,507
	\$	97,871	15,285	—	113,156

		2017			
		Level 1	Level 2	Level 3	Total
Mutual funds:					
Large-cap equity securities	\$	18,504	—	—	18,504
Small- and mid-cap equity securities		14,229	—	—	14,229
International equity securities		18,304	—	—	18,304
Debt securities		27,529	17,996	—	45,525
	\$	78,566	17,996	—	96,562

Effective January 2006, the System adopted the Owensboro Health, Inc. Nonqualified Supplemental Retirement Plan (Supplemental Retirement Plan). The Supplemental Retirement Plan was formed under Section 457(f) of the IRC of 1986, and management believes that it complies with all provisions applicable to a nonqualified deferred compensation plan under IRC Section 409A. Participants are eligible for employer contributions from 12% to 15% based on their position with the System. The employer contribution for each year is 100% vested after five years. Employer contributions occur each December 31. The System has accrued expenses related to the Supplemental Retirement Plan of approximately \$250 as of May 31, 2018 and 2017, and is included in accrued payroll and related liabilities in the consolidated balance sheets.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

(13) Risk Management and Self-Insured Liabilities

Effective January 1, 2003, the System maintains malpractice liability insurance with a commercial carrier on a claims-made basis for losses in excess of \$250 per occurrence. The System is self-insured for the first \$250 per occurrence. On January 1, 2004, the self-insured amount increased from \$250 to \$500 per occurrence. On January 1, 2005, the self-insured amount increased from \$500 to \$1,000 per occurrence. On December 1, 2010, the self-insured amount increased from \$1,000 to \$1,500 per occurrence. Accordingly, the System has made a provision in the accompanying consolidated financial statements for estimated unpaid malpractice claims, including incurred but not reported claims. The overall retroactive application date is January 1, 1978.

Through December 31, 2002, the System had professional liability insurance coverage with Reciprocal of America (ROA) on a claims-made basis. On April 30, 2003, the Commonwealth of Virginia filed an application to order ROA into liquidation. On June 20, 2003, the Virginia State Corporation Commission entered an Order of Liquidation declaring that ROA should be liquidated. Management believes that only a portion of all claims reported to ROA through December 31, 2002 will be paid through the ROA liquidation process. Management also believes that the System has adequately accrued for any potential shortfall for the payment of these reported claims and any incurred but not reported claims.

The System is self-insured up to the stop-loss amount of \$500 annually per individual for its medical and other healthcare benefits provided to its employees and their families. Contributions by the System and participating employees are based on actual claims experience. A provision for known claims and estimated incurred but not reported claims for those employees in the self-insured plan has been provided in the accompanying consolidated financial statements.

The System is self-insured up to \$500 per occurrence for workers' compensation claims and has purchased insurance to provide coverage for claims in excess of the self-insured retention. Such insurance coverage is on an occurrence basis. The System has made a provision in the accompanying consolidated financial statements for estimated workers' compensation claims known and estimated incurred but not reported claims.

The System is subject to various claims and lawsuits arising in the normal course of business. In the opinion of management, the ultimate resolution of these matters will not have a material adverse effect in the System's accompanying consolidated financial statements. Additionally, management is unaware of any unasserted claims that would have a material impact on the accompanying consolidated financial statements.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Notes to Consolidated Financial Statements

May 31, 2018 and 2017

(In thousands)

(14) Functional Expenses

The System provides general healthcare services to residents within its geographic location. Expenses related to providing these services for the years ended May 31, 2018 and 2017 are as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Healthcare services	\$ 414,216	404,244
General and administrative	<u>206,814</u>	<u>300,448</u>
Total functional expenses	<u>\$ 621,030</u>	<u>704,692</u>

(15) Related-Party Transactions

Owensboro Health has a 50% ownership in Owensboro Community Health Network, Inc. (OCHN); the other 50% owner is Ohio Valley Physicians Association, Inc. OCHN was incorporated in August 1999 and operates a preferred provider organization in the Commonwealth of Kentucky by contracting with various providers to provide medical services to the employees of contracted employers. Owensboro Health accounts for their OCHN investment on the equity method based on its ownership percentage. Owensboro Health is an employer utilizing OCHN's network. Owensboro Health paid OCHN approximately \$73 and \$10, respectively, in network administration fees for the year ended May 31, 2018 and 2017. Owensboro Health leases employees to OCHN for an amount equal to the employees' salaries plus benefits. For the years ended May 31, 2018 and 2017, OCHN reimbursed Owensboro Health approximately \$215 and \$224, respectively, for the salaries and benefits of these leased employees. Owensboro Health provides accounting functions to OCHN for a fee. Fees charged for the years ended May 31, 2018 and 2017 were approximately \$10.

Owensboro Health has a 65.7% ownership in OASF as of May 31, 2018 and 2017 with the remaining 34.3% owned by individual physicians and cogeneral partner Surgical Care Affiliates (SCA) for both years. OASF pays a management fee to SCA of 5.0% of net revenue, less bad debt expense. This management fee was approximately \$471 and \$379 for the years ended May 31, 2018 and 2017, respectively.

(16) Subsequent Events

The System has evaluated events subsequent to August 28, 2018 and through the date on which the consolidated financial statements were issued and identified no items.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Consolidating Schedule – Balance Sheet Information

May 31, 2018

(In thousands)

Assets	Owensboro Regional Hospital	OHMG	The Foundation for Health, Inc.	OMCL	HNWK	CIN	Muhlenberg	Elimination entries	Owensboro Health subtotal	OASF	OASF consolidation and elimination entries	Consolidated
	Current assets:											
Cash and cash equivalents	\$ 47,887	2,436	2,736	—	—	—	1,010	—	54,069	821	—	54,890
Investments	180,348	—	562	—	—	—	—	—	180,910	—	—	180,910
Patient accounts receivable, net	83,403	5,343	—	—	—	—	4,790	—	93,536	983	—	94,519
Inventories	12,033	129	—	—	—	—	1,881	—	14,043	2	—	14,045
Prepaid expenses and other current assets	383,552	162	(56)	—	—	382	4,926	(379,101)	9,865	47	—	9,912
Assets limited as to use, current portion	22,864	—	—	—	—	—	—	—	22,864	—	—	22,864
Total current assets	730,087	8,070	3,242	—	—	382	12,607	(379,101)	375,287	1,853	—	377,140
Assets limited as to use, less current portion	8,310	—	—	—	—	—	—	—	8,310	—	—	8,310
Property and equipment, net	493,069	106,217	3	—	—	—	5,476	—	604,765	1,278	—	606,043
Deferred compensation plan assets	12,277	—	—	—	—	—	—	—	12,277	—	—	12,277
Other assets	40,379	1,429	55	—	—	—	—	(26,906)	14,957	1,181	(2,484)	13,654
Total assets	\$ 1,284,122	115,716	3,300	—	—	382	18,083	(406,007)	1,015,596	4,312	(2,484)	1,017,424
Liabilities and Net Assets												
Current liabilities:												
Current maturities of long-term debt	\$ 8,755	—	—	—	—	—	—	—	8,755	—	—	8,755
Accounts payable	15,022	3,822	30	—	—	—	1,009	—	19,883	109	—	19,992
Accrued payroll and related liabilities	25,482	3,223	—	—	—	—	621	—	29,326	259	—	29,585
Other current liabilities	34,190	354,465	61	—	2,105	3,496	19,231	(379,100)	34,448	208	—	34,656
Due to third-party payors	20,538	—	—	—	—	—	538	—	21,076	—	—	21,076
Total current liabilities	103,987	361,510	91	—	2,105	3,496	21,399	(379,100)	113,488	576	—	114,064
Deferred compensation plan obligations	12,277	—	—	—	—	—	—	—	12,277	—	—	12,277
Long-term debt, less current maturities	590,170	—	—	—	—	—	—	—	590,170	—	—	590,170
Other noncurrent liabilities	—	—	—	—	—	—	—	—	—	164	—	164
Contractual lease obligation	—	—	—	—	—	—	2,683	—	2,683	—	—	2,683
Accrued pension cost	55,525	—	—	—	—	—	—	—	55,525	—	—	55,525
Total liabilities	761,959	361,510	91	—	2,105	3,496	24,082	(379,100)	774,143	740	—	774,883
Net assets (deficit):												
Unrestricted	522,163	(245,794)	1,691	—	(2,105)	(3,114)	(5,999)	(26,907)	239,935	3,572	(3,622)	239,885
Temporarily restricted	—	—	1,518	—	—	—	—	—	1,518	—	—	1,518
Total net assets (deficit) attributable to Owensboro Health, Inc.	522,163	(245,794)	3,209	—	(2,105)	(3,114)	(5,999)	(26,907)	241,453	3,572	(3,622)	241,403
Noncontrolling interests	—	—	—	—	—	—	—	—	—	—	1,138	1,138
Total net assets (deficit)	522,163	(245,794)	3,209	—	(2,105)	(3,114)	(5,999)	(26,907)	241,453	3,572	(2,484)	242,541
Total liabilities and net assets (deficit)	\$ 1,284,122	115,716	3,300	—	—	382	18,083	(406,007)	1,015,596	4,312	(2,484)	1,017,424

See accompanying independent auditors' report.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Consolidating Schedule – Statement of Operations and Changes in Net Assets Information

Year ended May 31, 2018

(In thousands)

	OHRH	OHMG	The Foundation for Health, Inc.	OMCL	HNWK	CIN	Muhlenberg	Elimination entries	Owensboro Health subtotal	OASF	OASF consolidation and elimination entries	Consolidated
Unrestricted revenue:												
Net patient service revenue	\$ 537,054	63,015	—	—	—	47	35,823	—	635,939	9,667	—	645,606
Provision for bad debts	(23,025)	(4,024)	—	—	—	—	(2,605)	—	(29,654)	(177)	—	(29,831)
Net patient service revenue less provision for bad debts	514,029	58,991	—	—	—	47	33,218	—	606,285	9,490	—	615,775
Other operating revenue	7,315	11,095	1,207	—	—	538	1,180	(10,301)	11,034	5	(477)	10,562
Total unrestricted revenue	521,344	70,086	1,207	—	—	585	34,398	(10,301)	617,319	9,495	(477)	626,337
Patient service and other expenses:												
Personnel	215,804	100,097	401	—	—	1,280	23,312	(1,046)	339,848	2,834	—	342,682
Professional fees	11,980	12,919	31	—	—	—	1,508	(3,971)	22,467	521	—	22,988
Drugs and supplies	108,399	4,685	5	—	435	109	6,024	(1,130)	118,527	2,468	—	120,995
Plant maintenance and operations	15,797	5,711	35	—	—	1	2,896	(4,074)	20,366	758	(477)	20,647
Kentucky provider tax	4,143	—	—	—	—	—	866	—	5,009	—	—	5,009
Other expenses	32,597	4,312	489	—	—	56	2,721	(839)	39,336	479	—	39,815
Depreciation and amortization	35,318	5,124	2	—	—	—	1,004	—	41,448	278	—	41,726
Interest expense	27,160	—	—	—	—	—	—	—	27,160	8	—	27,168
Total patient service and other expenses	451,198	132,848	963	—	435	1,446	38,331	(11,060)	614,161	7,346	(477)	621,030
Operating income (loss)	70,146	(62,762)	244	—	(435)	(861)	(3,933)	759	3,158	2,149	—	5,307
Nonoperating gains (losses):												
Investment income (loss), net	11,160	—	9	—	—	—	12	—	11,181	—	—	11,181
Contributions and other	1,599	(5)	(9)	—	—	60	10	(753)	902	(43)	(2,625)	(1,766)
Nonoperating gains (losses), net	12,759	(5)	—	—	—	60	22	(753)	12,083	(43)	(2,625)	9,415
Excess (deficiency) of revenue and gains over expenses and losses before noncontrolling interests	82,905	(62,767)	244	—	(435)	(801)	(3,911)	6	15,241	2,106	(2,625)	14,722
Noncontrolling interests	—	—	—	—	—	—	—	—	—	—	(722)	(722)
Excess (deficiency) of revenue and gains over expenses and losses	82,905	(62,767)	244	—	(435)	(801)	(3,911)	6	15,241	2,106	(3,347)	14,000
Accrued pension cost adjustment	8,274	—	—	—	—	—	—	—	8,274	—	—	8,274
Change in unrestricted net assets	91,179	(62,767)	244	—	(435)	(801)	(3,911)	6	23,515	2,106	(3,347)	22,274
Temporarily restricted net assets:												
Contributions	—	—	275	—	—	—	—	—	275	—	—	275
Net assets released from restrictions used for operations	—	—	(161)	—	—	—	—	—	(161)	—	—	(161)
Change in temporarily restricted net assets	—	—	114	—	—	—	—	—	114	—	—	114
Noncontrolling interests:												
Excess of revenue and gains over expenses and losses	—	—	—	—	—	—	—	—	—	—	722	722
Partnership investment	—	—	—	5,555	—	—	—	(5,555)	—	—	1,206	1,206
Distributions to minority shareholders	—	—	—	—	—	—	—	—	—	(1,775)	1,167	(608)
Change in noncontrolling interests	—	—	—	5,555	—	—	—	(5,555)	—	(1,775)	3,095	1,320
Change in total net assets	91,179	(62,767)	358	5,555	(435)	(801)	(3,911)	(5,549)	23,629	331	(252)	23,708
Net assets (deficit), beginning of year	430,984	(183,027)	2,851	(5,555)	(1,670)	(2,313)	(2,088)	(21,358)	217,824	3,241	(2,232)	218,833
Net assets (deficit), end of year	\$ 522,163	(245,794)	3,209	—	(2,105)	(3,114)	(5,999)	(26,907)	241,453	3,572	(2,484)	242,541

See accompanying independent auditors' report.

OBLIGATED GROUP

Combining Schedule – Statement of Operations and Changes in Net Assets Information

Year ended May 31, 2018

(In thousands)

	Owensboro Health	OMHG	Combination and elimination entries	Obligated Group
Unrestricted revenue:				
Net patient service revenue	\$ 537,054	63,015	—	600,069
Provision for bad debts	(23,025)	(4,024)	—	(27,049)
Net patient service revenue less provision for bad debts	514,029	58,991	—	573,020
Other operating revenue	7,315	11,095	(9,064)	9,346
Total unrestricted revenue	521,344	70,086	(9,064)	582,366
Patient service and other expenses:				
Personnel	215,804	100,097	(1,066)	314,835
Professional fees	11,980	12,919	(3,892)	21,007
Drugs and supplies	108,399	4,685	(1,659)	111,425
Plant maintenance and operation	15,797	5,711	(2,438)	19,070
Kentucky provider tax	4,143	—	—	4,143
Other expenses	32,597	4,312	(9)	36,900
Depreciation and amortization	35,318	5,124	—	40,442
Interest expense	27,160	—	—	27,160
Total patient service and other expenses	451,198	132,848	(9,064)	574,982
Operating income (loss)	70,146	(62,762)	—	7,384
Nonoperating gains:				
Investment income net	11,160	—	—	11,160
Contributions and other, net	1,599	(5)	—	1,594
Nonoperating gains, net	12,759	(5)	—	12,754
Excess (deficiency) of revenue and gains over expenses and losses	82,905	(62,767)	—	20,138
Accrued pension cost adjustment	8,274	—	—	8,274
Change in unrestricted net assets	91,179	(62,767)	—	28,412
Net assets, beginning of year	430,984	(183,027)	(26,906)	221,051
Net assets, end of year	\$ 522,163	(245,794)	(26,906)	249,463

See accompanying independent auditors' report.

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Hospital Utilization Statistics (Unaudited)

Years ended May 31

	2018	2017	2016	2015	2014	2013	2012	2011	2010	2009	2008	2007
Patient days:												
Acute patient days	62,507	71,770	75,943	70,289	65,456	68,845	71,587	72,788	70,016	71,950	71,662	72,403
TCC patient days	8,073	8,129	7,038	7,288	7,163	8,823	8,757	9,334	7,960	7,801	8,626	8,736
Rehab patient days	4,777	4,418	4,754	3,675	3,645	3,455	3,701	3,845	3,854	3,725	3,738	4,145
Total patient days	75,357	84,317	87,735	81,252	76,264	81,123	84,045	85,967	81,830	83,476	84,026	85,284
Average adult daily census	206	231	240	223	209	222	230	236	224	229	230	234
Licensed beds	477	477	477	477	477	477	477	477	477	477	477	477
Average number of available beds	384	380	352	352	354	366	377	372	364	359	372	374
Average adult occupancy	54%	61%	68%	63%	59%	61%	61%	63%	62%	64%	62%	63%
Adult discharges:												
Acute discharges	14,920	16,145	17,073	15,909	15,176	16,638	17,144	17,388	17,479	17,725	16,936	17,771
TCC discharges	778	741	698	744	662	669	642	645	569	585	551	587
Rehab discharges	398	380	426	326	323	300	317	311	307	314	315	304
Total adult discharges	16,096	17,266	18,197	16,979	16,161	17,607	18,103	18,344	18,355	18,624	17,802	18,662
Average adult length of stay:												
Acute length of stay	4.2	4.5	4.4	4.4	4.3	4.1	4.2	4.2	4.0	4.1	4.2	4.1
TCC length of stay	10.7	11.0	10.1	9.8	10.8	13.2	13.6	14.5	14.0	13.3	15.7	14.9
Rehab length of stay	11.8	11.5	11.2	11.3	11.3	11.5	11.7	12.4	12.6	11.9	11.9	13.6
Total average adult length of stay	4.7	4.9	4.8	4.8	4.7	4.6	4.6	4.7	4.5	4.5	4.7	4.6
Number of deliveries	2,060	2,059	2,123	1,961	1,926	1,815	1,863	1,820	1,766	1,860	1,811	1,908
Surgical cases:												
Inpatient	3,495	3,832	4,224	3,888	3,806	3,795	4,683	4,342	4,714	4,331	4,224	4,202
Outpatient	9,108	8,975	8,746	8,186	7,311	7,195	7,710	8,933	8,856	9,011	9,336	9,235
Endoscopy	4,577	4,650	4,939	4,978	4,981	4,930	4,395	5,190	5,254	5,362	5,600	5,684
ASC	6,902	6,249	6,068	5,918	5,605	6,140	7,000	6,103	5,784	5,085	5,148	4,909
Total surgical cases	24,082	23,706	23,977	22,970	21,703	22,060	23,788	24,568	24,608	23,789	24,308	24,030
Emergency room visits	70,286	73,129	73,074	68,718	64,081	65,851	63,901	63,043	63,592	63,298	65,185	66,217
Average number of visits per day	193	200	200	188	176	180	175	173	174	173	178	181
	365 days											

OWENSBORO HEALTH, INC. AND AFFILIATED ENTITIES

Hospital Utilization Statistics (Unaudited)

Years ended May 31

	2018	2017	2016	2015	2014	2013	2012	2011	2010	2009	2008	2007
Outpatient visits:												
Hospital physician clinics	549,145	537,026	527,444	430,817	249,894	220,301	206,951	191,907	143,311	96,048	83,002	N/A
Work Health	17,426	18,081	18,117	17,493	9,457	8,499	9,810	17,279	13,737	N/A	N/A	N/A
Outpatient ED visits	60,844	62,826	62,220	58,373	54,538	55,205	54,126	52,928	54,116	53,689	55,755	56,031
Convenient care visits	30,097	33,327	29,672	30,121	27,577	29,739	27,507	29,976	29,630	26,789	25,593	27,001
Observation visits	4,523	3,778	3,059	3,526	3,435	3,696	6,024	6,593	6,513	6,573	7,566	7,212
Outpatient surgery cases:												
Hospital	9,108	8,975	8,746	8,186	7,311	7,195	7,710	8,933	8,856	9,011	8,948	9,235
ASC	6,902	6,249	6,068	5,918	5,605	6,140	7,000	6,103	5,784	5,085	5,148	4,909
Total outpatient surgery visits	16,010	15,224	14,814	14,104	12,916	13,335	14,710	15,036	14,640	14,096	14,096	14,144
Ancillary visits:												
Lab	203,907	129,803	109,421	90,497	91,083	87,812	85,032	87,384	86,306	81,472	78,854	78,344
Physical therapy*	32,198	30,502	28,417	24,340	20,789	16,260	16,719	16,294	15,568	7,242	7,174	7,116
Wound care	3,444	3,432	3,113	3,086	4,658	2,952	2,914	1,262	1,105	908	784	755
Total ancillary visits	239,549	163,737	140,951	117,923	116,530	107,024	104,665	104,940	102,979	89,622	86,812	86,215
Diagnostic visits:												
Radiology	128,557	128,816	125,855	110,768	115,524	116,512	118,265	117,720	116,316	90,355	87,226	83,599
Cath lab:												
Inpatient cases	1,133	1,174	1,035	1,119	1,027	1,094	1,423	1,458	1,534	N/A	N/A	N/A
Outpatient cases	2,257	2,216	1,732	1,864	2,124	1,928	1,776	1,805	1,877	N/A	N/A	N/A
Total cath lab cases	3,390	3,390	2,767	2,983	3,151	3,022	3,199	3,263	3,411	2,936	3,470	3,534
Total diagnostic visits	131,947	132,206	128,622	113,751	118,675	119,534	121,464	120,983	119,727	93,291	90,696	87,133
Total outpatient visits	1,048,408	965,031	923,864	784,989	591,995	556,239	543,834	538,184	483,119	380,108	363,520	277,736
Employees only:												
Hospital	2,929	2,861	3,016	2,966	2,652	2,765	2,844	2,850	2,776	2,774	N/A	N/A
System	4,279	4,195	4,292	3,518	3,245	3,348	3,365	3,357	3,205	3,131	N/A	N/A
FTE's with contract:												
Hospital	2,667	2,628	2,684	2,604	2,569	2,598	2,544	2,466	2,323	2,289	N/A	N/A
System	3,882	3,831	3,887	3,246	3,113	3,020	3,038	2,881	2,695	2,598	N/A	N/A

* For the year ended May 31, 2010, these statistics were compiled utilizing visits versus billing units for the years ended May 31, 2005 through 2009.

See accompanying independent auditors' report.