



Consolidated Financial Statements,  
Supplementary Information and Report of  
Independent Certified Public Accountants

**Peninsula Regional Health System, Inc.**

June 30, 2019 and 2018



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## **Report of Independent Certified Public Accountants**

Board of Trustees  
Peninsula Regional Health System, Inc.

We have audited the accompanying consolidated financial statements of Peninsula Regional Health System, Inc. and subsidiaries (the “Health System”), which comprise the consolidated balance sheets as of June 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 consolidated 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 Health System’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 Health System’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, based on our audits, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Peninsula Regional Health System, Inc. and subsidiaries as of June 30, 2019 and 2018 and the results of their operations and changes in net assets, and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

### **Supplementary information**

Our audits were performed for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying consolidating information is presented for the purpose of additional analysis, rather than to present the financial position, results of operations and changes in net assets, and cash flows of the individual entities, and is not a required part of the consolidated financial statements. Such supplementary 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 our audits of the consolidated financial statements and certain additional procedures. These additional procedures include comparing and reconciling the 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 consolidating information is fairly stated, in all material respects, in relation to the consolidated financial statements as a whole.

### **Other matter**

As discussed in Note 2 to the consolidated financial statements, during the year ended June 30, 2019 the Health System adopted the following Accounting Standards Updates: 2014-09, *Revenue from Contracts with Customers*; 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*; and 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*. Our opinion is not modified with respect to these matters.

*Grant Thornton LLP*

Philadelphia, Pennsylvania

September 19, 2019

Peninsula Regional Health System, Inc.

Consolidated Balance Sheets  
(In Thousands)

	<b>June 30</b>	
	<b>2019</b>	<b>2018</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 46,639	\$ 36,881
Short-term investments	11,614	11,363
Patient accounts receivable	41,484	40,268
Supplies	9,450	9,782
Prepays and other	9,407	7,081
Total current assets	<u>118,594</u>	105,375
Investments	344,053	311,657
Assets limited as to use:		
Self-insurance fund	24,247	22,986
Donor-restricted fund	42,463	38,193
	<u>66,710</u>	61,179
Property and equipment, net	220,725	225,361
Other assets	21,108	28,006
Total assets	<u><u>\$ 771,190</u></u>	<u><u>\$ 731,578</u></u>

Peninsula Regional Health System, Inc.

Consolidated Balance Sheets (Continued)

(In Thousands)

	<b>June 30</b>	
	<b>2019</b>	<b>2018</b>
<b>Liabilities and net assets</b>		
Current liabilities:		
Current portion of long-term debt	\$ 2,394	\$ 2,281
Current portion of accrued self-insurance liabilities	3,695	3,025
Accounts payable	19,138	17,334
Accrued liabilities	20,595	18,623
Advances from third-party payors	9,775	10,084
Total current liabilities	<u>55,597</u>	<u>51,347</u>
Long-term debt, less current portion	132,736	135,931
Self-insurance liabilities	16,614	18,029
Accrued pension	155	-
Other liabilities	559	1,584
Total liabilities	<u>205,661</u>	<u>206,891</u>
Net assets:		
Net assets without donor restrictions:		
Peninsula Regional Health System, Inc.	516,916	480,754
Noncontrolling interest	1,590	1,541
Total net assets without donor restrictions	<u>518,506</u>	<u>482,295</u>
Net assets with donor restrictions	47,023	42,392
Total net assets	<u>565,529</u>	<u>524,687</u>
Total liabilities and net assets	<u>\$ 771,190</u>	<u>\$ 731,578</u>

See accompanying notes.

Peninsula Regional Health System, Inc.

Consolidated Statements of Operations and Changes in Net Assets  
(In Thousands)

	<b>Year Ended June 30</b>	
	<b>2019</b>	<b>2018</b>
Unrestricted revenue and other support:		
Patient service revenue	\$ 458,468	\$ 436,980
Other revenue	6,235	5,625
Total unrestricted revenue and other support	<u>464,703</u>	<u>442,605</u>
Expenses:		
Salaries and wages	189,698	179,887
Supplies and other expenses	189,762	177,731
Employee benefits	46,269	45,064
Depreciation	30,256	29,120
Interest	5,210	5,660
Total expenses	<u>461,195</u>	<u>437,462</u>
Income from operations	3,508	5,143
Nonoperating gains:		
Investment income	33,944	36,282
Other pension gains	2,828	1,511
Other	-	862
Total nonoperating gains	<u>36,772</u>	<u>38,655</u>
Excess of unrestricted revenue and other support over expenses	40,280	43,798
Non-controlling interest in (earnings) losses of controlled subsidiary	<u>(50)</u>	<u>315</u>
Excess of unrestricted revenue and other support over expenses attributable to Peninsula Regional Health System, Inc.	40,230	44,113

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Peninsula Regional Health System, Inc.

Consolidated Statements of Operations and Changes in Net Assets (Continued)  
*(In Thousands)*

	<b>Year Ended June 30</b>	
	<b>2019</b>	<b>2018</b>
Net assets without donor restrictions:		
Excess of unrestricted revenue and other support over expenses attributable to Peninsula Regional Health System, Inc.	\$ 40,230	\$ 44,113
Net assets released from restrictions, net	585	(524)
Change in non-controlling interests	50	(359)
Pension adjustment	(4,654)	18,617
Increase in net assets without donor restrictions	<u>36,211</u>	<u>61,847</u>
Net assets with donor restrictions:		
Contributions	2,055	2,525
Net realized gains on investments	3,010	3,636
Change in unrealized gains and losses on investments	599	253
Net assets released from restrictions, net	(1,033)	600
Increase in net assets with donor restrictions	<u>4,631</u>	<u>7,014</u>
Increase in net assets	<b>40,842</b>	<b>68,861</b>
Net assets at beginning of year	<u>524,687</u>	<u>455,826</u>
Net assets at end of year	<u><b>\$ 565,529</b></u>	<u><b>\$ 524,687</b></u>

*See accompanying notes.*

Peninsula Regional Health System, Inc.

Consolidated Statements of Cash Flows  
(In Thousands)

	<b>Year Ended June 30</b>	
	<b>2019</b>	<b>2018</b>
<b>Operating activities</b>		
Increase in net assets	\$ 40,842	\$ 68,861
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation	30,256	29,120
Pension adjustment	(4,654)	(18,617)
Amortization of original issue premium and financing costs	(802)	(795)
Equity in earnings of unconsolidated joint ventures	(482)	(1,561)
Losses on sale of property and equipment	67	430
Change in unrealized gains and losses on investments	632	(10,162)
Net realized gains on investments	(31,534)	(26,487)
Proceeds from restricted contributions	(2,055)	(2,525)
Changes in operating assets and liabilities:		
Patient accounts receivable	(1,055)	(1,163)
Supplies and other assets	(1,600)	677
Distributions from unconsolidated joint ventures	2,944	3,444
Accounts payable and accrued liabilities	3,614	1,458
Accrued pension	9,986	2,488
Other liabilities	(1,771)	(1,321)
Advances from third-party payors	(309)	278
Net cash provided by operating activities	<u>44,079</u>	<u>44,125</u>
<b>Investing activities</b>		
Change in investments and assets limited as to use	(7,275)	(16,689)
Investment in unconsolidated joint ventures	(1,134)	(1,824)
Purchases of property and equipment, net	(25,687)	(26,608)
Net cash used in investing activities	<u>(34,096)</u>	<u>(45,121)</u>
<b>Financing activities</b>		
Proceeds from restricted contributions	2,055	2,525
Repayments of long-term debt	(2,280)	(2,173)
Net cash (used in) provided by financing activities	<u>(225)</u>	<u>352</u>
Net increase (decrease) in cash and cash equivalents	9,758	(644)
Cash and cash equivalents at beginning of year	36,881	37,525
Cash and cash equivalents at end of year	<u>\$ 46,639</u>	<u>\$ 36,881</u>

See accompanying notes.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### **1. Organization and Mission**

Peninsula Regional Health System, Inc. (the “Health System”) serves as the parent company to Peninsula Regional Medical Center (the “Hospital”); Peninsula Regional Medical Center Foundation, Inc. (the “Foundation”); Peninsula Health Ventures, Inc. (“Health Ventures”); Peninsula Women’s Center, LLC; and Peninsula Regional Clinically Integrated Network, LLC. The Health System is a not-for-profit Maryland membership corporation established to manage the integrated delivery of health care services to the community. The Health System is the sole corporate member of the Hospital and the Foundation. In its capacity as sole corporate member, the Health System will appoint trustees, approve major expenditures, and approve long-term borrowings.

The Hospital is a not-for-profit, nonstock corporation founded in 1897 to serve the health care needs of its region. Primary service areas include the Maryland counties of Wicomico, Somerset, and Worcester; southern Delaware; and the northern Eastern Shore of Virginia. The Hospital’s mission is to improve the health care of the community by providing exceptional quality primary, secondary, and selected tertiary health care services to patients in a competent and compassionate manner, designed to elicit a high degree of customer satisfaction. The Hospital wholly owns Delmarva Peninsula Insurance Company (“DPIC”), a Cayman Island captive insurance company that provides professional and general liability insurance.

The Foundation is a not-for-profit, nonstock corporation organized to raise contributions exclusively for the benefit of charitable, educational, medical, and scientific purposes for the Hospital.

Health Ventures is a for-profit corporation organized for the purpose of owning, developing, operating, and investing in health care enterprises on the Delmarva Peninsula. The Health System owns all of the outstanding shares of common stock of Health Ventures.

The Health System and the McCready Foundation, Inc. (“McCready”), a nonprofit corporation, have entered into an affiliation agreement dated June 26, 2019 (the “McCready Affiliation”). Under the McCready Affiliation, the Health System will become the sole corporate member of McCready. This transaction is being reviewed by regulators and upon completion of that process, is expected to close on or before February 1, 2020. McCready currently owns and operates McCready Memorial Hospital, a 2 licensed bed facility, a skilled nursing facility and an assisted living facility in Crisfield, Maryland.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### **1. Organization and Mission (Continued)**

The Health System and Nanticoke Health Services, Inc. (“Nanticoke”), a nonprofit corporation have entered into an affiliation agreement dated July 15, 2019 (the “Nanticoke Affiliation”). Under the Nanticoke Affiliation, the Health System will become the sole corporate member of Nanticoke Memorial Hospital, the principal operating affiliate of Nanticoke. This transaction is being reviewed by regulators and upon completion of that process it is expected to close on January 1, 2020. Nanticoke, is currently the sole corporate member of Nanticoke Memorial Hospital, a 99 licensed bed hospital in Seaford, Delaware, serving the health care needs of Sussex County, Delaware.

### **2. Significant Accounting Policies**

#### **Principles of Consolidation**

The consolidated financial statements include the accounts of the Health System and all wholly-owned subsidiaries as described in Note 1. Additionally, the Health System has consolidated a 55%-owned affiliate, Delmarva Surgery Center, LLC, and recorded a noncontrolling interest equal to the remaining ownership interest.

#### **Recently Adopted Accounting Pronouncements**

Effective July 1, 2018, the Health System adopted Financial Accounting Standards Board (“FASB”) Accounting Standards Update (“ASU”) 2014-09, *Revenue from Contracts with Customers* (Topic 606) (“ASU 2014-09”), using the retrospective method of application to all contracts existing on July 1, 2017. The core principle of the standard is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The adoption of the standard had no impact on the Health System’s current or historical financial position, results of operations or cash flows. Additionally, management does not anticipate that the standard will have an impact on the amount or timing of when the Health System recognizes revenue prospectively. However, in accordance with the standard, the Health System now recognizes its previously reported provision for bad debts, primarily related to its self-pay patient population, as a direct reduction to revenues as an implicit pricing concession, instead of separately as a discrete deduction to arrive at patient service revenue. The Health System’s revenue recognition and accounts receivable policies are more fully described below.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### **2. Significant Accounting Policies (Continued)**

Effective July 1, 2018, the Health System adopted retrospectively and applied the practical expedient for FASB ASU 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. This standard makes changes to employers that sponsor defined benefit pension and/or other postretirement benefit plans to present the net periodic benefit cost in the income statement. Employers will present the service cost component of net periodic benefit cost in the same statement of operations line item as other employee compensation costs arising from services rendered during the period. Employers will present the other components of the net periodic benefit cost separately from the line item that includes the service cost and outside of any subtotal of operating income. This change resulted in a reclassification of the other components of the net periodic benefit cost for its pension plan for the year ended June 30, 2018. The other components of the net periodic benefit cost for its pension plan, gains of \$2,828 and \$1,511 for the years ended June 30, 2019 and 2018, respectively, are recorded within nonoperating gains in the consolidated statements of operations and changes in net assets.

For 2019, the Health System adopted FASB ASU 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*. This standard makes certain improvements to the previous reporting requirements for not-for-profit entities including: (1) the presentation for two classes of net assets at the end of the period, rather than the previously required three classes, as well as the annual change in each of the two classes; (2) information about liquidity and the availability of resources; and (3) addresses the lack of consistency with expenses and investment return. The Health System's consolidated financial statements have been adjusted to reflect the new requirements. The standard has been applied retrospectively to all years presented.

### **Use of Estimates**

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant management estimates and assumptions are used in recording patient accounts receivable and patient service revenue, useful lives of property and equipment, actuarial estimates for the pension plan, professional, general liabilities and workers' compensation costs, the reported fair value of certain assets and liabilities, and the allocation of functional expenses. Actual amounts could differ from those estimates.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### **2. Significant Accounting Policies (Continued)**

#### **Fair Value of Financial Instruments**

Financial instruments consist of cash equivalents, accounts receivable, investments and assets limited as to use, accounts payable, accrued liabilities, advances from third-party payors and long-term debt. The carrying amounts reported in the consolidated balance sheets for cash equivalents, accounts receivable, accounts payable, accrued liabilities, and advances from third-party payors, approximate fair value. Management's estimate of the fair value of other financial instruments is described elsewhere in the notes to the consolidated financial statements.

#### **Cash and Cash Equivalents**

Cash and cash equivalents include surplus operating funds invested in money market funds and highly-liquid corporate, U.S. government, and agency obligations, all with maturities of less than three months when purchased.

#### **Investments and Assets Limited As To Use**

Investments are carried at fair value. Fair values of all investments, including short-term investments, investments, and assets limited as to use are based on quoted market prices and/or prices obtained from a third party using other market data for the same or comparable instruments and transactions in establishing the prices. Short-term investments represent investments with contractual maturities within one year and current investments in money market funds that have been designated for investment purposes.

Assets limited as to use includes externally held assets held by trustees under self-insurance programs and assets internally held to meet donor's intentions. Assets limited as to use required to meet current liabilities of \$3,695 and \$3,025 as of June 30, 2019 and 2018, respectively, have been classified on the consolidated balance sheets as a component of short-term investments.

Investment income, including interest and dividend, realized gains and losses (the value of securities sold) is based on the specific identification method. Investment income on investments of restricted assets are added to or deducted from the appropriate restricted net assets when restricted as to use by the donor.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### **2. Significant Accounting Policies (Continued)**

#### **Patient Accounts Receivable**

Under the provisions of ASU 2014-09, when there is an unconditional right to payment, subject only to the passage of time, the right is treated as a receivable. Patient accounts receivable, including billed accounts and unbilled accounts, which have the unconditional right to payment, and estimated amounts due from third-party payers for retroactive adjustments, are recorded as receivables since the right to consideration is unconditional and only the passage of time is required before payment of that consideration is due. The estimated uncollectible amounts are generally considered implicit price concessions that are recorded as a direct reduction to patient accounts receivable rather than an allowance for doubtful accounts.

Discounts ranging from 2% to 6% of charges are given to Medicare, Medicaid, and certain approved commercial health insurance and health maintenance organization programs for regulated services. Discounts in varying percentages are given for certain unregulated services.

#### **Supplies**

Supplies are carried at the lower of cost or market, using the first-in, first-out method.

#### **Property and Equipment**

Property acquired 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. 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.

Software development costs that are incurred in the preliminary project stage for internal use software are expensed as incurred. During the development stage, direct consulting costs and payroll and payroll-related costs for employees that are directly associated with each project are capitalized and amortized over the estimated useful life of the software once the software is ready for its intended use. Capitalized software is amortized using the straight-line method over its estimated useful life, which is generally seven years. Replacements and upgrades and enhancements to existing systems that result in added functionality are capitalized, while maintenance and repairs are charged to expense as incurred.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

**2. Significant Accounting Policies (Continued)**

Gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted donations. Absent explicit donor stipulations about how long those assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

**Other Assets**

Other assets are comprised of:

	<b>June 30</b>	
	<b>2019</b>	<b>2018</b>
Investments in unconsolidated joint ventures (Note 5)	\$ 9,416	\$ 10,744
Reinsurance receivable (Note 7)	5,957	5,942
Prepaid pension (Note 9)	-	5,177
Contributions receivable, net (Note 10)	1,431	1,591
Other	4,304	4,552
Total	<u>\$ 21,108</u>	<u>\$ 28,006</u>

**Estimated Self-Insurance Liabilities**

The provision for estimated professional liability claims, general liability claims, and workers' compensation claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported.

**Net Assets with Donor Restrictions**

Certain net assets are temporarily restricted and whose use has been limited by donors to a specific time period or purpose.

Certain net assets have been permanently restricted by donors to be maintained by the Health System in perpetuity.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### 2. Significant Accounting Policies (Continued)

#### Performance Indicator

The performance indicator for the Health System is excess of unrestricted revenue and other support over expenses, which excludes net assets released from restrictions for property acquisitions net of transfers to restricted net assets, changes in non-controlling interest, and pension adjustment.

#### Donor-Restricted Gifts

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as net assets with donor restrictions if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or the purpose of the restriction is accomplished, net assets with donor restrictions are reclassified as net assets without donor restrictions and reported on the consolidated statements of operations and changes in net assets as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as contributions in net assets without donor restrictions in the accompanying consolidated financial statements.

#### Liquidity and Availability of Resources

As of June 30, 2019 and 2018, the adjusted working capital was \$407,050 and \$365,685, respectively, and the adjusted average days of cash on hand was 331 and 312 days, respectively, both of which include long-term investments.

Financial assets available for general expenditure within one year of the consolidated balance sheet date consist of the following:

	<b>June 30</b>	
	<b>2019</b>	<b>2018</b>
Cash	\$ 46,639	\$ 36,881
Short-term investments	7,919	8,338
Patient accounts receivable	41,484	40,268
Investments	344,053	311,657
	<u>\$ 440,095</u>	<u>\$ 397,144</u>

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### **2. Significant Accounting Policies (Continued)**

#### **Patient Service Revenue**

In accordance with ASU 2014-09, patient service revenue is reported at the amounts that reflect the consideration to which the Health System is expected to be entitled to in exchange for providing patient care for both the Hospital and any employed physicians. These amounts are due from patients, third-party payors (including managed care organizations and government programs, i.e., Medicare and Medicaid), and others and they included variable consideration for retroactive adjustments due to settlement of future audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, and investigations. Generally, patients and third-party payors are billed several days after the services are performed or shortly after discharge. Patient service revenue is recognized in the period in which the performance obligations are satisfied under contracts by transferring services to customers.

Performance obligations are determined based on the nature of the services provided. The Health System recognizes revenues for performance obligations satisfied over time based on actual charges incurred in relation to total expected charges. The Health System believes that this method provides an appropriate depiction of the transfer of services over the term of performance obligations based on the inputs needed to satisfy the obligations. Generally, performance obligations are satisfied over time related to patients receiving inpatient acute care services. The Health System 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. The Health System recognizes revenues for performance obligations satisfied at a point in time, which generally relate to patients receiving outpatient services, when: (1) services are provided; and (2) when it is believed the patient does not require additional services.

For services provided at the Hospital campus, all payors are required to pay the Maryland Health Services Cost Review Commission (“HSCRC”) approved rates. Management believes that this program will remain in effect at least through June 30, 2020. The major third-party payors, as recognized by the HSCRC, are allowed discounts of up to 6% on approved rates. The Hospital’s charges are subject to review and approval by the HSCRC. The total rate of reimbursement for services to patients under the Medicare and Medicaid programs is based on a waiver arrangement between the Centers for Medicare and Medicaid Service and the HSCRC. This waiver arrangement will be in place as long as Maryland hospitals achieve certain savings and improvements,

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### **2. Significant Accounting Policies (Continued)**

as defined. The Hospital has an agreement with the HSCRC to participate in its Global Budgeted Revenue (“GBR”) program. GBR methodology encourages hospitals to focus on population health strategies by establishing a fixed annual revenue cap for each GBR hospital. The agreement is evergreen in nature and covers both regulated inpatient and outpatient revenues.

Under GBR, hospital revenue is known at the beginning of each fiscal year, and for the year ending June 30, 2020 is expected to be approximately \$476,995. Annual revenue is calculated from a base year and is adjusted annually for inflation, infrastructure requirements, population changes, performance in quality-based programs, and changes in levels of uncompensated care. Revenue may also be adjusted annually for market levels and shifts of services to unregulated services. The HSCRC’s rate-setting methodology for hospital service centers that provide both inpatient and outpatient services and only outpatient services consists of establishing an acceptable unit rate for defined inpatient and outpatient service centers within a hospital. The actual average unit charge for each service center is compared to the approved rate monthly and annually. Overcharges and undercharges due to either patient volume or price variances, adjusted for penalties where applicable, are applied to decrease (in the case of overcharges) or increase (in the case of undercharges) in future approved rates on an annual basis. The Hospital undercharged by \$377 and \$863 for the years ended June 30, 2019 and 2018, respectively, which is within the allowable corridor as specified in the GBR Agreement.

The timing of the HSCRC’s rate adjustments for the Hospital could result in an increase or reduction in rates due to the variances and penalties described above in a year subsequent to the year in which such items occurred, and there is at least a possibility that the amounts may be material. For both the years ended June 30, 2019 and 2018, approximately 80% of patient service revenue was subject to the HSCRC’s regulations.

Services not located on the Hospital campus and certain other services are not regulated by the HSCRC. Medicare and Medicaid pay the revenues associated with these services based upon established fee schedules. Commercial payors pay at negotiated rates for these services.

For both the years ended June 30, 2019 and 2018, approximately 52% of patient service revenue was received under the Medicare program, 12% from CareFirst Blue Cross Blue Shield, 32% from contracts with other third parties, and 4% from other sources.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

**2. Significant Accounting Policies (Continued)**

Laws and regulations governing the HSCRC, Medicare and Medicaid programs, which represent a substantial portion of the patient service revenues, are 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. The Health System 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. While there are no currently known regulatory inquiries, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action.

Approximately 38% of accounts receivable were due from the Medicare program as of June 30, 2019 and 2018.

The Health System determines estimates of contractual adjustments and discounts based on government regulations, contractual agreements, discount policies and historical experience, as applicable. The Health System determines its estimate of implicit price concessions based on historical collection experience within each class of patients using a portfolio approach as a practical expedient to account for patient contracts as collective groups rather than individually. The consolidated financial statement effects of using this practical expedient are not materially different from an individual contract approach.

The following table sets forth the detail of patient service revenue:

	<b>Year Ended June 30</b>	
	<b>2019</b>	<b>2018</b>
Gross patient service revenue	\$ 593,753	\$ 563,434
Less: revenue deductions:		
Charity care	(8,455)	(7,898)
Contractual and other allowances	(118,854)	(109,391)
Implicit price concessions	(7,976)	(9,165)
Patient service revenue	<u>\$ 458,468</u>	<u>\$ 436,980</u>

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### **2. Significant Accounting Policies (Continued)**

#### **Charity Care**

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

The Health System maintains records to identify and monitor the level of charity care and community service it provides. These records include the amount of charges foregone based on established rates for services and supplies furnished under its charity care and community service policies and the number of patients receiving services under these policies. The Health System provided \$6,722 and \$6,279 for the years ended June 30, 2019 and 2018, respectively, of charity care at full cost including direct and indirect costs, based on the actual charity population using its cost to charge ratio. The HSCRC includes components within the rates to partially compensate eligible providers for uncompensated care.

Additionally, the Health System provides a wide range of community services to the general public. These include but are not limited to the following: free health screenings for breast cancer, prostate cancer, skin cancer, diabetes, high blood pressure, high blood cholesterol, hearing loss and glaucoma; free educational programs on a variety of health care topics; health fairs and demonstrations; and networking and coordination of services for the needy, elderly, and disabled. These community services are offered at the Health System and at schools, businesses, and other locations throughout the Health System's service area.

#### **Income Taxes**

The Health System and the Foundation have been recognized as supporting organizations exempt from federal income tax under Section 501(c)(3) as described in Sections 509(a)(3) of the Internal Revenue Code (the "Code"). The Hospital has been recognized as an organization exempt from federal income tax under Section 501(c)(3) as described in Sections 509(a)(1) and Section 170(b)(1)(A)(iii) of the Code. The Health System is subject to tax on income unrelated to its exempt purpose, unless that income is otherwise excluded by the Code. Each organization has processes presently in place to ensure the maintenance of its tax-exempt status; to identify and report unrelated income; to determine its filing and tax obligations in jurisdictions for which it has nexus; and to identify and evaluate other matters that may be considered tax positions.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### **2. Significant Accounting Policies (Continued)**

Peninsula Women's Center, LLC and Peninsula Regional Clinically Integrated Network, LLC, are limited liability companies with the Health System as sole member and are disregarded for income tax purposes. Health Ventures is a for-profit corporation, wholly owned by the Health System. DPIC is a Cayman Island captive insurance company, wholly owned by the Hospital. Under Cayman Islands tax regulations, no tax is imposed on DPIC for premium and investment income.

The Health System follows guidance that clarifies the accounting for uncertainty in tax positions taken or expected to be taken in a tax return, including issues relating to financial statement recognition and measurement. This guidance provides that the tax effects from an uncertain tax position can only be recognized in the financial statements if the position is "more-likely-than-not" to be sustained if the position were to be challenged by a taxing authority. The assessment of the tax position is based solely on the technical merits of the position, without regard to the likelihood that the tax position may be challenged.

The tax years ending June 30, 2019, 2018, 2017 and 2016 are still open to audit for both federal and state purposes. The Health System has determined that there are no material uncertain tax positions that require recognition or disclosure in the consolidated financial statements for the years ended June 30, 2019 and 2018.

### **Pending Accounting Pronouncement**

In February 2016, the FASB issued ASU 2016-02, *Leases*, which requires that most leased assets be recognized on the balance sheet as assets and liabilities for the rights and obligations created by these leases. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018. Early application is permitted. An entity is required to apply the amendments in the standard under the modified retrospective transition approach. This approach includes a number of optional practical expedients, which are described in the final standard. Under these practical expedients, an organization will continue to account for leases that commence before the effective date in accordance with current U.S. GAAP, unless the lease is modified. However, lessees are required to recognize on the balance sheet leased assets and liabilities for operating leases at each reporting date. The Health System has not determined the impact of this standard at this time.

### **Reclassifications**

Certain amounts in the 2018 consolidated financial statements have been reclassified to be consistent with the 2019 presentation, primarily due to the recently adopted accounting pronouncements.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

**3. Investments and Assets Limited As To Use**

Fair value of investments and assets limited as to use is summarized as follows:

	<b>June 30</b>	
	<b>2019</b>	<b>2018</b>
Cash and cash equivalents	\$ 18,924	\$ 19,636
U.S. Treasury securities	46,799	27,818
Corporate bonds	89,398	64,249
Mortgage-backed securities	42,388	29,986
Equity securities	224,868	242,510
Total	<u>\$ 422,377</u>	<u>\$ 384,199</u>
	<b>Year Ended June 30</b>	
	<b>2019</b>	<b>2018</b>
Investment income, net		
Interest and dividend income	\$ 7,132	\$ 4,464
Realized gains, net	28,524	22,851
Changes in unrealized gains and losses	(1,231)	9,909
Other	(481)	(942)
Total	<u>\$ 33,944</u>	<u>\$ 36,282</u>

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

**4. Property and Equipment**

A summary of property and equipment follows:

	<b>Estimated Useful Lives (in Years)</b>	<b>June 30</b>	
		<b>2019</b>	<b>2018</b>
Land	-	\$ 12,772	\$ 12,018
Land improvements	20	11,944	11,824
Buildings and improvements	15 - 40	265,973	256,604
Fixed equipment	20	37,115	36,331
Movable equipment	7 - 10	261,292	250,608
		<u>589,096</u>	<u>567,385</u>
Less accumulated depreciation		<u>(371,482)</u>	<u>(345,173)</u>
		217,614	222,212
Construction in progress		3,111	3,149
Property and equipment, net		<u>\$ 220,725</u>	<u>\$ 225,361</u>

As of June 30, 2019, the Health System was committed to building and equipment purchases totaling approximately \$5,813.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

(Dollar Amounts in Thousands)

**5. Investment in Unconsolidated Joint Ventures**

The Health System and physicians located throughout Maryland and Delaware have joined together, along with other non-related for-profit investors, to expand surgical and certain other services within the local communities through jointly owned ventures, as follows:

	Membership percentage	Investment in unconsolidated joint ventures		Equity earnings (losses) in unconsolidated joint ventures	
		June 30, 2019	2018	Year ended June 30, 2019	2018
Health System :					
Health Visions Delmarva, LLC	50%	\$ -	\$ 3	\$ (2)	\$ (27)
Advanced Health Collaborative I, LLC	25%	16	48	(88)	60
Advanced Health Collaborative II, LLC	25%	10	1,492	(1,674)	(1,484)
		<u>26</u>	<u>1,543</u>	<u>(1,764)</u>	<u>(1,451)</u>
Health Ventures:					
Peninsula Imaging, LLC	50%	3,822	3,794	1,028	949
AHP Delmarva, LLP	50%	1,056	945	268	270
Genesis Healthcare - Salisbury, LLC	50%	3,493	3,854	538	827
Peninsula Home Care, LLC	50%	293	558	584	931
PHC at Nanticoke, LLC	33%	39	-	1	32
Peninsula NRH Regional Rehab, LLC	50%	-	-	-	53
YDI, Inc.	50%	-	-	-	(50)
Corelife, Inc.	50%	127	50	(173)	-
Delmarva Endoscopy Center, LLC	80%	560	-	-	-
		<u>9,390</u>	<u>9,201</u>	<u>2,246</u>	<u>3,012</u>
		<u>\$ 9,416</u>	<u>\$ 10,744</u>	<u>\$ 482</u>	<u>\$ 1,561</u>

Regardless of the proportionate ownership of capital investment in these ventures, all decisions are made by the respective venture's operating board. In each case, the operating board is composed equally of members appointed by the Health System/Health Ventures and the other investors as a group. Accordingly, these are accounted on the equity method of accounting.

Equity earnings (losses) in unconsolidated joint ventures for the Health System are included in investment income, net and Health Ventures are included in other revenue on the consolidated statements of operations and changes in net assets, due to the type of operations of the joint venture.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

**6. Long-Term Debt**

Long-term debt consists of the following:

	<b>June 30,</b>	
	<b>2019</b>	<b>2018</b>
<b>Hospital:</b>		
Maryland Health and Higher Educational Facilities Authority (“MHHEFA”) Revenue Bonds Series 2015: Series 2015 5.00% serial and term bonds and effective rates ranging from 2.57% to 4.13% due in annual amounts ranging from \$2,195 to \$7,795 on July 1 of each year through 2045	<b>\$ 117,685</b>	<b>\$ 119,880</b>
<b>Delmarva Surgery Center, LLC:</b>		
Building and equipment collateral loans: 4.40% fixed rate due monthly through 2022	<b>1,527</b>	1,612
	<b>119,212</b>	121,492
Less current portion of Series 2015 serial bonds	<b>(2,305)</b>	(2,195)
Less current portion of building and equipment collateral loans	<b>(89)</b>	(86)
	<b>116,818</b>	119,211
Plus original issue premium - Series 2015	<b>17,109</b>	17,963
Less unamortized debt issue costs - Series 2015	<b>(1,191)</b>	(1,243)
Long-term debt, less current portion	<b>\$ 132,736</b>	<b>\$ 135,931</b>

**Series 2015 Revenue Bonds**

On February 5, 2015, MHHEFA authorized the issuance of \$126,665 aggregate principal amount of Revenue Bonds (Series 2015 Revenue Bonds) at a premium of \$20,770. The proceeds of the issue, after payment of financing costs, were used primarily (i) to advance refund the 2006 bonds and (ii) to finance \$25,000 of capital purchases.

The Hospital is required to make semiannual payments to the trustee sufficient to meet the annual debt service requirements. The premium and related financing costs on the Series 2015 Bonds are being amortized over the life of the bonds.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### 6. Long-Term Debt (Continued)

As security for the debt service requirements of the Series 2015 Bonds, MHHEFA has a first lien and claim on all receipts of the Hospital. The terms of the indenture agreement restrict the Hospital's ability to create additional indebtedness and its use of the facilities, and require the Hospital to maintain stipulated insurance coverage and a rate structure in each year sufficient to meet certain rate covenant requirements. The Hospital has complied with these financial covenants for the years ended June 30, 2019 and 2018.

Scheduled principal repayments on long-term debt for the years ending June 30, are as follows:

2020	\$	2,394
2021		2,513
2022		3,885
2023		2,665
2024		2,800
Thereafter		104,955
	\$	<u>119,212</u>

The Health System uses quoted market prices in estimating the fair value of its long-term debt. The fair value of the long-term debt outstanding as of June 30, 2019 and 2018, was approximately \$132,148 and \$132,590, respectively.

### 7. Self-Insurance Liabilities

DPIC provides Primary Medical Professional Liability ("MPL") and Primary General Liability ("GL") coverage to the Health System and its employed physicians on a mature claims-made basis. The primary MPL policy provides limits of liability of \$2,000 per occurrence with an \$8,000 annual aggregate. The primary GL policy provides limits of liability of \$1,000 per occurrence with a \$3,000 annual aggregate. The employed physicians are covered with retro dates consistent with their date of hire. This policy is retrospectively rated.

DPIC provides excess umbrella liability coverage on a mature claims-made basis with a retroactive date of March 1, 2005. The excess MPL coverage follows the form of the underlying MPL coverage providing a total of \$30,000 limits of liability. The umbrella liability coverage provides \$30,000 limits of liability in excess of scheduled underlying coverages. The excess umbrella liability coverage is 100% reinsured with an unrelated commercial insurance company for the first \$10,000 limit and another unrelated commercial insurance company for the second \$20,000 limit.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

**7. Self-Insurance Liabilities (Continued)**

DPIC assumed the MPL and GL coverage previously included under the Health System's self-insurance plan (the "LPT"), for incidents occurring between March 1, 1986 and June 30, 2013 for MPL and for occurrences between March 1, 2004 and June 30, 2013 for GL, that were reported to the Hospital prior to June 30, 2013. The policy provides MPL coverage limits varying from \$1,000 to \$2,000 per occurrence, with policy aggregates varying from \$3,000 to \$8,000. The policy provides GL coverage limits of \$1,000 per occurrence and \$3,000 annual aggregates.

DPIC also provides employee benefit plan stop loss coverage to the Health System on a claims-made basis. DPIC covers liability in excess of \$350 per covered person with a \$100 deductible. DPIC's liability above \$250 is fully reinsured with an unrelated commercial reinsurance company.

The reserves for reported professional liability claims and claims incurred but not reported ("IBNR") are reported gross of expected insurance recoveries. The reserves for reported claims and claims IBNR are reported within the self-insured liabilities in the consolidated balance sheets. In addition, the expected insurance recoveries are reported as reinsurance receivable in other assets in the consolidated balance sheets.

The loss reserves are management's best estimate based on actuarial estimates of the ultimate net cost of settling losses on incurred claims. The estimates are reviewed and adjusted, as necessary, as experience develops or new information becomes known. Management believes that the loss reserves are adequate; however, the ultimate settlement of losses may vary significantly from the amounts recorded in the accompanying consolidated financial statements.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

**7. Self-Insurance Liabilities (Continued)**

Accrued claims activity related to MPL, GL and employee benefit plan for the year ended June 30, is as follows:

	<u>2019</u>	<u>2018</u>
Accrued claims and IBNR - beginning of the year	\$ 17,274	\$ 15,826
Less: Reinsurance receivable	<u>(5,942)</u>	<u>(5,793)</u>
Accrued claims and IBNR, net - beginning of the year	11,332	10,033
 Incurred related to:		
Current year	2,500	2,950
Prior year	<u>(1,723)</u>	<u>(631)</u>
Total incurred	777	2,319
 Paid related to:		
Current year	6	(36)
Prior year	<u>(1,697)</u>	<u>(984)</u>
Total paid	<u>(1,691)</u>	<u>(1,020)</u>
 Accrued claims and IBNR, net - end of the year	10,418	11,332
Add: Reinsurance receivable	<u>5,957</u>	<u>5,942</u>
Accrued claims and IBNR - end of the year	<u>\$ 16,375</u>	<u>\$ 17,274</u>

The Hospital is also self-insured for workers' compensation up to an annual limit of \$500 per occurrence. The Hospital carries an excess liability insurance policy for workers' compensation claims above this limit. As of June 30, 2019 and 2018, \$3,788 and \$3,736, respectively, have been reserved for workers' compensation loss contingencies.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### **8. Fair Value Measurements**

U.S. GAAP establishes a framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are described below.

Level 1 Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Health System has the ability to access.

Level 2 Inputs to the valuation methodology include:

- Quoted prices for similar assets or liabilities in active markets
- Quoted prices for identical or similar assets or liabilities in inactive markets
- Inputs other than quoted prices that are observable for the asset or liability
- Inputs that are derived principally from or corroborated by observable market data by correlation or other means

Level 3 Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Health System believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

**8. Fair Value Measurements (Continued)**

The following table presents the Health System's assets measured at fair value, aggregated by level in the fair value hierarchy within which those measurements fall:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b><u>June 30, 2019</u></b>				
<b>Assets</b>				
Cash and cash equivalents	\$ 18,924	\$ -	\$ -	\$ 18,924
U.S. government securities	46,799	-	-	46,799
Corporate bonds	-	89,398	-	89,398
Government-sponsored mortgage-backed securities	-	42,388	-	42,388
Equity securities	224,868	-	-	224,868
Total assets	<u>\$ 290,591</u>	<u>\$ 131,786</u>	<u>\$ -</u>	<u>\$ 422,377</u>
<b><u>June 30, 2018</u></b>				
<b>Assets</b>				
Cash and cash equivalents	\$ 19,636	\$ -	\$ -	\$ 19,636
U.S. government securities	27,818	-	-	27,818
Corporate bonds	-	64,249	-	64,249
Government-sponsored mortgage-backed securities	-	29,986	-	29,986
Equity securities	242,510	-	-	242,510
Total assets	<u>\$ 289,964</u>	<u>\$ 94,235</u>	<u>\$ -</u>	<u>\$ 384,199</u>

The fair values of securities are determined by third-party service providers utilizing various methods depending on the specific type of investment. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Where significant inputs, including benchmark yields, broker-dealer quotes, issuer spreads, bids, offers, the London Interbank Offered Rate curve, and measures of volatility, are used by these third-party dealers or independent pricing services to determine fair values, the securities are classified within Level 2.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### **9. Pension Plans**

The Health System has a cash balance-type defined benefit pension plan, The Peninsula Regional Medical Center Pension Plus Plan (the “Plan”), covering substantially all of its employees. Plan benefits are based on years of service and the employees’ compensation during the last five years of covered employment. The Health System’s funding policy is to make sufficient contributions to the Plan to comply with the minimum funding provisions of the Employee Retirement Income Security Act of 1974. Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future.

The Plan provides annual allocations to a participant’s hypothetical account. When a participant retires, the participant has the choice to receive a lump-sum distribution equal to the value of the hypothetical account or to receive an annuity based on the value of the hypothetical account.

The Plan provided three different allocations: (i) a service-related allocation, (ii) an age-related allocation, and (iii) a matching allocation for certain employees. Both the service-related allocation and the age-related allocation were determined by multiplying a participant’s annual compensation by a certain percentage. The matching allocation operated to provide an annual allocation in the Plan based on the participant’s contribution to the Health System’s 403(b) plan.

The Health System has a 403(b) defined contribution savings plan that includes all full-time and part-time employees of the Health System. The Health System matches participant contributions for active participants as of December 31 who have completed at least 975 hours of service during the calendar year. The match is 25% of the first 1% of compensation for participants with 1 - 15 years of service and 50% of the first 2% for participants with more than 15 years of service. The Health System’s contribution expense for the years ended June 30, 2019 and 2018 was \$1,333 and \$1,253, respectively.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

**9. Pension Plans (Continued)**

The following provides a reconciliation of the changes in fair value of the Plan's assets and projected benefit obligations, and the Plan's funded status:

	<b>June 30</b>	
	<b>2019</b>	<b>2018</b>
Accumulated benefit obligation	<u>\$ 123,227</u>	<u>\$ 119,539</u>
Projected benefit obligation, beginning of year	\$ 131,111	\$ 136,240
Service cost	6,506	6,999
Interest cost	5,086	4,624
Actuarial gain	10,746	(7,872)
Benefits paid	<u>(4,534)</u>	<u>(8,880)</u>
Projected benefit obligation, end of year	<u>148,915</u>	<u>131,111</u>
Fair value of plan assets, beginning of year	136,288	125,288
Actual gain on plan assets	14,006	16,880
Employer contributions	3,000	3,000
Benefits paid	<u>(4,534)</u>	<u>(8,880)</u>
Fair value of plan assets, end of year	<u>148,760</u>	<u>136,288</u>
Funded status	<u>\$ (155)</u>	<u>\$ 5,177</u>
Amounts recognized in the consolidated balance sheets:		
Prepaid pension (other assets)	<u>\$ -</u>	<u>\$ 5,177</u>
Accrued pension	<u>\$ (155)</u>	<u>\$ -</u>
Net amounts recognized in net assets without donor restrictions:		
Net actuarial loss	<u>\$ 21,078</u>	<u>\$ 16,424</u>

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

(Dollar Amounts in Thousands)

**9. Pension Plans (Continued)**

Components of net periodic benefit cost and changes in net asset without donor restrictions are as follows:

	<b>Year Ended June 30</b>	
	<b>2019</b>	<b>2018</b>
Components of net periodic benefit cost recognized in employee benefits:		
Service cost	<b>\$ 6,506</b>	\$ 6,999
Components of net periodic benefit cost recognized in nonoperating gains:		
Interest cost	<b>5,086</b>	4,624
Expected return on plan assets	<b>(8,915)</b>	(8,361)
Recognized net actuarial loss	<b>1,001</b>	2,226
	<b>(2,828)</b>	(1,511)
Net periodic benefit cost	<b>3,678</b>	5,488
Recognized in net assets without donor restrictions as other changes in pension adjustment:		
Net actuarial loss	<b>(4,654)</b>	18,617
Total recognized in net periodic benefit cost and change in net assets without donor restrictions	<b>\$ (976)</b>	\$ 24,105

The estimated net actuarial loss for the Plan that will be amortized from net assets without donor restrictions into net periodic benefit cost over the next fiscal year is \$1,549.

Weighted average assumptions used to determine projected benefit obligations and net periodic benefit costs were as follows:

	<b>June 30,</b>	
	<b>2019</b>	<b>2018</b>
<b>Projected benefit obligation</b>		
Discount rate	<b>3.25%</b>	4.00%
Rates of increase in compensation levels:		
Service:		
<11	<b>8.00</b>	8.00
11<21	<b>5.00</b>	5.00
21=<	<b>3.00</b>	3.00

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

(Dollar Amounts in Thousands)

**9. Pension Plans (Continued)**

	<b>June 30,</b>	
	<b>2019</b>	<b>2018</b>
<b>Net periodic benefit cost and changes in unrestricted net asset</b>		
Discount rate	<b>4.00%</b>	3.50%
Expected long-term return on plan assets	<b>7.00</b>	7.00
Rate of increase in compensation levels:		
Service:		
<11	<b>8.00</b>	8.00
11<21	<b>5.00</b>	4.00
21=<	<b>3.00</b>	3.00

The defined benefit pension plan asset allocation as of the measurement date and the target asset allocation, presented as a percentage of total plan assets, were as follows:

	<b>June 30,</b>		<b>Target Allocation</b>
	<b>2019</b>	<b>2018</b>	
Debt securities	<b>40%</b>	29%	25% - 40%
Equity securities	<b>57</b>	68	45% - 75%
Cash and cash equivalents	<b>3</b>	3	1% - 10%
<b>Total</b>	<b>100%</b>	100%	

The Health System's defined benefit plan invests in a diversified mix of traditional asset classes. Investments in U.S. equity securities and fixed income securities are made to maximize long-term results while recognizing the need for adequate liquidity to meet ongoing benefit and administrative obligations. Risk tolerance of unexpected investment and actuarial outcomes is continually evaluated by understanding the pension plan's liability characteristics. This is performed through forecasting and assessing ranges of investment outcomes over short-term and long-term horizons, and by assessing the Health System's financial condition and its future potential obligations from both the pension and general operational requirements. Complementary investment styles, such as growth and value equity investing techniques, are utilized by the Health System's investment advisors to further improve portfolio and operational risk characteristics. Equity investments, both actively and passively managed, are used primarily to increase overall plan returns. Fixed income investments provide diversification benefits and liability hedging attributes that are desirable, especially in falling interest rate environments.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

(Dollar Amounts in Thousands)

**9. Pension Plans (Continued)**

Asset allocations and investment performance are formally reviewed at regularly scheduled meetings of the Health System's Financial Resources Committee.

The overall rate of expected return on assets assumption was based on historical returns, with adjustments made to reflect expectations of future returns. The extent to which the future expectations were recognized included the target rates of return for the future, which have not historically changed.

The fair values of the Plan assets as of June 30, by asset category (see Note 10 for a description of the asset categories), are as follows:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b><u>June 30, 2019</u></b>				
<b>Assets</b>				
Investments at fair value:				
Cash and cash equivalents	\$ 3,033	\$ -	\$ -	\$ 3,033
U.S. Treasuries	17,071	-	-	17,071
Government-sponsored mortgage-backed securities	-	10,347	-	10,347
Corporate debt securities	-	32,654	-	32,654
Publicly traded equity securities	85,186	-	-	85,186
Other	469	-	-	469
Total Plan investments	<u>\$ 105,759</u>	<u>\$ 43,001</u>	<u>\$ -</u>	<u>\$ 148,760</u>
<b><u>June 30, 2018</u></b>				
<b>Assets</b>				
Investments at fair value:				
Cash and cash equivalents	\$ 3,525	\$ -	\$ -	\$ 3,525
U.S. Treasuries	9,179	-	-	9,179
Government-sponsored mortgage-backed securities	-	8,810	-	8,810
Corporate debt securities	-	22,282	299	22,581
Publicly traded equity securities	92,193	-	-	92,193
Total Plan investments	<u>\$ 104,897</u>	<u>\$ 31,092</u>	<u>\$ 299</u>	<u>\$ 136,288</u>

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### 9. Pension Plans (Continued)

The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

*U.S. Treasuries:* The fair value is determined by an active price for an identical security in an observable market.

*Corporate debt securities and government-sponsored mortgage-backed securities:* The fair value is estimated using quoted prices for similar assets in active markets or quoted prices for identical or similar assets in non-active markets (few transactions, limited information, noncurrent prices, and high variability over time).

*Money market funds:* The carrying value of these money market funds approximates fair value as the maturities are less than three months.

*Publicly traded equity securities:* The fair value is determined by market quotes for an identical security in an observable market.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Health System believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

### Cash Flows

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid as follows for the years ending June 30:

2020	\$	8,547
2021		9,473
2022		9,657
2023		10,083
2024		10,498
2025 - 2029		54,233

The Health System intends to make voluntary contributions of \$3,000 to the defined benefit pension plan for the year ending June 30, 2020. This funding level exceeds any regulatory requirements for 2020.

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

**10. Net Assets With Donor Restrictions**

Temporarily restricted net assets are available for the following purposes:

	<b>June 30</b>	
	<b>2019</b>	<b>2018</b>
Subject to expenditure for specific purpose or time:		
Capital purposes	\$ 20,608	\$ 18,379
Patient services	13,869	11,905
Educational purposes	4,301	3,872
	<u>38,778</u>	<u>34,156</u>
Investments to be held in perpetuity, the income from which is expendable to support health care services	8,245	8,236
Total	<u>\$ 47,023</u>	<u>\$ 42,392</u>

The Foundation has ongoing fundraising campaigns, which include pledges and contributions receivable included in other assets on the consolidated balance sheets. Scheduled payments on pledges receivable are as follows:

	<b>June 30</b>	
	<b>2019</b>	<b>2018</b>
Due:		
Within one year	\$ 219	\$ 479
2 to 5 years	1,204	1,179
Greater than 5 years	205	205
	<u>1,628</u>	<u>1,863</u>
Less:		
Impact of discounting of pledges receivable to net present value	(60)	(98)
Allowance for uncollectible pledges	(137)	(174)
Net pledges receivable, for capital purposes	<u>\$ 1,431</u>	<u>\$ 1,591</u>

Peninsula Regional Health System, Inc.

Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

**11. Functional Expenses**

The Health System considers health care services and general and administrative to be its primary functional categories for purposes of expense classification. The operating expenses by functional classification:

	<b>Health Care Services</b>	<b>General and Administrative</b>	<b>Total</b>
<b><u>Year ended June 30, 2019</u></b>			
Salaries and wages	\$ 165,117	\$ 24,581	\$ 189,698
Supplies and other expenses	165,172	24,590	189,762
Employee benefits	40,273	5,996	46,269
Depreciation	26,335	3,921	30,256
Interest	4,535	675	5,210
	<b><u>\$ 401,432</u></b>	<b><u>\$ 59,763</u></b>	<b><u>\$ 461,195</u></b>
<b><u>Year ended June 30, 2018</u></b>			
Salaries and wages	\$ 158,390	\$ 21,497	\$ 179,887
Supplies and other expenses	156,490	21,241	177,731
Employee benefits	39,679	5,385	45,064
Depreciation	25,640	3,480	29,120
Interest	4,983	677	5,660
	<b><u>\$ 385,182</u></b>	<b><u>\$ 52,280</u></b>	<b><u>\$ 437,462</u></b>

**12. Commitments and Contingencies**

The Health System has been named as a defendant in various lawsuits arising from the performance of its normal activities. In the opinion of the Health System's management, after discussion with legal counsel, the amount, if any, of the Health System's ultimate liability under these lawsuits will not have a material adverse effect on the consolidated financial statements.

A portion of the Health System's revenues is received from health maintenance organizations and other managed care payors. Managed care payors generally use case management activities to control utilization. These payors also have the ability to select providers offering the most cost-effective care. Management does not believe that the Health System has undue exposure to any one managed care payor.

# Peninsula Regional Health System, Inc.

## Notes to Consolidated Financial Statements (Continued)

June 30, 2019 and 2018

*(Dollar Amounts in Thousands)*

### 12. Commitments and Contingencies (Continued)

#### Operating Leases

The Health System leases certain of its operating facilities and equipment. These leases, which expire through 2028, generally requires payment of all maintenance, property tax, and insurance costs.

At June 30, 2019, aggregate amounts of future minimum payments under operating leases were as follows:

2020	\$	2,427
2021		2,250
2022		1,575
2023		1,141
2024		1,163
Thereafter		3,706

Rent expense is recognized over the terms of the leases. Rent expense was \$2,635 and \$2,828 for the years ended June 30, 2019 and 2018, respectively.

### 13. Subsequent Events

The Health System has evaluated its June 30, 2019 consolidated financial statements for subsequent events through September 19, 2019, the date the consolidated financial statements were issued. Management is not aware of any subsequent events which require recognition or disclosure in the consolidated financial statements, except as noted elsewhere in the footnotes to the consolidated financial statements.

## Supplementary Information

Peninsula Regional Health System, Inc.

Consolidating Balance Sheet

(In Thousands)

June 30, 2019

	Peninsula Regional Medical Center	Peninsula Regional Medical Center Foundation, Inc.	Peninsula Health Ventures, Inc.	Peninsula Regional Clinically Integrated Network	Peninsula Surgery Center	Peninsula Regional Health System, Inc.	Eliminations	Consolidated
<b>Assets</b>								
Current assets:								
Cash and cash equivalents	\$ 37,691	\$ 1,526	\$ 6,975	\$ 350	\$ 83	\$ 14	\$ -	\$ 46,639
Short-term investments	11,614	-	-	-	-	-	-	11,614
Intercompany receivables	3,704	-	-	-	-	-	(3,704)	-
Patient accounts receivable	40,535	-	657	-	292	-	-	41,484
Supplies	9,105	-	345	-	-	-	-	9,450
Prepays and other	9,364	-	43	-	-	-	-	9,407
Total current assets	112,013	1,526	8,020	350	375	14	(3,704)	118,594
Investments	344,053	-	-	-	-	-	-	344,053
Investment in subsidiaries	-	-	-	-	-	573,056	(573,056)	-
Assets limited as to use:								
Self-insurance fund	24,247	-	-	-	-	-	-	24,247
Donor-restricted fund	43,894	5,262	-	-	-	-	(6,693)	42,463
Total assets limited as to use	68,141	5,262	-	-	-	-	(6,693)	66,710
Property and equipment, net	216,238	-	3,322	-	1,165	-	-	220,725
Other assets	10,043	1,431	9,608	-	-	26	-	21,108
Total assets	\$ 750,488	\$ 8,219	\$ 20,950	\$ 350	\$ 1,540	\$ 573,096	\$ (583,453)	\$ 771,190

Peninsula Regional Health System, Inc.

Consolidating Balance Sheet (Continued)

(In Thousands)

June 30, 2019

	Peninsula Regional Medical Center	Peninsula Regional Medical Center Foundation, Inc.	Peninsula Health Ventures, Inc.	Peninsula Regional Clinically Integrated Network	Peninsula Surgery Center	Peninsula Regional Health System, Inc.	Eliminations	Consolidated
<b>Liabilities and net assets</b>								
Current liabilities:								
Current portion of long-term debt	\$ 2,305	\$ -	\$ 89	\$ -	\$ -	\$ -	\$ -	\$ 2,394
Current portion of accrued self-insurance liabilities	3,695	-	-	-	-	-	-	3,695
Intercompany payables	-	17	27	692	504	2,464	(3,704)	-
Accounts payable	18,753	-	385	-	-	-	-	19,138
Accrued liabilities	20,595	-	-	-	-	-	-	20,595
Advances from third-party payors	9,775	-	-	-	-	-	-	9,775
Total current liabilities	55,123	17	501	692	504	2,464	(3,704)	55,597
Long-term debt, less current portion	131,317	-	1,419	-	-	-	-	132,736
Self insured liabilities	16,614	-	-	-	-	-	-	16,614
Accrued pension	155	-	-	-	-	-	-	155
Other liabilities	559	-	-	-	-	-	-	559
Total liabilities	203,768	17	1,920	692	504	2,464	(3,704)	205,661
Net assets:								
Net assets without donor restrictions:								
Peninsula Regional Health System, Inc.	499,697	1,509	17,440	(342)	1,036	516,916	(519,340)	516,916
Non-controlling interest	-	-	1,590	-	-	-	-	1,590
Total net assets without donor restrictions	499,697	1,509	19,030	(342)	1,036	516,916	(519,340)	518,506
Net assets with donor restrictions	47,023	6,693	-	-	-	53,716	(60,409)	47,023
Total net assets	546,720	8,202	19,030	(342)	1,036	570,632	(579,749)	565,529
Total liabilities and net assets	\$ 750,488	\$ 8,219	\$ 20,950	\$ 350	\$ 1,540	\$ 573,096	\$ (583,453)	\$ 771,190

Peninsula Regional Health System, Inc.

Consolidating Statement of Operations

(In Thousands)

Year Ended June 30, 2019

	Peninsula Regional Medical Center	Peninsula Regional Medical Center Foundation, Inc.	Peninsula Health Ventures, Inc.	Peninsula Regional Clinically Integrated Network	Peninsula Surgery Center	Peninsula Regional Health System, Inc.	Eliminations	Consolidated
Unrestricted revenue and other support:								
Patient service revenue	\$ 452,372	\$ -	\$ 4,470	\$ -	\$ 1,626	\$ -	\$ -	\$ 458,468
Other operating revenue	3,625	-	2,261	349	-	-	-	6,235
Net assets released from restrictions	-	945	-	-	-	-	(945)	-
Total unrestricted revenue and other support	455,997	945	6,731	349	1,626	-	(945)	464,703
Expenses:								
Salaries and wages	188,959	-	-	686	53	-	-	189,698
Supplies and other expenses	181,199	6	6,063	710	1,784	-	-	189,762
Employee benefits	46,193	-	-	72	4	-	-	46,269
Depreciation	29,763	-	206	-	287	-	-	30,256
Interest	5,140	-	70	-	-	-	-	5,210
Contributions to Hospital	-	945	-	-	-	-	(945)	-
Total expenses	451,254	951	6,339	1,468	2,128	-	(945)	461,195
Income (loss) from operations	4,743	(6)	392	(1,119)	(502)	-	-	3,508
Nonoperating gains (losses):								
Investment income (loss)	34,387	340	981	-	-	(1,764)	-	33,944
Other pension gains	2,828	-	-	-	-	-	-	2,828
Other	-	-	-	-	-	-	-	-
Total nonoperating gains (losses)	37,215	340	981	-	-	(1,764)	-	36,772
Non-controlling interest elimination	-	-	(50)	-	-	-	-	(50)
Excess (deficit) of unrestricted revenue and other support over expenses	\$ 41,958	\$ 334	\$ 1,323	\$ (1,119)	\$ (502)	\$ (1,764)	\$ -	\$ 40,230



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