

COMBINED FINANCIAL STATEMENTS  
AND SUPPLEMENTARY INFORMATION

Presbyterian Healthcare Services and Affiliates  
Years Ended December 31, 2017 and 2016  
With Report of Independent Auditors

Ernst & Young LLP



Building a better  
working world

Presbyterian Healthcare Services and Affiliates

Combined Financial Statements  
and Supplementary Information

Years Ended December 31, 2017 and 2016

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## Report of Independent Auditors

The Board of Directors  
Presbyterian Healthcare Services

We have audited the accompanying combined financial statements of Presbyterian Healthcare Services and Affiliates, which comprise the combined balance sheets as of December 31, 2017 and 2016, and the related combined statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the combined financial statements.

### **Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in conformity 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 financial statements that are free of material misstatement, whether due to fraud or error.

### **Auditor's Responsibility**

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the combined 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 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 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 financial statements referred to above present fairly, in all material respects, the combined financial position of Presbyterian Healthcare Services and Affiliates at December 31, 2017 and 2016, and the combined results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

*Ernst + Young LLP*

April 13, 2018

# Presbyterian Healthcare Services and Affiliates

## Combined Balance Sheets

|  | December 31           |                     |
|--|-----------------------|---------------------|
|  | 2017                  | 2016                |
|  | <i>(In Thousands)</i> |                     |
| <b>Assets</b>  |                       |                     |
| Current assets:  |                       |                     |
| Cash and cash equivalents  | \$ 256,172            | \$ 302,030          |
| Accounts receivable, less allowance for doubtful accounts<br>of \$29,638 and \$33,378 in 2017 and 2016, respectively | 132,820               | 120,201             |
| Other receivables  | 111,147               | 120,723             |
| Estimated third-party payor receivable   | –                     | 1,212               |
| Inventories, prepaid expenses, and other current assets  | 53,799                | 47,962              |
| Total current assets   | <u>553,938</u>        | <u>592,128</u>      |
| Assets limited as to use or restricted:  |                       |                     |
| Designated for long-term purposes  | 2,025,699             | 1,835,466           |
| Designated for self-insurance funds  | 146,774               | 127,749             |
| Restricted by donors   | 45,160                | 38,274              |
| Held by trustee  | 94,350                | 23,757              |
| Restricted for statutory requirements  | 101,350               | 116,962             |
|  | <u>2,413,333</u>      | <u>2,142,208</u>    |
| Property and equipment, net  | 932,121               | 850,763             |
| Goodwill   | 52,701                | 55,626              |
| Other assets   | 109,849               | 87,447              |
| Total assets   | <u>\$ 4,061,942</u>   | <u>\$ 3,728,172</u> |
| <b>Liabilities and net assets</b>  |                       |                     |
| Current liabilities:   |                       |                     |
| Accounts payable   | \$ 76,062             | \$ 59,930           |
| Due under Medicaid contract  | 57,726                | 186,390             |
| Accrued liabilities  | 144,132               | 176,791             |
| Medical claims payable   | 120,752               | 136,442             |
| Estimated third-party payor settlements  | 3,073                 | –                   |
| Current portion of long-term debt and capital leases   | 15,580                | 14,677              |
| Total current liabilities  | <u>417,325</u>        | <u>574,230</u>      |
| Long-term debt and capital leases, net of current portion  | 847,665               | 684,707             |
| Employee benefit plans   | 226,912               | 206,041             |
| Self-insurance plans   | 152,354               | 122,787             |
| Other liabilities  | 97,990                | 101,675             |
| Total liabilities  | <u>1,742,246</u>      | <u>1,689,440</u>    |
| Net assets:  |                       |                     |
| Unrestricted   | 2,274,535             | 1,999,386           |
| Temporarily restricted   | 33,601                | 28,126              |
| Permanently restricted   | 11,560                | 11,220              |
| Total net assets   | <u>2,319,696</u>      | <u>2,038,732</u>    |
| Total liabilities and net assets   | <u>\$ 4,061,942</u>   | <u>\$ 3,728,172</u> |

*See accompanying notes.*

Presbyterian Healthcare Services and Affiliates

Combined Statements of Operations

|  | <b>Year Ended December 31</b> |              |
|--|-------------------------------|--------------|
|  | <b>2017</b>                   | <b>2016</b>  |
|  | <i>(In Thousands)</i>         |              |
| Revenues:  |                               |              |
| Net premiums   | <b>\$ 1,988,757</b>           | \$ 2,047,220 |
| Patient service revenue                              | <b>1,101,684</b>              | 1,073,754    |
| Less provision for doubtful accounts                 | <b>(30,070)</b>               | (53,051)     |
| Net patient service revenue                          | <b>1,071,614</b>              | 1,020,703    |
| Other operating revenues                             | <b>63,671</b>                 | 68,205       |
| Total operating revenues                             | <b>3,124,042</b>              | 3,136,128    |
| Expenses:  |                               |              |
| Medical claims                                       | <b>1,205,694</b>              | 1,218,620    |
| Salaries, wages and employee benefits                | <b>948,249</b>                | 917,048      |
| Purchased services and other                         | <b>464,009</b>                | 477,336      |
| Supplies   | <b>284,758</b>                | 281,210      |
| Professional fees                                    | <b>48,070</b>                 | 43,096       |
| Depreciation and amortization                        | <b>95,700</b>                 | 95,933       |
| Interest   | <b>28,965</b>                 | 27,971       |
| Total expenses                                       | <b>3,075,445</b>              | 3,061,214    |
| Operating income                                     | <b>48,597</b>                 | 74,914       |
| Other income (loss):                                 |                               |              |
| Investment income                                    | <b>168,036</b>                | 74,135       |
| Net unrealized gains on investments                  | <b>104,488</b>                | 53,087       |
| Loss on bond defeasance                              | <b>(14,254)</b>               | –            |
| Pension settlement loss                              | –                             | (24,176)     |
| Change in fair value of interest rate swaps          | <b>2,779</b>                  | 4,186        |
| Total other income                                   | <b>261,049</b>                | 107,232      |
| Excess of revenues over expenses before income taxes | <b>309,646</b>                | 182,146      |
| Provision for income taxes                           | <b>8,987</b>                  | 24,794       |
| Excess of revenues over expenses                     | <b>\$ 300,659</b>             | \$ 157,352   |

*See accompanying notes.*

Presbyterian Healthcare Services and Affiliates

Combined Statements of Changes in Net Assets

|   | <b>Year Ended December 31</b> |                     |
|---|-------------------------------|---------------------|
|   | <b>2017</b>                   | <b>2016</b>         |
|   | <i>(In Thousands)</i>         |                     |
| <b>Unrestricted net assets</b>                |                               |                     |
| Excess of revenues over expenses              | \$ 300,659                    | \$ 157,352          |
| Change in pension obligation                  | (25,995)                      | 13,188              |
| Other changes in net assets                   | 485                           | (688)               |
| Increase in unrestricted net assets           | <u>275,149</u>                | <u>169,852</u>      |
| <b>Temporarily restricted net assets</b>      |                               |                     |
| Donor-restricted contributions and earnings   | 6,098                         | 3,193               |
| Net assets released from restrictions         | (2,234)                       | (1,861)             |
| Net unrealized gains on investments           | 1,517                         | 704                 |
| Other changes in net assets                   | 94                            | 93                  |
| Increase in temporarily restricted net assets | <u>5,475</u>                  | <u>2,129</u>        |
| <b>Permanently restricted net assets</b>      |                               |                     |
| Other changes in net assets                   | 340                           | 369                 |
| Increase in permanently restricted net assets | <u>340</u>                    | <u>369</u>          |
| Increase in net assets                        | 280,964                       | 172,350             |
| Net assets, beginning of year                 | 2,038,732                     | 1,866,382           |
| Net assets, end of year                       | <u>\$ 2,319,696</u>           | <u>\$ 2,038,732</u> |

*See accompanying notes.*

# Presbyterian Healthcare Services and Affiliates

## Combined Statements of Cash Flows

|  | <b>Year Ended December 31</b> |                   |
|--|-------------------------------|-------------------|
|  | <b>2017</b>                   | <b>2016</b>       |
|  | <i>(In Thousands)</i>         |                   |
| <b>Operating activities</b>  |                               |                   |
| Increase in net assets   | \$ 280,964                    | \$ 172,350        |
| Adjustments to reconcile increase in net assets<br>to net cash provided by operating activities: |                               |                   |
| Net unrealized gains on investments  | (104,488)                     | (53,087)          |
| Change in fair value of interest rate swaps  | (2,779)                       | (4,186)           |
| Loss on bond defeasance  | 14,254                        | -                 |
| Loss on pension settlement   | -                             | 24,176            |
| Depreciation and amortization  | 95,700                        | 95,933            |
| Goodwill impairment  | 2,925                         | -                 |
| Provision for doubtful accounts  | 30,070                        | 53,051            |
| Changes in operating assets and liabilities:   |                               |                   |
| Accounts receivable  | (42,689)                      | (59,885)          |
| Other receivables  | 9,577                         | (1,602)           |
| Inventories, prepaid expenses, and other current assets  | (5,837)                       | 1,506             |
| Trading securities, net  | (111,656)                     | (105,935)         |
| Other assets   | (22,402)                      | (8,611)           |
| Accounts payable   | 16,132                        | 2,148             |
| Due under Medicaid contract  | (128,664)                     | 18,094            |
| Accrued liabilities  | (32,659)                      | 16,764            |
| Medical claims payable   | (15,690)                      | (2,955)           |
| Estimated third-party payor receivable/settlements   | 4,284                         | (3,744)           |
| Other liabilities  | 49,532                        | (40,122)          |
| Net cash provided by operating activities  | <u>36,574</u>                 | <u>103,895</u>    |
| <b>Investing activities</b>  |                               |                   |
| Sales of assets held by trustee and statutory deposits   | 219,773                       | 42,916            |
| Purchases of assets held by trustee and statutory deposits                                       | (274,754)                     | (22,081)          |
| Purchases of property and equipment  | (177,058)                     | (89,648)          |
| Net cash used in investing activities  | <u>(232,039)</u>              | <u>(68,813)</u>   |
| <b>Financing activities</b>  |                               |                   |
| Proceeds from issuance of long-term debt   | 313,250                       | -                 |
| Payments on long-term debt and capital leases  | (163,643)                     | (18,948)          |
| Net cash provided by (used in) financing activities  | <u>149,607</u>                | <u>(18,948)</u>   |
| Net (decrease) increase in cash and cash equivalents   | (45,858)                      | 16,134            |
| Cash and cash equivalents, beginning of year   | 302,030                       | 285,896           |
| Cash and cash equivalents, end of year   | <u>\$ 256,172</u>             | <u>\$ 302,030</u> |
| <b>Supplemental disclosures of cash flow information</b>   |                               |                   |
| Cash paid for interest   | \$ 28,567                     | \$ 29,406         |
| Cash paid for income taxes   | <u>\$ 24,800</u>              | <u>\$ 14,435</u>  |

*See accompanying notes.*

# Presbyterian Healthcare Services and Affiliates

## Notes to Combined Financial Statements

*(Dollar Amounts in Thousands)*

December 31, 2017

### 1. Organization

Presbyterian Healthcare Services (PHS) is a New Mexico nonprofit corporation exempt from income taxes under Section 501(c)(3) of the Internal Revenue Code (the Code). PHS is a diversified health care organization that owns, leases, controls, operates, or manages a variety of health care-related organizations, including seven hospitals in New Mexico, a for-profit health maintenance organization (HMO), and several other affiliated organizations. PHS provides a broad range of health care services, including inpatient, outpatient, subacute, home health care and physician services.

PHS consists of the following divisions and affiliates:

#### Presbyterian Healthcare Services Divisions

Presbyterian Hospital,\* including the following, which are designated as remote locations of Presbyterian Hospital:  
Presbyterian Kaseman Hospital\*  
Presbyterian Northside\*  
Presbyterian Rust Medical Center\*  
Santa Fe Medical Center \*\*  
Plains Regional Medical Center\*  
Presbyterian Española Hospital\*  
Socorro General Hospital\*  
Lincoln County Medical Center (leased facility)  
Dr. Dan C. Trigg Memorial Hospital (leased facility)

#### Presbyterian Healthcare Services Affiliates

Southwest Health Foundation  
Presbyterian Network, Inc. (PNI):  
Presbyterian Insurance Company, Inc. (PIC)  
Presbyterian Health Plan, Inc. (PHP)  
Fluent Health, LLC (Fluent)  
Albuquerque Imaging Associates  
Southwest Magnetic Imaging Associates  
Presbyterian Properties, Inc.  
Presbyterian Healthcare Foundation\*  
Bernalillo County Health Care Corporation  
d.b.a. Albuquerque Ambulance Service\*

\* Denotes Obligated Group members.

\*\* The Santa Fe Medical Center, a member of the Obligated Group, is under construction and is scheduled to open in late 2018.

PHS accesses the capital markets through an Obligated Group. Obligated Group members include PHS and certain divisions and affiliates as noted above, which are jointly and severally liable for the long-term debt outstanding under a Master Trust Indenture. None of the other PHS affiliates have any obligation related to requirements of the Master Trust Indenture. The Obligated Group's net assets represent approximately 77% and 76% of PHS and affiliates' combined net assets at December 31, 2017 and 2016, respectively.

# Presbyterian Healthcare Services and Affiliates

## Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

### **1. Organization (continued)**

Presbyterian Network, Inc. (PNI) is a wholly owned subsidiary of Southwest Health Foundation. PNI is the parent organization of two wholly owned subsidiaries: Presbyterian Health Plan, Inc. (PHP) and Presbyterian Insurance Company, Inc. (PIC). PHP is a state-licensed Health Maintenance Organization (HMO) in New Mexico and is also a federally qualified HMO under Title XIII of the Public Health Service Act. PHP provides comprehensive health care services in New Mexico to individuals primarily through health maintenance contracts with employer groups and individuals. The Company has a five-year contract with the State of New Mexico to provide physical health, behavioral health, and long-term care services to Medicaid eligible individuals under the Centennial Care program. PHP also offers an HMO product to Medicare-eligible individuals (Medicare Advantage). The Medicare Advantage product provides managed care services that include all Medicare benefits and, in some cases, additional managed care services. PIC offers preferred provider and indemnity products to individuals through contracts with employer groups.

On January 1, 2017, PHP, along with PNI and PIC, formed a management services organization, Fluent Health, LLC, to facilitate potential health plan joint ventures outside of the state of New Mexico. PHP owns 95% of Fluent, which is a Delaware limited liability company. The remaining 5% is owned by PIC. The business purpose of Fluent is to provide claims processing, administrative, management, and consulting services to health plans. Fluent began providing these services to PHP and PIC on January 1, 2017.

### **Basis of Presentation**

The accompanying combined financial statements include the accounts of PHS and its affiliates as described in Note 1 (collectively, Presbyterian Healthcare Services). All significant intercompany balances and transactions have been eliminated in combination.

# Presbyterian Healthcare Services and Affiliates

## Notes to Combined Financial Statements (continued) (Dollar Amounts in Thousands)

### 2. Summary of Significant Accounting Policies

#### Pending Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, together with subsequent amendments, updates and an extension of the effective date (collectively the New Revenue Standard), which supersedes most existing revenue recognition guidance, including industry-specific health care guidance. The New Revenue Standard provides for a single comprehensive principles-based standard for the recognition of revenue across all industries. PHS initiated an adoption plan in 2017, beginning with preliminary evaluation of the standard, and subsequently performed additional analysis of revenue streams and transactions under the new standard. In particular, PHS performed analysis into the application of the portfolio approach as a practical expedient to group patient contracts with similar characteristics, such that revenue for a given portfolio would not be materially different than if it were evaluated on a contract-by-contract basis. The adoption plan has been completed and the impact to the consolidated financial statements for periods subsequent to adoption is not material. As part of the impact assessment, PHS evaluated any variable consideration, potential constraints on the estimate of variable consideration, and significant financing components, in particular as it related to third party settlements. PHS anticipates that for periods subsequent to adoption, the majority of what is currently classified as bad debt expense under operating expenses will be treated as an implicit price concession factored into net revenue, consistent with the intent of the standard. The new standard also requires enhanced disclosures related to the disaggregation of revenue, information about contract balances, and other disclosures about contracts with customers, including revenue recognition policies to identify performance obligations and significant judgments in measurement and recognition. PHS adopted the new revenue standard as of January 1, 2018 using the modified retrospective method and the adoption did not have a material impact.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. ASU 2016-02 requires the rights and obligations arising from lease contracts, including existing and new arrangements, to be recognized as assets and liabilities on the balance sheet. PHS anticipates that the adoption of ASU 2016-02 will result in an increase in both total assets and total liabilities. This accounting standard will also require additional disclosures about the amount, timing and uncertainty of cash flows arising from leases. PHS is currently evaluating the impact of adopting this accounting standard, which will be effective January 2019.

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued) (Dollar Amounts in Thousands)

#### 2. Summary of Significant Accounting Policies (continued)

In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. This accounting standard will change the presentation of net assets into two categories, net assets with donor restrictions and net assets without donor restrictions. This accounting standard will also allow companies to elect to use either the direct or indirect cash flow method, and requires additional liquidity disclosures and presentation of expenses by both natural and functional classification. This accounting standard is effective for fiscal years beginning after December 15, 2017 and interim periods thereafter. PHS adopted this standard January 1, 2018, which primarily revised the presentation of PHS's net assets between net assets with and without donor restrictions. PHS elected to continue to use the indirect cash flow method.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230) Classification of Certain Cash Receipts and Cash Payments*, which applies to all entities that are required to present a statement of cash flows under Topic 230. ASU 2016-15 addresses the presentation and classification of cash flows related to certain matters pertaining to debt, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, distributions received from equity method investees, and certain other separately identifiable cash flows. The amendments in ASU 2016-15 should be applied using a retrospective transition method to each period presented, unless it is impracticable. PHS is currently evaluating the potential impact of this guidance, which will be effective January 2019.

In November 2016, the FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230) Restricted Cash*, which applies to all entities that have restricted cash and are required to present a statement of cash flows under Topic 230. ASU 2016-18 requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. The amendments in ASU 2016-18 should be applied using a retrospective transition method to each period presented. Management is currently evaluating the potential impact of this guidance, which will be effective January 2019.

In January 2017, the FASB issued ASU 2017-04, *Intangibles – Goodwill and Other (Topic 350)*. The accounting standard simplified the test used to evaluate goodwill and other intangibles for impairment. Under the new accounting standard, a company will perform its annual goodwill impairment test by comparing the fair value of the reporting unit with its carrying amount. An impairment charge will be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the impairment loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. A company will still have the option to perform

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued) (Dollar Amounts in Thousands)

#### **2. Summary of Significant Accounting Policies (continued)**

the qualitative assessment for a reporting unit. This accounting standard is effective for fiscal years beginning after December 15, 2020. Management is currently evaluating the impact of adopting this accounting standard, which will be effective January 2021.

#### **Adopted Accounting Pronouncements**

In May 2015, the FASB issued ASU 2015-07, *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*. Topic 820, *Fair Value Measurement*, permits a reporting entity, as a practical expedient, to measure the fair value of certain investments using the net asset value per share of the investment. ASU 2015-07 removes the requirement to categorize investments within the fair value hierarchy for which fair values are measured using the net asset value per share practical expedient. It also limits disclosures to investments for which the entity has elected to measure the fair value using the practical expedient. PHS adopted the accounting standard in 2017.

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

Cash and cash equivalents include bank deposits and highly liquid investments with original maturities at the time of purchase of three months or less. The carrying value of cash and cash equivalents approximates fair value.

#### **Net Patient Accounts Receivable**

Net patient accounts receivable have been adjusted to the estimated amounts expected to be collected. Accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectability of accounts receivable, PHS analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for doubtful accounts.

Management regularly reviews data about these major payor sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts. For receivables associated with services provided to patients who have third-party coverage, PHS analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for doubtful accounts, if necessary (for example, for expected uncollectible deductibles and co-payments on accounts for which the third-party payor has not yet paid, or for payors who are known to be having financial difficulties

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **2. Summary of Significant Accounting Policies (continued)**

that make the realization of amounts due unlikely). PHS has a policy of providing discounts to self-pay patients without insurance. For receivables associated with self-pay patients (which include both patients without insurance and patients with deductible and co-payment balances due for which third-party coverage exists for part of the bill), PHS records a significant provision for doubtful accounts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates if applicable) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

PHS's allowance for doubtful accounts as a percentage of self-pay patient receivables was 69% and 78% at December 31, 2017 and 2016, respectively. PHS's provision for doubtful accounts decreased to \$30,070 for fiscal year 2017 from \$53,051 for fiscal year 2016. The lower allowance and provision for doubtful accounts were offset by higher allowance for charity care and charity care write offs in 2017. Due to enhanced screening of self-pay patients in 2017, there were more patients classified as charity care than in 2016. PHS's uninsured discount policies during fiscal years 2017 and 2016 provided for a discount of 30% from standard rates for most services. These uninsured discounts are recorded with contractual adjustments as a deduction of patient service revenue.

#### **Assets Limited as to Use or Restricted**

Assets limited as to use or restricted include assets set aside by PHS for future long-term purposes, including capital improvements and self-insurance over which PHS retains control and may at its discretion subsequently use for other purposes, and investments held by PNI that are used to meet specified capital requirements for regulatory purposes. In addition, assets limited as to use or restricted include assets held by trustees under bond indenture agreements, contributions by donors with stipulated restrictions, and amounts on deposit to satisfy statutory requirements of the New Mexico Office of Superintendent of Insurance.

These assets consist primarily of cash, cash equivalents, government securities, other fixed-income securities, equity securities, and alternative investments. The carrying amounts of investments in marketable debt and equity securities are reported on the combined balance sheets at fair value. Alternative investments are reported at net asset value using the equity method of accounting, except for alternative investments held by Presbyterian Healthcare Foundation, which are reported at fair value, and alternative investments held as plan assets related to the defined benefit pension plan, which are also reported at fair value.

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **2. Summary of Significant Accounting Policies (continued)**

Income or loss related to the investment portfolio (including realized and unrealized gains and losses on investments, interest, and dividends) is included in the excess of revenues over expenses unless the income or loss is restricted by donor or law.

Income or loss restricted by donor or by law is classified as a change in temporarily or permanently restricted net assets consistent with the applicable restrictions.

As a condition of its Medicaid Centennial Care contract with the State of New Mexico Human Services Department (HSD), PHP is required to maintain an account with a balance equal to 90% of the average of the past three months capitation payments made to PHP from HSD. As of December 31, 2017 and 2016, \$100,131 and \$98,718, respectively, was held in bonds in a restricted managed asset account to satisfy this requirement. Prior to 2017, HSD also required a reserve of 1.5% of monthly premium payments to be held in a segregated account related to performance guarantees under PHP's Centennial Care contract. At December 31, 2016, \$17,689 was held in a depository cash account to satisfy this requirement. For 2017, this segregated account was no longer required.

#### **Fair Value Measurements**

Accounting Standards Codification (ASC) 820, *Fair Value Measurement*, requires the categorization of financial assets and liabilities into a three-level hierarchy based on pricing inputs to the valuation technique. The fair value hierarchy gives the highest priority to the quoted prices in active markets for identical assets and liabilities and the lowest priority to unobservable inputs. The various levels of the fair value hierarchy are described as follows:

Level 1 – Pricing is based on observable inputs, such as quoted prices in active markets.

Level 2 – Pricing inputs are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued) (Dollar Amounts in Thousands)

#### 2. Summary of Significant Accounting Policies (continued)

Level 3 – Pricing inputs are generally unobservable and include situations where there is little, if any, market activity for the investment. The inputs into the determination of fair value require management’s judgment or estimation of assumptions that market participants would use in pricing the assets or liabilities. The fair values are therefore determined using factors that involve considerable judgment and interpretations, including but not limited to private and public comparables, third-party appraisals, discounted cash flow models and fund manager estimates.

Assets and liabilities measured at fair value are based on one or more of three valuation techniques noted in ASC 820. Where more than one technique is noted, individual assets or liabilities were valued using one or more of the noted techniques. The valuation techniques are as follows:

- (a) *Market Approach* – Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities
- (b) *Cost Approach* – Amount that would be required to replace the service capacity of an asset (replacement cost)
- (c) *Income Approach* – Techniques to convert future amounts to a single present amount based on market expectations (including present value techniques, option pricing and excess earnings models)

When observable market data is available, it is required to be used in determining the fair value measurement. When inputs used to measure fair value fall within different levels of the hierarchy, the level within which the fair value measurement is categorized is based on the lowest level of input that is significant to the fair value measurement.

The majority of PHS’s marketable debt and equity securities are measured based on observable market prices. PHS’s interest rate swaps are measured using models based upon observable pricing inputs. Note 7 further describes the methods applied to determine fair value of PHS’s financial assets and liabilities.

The carrying values of financial instruments classified as current assets and current liabilities approximate fair value due to their liquidity and short-term natures.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)

(Dollar Amounts in Thousands)

**2. Summary of Significant Accounting Policies (continued)**

**Inventories**

Inventories, consisting of drugs and supplies, are stated at the lower of cost (first-in, first-out method) or market.

**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. For property and equipment under capital lease, amortization is determined over the shorter period of the lease term or the estimated useful life of the property and equipment. Such amortization is included in depreciation and amortization expense. The following useful lives are being used by PHS:

|                                    |            |
|------------------------------------|------------|
| Land improvements                  | 2–25 years |
| Buildings and improvements         | 5–40 years |
| Equipment and capitalized software | 3–20 years |

Interest cost incurred on borrowed funds, net of interest earned on assets held by trustee during the period of construction of qualified capital projects, is capitalized as a component of the cost of acquiring those assets.

**Goodwill**

PHS follows the provisions of ASC 350, *Intangibles – Goodwill and Other*. Goodwill is not amortized, but rather is tested annually for impairment. Management assesses goodwill impairment using a quantitative method and determined there was a goodwill impairment of \$2,925 in 2017 which has been recorded in depreciation and amortization expenses. There was no goodwill impairment for the year ended December 31, 2016.

# Presbyterian Healthcare Services and Affiliates

## Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

### **2. Summary of Significant Accounting Policies (continued)**

#### **Impairment of Long-Lived Assets**

PHS evaluates whether events and circumstances have occurred that indicate the remaining estimated useful lives of long-lived assets, other than goodwill, may not be recoverable. The assessment of possible impairment is based on the ability to recover the carrying amount of the asset based on undiscounted cash flows. Impairments are calculated as the total by which the carrying amount of the asset exceeds its estimated fair value. For the year ended December 31, 2017 and 2016, management determined that there was no impairment of its long-lived assets.

#### **Investments in Unconsolidated Entities**

Investments in unconsolidated entities are accounted for under the cost or equity method of accounting, as appropriate. PHS utilizes the equity method of accounting for its investment in entities over which it exercises significant influence. PHS's equity income or loss on these investments is recorded as other operating revenue.

#### **Temporarily and Permanently Restricted Net Assets**

Temporarily restricted net assets are those whose use has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained in perpetuity.

Unconditional pledges to give cash and other assets are reported at fair value at the date the pledge is received. The gifts are reported as temporarily restricted net assets 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 purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and recognized as a component of other operating revenue. Donor-restricted contributions whose restrictions are met within the same year as received are reflected as unrestricted contributions in other operating revenue.

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **2. Summary of Significant Accounting Policies (continued)**

##### **Premium Revenues, Medical Claims Payable, and Health Care Expenses**

Premium revenues are recognized in the month in which members are entitled to health care services. Premiums collected in advance are recorded as unearned premiums and are included in accrued liabilities on the accompanying combined balance sheets. During 2017 and 2016, premium revenue from the Medicaid product line represented approximately 59% and 61%, respectively, of total premium revenue. In addition, during 2017 and 2016, premium revenue from the Medicare Advantage product line represented approximately 21% and 19%, respectively, of total premium revenue, and the Commercial products represented 20% of total premium revenue in both 2017 and 2016. Coordination of benefits and subrogation are recognized in the period such amounts are determined to be recoverable from other insurers.

In 2014, PHP contracted with the state of New Mexico to serve the Medicaid population under the New Mexico Centennial Care program. All Medicaid services, including physical health, behavioral health, and long-term care, are provided as part of this program. PHP was one of four HMOs awarded five-year contracts by the state to administer the New Mexico Centennial Care program.

Under this contract, PHP receives a fixed premium from the state to provide comprehensive health care services for enrollees, including those enrollees receiving services from PHS. PHS facilities and physicians are paid capitated or discounted fee-for-service rates from each of the MCOs. The medical claims costs of PHP on the combined statements of operations are net of intercompany eliminations for services rendered by PHS facilities totaling \$753,629 and \$744,256 for the years ended December 31, 2017 and 2016, respectively.

Under the Medicaid Centennial Care contract, PHP is permitted to retain 100% of the underwriting gain generated up to 3% annually. Underwriting gains above 3% are shared 50/50 between PHP and HSD. Additionally, for a Medicaid expansion product and Hepatitis C drugs, PHP is subject to risk corridor adjustments. PHP and HSD share in excess gains or losses generated under the contract based on a tiered structure. Liabilities for the underwriting gain limitation and risk corridors of \$41,347 and \$166,459, as of December 31, 2017 and 2016, respectively, are recorded on the accompanying combined balance sheets in due under Medicaid contract.

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **2. Summary of Significant Accounting Policies (continued)**

Under the Medicaid Centennial Care contract, PHP is also subject to retroactive enrollment reconciliation. Under the contract, members whose effective date of Medicaid eligibility is determined prior to HSD's notification date are considered retroactive enrollment. Under the contract, PHP may retain premiums equal to the medical expense and a percentage of total medical expense for administrative costs. Medical expense in excess is reimbursed by HSD. Premiums in excess of medical expense and the percentage for administrative costs are due back to HSD. A liability for the retroactive enrollment reconciliation of \$4,241 and \$19,931, as of December 31, 2017 and 2016, respectively, are recorded on the accompanying combined balance sheets in due under Medicaid contract.

In 2017, HSD issued a Letter of Direction under the Medicaid Centennial Care contract, clarifying the retrospective reconciliation of the Community Benefit capitation payments the Company receives for Long Term Care members. As part of this reconciliation, HSD reviews claims for Long Term Care members to validate that they are receiving services within 90 days of becoming eligible, and also that there is no more than a 90 day break in such services. If HSD determines that services were not accessed, they have the right to recoup the original payment and repay for the member at an appropriate lower level premium. In 2017, in accordance with this new Letter of Direction, the Company determined there is a liability for 2017 and 2016 of \$14,362 and \$0, respectively. This is recorded on the accompanying combined balance sheets in due under Medicaid contract.

The current five-year contract for the Centennial Care program contract ends December 31, 2018. At the beginning of 2018, the Company was awarded a new four-year contract with the State of New Mexico to continue to provide physical health, behavioral health, and long-term care services to Medicaid eligible individuals under the Centennial Care program, starting January 1, 2019.

PHP and PIC serve as plan sponsors to offer Medicare Part D prescription drug insurance coverage under a contract with the Centers for Medicare and Medicaid Services (CMS). Premium revenue is recognized ratably over the period in which eligible individuals are entitled to receive prescription drug benefits. Premium revenues are subject to a comprehensive risk reconciliation under which CMS shares in a portion of direct surplus or deficit related to Medicare Part D premiums. In addition to premium revenues, PHP and PIC receive prepayments from CMS related to low income, cost sharing, and catastrophic reinsurance subsidies. PHP and PIC are fully reimbursed by CMS for costs incurred under these contract elements and, accordingly, there is no insurance risk to either company. Amounts received for these subsidies are not reflected as

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **2. Summary of Significant Accounting Policies (continued)**

premium revenue, but rather are accounted for as deposits with the related liability recorded on the combined balance sheets. Pharmacy benefit costs not related to low income, cost sharing, or catastrophic reinsurance subsidies and administrative costs under the contract are expensed as incurred.

The estimated cost of all health services rendered to members through December 31 but not yet paid as of that date, is included in medical claims payable. This claims expense estimate is developed using actuarial assumptions based on historical experience with respect to the timing of payments in relation to the dates of service. Subsequent changes to prior period estimates are reflected in the current period. Losses on contracts are recognized in the period when health care costs are expected to exceed premium revenue.

#### **Patient Service Revenue**

PHS has agreements with third-party payors that provide for payments at amounts different from established charges. The basis for payment under these agreements includes prospectively determined rates, cost reimbursement and negotiated discounts from established charges.

Patient service revenues are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments due to future audits, reviews and investigations. The differences between the estimated and actual adjustments are recorded as part of patient service revenue in future periods, as the amounts become known, or as years are no longer subject to such audits, reviews and investigations.

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### 2. Summary of Significant Accounting Policies (continued)

For uninsured patients who do not qualify for charity care, PHS recognizes revenue on the basis of discounted rates, as provided by its policy. On the basis of historical experience, a significant portion of PHS's uninsured patients will be unable or unwilling to pay for the services provided. Thus, PHS records a significant provision for doubtful accounts related to uninsured patients in the period the services are provided. Patient service revenue, net of contractual allowances and discounts (but before the provision for doubtful accounts) is recognized from these major payor sources as follows:

|  | <b>Year Ended December 31</b> |                            |
|--|-------------------------------|----------------------------|
|  | <b>2017</b>                   | <b>2016</b>                |
| Patient service revenue (net of contractual allowances and discounts): |                               |                            |
| Third-party payors   | <b>\$ 1,050,474</b>           | \$ 1,021,171               |
| Self-pay   | <b>51,210</b>                 | 52,583                     |
| Total  | <b><u>\$ 1,101,684</u></b>    | <b><u>\$ 1,073,754</u></b> |

#### Charity Care

As an integral part of its mission, PHS provides care to all patients, regardless of ability to pay for needed services. A patient is classified as a charity care patient in accordance with standards established across PHS and its affiliates. Charity care represents services rendered for which no, or only partial, payment is expected and, as such, is not included in revenues on the combined statements of operations.

#### Excess of Revenues Over Expenses

The combined statements of operations include a measurement for excess of revenues over expenses. Changes in unrestricted net assets, which are excluded from excess of revenues over expenses, include contributions of long lived assets (including assets acquired using contributions that, by donor restrictions, were to be used for the purpose of acquiring such assets) and changes in the pension liability.

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued) (Dollar Amounts in Thousands)

#### 2. Summary of Significant Accounting Policies (continued)

##### Other Income and Loss

Activities that result in gains or losses and are unrelated to the primary mission of PHS are considered to be other income and losses. Accordingly, investment income, changes in unrealized gains and losses on investments, gain (loss) on debt extinguishment, gains (losses) on the settlement of pension obligations and unrealized changes in the fair value of interest rate swaps are reported as a component of other income (loss).

##### Taxes

PHS and all of its affiliates, except for PNI and its subsidiaries, have been determined to be tax-exempt corporations by the Internal Revenue Service and generally are not subject to federal taxes on income.

The taxable affiliates utilize the liability method in accounting for income taxes. Under this method, deferred income tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using the currently enacted tax rates and laws. Valuation allowances are used to reduce deferred tax assets to their estimated net realizable values when management determines ultimate recovery is not probable.

PHP and PIC are required to pay premium taxes to the state based on a percentage of adjusted premiums received related to the Commercial and Medicaid product lines. As a result of paying premium taxes, PHP and PIC are exempt from paying state income taxes. PHP and PIC recorded net premium tax expense totaling \$50,184 and \$54,119 in 2017 and 2016, respectively. These amounts are included within purchased services and other expenses on the accompanying combined statements of operations.

ASC 740, *Income Taxes*, prescribes criteria for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. ASC 740 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As of December 31, 2017 and 2016, there was no significant impact on the combined financial statements related to the tax positions taken. There were no significant tax positions taken by management that required accrual as of December 31, 2017 or 2016.

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **2. Summary of Significant Accounting Policies (continued)**

The Tax Cuts and Jobs Act was enacted on December 22, 2017 and reduced the Federal corporate income tax rate to 21% effective January 1, 2018. The Company applied the newly enacted federal income tax rate to its deferred tax assets and liabilities as of December 31, 2017.

Based on our preliminary estimates, we believe Tax Legislation will materially impact the 2018 adjusted effective tax rate, primarily as a result of the reduced corporate statutory tax rate. See Note 16 for further information.

#### **Derivative and Hedging Instruments**

In accordance with ASC 815, *Derivatives and Hedging*, derivatives are recognized as either assets or liabilities at fair value on the combined balance sheets, regardless of the purpose or intent for holding them. For those derivatives not designated as hedges under such standards, the changes in fair value are recognized in excess of revenue over expenses. For those derivatives previously designated as hedges under such standards, the effective portion of the changes in fair value previously recognized in unrestricted net assets is being amortized into the excess of revenues over expenses over the remaining lives of the derivative instruments.

#### **Benefit Plans**

PHS is the plan sponsor of a defined benefit pension plan (Plan I) and five other limited postretirement benefit plans. The funded status of Plan I is recognized on the combined balance sheets as the difference between the fair value of the investments and the actuarially determined pension obligation. Other required disclosures of ASC 715, *Compensation – Retirement Benefits*, include the accumulated benefit obligation and fair value of the plan's assets, assumptions used in the benefit obligation calculation, contributions, the asset allocation of the plan, and the expected benefits to be paid, which can be found in Note 11.

In addition to Plan I, PHS and PHP sponsor certain defined contribution plans. Contributions to these plans are expensed as earned by the employees.

# Presbyterian Healthcare Services and Affiliates

## Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

### 2. Summary of Significant Accounting Policies (continued)

#### Use of Estimates

The preparation of combined financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Actual results could differ from those estimates.

#### Reclassifications

Certain prior year amounts have been reclassified for consistency with the current year presentation. Balances of \$311 in other receivables and \$3,123 in accrued liabilities have been reclassified to third party settlements within the balance sheet for the year ended December 31, 2016.

Other receivables of \$311 and accrued liabilities of \$3,123 have been reclassified to estimated third party settlements of \$2,812 within the operating activities for the year end December 31, 2016.

### 3. Patient Service Revenue

A summary of payment arrangements with major third-party payors follows:

*Medicare* – Inpatient acute care and certain outpatient services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge or procedure. These rates vary according to patient classification systems based on clinical, diagnostic and other factors.

*Medicaid* – The State Medicaid program consists of two primary plans. The larger plan is the New Mexico Centennial Care program. All Medicaid services, including physical health, behavioral health, and long-term care, are provided as part of the New Mexico Centennial Care program. The smaller plan is a traditional Medicaid plan. PHS facilities and physicians are paid for inpatient acute care services on prospectively determined rates per discharge. Payments for outpatient services are made on a discounted fee-for-service basis.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**3. Patient Service Revenue (continued)**

The Medicare cost reports for Presbyterian Hospital, Plains Regional Medical Center and Presbyterian Española Hospital have been audited through December 31, 2014. The Medicare cost report of Lincoln County Medical Center, Socorro General Hospital and Dr. Dan C. Trigg Memorial Hospital has been audited by CMS through December 31, 2015. The Medicaid cost reports for Presbyterian Hospital, Presbyterian Española Hospital, Dr. Dan C. Trigg Memorial Hospital, Socorro General Hospital, Lincoln Medical County Center and Plains Regional Medical Center have been audited through December 31, 2014. Management believes that estimated settlements accrued related to unaudited cost reports are adequate.

Estimates are continually monitored and reviewed, and as settlements are made or estimates adjusted, differences are reflected in current operations. Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates could change by a material amount in the near term. Patient service revenue increased approximately \$20,000 for changes in estimates related to third-party payor settlements.

*Others* – PHS has also entered into payment agreements with certain commercial insurance carriers, HMOs and preferred provider organizations. The basis for payment to PHS under these agreements includes prospectively determined rates per discharge, discounts from established charges and prospectively determined daily rates.

Amounts received from third-party payors in excess of expected reimbursement are reflected as estimated third-party payor settlements on the accompanying combined financial statements.

PHS’s major payor utilization percentages, based upon gross patient service revenue are summarized as follows:

|            | <b>Year Ended December 31</b> |             |
|------------|-------------------------------|-------------|
|            | <b>2017</b>                   | <b>2016</b> |
| Medicare   | <b>42%</b>                    | 41%         |
| Commercial | <b>27</b>                     | 27          |
| Medicaid   | <b>26</b>                     | 26          |
| Self-pay   | <b>2</b>                      | 2           |
| Other      | <b>3</b>                      | 4           |
|            | <b>100%</b>                   | 100%        |

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### 4. Other Operating Revenues

Other operating revenues consist of the following:

|                                 | Year Ended December 31 |                  |
|---------------------------------|------------------------|------------------|
|                                 | 2017                   | 2016             |
| Health plan administrative fees | \$ 23,598              | \$ 24,460        |
| Contributions and other         | 30,280                 | 29,814           |
| Tax appropriation revenue       | 9,793                  | 13,931           |
|                                 | <u>\$ 63,671</u>       | <u>\$ 68,205</u> |

#### Electronic Health Records Incentive Payments

Starting in 2013, the Medicare and Medicaid programs are providing an incentive payment to eligible hospitals and professionals if meaningful-use certified electronic health record (EHR) technology is adopted. The incentive payment is recognized when management is reasonably assured that PHS has complied with the conditions set forth by Medicare and Medicaid. \$1,077 and \$2,733 in incentive payments were recognized in other operating revenue for the years ended December 31, 2017 and 2016, respectively, relating to the Medicare and Medicaid incentive programs. PHS's attestation of compliance with the meaningful use criteria is subject to audit by the federal government or its designee. Additionally, EHR incentive payments are subject to retrospective adjustments upon final settlement of the applicable cost report from which payments were initially calculated.

#### 5. Community Benefit

In support of its mission and philosophy, PHS voluntarily provides free care to patients who cannot afford health care due to inadequate resources and/or patients who are uninsured. Because PHS does not pursue collection of amounts determined to qualify as charity care, such amounts are not reported as patient service revenues. The estimated cost of this voluntary free care less the amount, if any, ultimately received was \$37,947 and \$27,887 in 2017 and 2016, respectively.

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **5. Community Benefit (continued)**

In addition, PHS provides services to other patients under certain government-reimbursed public aid programs, which pay providers amounts that are generally less than the cost of rendering the services provided to the patients. The estimated unreimbursed cost of this care was approximately \$204,272 and \$122,256 in 2017 and 2016, respectively. These unreimbursed costs and costs of voluntary free care do not include any governmental funds received for providing access to health care to all residents of the local community.

PHS uses information from its cost accounting system and certain cost-to-charge ratios, where applicable, to estimate the cost of financial assistance and other community benefits reported.

PHS, in furtherance of its mission, also commits significant time and resources to endeavors and critical services that meet otherwise unfilled community needs. Many of these activities are sponsored with the knowledge that they will not be self-supporting or financially viable. Such programs include health screenings and assessments; cancer and other support groups; hospice programs; free transportation, lodging, meals and medications for transient patients when needed; funding for homeless health care programs; significant ongoing and temporary donations of office space and telephone systems for nonprofit health care organizations, including the American Heart Association and the Meals on Wheels program; elementary school education on Healthy Choices; free flu vaccine clinics; participation in regular blood drives; and the provision of educational opportunities for students interested in pursuing medical-related or pastoral careers.

#### **6. Assets Limited as to Use or Restricted**

PHS has designated the accumulation of certain funds for future replacement of property and equipment, other capital improvements, debt retirement, self-insurance reserves, and other long-term purposes. Under the terms of the Master Trust Indenture for the outstanding bond issues, funds held by the trustee have been established and legally designated for debt service and qualifying capital expenditures.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**6. Assets Limited as to Use or Restricted (continued)**

The following is a summary of assets limited as to use or restricted at fair value, except for certain alternative investments, which are recorded at net asset value using the equity method:

|                                    | <b>December 31</b>  |              |
|------------------------------------|---------------------|--------------|
|                                    | <b>2017</b>         | <b>2016</b>  |
| Cash and cash equivalents          | <b>\$ 106,611</b>   | \$ 60,909    |
| Fixed-income securities            | <b>905,359</b>      | 815,217      |
| Equity securities                  | <b>972,554</b>      | 819,052      |
| Government securities and other    | <b>114,372</b>      | 124,010      |
| Public master limited partnerships | <b>60,188</b>       | 62,063       |
|                                    | <b>2,159,084</b>    | 1,881,251    |
| Alternative investments            | <b>254,249</b>      | 260,957      |
|                                    | <b>\$ 2,413,333</b> | \$ 2,142,208 |

*Fixed-Income and Government Securities* – This investment class includes investments in various fixed-income instruments that include investment-grade and high-yield domestic and international bonds, mortgage pools and bonds issued by U.S. government agencies. This investment class also includes investments in common trust funds, mutual funds, exchange-traded funds and separately managed accounts that hold investments in fixed-income securities. The fixed-income investments are exposed to various kinds and levels of risk, including interest rate risk, credit risk, foreign exchange risk and liquidity risk.

*Equity Securities* – This investment class consists primarily of common equity securities of domestic and international companies. These securities trade through the major public domestic and international exchanges. This investment class also includes investments in common trust funds, mutual funds and exchange-traded funds that hold investments in equity securities. The equity securities investments are exposed to various risks, including market risk; individual security risk; foreign exchange risk; and, for common equity of companies with a small market capitalization, liquidity risk.

*Public Master Limited Partnerships* – This investment class consists of master limited partnerships that invest in various domestic infrastructure assets within the energy industry. The securities held within the limited partnership trade through the major public domestic exchanges and are exposed to various risks, including market risk, individual security risk, regulatory risk, interest rate risk and liquidity risk.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**6. Assets Limited as to Use or Restricted (continued)**

*Alternative Investments* – Funds in this class are invested with external investment managers who invest primarily in various alternative categories, including real estate, long- and short-equity positions, merger and event arbitrage, natural resources, distressed credit, managed futures, fixed-income arbitrage and foreign exchange. These investments are domestic and international in nature and have varying degrees of illiquidity. The risks associated with these investments are numerous and include liquidity risk, market risk, event risk, interest rate risk, foreign exchange risk and investment manager risk. In addition, the investment managers are not required to register with the Securities and Exchange Commission and are not subject to regulatory controls. As unregistered investment vehicles, these funds are not required to disclose the holdings in their portfolios to investors. Given the numerous risks involved, these funds have a greater likelihood of losing invested capital.

Investment income on assets limited as to use or restricted (excluding restricted by donor) consists of the following:

|  | <b>Year Ended December 31</b> |                   |
|--|-------------------------------|-------------------|
|  | <b>2017</b>                   | <b>2016</b>       |
| Interest and dividend income                           | \$ 39,426                     | \$ 42,313         |
| Net realized gains on marketable securities            | <b>128,610</b>                | 31,822            |
| Total realized income                                  | <b>168,036</b>                | 74,135            |
| Net unrealized gains on marketable securities          | <b>118,169</b>                | 52,114            |
| Net unrealized (loss) gains on alternative investments | <b>(13,681)</b>               | 973               |
|  | <b>\$ 272,524</b>             | <b>\$ 127,222</b> |

**7. Fair Value Measurements**

PHS's alternative investments, totaling \$254,249 and \$260,957 as of December 31, 2017 and 2016 respectively, are accounted for using the equity method of accounting. Accordingly, the alternative investments are omitted from the following tables of financial instruments measured at fair value.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
(Dollar Amounts in Thousands)

**7. Fair Value Measurements (continued)**

The following table presents the fair value hierarchy for those financial assets and liabilities measured at fair value on a recurring basis at December 31, 2017:

|  | Level 1           | Level 2*          | Level 3     | Fair Value          | Carrying Value<br>at December 31,<br>2017 | Valuation<br>Technique** |
|--|-------------------|-------------------|-------------|---------------------|---|--------------------------|
|  | (In Thousands)    |                   |             |                     |   |                          |
| <b>Designated for long-term purposes</b>     |                   |                   |             |                     |   |                          |
| Money market                                 | \$ 5,949          | \$ –              | \$ –        | \$ 5,949            | \$ 5,949                                  | a                        |
| Government and agencies                      | 57,429            | –                 | –           | 57,429              | 57,429                                    | a                        |
| Bond funds                                   | 345,310           | 173,725           | –           | 519,035             | 519,035                                   | a/c                      |
| Corporate and municipal bonds                | –                 | 274,051           | –           | 274,051             | 274,051                                   | a                        |
| Equity funds                                 | 440,515           | 445,017           | –           | 885,532             | 885,532                                   | a                        |
| Other public equities                        | 54,513            | –                 | –           | 54,513              | 54,513                                    | a                        |
| Other  | –                 | 728               | –           | 728                 | 728                                       | a                        |
| Total designated for long-term purposes      | <u>\$ 903,716</u> | <u>\$ 893,521</u> | <u>\$ –</u> | <u>\$ 1,797,237</u> | <u>\$ 1,797,237</u>                       |                          |
| <b>Designated for self-insurance funds</b>   |                   |                   |             |                     |   |                          |
| Money market                                 | \$ 2,997          | \$ –              | \$ –        | \$ 2,997            | \$ 2,997                                  | a                        |
| Government and agencies                      | 1,802             | –                 | –           | 1,802               | 1,802                                     | a                        |
| Bond funds                                   | 29,054            | 15,479            | –           | 44,533              | 44,533                                    | a/c                      |
| Corporate and municipal bonds                | –                 | 5,660             | –           | 5,660               | 5,660                                     | a                        |
| Equity funds                                 | 19,020            | 49,483            | –           | 68,503              | 68,503                                    | a                        |
| Other public equities                        | 4,521             | –                 | –           | 4,521               | 4,521                                     | a                        |
| Total designated for self-insurance funds    | <u>\$ 57,394</u>  | <u>\$ 70,622</u>  | <u>\$ –</u> | <u>\$ 128,016</u>   | <u>\$ 128,016</u>                         |                          |
| <b>Restricted by donors</b>                  |                   |                   |             |                     |   |                          |
| Money market                                 | \$ 143            | \$ –              | \$ –        | \$ 143              | \$ 143                                    | a                        |
| Government and agencies                      | 1,191             | –                 | –           | 1,191               | 1,191                                     | a                        |
| Bond funds                                   | 7,353             | 3,603             | –           | 10,956              | 10,956                                    | a/c                      |
| Corporate and municipal bonds                | –                 | 5,683             | –           | 5,683               | 5,683                                     | a                        |
| Equity funds                                 | 9,290             | 9,229             | –           | 18,519              | 18,519                                    | a                        |
| Other public equities                        | 1,154             | –                 | –           | 1,154               | 1,154                                     | a                        |
| Other  | –                 | 485               | –           | 485                 | 485                                       | a                        |
| Total restricted by donors                   | <u>\$ 19,131</u>  | <u>\$ 19,000</u>  | <u>\$ –</u> | <u>\$ 38,131</u>    | <u>\$ 38,131</u>                          |                          |
| <b>Held by trustee</b>                       |                   |                   |             |                     |   |                          |
| Money market                                 | \$ 94,350         | \$ –              | \$ –        | \$ 94,350           | \$ 94,350                                 | a                        |
|  | <u>\$ 94,350</u>  | <u>\$ –</u>       | <u>\$ –</u> | <u>\$ 94,350</u>    | <u>\$ 94,350</u>                          |                          |
| <b>Restricted for statutory requirements</b> |                   |                   |             |                     |   |                          |
| Money market                                 | \$ 3,172          | \$ –              | \$ –        | \$ 3,172            | \$ 3,172                                  | a                        |
| Government and Agencies                      | 29,284            | 23,453            | –           | 52,737              | 52,737                                    | a                        |
| Corporate and municipal bonds                | –                 | 45,441            | –           | 45,441              | 45,441                                    | a                        |
|  | <u>\$ 32,456</u>  | <u>\$ 68,894</u>  | <u>\$ –</u> | <u>\$ 101,350</u>   | <u>\$ 101,350</u>                         |                          |
| <b>Financial liabilities</b>                 |                   |                   |             |                     |   |                          |
| Interest rate swaps                          | \$ –              | \$ (19,954)       | \$ –        | \$ (19,954)         | \$ (19,954)                               | a                        |

\* Approximately 70% of Level 2 assets consist of commingled funds in which the underlying assets are primarily marketable debt and equity securities that trade on nationally recognized exchanges.

\*\*Valuation techniques are described in Note 2.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)

(Dollar Amounts in Thousands)

**7. Fair Value Measurements (continued)**

The following table presents the fair value hierarchy for those financial assets and liabilities measured at fair value on a recurring basis at December 31, 2016:

|  | Level 1           | Level 2*          | Level 3     | Fair Value          | Carrying Value<br>at December 31,<br>2016 | Valuation<br>Technique** |
|--|-------------------|-------------------|-------------|---------------------|---|--------------------------|
|  | (In Thousands)    |                   |             |                     |   |                          |
| <b>Designated for long-term purposes</b>     |                   |                   |             |                     |   |                          |
| Money market                                 | \$ 14,878         | \$ –              | \$ –        | \$ 14,878           | \$ 14,878                                 | a                        |
| Government and agencies                      | 57,556            | –                 | –           | 57,556              | 57,556                                    | a                        |
| Bond funds                                   | 274,545           | 168,639           | –           | 443,184             | 443,184                                   | a/c                      |
| Corporate and municipal bonds                | –                 | 275,098           | –           | 275,098             | 275,098                                   | a                        |
| Equity funds                                 | 422,284           | 325,985           | –           | 748,269             | 748,269                                   | a                        |
| Other public equities                        | 56,313            | –                 | –           | 56,313              | 56,313                                    | a                        |
| Other  | –                 | 710               | –           | 710                 | 710                                       | a                        |
| Total designated for long-term purposes      | <u>\$ 825,576</u> | <u>\$ 770,432</u> | <u>\$ –</u> | <u>\$ 1,596,008</u> | <u>\$ 1,596,008</u>                       |                          |
| <b>Designated for self-insurance funds</b>   |                   |                   |             |                     |   |                          |
| Money market                                 | \$ 2,637          | \$ –              | \$ –        | \$ 2,637            | \$ 2,637                                  | a                        |
| Government and agencies                      | 1,288             | –                 | –           | 1,288               | 1,288                                     | a                        |
| Bond funds                                   | 26,740            | 14,371            | –           | 41,111              | 41,111                                    | a/c                      |
| Corporate and municipal bonds                | –                 | 5,200             | –           | 5,200               | 5,200                                     | a                        |
| Equity funds                                 | 27,087            | 29,268            | –           | 56,355              | 56,355                                    | a                        |
| Other public equities                        | 4,664             | –                 | –           | 4,664               | 4,664                                     | a                        |
| Other  | –                 | 2,035             | –           | 2,035               | 2,035                                     | a                        |
| Total designated for self-insurance funds    | <u>\$ 62,416</u>  | <u>\$ 50,874</u>  | <u>\$ –</u> | <u>\$ 113,290</u>   | <u>\$ 113,290</u>                         |                          |
| <b>Restricted by donors</b>                  |                   |                   |             |                     |   |                          |
| Money market                                 | \$ 287            | \$ –              | \$ –        | \$ 287              | \$ 287                                    | a                        |
| Government and agencies                      | 1,110             | –                 | –           | 1,110               | 1,110                                     | a                        |
| Bond funds                                   | 5,294             | 3,252             | –           | 8,546               | 8,546                                     | a/c                      |
| Corporate and municipal bonds                | –                 | 5,304             | –           | 5,304               | 5,304                                     | a                        |
| Equity funds                                 | 8,142             | 6,286             | –           | 14,428              | 14,428                                    | a                        |
| Other public equities                        | 1,086             | –                 | –           | 1,086               | 1,086                                     | a                        |
| Other  | –                 | 473               | –           | 473                 | 473                                       | a                        |
| Total restricted by donors                   | <u>\$ 15,919</u>  | <u>\$ 15,315</u>  | <u>\$ –</u> | <u>\$ 31,234</u>    | <u>\$ 31,234</u>                          |                          |
| <b>Held by trustee</b>                       |                   |                   |             |                     |   |                          |
| Money market                                 | \$ 23,757         | \$ –              | \$ –        | \$ 23,757           | \$ 23,757                                 | a                        |
|  | <u>\$ 23,757</u>  | <u>\$ –</u>       | <u>\$ –</u> | <u>\$ 23,757</u>    | <u>\$ 23,757</u>                          |                          |
| <b>Restricted for statutory requirements</b> |                   |                   |             |                     |   |                          |
| Money market                                 | \$ 19,350         | \$ –              | \$ –        | \$ 19,350           | \$19,350                                  | a                        |
| Government and Agencies                      | 60,838            | –                 | –           | 60,838              | 60,838                                    |                          |
| Corporate and municipal bonds                | 36,774            | –                 | –           | 36,774              | 36,774                                    | a                        |
|  | <u>\$ 116,962</u> | <u>\$ –</u>       | <u>\$ –</u> | <u>\$ 116,962</u>   | <u>\$ 116,962</u>                         |                          |
| <b>Financial liabilities</b>                 |                   |                   |             |                     |   |                          |
| Interest rate swaps                          | \$ –              | \$ (22,668)       | \$ –        | \$ (22,668)         | \$ (22,668)                               | a                        |

\* Approximately 66% of Level 2 assets consist of commingled funds in which the underlying assets are primarily marketable debt and equity securities that trade on nationally recognized exchanges.

\*\* Valuation techniques are described in Note 2.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**7. Fair Value Measurements (continued)**

There were no changes in the fair value level classification, between Level 1 and level 2, for any investments in 2017 or 2016. PHS has no Level 3 investments.

As of December 31, 2017 and 2016, PHS had a total of \$254,249 and \$260,957, respectively, invested in alternative investments representing various hedge funds and real asset investments that include limited liability companies and limited liability partnerships, as follows:

|                      | <b>December 31</b> |                   |
|----------------------|--------------------|-------------------|
|                      | <b>2017</b>        | <b>2016</b>       |
| Equity long/short    | \$ 17,334          | \$ 21,353         |
| Event driven         | 33,191             | 33,569            |
| Relative value       | 46,033             | 24,200            |
| Tactical trading     | 37,200             | 30,385            |
| Private equity       | 5,301              | 5,329             |
| Real assets          | 82,519             | 99,769            |
| Total cost basis     | 221,578            | 214,605           |
| Unrealized gain, net | 32,671             | 46,352            |
|                      | <u>\$ 254,249</u>  | <u>\$ 260,957</u> |

Approximately 96% of these alternative investments represent investments with original lockup periods ranging from one month to five years. The remaining exposure represents investments with longer lockups and limited redemption rights. There were no material unfunded commitments at December 31, 2017.

**Fair Value of Long-Term Debt**

The fair value of long-term debt is estimated based upon published or quoted market prices (Level 2 measurements) for these issues or, where such prices not available, on similar issues and approximated \$892,185 and \$714,123 at December 31, 2017 and 2016, respectively.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**8. Property and Equipment, Net**

Property and equipment, net, consists of the following:

|  | <b>December 31</b> |             |
|--|--------------------|-------------|
|  | <b>2017</b>        | <b>2016</b> |
| Land and improvements                          | <b>\$ 120,147</b>  | \$ 115,460  |
| Buildings and improvements                     | <b>1,010,721</b>   | 964,605     |
| Equipment                                      | <b>574,324</b>     | 552,333     |
| Software                                       | <b>234,231</b>     | 224,020     |
|  | <b>1,939,423</b>   | 1,856,418   |
| Less accumulated depreciation and amortization | <b>1,141,179</b>   | 1,058,645   |
|  | <b>798,244</b>     | 797,773     |
| Construction-in-progress                       | <b>133,877</b>     | 52,990      |
|  | <b>\$ 932,121</b>  | \$ 850,763  |

Unamortized software was \$51,458 and \$65,494 as of December 31, 2017 and 2016, respectively. Software amortization expense was \$24,247 and \$25,116 for the years ended December 31, 2017 and 2016, respectively, and is included in depreciation and amortization expense.

At December 31, 2017, PHS has future capital commitments of \$37,718.

PHS capitalized interest costs in the amounts of \$2,316 and \$407 in 2017 and 2016, respectively.

**9. Medical Claims Expense**

For the years ended December 31, 2017 and 2016, medical claims expense decreased \$13,667 and \$26,243 in 2017 and 2016, respectively, as a result of changes in estimates of unpaid claims and claims adjustment expenses. These changes generally are the result of ongoing analyses of recent loss development trends. Original estimates are increased or decreased as additional information becomes known regarding individual claims.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**10. Long-Term Debt, Capital Leases, and Interest Rate Swaps**

|   | December 31       |                   |
|---|-------------------|-------------------|
|   | 2017              | 2016              |
| 2017 Series A Hospital System Revenue Bonds (New Mexico Hospital Equipment Loan Council), fixed-interest coupon rates of 2.0% to 5.0% payable semiannually on the established interest payment dates, principal payments beginning in 2018.   | \$ 239,115        | \$ —              |
| 2017 Series B Taxable Hospital System Revenue Bonds (New Mexico Hospital Equipment Loan Council), fixed-interest coupon rates of 4.0% and 5.0% payable semiannually on the established interest payment dates, principal payments beginning in 2037 through 2046.   | 65,665            | —                 |
| 2015 Series A Hospital System Revenue Bonds (New Mexico Hospital Equipment Loan Council), fixed-interest coupon rates from 4.125% to 5.0% at December 31, 2017, payable semiannually on the established interest payment dates, principal payments beginning in 2016 through 2044                         | 224,775           | 231,095           |
| 2012 Series A Hospital System Revenue Bonds (New Mexico Hospital Equipment Loan Council), fixed-interest coupon rates from 4.0% to 5.0% at December 31, 2017, payable semiannually on the established interest payment dates, principal payments beginning in 2033 through 2042                           | 75,000            | 75,000            |
| 2009 Series A Hospital System Revenue Bonds (New Mexico Hospital Equipment Loan Council), fixed-interest coupon rates from 5.0% to 5.125% at December 31, 2017, payable semiannually on the established interest payment dates, principal payments beginning in 2033 through 2039, defeased in 2017       | —                 | 134,610           |
| 2008 Series B, C, and D Hospital System Revenue Bonds (New Mexico Hospital Equipment Loan Council), variable-rate demand bonds with interest rate of 1.70% to 1.76% at December 31, 2017, payable monthly on the established interest payment date, principal payable in annual installments through 2034 | 178,695           | 185,985           |
| 2012 note payable to bank, variable rate, interest payable quarterly at one-month LIBOR plus .90% (2.46% at December 31, 2017) due October 2022   | 50,000            | 50,000            |
| Capital lease obligations and other   | 5,849             | 6,916             |
|   | <b>839,099</b>    | <b>683,606</b>    |
| Premiums and (discounts) on long-term debt, net   | 31,314            | 21,944            |
| Less deferred financing fees  | 7,168             | 6,166             |
|   | <b>863,245</b>    | <b>699,384</b>    |
| Less current portion  | 15,580            | 14,677            |
|   | <b>\$ 847,665</b> | <b>\$ 684,707</b> |

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **10. Long-Term Debt, Capital Leases, and Interest Rate Swaps (continued)**

The 2017 Series A Revenue Bonds totaling \$239,115 were issued through the New Mexico Hospital Equipment Loan Council in May 2017. Proceeds of the bonds were issued to defease the 2009 Series A Revenue Bonds and provide funding for the construction of a new hospital facility in Santa Fe, New Mexico, which is scheduled to open in late 2018. The 2017 Series A bonds are fixed-rate bonds and have annual maturities in August 2018 through 2016.

The 2017 Series B Taxable Revenue Bonds totaling \$65,665 were issued through the New Mexico Hospital Equipment Loan Council in May 2017. Proceeds of the bonds are being used to fund the construction of a physician office building adjacent to the new hospital in Santa Fe, New Mexico, and expand PHS's administrative office in Albuquerque, New Mexico. The 2017 Series B bonds are fixed rate bonds and have annual maturities beginning in August 2037 and continuing through 2046.

The 2015 Series A Revenue Bonds were issued through the New Mexico Hospital Equipment Loan Council. Proceeds of the bonds were used to defease the 2008 Series A Bonds, reimburse PHS for prior capital expenditures and pay the costs of issuance. The remaining portion of the proceeds will be used to fund current and future capital projects. The 2015 bonds are fixed-rate serial and term bonds and have scheduled maturities and mandatory sinking fund deposits starting in August 2016 and August 2040, respectively, and continue through 2044.

The 2012 Series A Revenue Bonds were issued through the New Mexico Hospital Equipment Loan Council in August 2012. Proceeds of the bonds are being used to fund various health care facilities throughout the PHS system, including a patient tower at the Española Hospital, a cancer center on the Rust Medical Center campus, a physician office building adjacent to Socorro General Hospital, and other general capital improvements, and were also used to pay costs of issuance. The 2012 bonds are fixed-rate term bonds and have scheduled mandatory sinking fund deposits starting in 2013 and continuing through 2042. In August 2012, PHS also obtained a \$50,000 taxable bank direct loan (the 2012 Bank Loan), of which \$50,000 was outstanding as of December 31, 2017 and 2017. Proceeds of the 2012 Bank Loan were used for a new system corporate office, which was completed in 2014.

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **10. Long-Term Debt, Capital Leases, and Interest Rate Swaps (continued)**

The 2009 Series A Revenue Bonds totaling \$134,610 of original issue discount bonds were issued through the New Mexico Hospital Equipment Loan Council. Proceeds of the bonds were used to fund a project for the construction of the Rust Medical Center and pay the costs of issuance. The 2009 bonds are fixed-rate term bonds and have scheduled mandatory sinking fund deposits starting in 2033 and continue through 2039. The 2009 bonds were defeased in 2017 and a loss of \$14,254 was recognized.

The 2008 Revenue Bonds were issued through the New Mexico Hospital Equipment Loan Council in four series (Series A, Series B, Series C, and Series D) (the Series 2008 Bonds) in November 2008. The Series 2008 Bonds were designed to defease the 2005 Series A and B Revenue Bonds (\$201,895); to pay off a Wells Fargo Credit Agreement, which defeased the 2004 Series A through D Bonds (\$128,655) and the 1993A Bonds (\$17,900) during March and April 2008; to reimburse PHS for prior capital expenditures; and to pay certain costs of issuing the Series 2008 Bonds. The Series 2008 A Bonds were refunded in their entirety in 2015 and have been legally defeased. The Series 2008 B through D Bonds are variable-rate demand obligations and bear interest on a daily (Series C and D) and weekly (Series B) rate period at amounts set by a remarketing agent. The interest rate mode can be modified under the terms of the legal documents. To secure the tender price of the Series 2008 B Bonds, PHS has entered into standby bond purchase agreements with JPMorgan Chase Bank, N.A., and Wells Fargo, N.A. for the Series 2008 C and D Bonds. The standby bond purchase agreements expire in November 2018, 2019 and 2020 for the Series 2008 C, D, and B Bonds, respectively.

The Series 2008 B, C, and D Bonds are subject to optional redemption at the discretion of PHS. In addition, the Series 2008 Bonds have a schedule of mandatory sinking fund deposits through 2034.

All of the outstanding bonds are collateralized by a pledge of unrestricted receivables of the Obligated Group, as defined under the Master Trust Indenture. The Master Trust Indenture of the Obligated Group requires, among other things, that certain funds be established and held by a trustee. The Master Trust Indenture also requires certain limitations on additional indebtedness, liens on property, and disposition or transfers of assets, as well as the maintenance of certain cash balances and other financial ratios. The Obligated Group was in compliance with all such covenants at December 31, 2017.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**10. Long-Term Debt, Capital Leases, and Interest Rate Swaps (continued)**

Scheduled principal payments and sinking fund requirements on long-term debt at December 31 are as follows:

|            | <b>Long-Term<br/>Debt</b>     |
|------------|-------------------------------|
|            | <hr/>                         |
| 2018       | \$ 15,592                     |
| 2019       | 16,161                        |
| 2020       | 16,829                        |
| 2021       | 17,548                        |
| 2022       | 18,285                        |
| Thereafter | 778,830                       |
|            | <hr/> <b>\$ 863,245</b> <hr/> |

**Interest Rate Swaps**

In connection with the Series 2005 Bonds, PHS entered into two floating to fixed-rate swaps (the 2005 Swaps) effective July 28, 2005, for notional amounts of \$102,400 and \$102,600. On November 25, 2008, PHS refunded the Series 2005 Bonds with the Series 2008 B–D Bonds. The amortization schedule for the Series 2008 B–D Bonds was established to match the amortization of the Series 2005 Bonds. The 2005 Swaps provide that PHS receives a floating amount based on a percentage of one-month LIBOR (58.30% of LIBOR plus 0.36%) and PHS pays a fixed rate of 3.085% based on a notional amount equal to the principal amount of the Series 2005 Bonds. As of and subsequent to April 1, 2007, PHS recognizes the entire change in the fair value of these swaps within the excess of revenues over expenses under ASC 815, as discussed in Note 2. The total outstanding notional amount of the 2005 Swaps was \$153,950 and \$161,240 at December 31, 2017 and 2016, respectively.

On February 9, 2006, PHS entered into a series of four floating to fixed-rate, forward-dated swaps (the 2006 Swaps) in notional amounts of \$38,695, \$38,665, \$31,460, and \$25,720. The 2006 Swaps were effective January 2, 2007, and provide that PHS receives a floating amount based on a percentage of one-month LIBOR (68%) and PHS pays a weighted average fixed rate of 3.564% based on a notional amount equal to the principal amount of the Series 2004 Bonds. On June 5, 2009, PHS terminated the two 2006 Swaps that were initially originated in the notional amounts of \$31,460 and \$25,720 and partially terminated two of the 2006 Swaps that were initially

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **10. Long-Term Debt, Capital Leases, and Interest Rate Swaps (continued)**

originated in the notional amounts of \$38,695 and \$38,665. The remaining portion of the 2006 Swaps match the amortization schedule for the Series 2008 B–D Bonds that are not hedged by the 2005 Swaps. As of and subsequent to April 1, 2007, PHS recognizes the entire change in the fair value of these swaps within the excess of revenue over expenses under ASC 815, as discussed in Note 2. The total outstanding notional amount of the 2006 Swaps was \$24,745 at both December 31, 2017 and 2016.

All derivatives that are being measured by PHS under ASC 820 are considered Level 2 assets (liabilities) because a quoted price can be obtained from a number of dealer counterparties and other market sources based on observable interest rates and yield curves for the full term of the asset or liability. In order to measure the fair value of municipal derivatives under ASC 820, PHS adjusted its mid-market periodic values of the swaps outstanding to incorporate non-performance risk by PHS (when the financial instrument is a liability) or the counterparty (when the financial instrument is an asset). In order to determine the risk of non-performance when the financial instrument is a liability, PHS has determined the change in the credit market for debt issues by entities with the same credit characteristics as PHS. To determine non-performance risk when the instrument is an asset, PHS determines the change in the credit market for debt issues by the counterparty.

As of December 31, 2017 and 2016, the fair value of the 2005 and 2006 Swaps was a net liability of \$19,954 and \$22,668, respectively, and is included in other liabilities on the accompanying combined balance sheets.

If the liability related to the swaps were to exceed \$40,000, PHS would be required to post a cash deposit for amounts in excess of the threshold as collateral with the counterparty. This collateral threshold would be reduced to \$30,000 if PHS's current AA credit rating were to fall to A+, reduced to \$20,000 at a rating of A, and further reduced to zero at a credit rating below A.

Interest expense included \$4,066 and \$4,879 in 2017 and 2016, respectively, related to net periodic payments to the counterparty.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**11. Employee Benefit Plans**

PHS has a defined benefit pension plan (Plan I) that previously covered substantially all of the employees of its related organizations, except employees of PNI. Effective January 1, 2006, Plan I was closed to new entrants, but it continued to accrue benefits for those employees in the plan as of December 31, 2005 until December 31, 2012, when Plan I was amended to cease future benefit accruals. Any benefits earned by participants under Plan I at December 31, 2012, will be preserved and will be payable based on Plan I's provisions.

PHS contributes such amounts as necessary on an actuarial basis to provide Plan I with assets sufficient to meet the benefits to be paid to Plan I participants. PHS contributed \$13,041 and \$9,560 in 2017 and 2016, respectively, to Plan I.

A summary of Plan I's benefit obligation, assets, and funded status is as follows:

|   | <b>Year Ended December 31</b> |                     |
|---|-------------------------------|---------------------|
|   | <b>2017</b>                   | <b>2016</b>         |
| Change in benefit obligation:             |                               |                     |
| Benefit obligation at beginning of year   | \$ 492,240                    | \$ 544,601          |
| Service cost                              | 3,500                         | 3,800               |
| Interest cost                             | 22,305                        | 25,384              |
| Plan amendments                           | –                             | 17,372              |
| Plan settlements                          | –                             | (77,820)            |
| Actuarial loss                            | 58,687                        | 6,164               |
| Benefits paid and plan expenses           | (23,021)                      | (27,261)            |
| Benefit obligation at end of year         | <u>\$ 553,711</u>             | <u>\$ 492,240</u>   |
| Change in assets:                         |                               |                     |
| Fair value of assets at beginning of year | \$ 333,107                    | \$ 390,694          |
| Actual return on assets                   | 53,259                        | 37,934              |
| Employer contribution                     | 13,041                        | 9,560               |
| Plan settlements                          | –                             | (77,820)            |
| Benefits paid and plan expenses           | (23,021)                      | (27,261)            |
| Fair value of plan assets at end of year  | <u>\$ 376,386</u>             | <u>\$ 333,107</u>   |
| Funded status at year-end                 | <u>\$ (177,325)</u>           | <u>\$ (159,133)</u> |

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**11. Employee Benefit Plans (continued)**

|  | <b>Year Ended December 31</b> |                            |
|--|-------------------------------|----------------------------|
|  | <b>2017</b>                   | <b>2016</b>                |
| Amounts not yet reflected in net periodic benefit cost and included in net assets: |                               |                            |
| Accumulated loss   | <b>\$ (188,888)</b>           | \$ (164,657)               |
| Cumulative changes in unrestricted net assets                                      | <b>(188,888)</b>              | (164,657)                  |
| Cumulative employer contributions in excess of net periodic benefit cost           | <b>11,563</b>                 | 5,524                      |
| Net amount recognized in the combined balance sheets                               | <b><u>\$ (177,325)</u></b>    | <b><u>\$ (159,133)</u></b> |

The actuarial loss recorded in 2017 was primarily due to the change in discount rate from 4.62% to 3.93%. This change increased the benefit obligation by \$49,700 in 2017.

PHS recorded a 2016 year settlement charge of \$24,176 for the risk transfer activities that occurred in 2016. This settlement charge is in addition to the regular periodic benefit cost of \$4,236. These risk transfer activities are also the primary cause for the decrease on both pension obligation and assets during 2016.

A summary of the projected benefit obligation, accumulated benefit obligation, and fair value of plan assets is as follows:

|                                | <b>2017</b>       | <b>2016</b> |
|--------------------------------|-------------------|-------------|
| Projected benefit obligation   | <b>\$ 553,711</b> | \$ 492,240  |
| Accumulated benefit obligation | <b>553,711</b>    | 492,240     |
| Fair value of plan assets      | <b>376,386</b>    | 333,107     |

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**11. Employee Benefit Plans (continued)**

Net periodic benefit cost includes the following components:

|  | <u>2017</u>     | <u>2016</u>     |
|--|-----------------|-----------------|
| Service cost – benefits earned during the year | \$ 3,500        | \$ 3,800        |
| Interest cost on projected benefit obligation  | 22,305          | 25,384          |
| Expected return on Plan I assets               | (23,082)        | (28,368)        |
| Amortization of prior service credit           | 1,561           | –               |
| Recognized net actuarial loss                  | 2,718           | 3,420           |
| Net periodic pension benefit cost              | <u>\$ 7,002</u> | <u>\$ 4,236</u> |

Assumptions used to determine benefit obligation as of the measurement date are as follows:

|   | <u>2017</u> | <u>2016</u> |
|---|-------------|-------------|
| Discount rate at end of year            | 3.93%       | 4.62%       |
| Rate of increase in compensation levels | N/A         | N/A         |

Assumptions used to determine net periodic pension benefit cost are as follows:

|   | <u>2017</u> | <u>2016</u> |
|---|-------------|-------------|
| Discount rate at beginning of year          | 4.62%       | 4.75%       |
| Rate of increase in compensation levels     | N/A         | N/A         |
| Expected long-term rate of return on assets | 6.75%       | 7.0%        |

Contributions to be made during 2018 have not been finalized, but are expected to be \$28,500.

The expected return on Plan I assets has been developed using both historical and future expected returns for each asset class. Based on the target asset mix as of December 31, 2017, PHS has selected a long-term rate of return of 6.75% using this approach.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**11. Employee Benefit Plans (continued)**

The asset allocation for Plan I by asset class at the measurement date was as follows:

|   | <b>2017</b> | <b>2016</b> |
|---|-------------|-------------|
| Cash and cash equivalents               | <b>1%</b>   | 2%          |
| Fixed-income securities                 | <b>42</b>   | 38          |
| Common stock and equity                 | <b>47</b>   | 49          |
| Absolute return, hedge funds, and other | <b>10</b>   | 11          |
|   | <b>100%</b> | 100%        |

Plan I assets have historically been invested in a portfolio designed to preserve principal and obtain competitive investment returns and long-term investment growth, consistent with actuarial assumptions, while minimizing unnecessary investment risk. Diversification is achieved by retaining multiple investment managers with complementary philosophies, styles, and approaches.

Plan I asset allocation targets at the measurement date were as follows:

|                                 | <b>Target</b> | <b>Range</b> |
|---------------------------------|---------------|--------------|
| Cash and cash equivalents       | 1%            | 0%–6%        |
| Fixed-income securities         | 44            | 39–49        |
| Domestic equity securities      | 20            | 15–25        |
| International equity securities | 20            | 15–25        |
| Other                           | 15            | 7–25         |

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
(Dollar Amounts in Thousands)

**11. Employee Benefit Plans (continued)**

The value of PHS's Plan I assets measured at fair value on a recurring basis were determined using the following inputs at December 31, 2017 and 2016. The totals do not include alternative investments of \$35,153 and \$37,561, respectively.

|                                       | Level 1           | Level 2*          | Total Fair<br>Value | Valuation<br>Technique*<br>(a, b, c) |
|---------------------------------------|-------------------|-------------------|---------------------|--------------------------------------|
| <i>(In Thousands)</i>                 |                   |                   |                     |                                      |
| <b>2017</b>                           |                   |                   |                     |                                      |
| Money market                          | \$ 2,480          | \$ —              | \$ 2,480            | a                                    |
| Bond funds                            | 33,449            | 122,850           | 156,299             | a/c                                  |
| Common equities                       | 64,994            | 99,552            | 164,546             | a                                    |
| Public Master Limited<br>Partnerships | 17,908            | —                 | 17,908              | a                                    |
| Total financial assets                | <u>\$ 118,831</u> | <u>\$ 222,402</u> | <u>\$ 341,233</u>   |                                      |
| <b>2016</b>                           |                   |                   |                     |                                      |
| Money market                          | \$ 6,792          | \$ —              | \$ 6,792            | a                                    |
| Bond funds                            | 17,189            | 108,543           | 125,732             | a/c                                  |
| Common equities                       | 79,233            | 63,216            | 142,449             | a                                    |
| Public Master Limited<br>Partnerships | 20,573            | —                 | 20,573              | a                                    |
| Total financial assets                | <u>\$ 123,787</u> | <u>\$ 171,759</u> | <u>\$ 295,546</u>   |                                      |

\* Valuation techniques are described in Note 2.

At December 31, 2017 and 2016, Plan I's alternative investments of \$35,153 and \$37,561, respectively, are comprised of a hedge fund-of-funds and a private real estate investment trust (REIT). As described in Note 2, management has elected to use the net asset value per share, or its equivalent, as a practical expedient for fair value of Plan I's interest in alternative investments. The underlying funds have restrictions on the timing of withdrawals, which may reduce liquidity from three to six months.

# Presbyterian Healthcare Services and Affiliates

## Notes to Combined Financial Statements (continued) *(Dollar Amounts in Thousands)*

### 11. Employee Benefit Plans (continued)

Expected benefits to be paid to the Plan I participants and beneficiaries are as follows:

|           |           |
|-----------|-----------|
| 2018      | \$ 21,073 |
| 2019      | 22,960    |
| 2020      | 24,451    |
| 2021      | 25,893    |
| 2022–2027 | 178,849   |

In addition to Plan I, PHS also has five other limited postretirement benefit plans subject to the funded status recognition provisions of ASC 715. Plan I is funded, and the other postretirement plans are unfunded. During 2017, unrestricted net assets increased by approximately \$25,995, and during 2016, unrestricted net assets increased by \$13,188 for changes in the funded status of Plan I and the other postretirement benefit plans.

PHS has a defined contribution Plan (Plan II), which consists of a Section 403(b) plan and a Section 401(a) plan under the Code. Plan II requires PHS to pay a basic employer contribution, as well as match participant contributions up to a stated maximum percentage of the participant's salary. Contributions to Plan II are expensed as earned by employees and were \$27,880 and \$26,985 in 2017 and 2016, respectively.

PHP has a 401(k) defined contribution plan (Plan III) for PHP employees. Plan III requires PHP to match participant contributions up to a stated maximum percentage of the participant's salary. Plan III additionally provides an employer contribution for all employees regardless of whether the employee individually contributes to the Plan III. PHP contributions to Plan III are expensed as earned by employees and were \$3,279 and \$2,678 in 2017 and 2016, respectively.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**12. Restricted Net Assets**

Permanently or temporarily restricted net assets are recorded in accordance with the intent of the donor. Restricted net assets are available for the following purposes as of December 31:

|   | 2017             |                  | 2016             |                  |
|---|------------------|------------------|------------------|------------------|
|   | Temporarily      | Permanently      | Temporarily      | Permanently      |
| Program services and<br>facility improvements | \$ 29,012        | \$ 9,764         | \$ 24,245        | \$ 9,567         |
| Education                                     | 4,589            | 1,796            | 3,881            | 1,653            |
|   | <u>\$ 33,601</u> | <u>\$ 11,560</u> | <u>\$ 28,126</u> | <u>\$ 11,220</u> |

**13. Concentration of Credit Risk**

PHS provides health care services through its inpatient and outpatient care facilities throughout New Mexico. PHS grants credit to patients, most of whom are insured under third-party payor agreements, without requiring collateral or other security in extending credit to patients. However, PHS 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, HMOs and commercial insurance policies). The following table summarizes the percentage of net patient accounts receivable from all payors:

|   | December 31 |             |
|---|-------------|-------------|
|   | 2017        | 2016        |
| Managed care and other third-party payors | 70%         | 72%         |
| Government                                | 22          | 22          |
| Self-pay                                  | 8           | 6           |
| Total                                     | <u>100%</u> | <u>100%</u> |

Managed care and other third-party payors consist of receivables from various payors, including contracted third-party payors providing commercial and government programs. Management does not believe there is any significant concentration of credit risks associated with accounts receivable. Furthermore, management continually monitors and adjusts its allowances (contractual and doubtful accounts) associated with these receivables.

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **14. Commitments and Contingencies**

##### **Litigation and Other Contingent Liabilities**

PHS is subject to pending and threatened legal actions arising during the ordinary course of business. Management and legal counsel periodically assess whether losses have been incurred related to pending or threatened litigation, claims, and assessments. Loss estimates are continually monitored and reviewed, and as estimates are adjusted, changes in estimated losses are reflected in current operations. Losses incurred due to the actual results of litigation could differ from estimates recorded. In management's opinion, upon consultation with legal counsel, these matters should not have a material adverse effect on PHS's combined financial condition, results of operations, or cash flows. However, PHS's evaluation of the likely effects of these actions could change in the future, and an unfavorable outcome, depending upon the amount and timing, could have a material effect on PHS's combined financial condition, results of operations or cash flows of a future period.

##### **Patient Protection and Affordable Care Act**

The ACA, signed into law on March 23, 2010, created significant changes and will continue to create significant changes for health insurance markets, including changes to Medicare Advantage payments and the Medical Loss Ratio (MLR) provision that requires insurers to pay rebates to customers when insurers do not meet or exceed the specified MLR thresholds. Most of the provisions of the ACA with more significant effects on the health insurance marketplace, both state and federal, went into effect on January 1, 2014, including a requirement that insurers guarantee the issuance of coverage to all individuals regardless of health status, strict rules on how health insurance is rated, the assessment of new taxes and fees (including annual fees on health insurance companies), the creation of new insurance exchanges for individuals and small groups, the availability of premium subsidies for certain individual products, and substantial expansions in eligibility for Medicaid. Implementation of the ACA brings with it significant oversight responsibilities by health insurers that may result in increased governmental audits, increased assertions of False Claims Act violations, and an increased risk of other litigation.

Despite significant preparation for the advent of the new federal and state health insurance exchanges, there were many technical difficulties in the implementation of the exchanges, which entailed uncertainties associated with mix and volume of business. In November 2013, CMS notified the various state insurance commissioners that, under a transitional policy, health insurance coverage in the individual or small group market that was renewed for a policy year starting between January 1, 2014 and October 1, 2014, and that would otherwise have been

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **14. Commitments and Contingencies (continued)**

deemed non-compliant with certain market reforms under Health Care Reform, would nonetheless not be considered by CMS to be out of compliance with respect to such market reforms, provided certain conditions were met. CMS further encouraged state agencies responsible for enforcing the specified market reforms to adopt the same transitional policy with respect to this coverage. The state of New Mexico took the position that individual policies had no transition period and should be renewed to be compliant by January 1, 2015. For small group policies, the state took the position of allowing a transition period through December 31, 2015, and policies must have been renewed to be compliant by January 1, 2016.

Due to the impact of the transitional policy, PHS may be adversely selected by individuals who will have a higher acuity level than the anticipated pool of participants in the exchange markets. In addition, the risk adjustment, reinsurance, and risk corridor premium stabilization programs of Health Care Reform, or Health Care Reform Premium Stabilization Programs, established to apportion risk among insurers, may not be effective in appropriately mitigating the financial risks related to PHS's exchange products. These factors, along with the limited information about the individuals who have access to these newly established exchanges that was available when PHS established premiums, may have a material adverse effect on PHS's combined results of operations if premiums are not adequate or do not appropriately reflect the acuity of these individuals. Any variation from PHS's expectations regarding acuity, enrollment levels, adverse selection, or other assumptions utilized in setting adequate premium rates could have a material adverse effect on PHS's combined financial position, results of operations, and cash flows. As a result of such an effect in 2016 in the individual market, PHS chose not to offer individual products on the exchange for 2017. Small group products continue to be offered.

#### **Health Insurer Fee**

Due to the Affordable Care Act Health Insurer Industry Fee, there was a special surplus adjustment of \$32,274 in 2017 relative to the 2018 reporting year. However, the fee was suspended for 2017 so no special surplus was required for 2016.

#### **Health Care Regulatory Environment**

The health care industry is subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not limited to, matters such as licensure, accreditation, government health care program participation requirements, reimbursement for

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **14. Commitments and Contingencies (continued)**

patient services, and Medicare and Medicaid fraud and abuse. Violations of these laws and regulations could result in exclusion from government health care programs, together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed and paid. Management believes that it has established adequate reserves to investigate, defend, and ultimately resolve any alleged instances of noncompliance. Compliance with such laws and regulations can be subject to future government review, as well as regulatory actions unknown or unasserted at this time.

#### **Self-Insurance Plans**

PHS is self-insured for professional and general liability, workers' compensation, and employee health insurance. PHS purchases claims-made insurance to cover professional liability and workers' compensation claims in excess of the self-insured limits. There are known claims and incidents that may result in the assertion of additional claims, as well as claims for unknown incidents that may be asserted arising from services provided to patients. PHS has engaged independent actuaries to estimate the ultimate costs, if any, of the settlement of such claims. Accrued professional liability, general liability, and workers' compensation losses of \$148,065 and \$118,405 at December 31, 2017 and 2016, respectively, have been discounted at 2.75% and 2.65%, respectively, and in management's opinion, such amounts provide an adequate reserve for loss contingencies. The increase in the accrued liability can be attributed to adverse claim development. The accrued liability relating to professional and general liability and workers' compensation at December 31, 2017 and 2016 is reported on a gross basis and, therefore, has not been reduced by estimated insurance recoveries of \$18,166 and \$12,330, respectively, which are reported in other receivables. The accrued liability for estimated employee health claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported and totaled \$4,289 and \$4,382 at 2017 and 2016, respectively.

At December 31, 2017 and 2016, PHS had an available line of credit to collateralize the workers' compensation coverage of \$10,400, of which none was outstanding.

#### **Surety Bond**

The Medicaid Centennial Care Contract requires PHP to provide a performance bond equal to 90% of the average of the past three months capitation payments made to PHP from HSD. As of December 31, 2017 and 2016, PHP met this requirement through a surety bond issued by an unrelated insurance company in the amount of \$94,000 and \$96,662, respectively. PHP has indemnified the issuer of the bond for any and all losses.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**14. Commitments and Contingencies (continued)**

**Operating Leases**

Future minimum rental payments required for the next five years and thereafter for all operating leases that have initial or remaining noncancelable lease terms in excess of one year at December 31, 2017 are as follows:

|            |                 |
|------------|-----------------|
| 2018       | \$ 2,100        |
| 2019       | 2,001           |
| 2020       | 591             |
| 2021       | 128             |
| 2022       | 10              |
| Thereafter | 592             |
|            | <u>\$ 5,422</u> |

Rent expense under operating leases for the years ended December 31, 2017 and 2016 totaled \$5,609 and \$5,380, respectively.

**15. Functional Expenses**

PHS provides general health care services to residents within its geographic region. Expenses related to providing these services are as follows:

|   | <b>Year Ended December 31</b> |                     |
|---|-------------------------------|---------------------|
|   | <b>2017</b>                   | <b>2016</b>         |
| Health care services  | <b>\$ 2,585,552</b>           | \$ 2,529,406        |
| Non-clinical and support services, including general and administrative | <b>489,893</b>                | 531,808             |
|   | <u><b>\$ 3,075,445</b></u>    | <u>\$ 3,061,214</u> |

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)  
*(Dollar Amounts in Thousands)*

**16. Income Taxes**

The components of the provision for income taxes at December 31 are as follows:

|                                  | <u>2017</u>     | <u>2016</u>      |
|----------------------------------|-----------------|------------------|
| Current                          | \$ 12,465       | \$ 25,454        |
| Deferred                         | (3,478)         | (660)            |
| Total provision for income taxes | <u>\$ 8,987</u> | <u>\$ 24,794</u> |

On December 22, 2017, the Tax Cuts and Jobs Act was enacted (Enactment), which significantly revised U.S. corporate income tax law by, among other things, reducing the corporate statutory income tax rate from 35% to 21%, beginning January 1, 2018. This reduction in the corporate statutory income tax rate required PHS, for PNI operations only, to re-evaluate certain of its deferred tax assets and liabilities, as of the date of Enactment, to reflect the revised income tax rates applicable to future periods. PHS believes that it has made a reasonable estimate of the income tax effects of the Tax Cuts and Jobs Act as of and for the year ended December 31, 2017. However, PHS was required to base certain of its estimates and assumptions on incomplete information and/or preliminary interpretations of the effects of Enactment. For tax-exempt entities, the Enactment also requires organizations to categorize certain fringe benefit expenses as a source of unrelated business income, pay an excise tax on remuneration above certain thresholds that is paid to executives by the organization, and report income or loss from unrelated business activities on an activity-by-activity basis, among other provisions. Certain regulatory guidance provides for a measurement period of up to one year, during which the accounting for the effects of the Tax Cuts and Jobs Act may be completed. As a result, PHS may need to reflect further adjustments to its deferred tax assets and liabilities recorded as of December 31, 2017 in future periods upon obtaining, preparing, or analyzing additional information about facts and circumstances that existed as of that date that, if known at that time, would have affected the income tax effects initially reported. PHS determined that the \$5,548 of adjustments to the deferred tax assets in connection with the reduction of the corporate income tax rate are provisional amounts and reasonable estimates at December 31, 2017. PHS does not expect the amounts of any future income tax adjustments that may be required to be made to PHS's deferred tax assets as of December 31, 2017 to be material.

Presbyterian Healthcare Services and Affiliates

Notes to Combined Financial Statements (continued)

(Dollar Amounts in Thousands)

**16. Income Taxes (continued)**

|                                       | <u>2017</u>     | <u>2016</u>      |
|---------------------------------------|-----------------|------------------|
| Computed tax expense at combined rate | \$ 15,030       | \$ 14,647        |
| Tax reform – tax rate differential    | (5,548)         | –                |
| PPACA health provider fee             | –               | 10,264           |
| Change in valuation allowance         | (78)            | 266              |
| Other permanent differences           | (362)           | (256)            |
| Provision to return differences       | 66              | (41)             |
| State taxes and other                 | (121)           | (86)             |
|                                       | <u>\$ 8,987</u> | <u>\$ 24,794</u> |

Deferred tax assets (liabilities) were comprised of the following at December 31:

|  | <u>2017</u>        | <u>2016</u>        |
|--|--------------------|--------------------|
| Deferred tax assets:                               |                    |                    |
| Medical liabilities and other reserves             | \$ 3,100           | \$ 3,499           |
| Medical claims payable (incurred but not reported) | 191                | 376                |
| Premium deficiency reserve                         | –                  | 1,171              |
| Deferred compensation                              | 313                | 693                |
| Premium tax settlement                             | –                  | 4,900              |
| Investments  | 317                | 496                |
| Unrealized loss on investments                     | 568                | 1,496              |
| Net operating loss carryforwards                   | 729                | 807                |
| Total deferred tax assets                          | <u>5,218</u>       | <u>13,438</u>      |
| Deferred tax liabilities:                          |                    |                    |
| Amortization of intangibles                        | (14,052)           | (21,220)           |
| Prepaid insurance                                  | (95)               | (142)              |
| Depreciation                                       | –                  | (24)               |
| Partnership – book/tax difference                  | (208)              | (213)              |
| Gains on sale of securities                        | (259)              | (936)              |
| Unrealized gains on investments                    | (1,819)            | (5,518)            |
| Total deferred tax liabilities                     | <u>(16,433)</u>    | <u>(28,053)</u>    |
| Valuation allowance                                | (729)              | (807)              |
| Deferred tax liabilities, net                      | <u>\$ (11,944)</u> | <u>\$ (15,422)</u> |

At December 31, 2017 and 2016, PNI had no federal net operating loss carryforwards. PNI is subject to state income tax and has state net operating loss carryforwards at December 31, 2017 and 2016 of \$12,022 and \$16,803, respectively, of which a portion is expiring each year.

## Presbyterian Healthcare Services and Affiliates

### Notes to Combined Financial Statements (continued)

*(Dollar Amounts in Thousands)*

#### **16. Income Taxes (continued)**

At December 31, 2017 and 2016, a valuation allowance in the amount of \$729 and \$807, respectively, was established against the deferred tax asset related to the state net operating loss carryforwards, as management currently believes that the benefit from some or all of this deferred tax asset may not be realized.

In the normal course of business, PNI is subject to examination by taxing authorities, and PNI is no longer subject to U.S. federal, state, or local income tax examinations for years before 2013. PNI does not have any current federal tax disputes.

#### **17. Subsequent Events**

PHS has evaluated subsequent events occurring between the end of the most recent fiscal year end and April 13, 2018, the date the combined financial statements were issued.

In 2018, PHP was awarded a five-year contract by the state of New Mexico to provide Medicaid services, including physical health, behavioral health and long-term care, as part of the Centennial Care 2.0 program beginning January 1, 2019. PHP was one of three managed care organizations selected to serve the state's Medicaid population.

# Supplementary Information



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## Report of Independent Auditors on Supplementary Information

The Board of Directors  
Presbyterian Healthcare Services

Our audit was conducted for the purpose of forming an opinion on the combined financial statements as a whole. The combining balance sheet and statement of operations for the year ended December 31, 2017 is presented for purposes of additional analysis and is not a required part of the 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 combined financial statements. The information has been subjected to the auditing procedures applied in the audit of the combined financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements, or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the information is fairly stated, in all material respects, in relation to the combined financial statements as a whole.

*Ernst & Young LLP*

April 13, 2018

# Presbyterian Healthcare Services and Affiliates

## Combining Balance Sheet

December 31, 2017

|  | <b>Obligated<br/>Group</b> | <b>Presbyterian<br/>Network, Inc.</b> | <b>Other Non-<br/>Obligated<br/>Group<br/>Members</b> | <b>Eliminations</b> | <b>Combined</b>     |
|--|----------------------------|---------------------------------------|---|---------------------|---------------------|
|  | <i>(In Thousands)</i>      |                                       |   |                     |                     |
| <b>Assets</b>  |                            |                                       |   |                     |                     |
| Current assets:  |                            |                                       |   |                     |                     |
| Cash and cash equivalents                                  | \$ 146,336                 | \$ 108,939                            | \$ 897  | \$ –                | \$ 256,172          |
| Accounts receivable, net                                   | 145,043                    | –                                     | 6,102   | (18,325)            | 132,820             |
| Other receivables  | 51,363                     | 81,441                                | 146   | (21,803)            | 111,147             |
| Inventories, prepaid expenses,<br>and other current assets | 44,236                     | 8,128                                 | 1,435   | –                   | 53,799              |
| Total current assets                                       | 386,978                    | 198,508                               | 8,580   | (40,128)            | 553,938             |
| Assets limited as to use or restricted:                    |                            |                                       |   |                     |                     |
| Designated for long-term purposes                          | 1,688,240                  | 336,839                               | 620   | –                   | 2,025,699           |
| Designated for self-insurance funds                        | 146,774                    | –                                     | –   | –                   | 146,774             |
| Restricted by donors                                       | 45,160                     | –                                     | –   | –                   | 45,160              |
| Held by trustee  | 94,350                     | –                                     | –   | –                   | 94,350              |
| Restricted for statutory requirements                      | –                          | 101,350                               | –   | –                   | 101,350             |
|  | 1,974,524                  | 438,189                               | 620   | –                   | 2,413,333           |
| Property and equipment, net                                | 898,263                    | 512                                   | 33,346  | –                   | 932,121             |
| Goodwill   | 200                        | 52,501                                | –   | –                   | 52,701              |
| Intercompany (payables) receivables                        | (30,649)                   | (30,539)                              | 61,188  | –                   | –                   |
| Other assets   | 86,256                     | 13,573                                | 124,910   | (114,890)           | 109,849             |
| Total assets   | <u>\$ 3,315,572</u>        | <u>\$ 672,744</u>                     | <u>\$ 228,644</u>                                     | <u>\$ (155,018)</u> | <u>\$ 4,061,942</u> |

Presbyterian Healthcare Services and Affiliates

Combining Balance Sheet (continued)

|  | <b>Obligated<br/>Group</b> | <b>Presbyterian<br/>Network, Inc.</b> | <b>Other Non-<br/>Obligated<br/>Group<br/>Members</b> | <b>Eliminations</b> | <b>Combined</b>     |
|--|----------------------------|---------------------------------------|---|---------------------|---------------------|
|  | <i>(In Thousands)</i>      |                                       |   |                     |                     |
| <b>Liabilities and net assets</b>                            |                            |                                       |   |                     |                     |
| Current liabilities:   |                            |                                       |   |                     |                     |
| Accounts payable   | \$ 67,108                  | \$ 7,612                              | \$ 1,342  | \$ —                | \$ 76,062           |
| Due under Medicaid contract                                  | —                          | 57,726                                | —   | —                   | 57,726              |
| Accrued liabilities  | 140,408                    | 39,289                                | 3,099   | (38,664)            | 144,132             |
| Medical claims payable                                       | —                          | 122,216                               | —   | (1,464)             | 120,752             |
| Estimated third-party payor settlements                      | 5,171                      | —                                     | (2,098)   | —                   | 3,073               |
| Current portion of long-term debt<br>and capital leases      | 15,580                     | —                                     | —   | —                   | 15,580              |
| Total current liabilities                                    | 228,267                    | 226,843                               | 2,343   | (40,128)            | 417,325             |
| Long-term debt and capital leases, net of<br>current portion |                            |                                       |   |                     |                     |
|  | 847,665                    | —                                     | —   | —                   | 847,665             |
| Employee benefit plans                                       | 226,912                    | —                                     | —   | —                   | 226,912             |
| Self-insurance plans   | 152,354                    | —                                     | —   | —                   | 152,354             |
| Other liabilities  | 78,460                     | 17,920                                | 1,610   | —                   | 97,990              |
| Total liabilities  | 1,533,658                  | 244,763                               | 3,953   | (40,128)            | 1,742,246           |
| Net assets:  |                            |                                       |   |                     |                     |
| Unrestricted   | 1,736,753                  | 427,981                               | 224,692   | (114,890)           | 2,274,536           |
| Temporarily restricted                                       | 33,601                     | —                                     | —   | —                   | 33,601              |
| Permanently restricted                                       | 11,560                     | —                                     | —   | —                   | 11,560              |
| Total net assets   | 1,781,914                  | 427,981                               | 224,692   | (114,890)           | 2,319,697           |
| Total liabilities and net assets                             | <u>\$ 3,315,572</u>        | <u>\$ 672,744</u>                     | <u>\$ 228,644</u>                                     | <u>\$ (155,018)</u> | <u>\$ 4,061,942</u> |

# Presbyterian Healthcare Services and Affiliates

## Combining Statement of Operations

Year Ended December 31, 2017

|   | <b>Obligated<br/>Group</b> | <b>Presbyterian<br/>Network, Inc.</b> | <b>Other Non-<br/>Obligated<br/>Group<br/>Members</b> | <b>Eliminations</b> | <b>Combined</b>   |
|---|----------------------------|---------------------------------------|---|---------------------|-------------------|
|   | <i>(In Thousands)</i>      |                                       |   |                     |                   |
| Revenues:   |                            |                                       |   |                     |                   |
| Net premiums  | \$ 440,752                 | \$ 1,983,807                          | \$ –  | \$ (435,802)        | \$ 1,988,757      |
| Patient service revenue                                 | 1,355,820                  | –                                     | 62,565  | (316,701)           | 1,101,684         |
| Less provision for doubtful accounts                    | (27,720)                   | –                                     | (2,350)   | –                   | (30,070)          |
| Net patient service revenue                             | 1,328,100                  | –                                     | 60,215  | (316,701)           | 1,071,614         |
| Other operating revenues                                | 53,090                     | 30,291                                | 8,188   | (27,898)            | 63,671            |
| Total operating revenues                                | 1,821,942                  | 2,014,098                             | 68,403  | (780,401)           | 3,124,042         |
| Expenses:   |                            |                                       |   |                     |                   |
| Medical claims  | 233,275                    | 1,726,048                             | –   | (753,629)           | 1,205,694         |
| Salaries, wages and employee benefits                   | 829,284                    | 94,024                                | 30,202  | (5,261)             | 948,249           |
| Purchased services and other                            | 287,134                    | 179,386                               | 19,000  | (21,511)            | 464,009           |
| Supplies  | 280,410                    | 559                                   | 3,789   | –                   | 284,758           |
| Professional fees                                       | 45,014                     | 4                                     | 3,052   | –                   | 48,070            |
| Depreciation and amortization                           | 90,947                     | 199                                   | 4,554   | –                   | 95,700            |
| Interest  | 28,977                     | –                                     | (12)  | –                   | 28,965            |
| Total expenses  | 1,795,041                  | 2,000,220                             | 60,585  | (780,401)           | 3,075,445         |
| Operating income  | 26,901                     | 13,878                                | 7,818   | –                   | 48,597            |
| Other income (loss):                                    |                            |                                       |   |                     |                   |
| Investment income                                       | 131,507                    | 35,934                                | 595   | –                   | 168,036           |
| Net unrealized gains (losses) on<br>investments         | 111,367                    | (6,879)                               | –   | –                   | 104,488           |
| Loss on bond defeasance                                 | (14,254)                   | –                                     | –   | –                   | (14,254)          |
| Change in fair value of interest rate swaps             | 2,779                      | –                                     | –   | –                   | 2,779             |
| Total other income                                      | 231,399                    | 29,055                                | 595   | –                   | 261,049           |
| Excess of revenues over expenses before<br>income taxes | 258,300                    | 42,933                                | 8,413   | –                   | 309,646           |
| Provision (benefit) for income taxes                    | –                          | 9,255                                 | (268)   | –                   | 8,987             |
| Excess of revenues over expenses                        | <u>\$ 258,300</u>          | <u>\$ 33,678</u>                      | <u>\$ 8,681</u>                                       | <u>\$ –</u>         | <u>\$ 300,659</u> |

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