



THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Consolidated Financial Statements
and Credit Group Schedules

June 30, 2018 and 2017

(With Independent Auditors' Report Thereon)

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

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KPMG LLP
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Independent Auditors' Report

To the Board of Trustees
The Queen's Health Systems and Subsidiaries:

We have audited the accompanying consolidated financial statements of The Queen's Health Systems and its subsidiaries, which comprise the consolidated balance sheets as of June 30, 2018 and 2017, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The Queen's Health Systems and its subsidiaries as of June 30, 2018 and 2017, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.



Other Matters

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary information as of and for the year ended June 30, 2018 included in Schedules 1 and 2 is presented for purposes of additional analysis and is not a required part of the 2018 consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the 2018 consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the 2018 consolidated financial statements as a whole.

Restriction on Use

This report is intended solely for the information and use of the Board of Trustees and management of The Queen's Health Systems; U.S. Bank National Association, as Master Trustee and Bond Trustee; the Department of Budget and Finance of the State of Hawaii, as Issuer; Bank of Hawaii, as Lender; and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

Honolulu, Hawaii
October 24, 2018

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Consolidated Balance Sheets

June 30, 2018 and 2017

(In thousands)

| Assets | 2018 | 2017 |
|---|---------------------|------------------|
| Current assets: | | |
| Cash and cash equivalents | \$ 135,974 | 80,803 |
| Receivables – less allowances for uncollectible accounts of \$52,484 in 2018 and \$46,930 in 2017 | 206,253 | 223,778 |
| Inventories | 19,908 | 19,965 |
| Investments | 1,212,017 | 1,145,999 |
| Assets whose use is limited or restricted – current | 16,063 | 14,116 |
| Prepaid expenses and other assets | 15,129 | 12,044 |
| Total current assets | <u>1,605,344</u> | <u>1,496,705</u> |
| Investments – less current portion | 88,292 | 71,073 |
| Assets whose use is limited or restricted – less current portion | 53,363 | 63,577 |
| Land, buildings, and equipment, net | 643,308 | 656,554 |
| Goodwill | 7,619 | 7,619 |
| Deferred income tax asset | 6,833 | 11,282 |
| Straight-line rents receivable | 65,861 | 61,277 |
| Beneficial interests in trusts | 109,245 | 108,821 |
| Other assets | 35,510 | 31,705 |
| Total | <u>\$ 2,615,375</u> | <u>2,508,613</u> |
| Liabilities and Net Assets | | |
| Current liabilities: | | |
| Accounts payable and other accrued liabilities | \$ 89,233 | 102,605 |
| Accrued salaries and benefits | 74,800 | 66,754 |
| Other current liabilities | 17,917 | 16,583 |
| Due to government reimbursement programs – current | 8,254 | 6,037 |
| Short-term and long-term debt – current | 10,562 | 9,386 |
| Long-term debt subject to short-term remarketing arrangements | 98,487 | 103,380 |
| Total current liabilities | <u>299,253</u> | <u>304,745</u> |
| Long-term debt – less current portion | 369,538 | 372,893 |
| Pension and postretirement liabilities | 167,389 | 224,994 |
| Due to government reimbursement programs – less current portion | 11,313 | 14,952 |
| Other long-term liabilities | 51,058 | 54,378 |
| Total liabilities | <u>898,551</u> | <u>971,962</u> |
| Net assets: | | |
| Unrestricted | 1,579,538 | 1,399,980 |
| Temporarily restricted | 22,160 | 22,203 |
| Permanently restricted | 115,126 | 114,468 |
| Total net assets | <u>1,716,824</u> | <u>1,536,651</u> |
| Total | <u>\$ 2,615,375</u> | <u>2,508,613</u> |

See accompanying notes to consolidated financial statements.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Consolidated Statements of Operations and Changes in Net Assets

Years ended June 30, 2018 and 2017

(In thousands)

| | <u>2018</u> | <u>2017</u> |
|---|------------------|------------------|
| Unrestricted operating revenues: | | |
| Net patient service revenues | \$ 1,225,984 | 1,142,464 |
| Rental revenues | 85,082 | 81,133 |
| Other | 51,359 | 51,223 |
| Total unrestricted operating revenues | <u>1,362,425</u> | <u>1,274,820</u> |
| Net assets released from restrictions | <u>7,997</u> | <u>4,659</u> |
| Total operating revenues and other support | <u>1,370,422</u> | <u>1,279,479</u> |
| Unrestricted operating expenses: | | |
| Salaries, wages, and employee benefits | 716,760 | 716,419 |
| Supplies | 230,836 | 222,959 |
| Purchased services | 103,248 | 104,198 |
| Depreciation and amortization | 72,880 | 62,772 |
| Professional fees | 61,380 | 66,785 |
| Sustainability fees and taxes – other than income taxes | 52,299 | 37,239 |
| Rent and utilities | 33,658 | 31,822 |
| Interest | 17,475 | 17,093 |
| Other | 29,539 | 37,104 |
| Total unrestricted operating expenses | <u>1,318,075</u> | <u>1,296,391</u> |
| Operating income (loss) | <u>52,347</u> | <u>(16,912)</u> |
| Nonoperating income (expense): | | |
| Investment income, net | 101,164 | 127,657 |
| Income tax expense | (4,384) | (3,451) |
| Gain on interest rate swap | 6,194 | 9,568 |
| Other expense | (3,219) | (2,836) |
| Total nonoperating income, net | <u>99,755</u> | <u>130,938</u> |
| Excess of revenues over expenses, carried forward | <u>152,102</u> | <u>114,026</u> |

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES
Consolidated Statements of Operations and Changes in Net Assets
Years ended June 30, 2018 and 2017
(In thousands)

| | <u>2018</u> | <u>2017</u> |
|---|---------------------|------------------|
| Excess of revenues over expenses, brought forward | \$ 152,102 | 114,026 |
| Other changes: | | |
| Net assets released from restrictions used for capital expenditures | 1,256 | 380 |
| Net unrealized gain on investments | 2,751 | 16,705 |
| Pension related changes other than net periodic pension cost | 23,449 | 38,751 |
| Other changes, net | — | (215) |
| Total other changes | <u>27,456</u> | <u>55,621</u> |
| Increase in unrestricted net assets | <u>179,558</u> | <u>169,647</u> |
| Temporarily restricted net assets: | | |
| Gifts and grants | 6,723 | 7,471 |
| Investment gains, net | 1,182 | 1,567 |
| Net assets released from restrictions used for capital expenditures | (1,256) | (380) |
| Net assets released from restrictions used for operating expenses | (6,707) | (4,363) |
| Other changes, net | 15 | (7) |
| (Decrease) increase in temporarily restricted net assets | <u>(43)</u> | <u>4,288</u> |
| Permanently restricted net assets: | | |
| Cash distributions from perpetual trusts | (1,290) | (296) |
| Other changes, net | 1,948 | 233 |
| Increase (decrease) in permanently restricted net assets | <u>658</u> | <u>(63)</u> |
| Increase in net assets | 180,173 | 173,872 |
| Net assets – beginning of year | <u>1,536,651</u> | <u>1,362,779</u> |
| Net assets – end of year | <u>\$ 1,716,824</u> | <u>1,536,651</u> |

See accompanying notes to consolidated financial statements.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended June 30, 2018 and 2017

(In thousands)

| | <u>2018</u> | <u>2017</u> |
|--|-------------------|-----------------|
| Operating activities: | | |
| Increase in net assets | \$ 180,173 | 173,872 |
| Adjustments to reconcile increase in net assets to net cash provided by operating activities: | | |
| Net realized and unrealized gains on investments | (89,802) | (134,442) |
| Gain on interest rate swap | (6,194) | (9,568) |
| Depreciation and amortization | 72,880 | 62,772 |
| Provision for bad debts | 61,323 | 50,397 |
| Amortization of bond premium | (2,327) | (2,370) |
| Gain on disposition of land, buildings, and equipment | (1,979) | (994) |
| Pension related changes other than net periodic pension cost | (23,449) | (38,751) |
| Deferred income taxes | 2,635 | (209) |
| Change in value of beneficial interests in trusts | (424) | 1,245 |
| Changes in operating assets and liabilities: | | |
| Receivables | (48,382) | (54,635) |
| Due to government reimbursement programs | (1,423) | (8,301) |
| Accounts payable and accrued salaries, benefits, and other liabilities | (45,683) | 19,130 |
| Other assets and liabilities | (1,132) | 1,173 |
| Net cash provided by operating activities | <u>96,216</u> | <u>59,319</u> |
| Investing activities: | | |
| Purchases of investments and assets whose use is limited or restricted | (232,019) | (497,140) |
| Proceeds from sales and maturities of investments and assets whose use is limited or restricted | 246,854 | 529,530 |
| Purchases of land, buildings, and equipment | (45,080) | (80,507) |
| Proceeds from sales of land, buildings, and equipment | 102 | 392 |
| Net cash used in investing activities | <u>(30,143)</u> | <u>(47,725)</u> |
| Financing activities: | | |
| Repayment of debt | (10,102) | (9,501) |
| Dividend distribution to non-controlling interest holder | (800) | (600) |
| Net cash used in financing activities | <u>(10,902)</u> | <u>(10,101)</u> |
| Increase in cash and cash equivalents | 55,171 | 1,493 |
| Cash and cash equivalents – beginning of year | <u>80,803</u> | <u>79,310</u> |
| Cash and cash equivalents – end of year | \$ <u>135,974</u> | <u>80,803</u> |
| Supplemental cash flow information: | | |
| Interest paid – net of amounts capitalized | \$ 20,153 | 20,213 |
| Income taxes paid | 2,751 | 4,890 |
| Supplemental disclosures of noncash investing and financing activities: | | |
| Purchase of buildings and equipment included in accounts payable and other accrued liabilities at year-end | \$ 15,976 | 8,441 |
| Capital expenditures funded by capital lease borrowings | 6,150 | — |

See accompanying notes to consolidated financial statements.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

(1) Organization and Summary of Significant Accounting Policies

Organization and Mission

The mission of The Queen's Health Systems (QHS, or the Parent Company) is to fulfill the intent of Queen Emma and King Kamehameha IV to provide in perpetuity quality health care services to improve the well-being of Native Hawaiians and all of the people of Hawaii. QHS is a tax-exempt support organization as described in Sections 501(c)(3) and 509(a)(3) of the Internal Revenue Code. QHS is the sole member of The Queen's Medical Center (QMC), Queen Emma Land Company (QEL), Molokai General Hospital (MGH) and North Hawaii Community Hospital (NHCH), and is also the parent of Queen's Development Corporation (QDC) and Queen's Insurance Exchange, Inc. (QIE).

QMC's Punchbowl facility opened its doors in 1859, and relocated shortly thereafter to its permanent location on Punchbowl Street in the city of Honolulu. Today, QMC Punchbowl operates a 535-bed acute care hospital and a 40-bed offsite acute care unit located on the 7th floor of Kuakini Health System's Hale Pulama Mau building. QMC's West O'ahu facility is an 80-bed community hospital with 24 hour emergency services. QEL oversees QHS's investment portfolio, as well as manages its substantial land and real estate holdings, most of which exist under leases to produce rental income. MGH operates a 15-bed hospital on the island of Molokai. NHCH is an acute-care hospital with 35 licensed beds and 24 hour emergency services located in Kamuela on the island of Hawaii. QMC, MGH and NHCH provide services to patients, substantially all of whom are Hawaii residents, under unsecured credit terms. QDC owns and manages income-producing, health care-related real estate and is engaged in other health-related business activities. QIE is a Hawaii-domiciled, pure captive insurance company.

QHS, QMC, MGH and NHCH are all members of The Queen's Health Systems Obligated Group (the Obligated Group). Each member is jointly and severally liable for long-term debt issued by the Obligated Group.

The Obligated Group, QDC and Diagnostic Laboratory Services, Inc. (DLS), a 90% owned QDC subsidiary, are all members of The Queen's Health Systems Credit Group (the Credit Group). Effective for the fiscal year ended June 30, 2018, QEL also became a member of the Credit Group.

Significant Accounting Policies

(a) Principles of Consolidation

These consolidated financial statements include the accounts of all entities for which the Parent Company is the sole member or controlling stockholder (collectively, QHS). Intercompany balances and transactions have been eliminated in the consolidated financial statements.

(b) Use of Estimates

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions based on available information that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include contractual and uncollectible allowances for receivables, valuation of investments, and reserves

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June 30, 2018 and 2017

(Dollars in thousands)

for self-insurance and pension and postretirement obligations. Actual results could differ from those estimates.

(c) Cash and Cash Equivalents

Cash equivalents include money market funds and short-term, highly liquid investments with maturities of three months or less at date of purchase, and are stated at cost, which approximates fair value. Excluded are amounts whose use is limited or restricted by board designations or other arrangements under trust agreements.

(d) Allowance for Uncollectible Accounts

QHS provides for accounts receivable that could become uncollectible by establishing an allowance to reduce the carrying value of such receivables to their estimated net realizable value. QHS estimates the allowance based on the aging of the accounts receivable, historical collection experience by payor, and other relevant factors.

(e) Inventories

Inventories, consisting principally of medical drugs and supplies, are valued at the lower of cost (average cost method) or market.

(f) Investments

Investments, including assets limited or restricted as to use, include money market funds, debt and equity securities, mutual funds, common trust funds and interests in limited partnerships including private equities. Money market funds classified as investments represent funds held temporarily until suitable investment opportunities are identified. Investments in money market funds, debt and equity securities, and mutual funds with readily determinable market values are measured at fair value based on quoted market prices or observed transactions. Investments also include alternative investments, such as common trust funds, and interests in limited liability entities (hedge funds, equity funds, real estate investments, and private equities), accounted for under the equity method of accounting. Management determines the appropriate classification of all investments at the date of purchase and evaluates such designations at each balance sheet date. QHS classifies its investments in debt and equity securities that are managed in "separate accounts" by fund managers as trading securities. Investments classified as other-than-trading securities are recorded at fair value, with changes in value recorded as other changes in unrestricted net assets. Investments that are available for current operations are classified as current assets. Investments that cannot be sold within a year due to restrictions contained in the agreements are classified as noncurrent assets.

Investment income, which is presented within the performance indicator, includes all dividends and interest, unrestricted realized gains and losses, other-than-temporary impairment (OTTI), unrealized gains and losses on trading securities, and equity in earnings and losses of alternative investments. Investment management fees are netted against investment income.

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Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

QHS assesses whether OTTI has occurred based upon a case-by-case evaluation of the underlying reasons for the decline in estimated fair value of its investments. All securities with a gross unrealized loss at each reporting period are subjected to a process for identifying OTTI. QHS considers a wide range of factors, as described below, about the security issuer and uses its best judgment in evaluating the cause of the decline in the estimated fair value of the security and in assessing the prospects for near-term recovery. Inherent in the evaluation of each security are assumptions and estimates about the operations of the issuer and its future earnings potential.

Considerations used by QHS in the impairment evaluation process include, but are not limited to, the following:

- Duration and extent that the estimated fair value has been below net carrying amount
- Ability and intent to hold the investment for a period of time to allow for a recovery of value
- Fundamental analysis of the liquidity and financial condition of the specific issuers
- Industry factors or conditions related to a geographic area that are negatively affecting the security
- Underlying valuation of assets specifically pledged to support the credit
- Past due interest or principal payments or other violations of covenants
- Deterioration of the overall financial condition of the specific issuer
- Downgrades by a rating agency

The cost basis of securities that are deemed to be other-than-temporarily impaired is written down to estimated fair value in the period the other-than-temporary impairment is recognized. There were no such impairment charges in the years ended June 30, 2018 and 2017.

(g) Assets Whose Use is Limited or Restricted

Assets whose use is limited or restricted include assets restricted by the donor and assets held by trustees for the repayment of bonds and purchase of capital assets. Amounts required to meet current obligations of QHS have been reflected as current assets in the consolidated balance sheets as of June 30, 2018 and 2017.

(h) Land, Buildings, and Equipment

Land, buildings and equipment are recorded on the basis of cost or fair market value at the date of acquisition or donation, respectively. Buildings and equipment, including amounts recorded under capital lease obligations, are depreciated by the straight-line method over their estimated useful lives ranging from 3 to 40 years. Leasehold improvements are amortized using the straight-line method over the lesser of their estimated useful lives or the remaining term of the related leases. Development and interest costs are capitalized during the construction period of major capital projects.

(i) Goodwill

Goodwill is not amortized. It is tested for impairment on an annual basis and when a triggering event occurs between annual impairment tests.

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(Dollars in thousands)

(j) Long-Lived Assets

Long-lived assets held and used by QHS are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. When such events or changes occur, an estimate of the future cash flows expected to result from the use of the assets and their eventual disposition is made. If the sum of such expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the assets, an impairment loss is recognized in an amount by which the assets' net book values exceed fair values. Estimated useful lives are periodically reviewed and changes are made when necessary.

(k) Beneficial Interests in Trusts

NHCH holds beneficial interests in certain trusts. QHS measures these interests using Level 3 inputs (see note 2 for further discussion of the fair value hierarchy).

(l) Insurance Claims and Related Insurance Recoveries

QHS estimates its insurance reserves without consideration of insurance recoveries, and therefore records estimated recoveries separately from its reserves.

(m) Derivative Financial Instruments

QHS periodically uses derivative financial instruments, such as interest rate hedging products, to mitigate risk. The use of derivative instruments is limited to reducing its risk exposure by utilizing interest rate swap agreements. The swaps are not designated as hedges for accounting purposes. Accordingly, QHS records the value of its swaps as other assets or liabilities in its consolidated balance sheets and records the change in the fair value of the swaps as nonoperating income or expense.

(n) Income Taxes

QDC and its majority-owned subsidiary, DLS, file consolidated income tax returns. QIE files separate income tax returns. Deferred tax assets and liabilities are recorded for differences between the financial statement and income tax bases for assets and liabilities. Deferred tax assets are reduced by a valuation allowance if it is more likely than not that some portion or all of the net deferred tax assets will not be realized. A valuation allowance has been recorded to reduce certain future net deferred tax assets to the amounts that will more likely than not be realized.

All other consolidated affiliates, besides QDC, DLS and QIE, are not-for-profit organizations that are exempt from federal and state income taxes pursuant to Section 501(a) of the Internal Revenue Code and related Hawaii Revised Statutes. QHS, QEL, QMC, NHCH and MGH are subject to federal and state income taxes solely on their unrelated business taxable income. Unrelated business taxable income is not material to the consolidated financial statements. QHS evaluates its uncertain tax positions and has no material unrecognized tax positions as of June 30, 2018. QHS does not believe it is subject to audit by taxing jurisdictions for periods prior to fiscal year ended June 30, 2014.

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(o) Contributions and Temporarily and Permanently Restricted Net Assets

Unconditional promises made by donors of cash and other assets are reported at fair value at the date the promise is received. Restricted net assets consist of donations and other funds where restrictions have been imposed by donors as to the use of the funds. Temporarily restricted net assets consist of those net assets whose use by QHS has been limited by donors to a specific purpose or time period. When a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restrictions. Permanently restricted net assets consist of the principal of net assets whose use by QHS has been restricted in perpetuity by the donors. Earnings on permanently restricted net assets are considered unrestricted, unless otherwise restricted by the donor.

(p) Net Patient Service Revenue

Net patient service revenue is recognized, and patient accounts receivable is recorded as services are provided, and are reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors.

Significant concentrations of patient accounts receivable at June 30, 2018 and 2017 included the following:

| | <u>2018</u> | <u>2017</u> |
|------------------------------------|-------------|-------------|
| Medicare | 34 % | 37 % |
| Medicaid | 18 | 15 |
| Hawaii Medical Service Association | 12 | 14 |

Accounts receivable are reduced by allowances for contractually obligated deductions and for doubtful accounts. Allowances are calculated based on recent negotiated reimbursement amounts, actual payments received and historical trends for every payor-source category. Management reviews and updates these calculations monthly. The difference between the standard rates and the amounts actually collected on patient accounts is charged off against these contractual allowances and allowances for doubtful accounts.

The QHS allowance for doubtful accounts was \$52,484 and \$46,930 as of June 30, 2018 and 2017, respectively. The provision for bad debts included in net patient service revenues was \$61,323 and \$50,397 for the years ended June 30, 2018 and 2017, respectively.

(q) Government Reimbursement Programs

QHS renders services to patients under contractual agreements with the Medicare and Medicaid programs. The percentage of patient service revenue attributable to the Medicare and Medicaid programs approximated 43% and 22%, and 42% and 21%, respectively, in 2018 and 2017. Medicare acute inpatient services are reimbursed based on clinical, diagnostic and other factors. Medicaid

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(Dollars in thousands)

inpatient services are reimbursed at a per diem rate for routine services and a per discharge rate for ancillary services. Outpatient services related to Medicare and Medicaid beneficiaries are paid based upon a prospective payment system, fee schedules, percentage of charges or a cost reimbursement method. Prospectively determined reimbursements are paid to QHS based on claims submitted; however, certain items, such as medical education costs, capital costs, bad debts and disproportionate share hospital (DSH) payment adjustments are reimbursed based upon estimated interim rates with final settlement determined after annual cost reports submitted by QHS are audited by the fiscal intermediary.

Estimation differences between final settlements and amounts accrued in previous years due to audit adjustments recorded by the fiscal intermediary are reported as current year increases to revenues and excess of revenues over expenses and amounted to \$1,152 and \$169 for the years ended June 30, 2018 and 2017, respectively. In the year ended June 30, 2017, QHS released \$8,400 of Medicare Disproportionate Share Hospital (DSH) – Supplemental Security Income (SSI) liabilities due to the expiration of post-final settlement reopening windows for several cost report years.

QHS participates in the State of Hawaii Hospital Sustainability Program. Under this program, private hospitals have historically received supplemental payments directly from the State of Hawaii Department of Health. Effective calendar year 2017, supplemental payments are received directly from the Quest Integration plans. These payments are funded by sustainability fees paid by participating hospitals and matching federal funds. Sustainability payments recognized by QHS were \$64,467 and \$40,151, and are reported in net patient service revenues for the years ended June 30, 2018 and 2017, respectively. Sustainability fees paid by QHS were \$31,645 and \$18,569, and are reported in sustainability fees and taxes – other than income taxes for the years ended June 30, 2018 and 2017, respectively. Amounts under this program are subject to annual determination by the State of Hawaii. A similar program has been established for calendar years 2018 and 2019.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is a reasonable probability that recorded estimates will change by a material amount in the near term. QHS believes that it is in compliance with applicable laws and regulations and actively resolves issues as identified. Compliance with such laws and regulations can be subject to future government review and interpretation, and noncompliance could result in significant regulatory action, including fines, penalties and exclusion from the Medicare and Medicaid programs.

(r) Charity Care and Community Benefits

As part of its mission, QHS provides health care services to improve the well-being of the community. QHS provides care to patients who meet certain criteria under its financial assistance policy without charge or at amounts less than its established rates. Because collection of amounts determined to qualify as charity care are not pursued, they are not reported as net patient service revenues.

The estimated cost of these charity care services is determined using a ratio of cost to gross charges and applying that ratio to the gross charges forgone associated with providing care to charity patients for the period. Gross charges associated with providing care to charity patients includes only the related charges for those patients who are financially unable to pay, that qualify under the QHS charity care policy and that do not otherwise qualify for reimbursement from a governmental program. The

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(Dollars in thousands)

estimated costs and expenses incurred to provide charity care were \$2,489 and \$2,664 for the years ended June 30, 2018 and 2017, respectively.

Community Benefits programs include health screenings, health care training, community education through various seminars and classes, medical research, clinic and community services as well as providing for costs in excess of third-party reimbursement. QHS participates in several residency programs and provides a clinical setting in nursing, pharmacy and cardiac fellowship training. Community education classes of health-related topics include women's health, diabetes, child safety, dealing with cancer, cardiology, support groups, glaucoma, weight loss, wellness and pregnancy. QHS operates the Queen Emma Clinic, Dental Clinic and Behavioral Health programs at a loss for the benefit of the community. The Queen's Transplant Center was established to provide access to life saving organ transplantation to the community of Hawaii. The efforts to improve health care in the community are also demonstrated through Native Hawaiian Health program clinical outcomes, health care training, research, access and outreach. QHS continually assesses and develops programs and services focused on the Native Hawaiian community through collaborations with the community.

(s) Rental Revenues

QHS recognizes revenues when delivery has occurred, persuasive evidence of an agreement exists, the fee is fixed or determinable and collectibility is reasonably assured. QHS, as lessor, has entered into certain lease agreements that provide for scheduled rent increases. For such leases, rental income is recognized on a straight-line basis over the terms of the respective leases. The difference between the straight-line amount and the rent received each period is recorded as straight-line rents receivable. Also included in rental revenues are certain percentage rents determined in accordance with the terms of the leases. Rental revenues that are contingent upon the lessee meeting certain pre-determined thresholds are recognized only after the contingency has been resolved (e.g., sales thresholds have been achieved).

(t) Expenses by Functional Classification

Expenses incurred during the years ended June 30, 2018 and 2017 were for the following programs and support services:

| | <u>2018</u> | <u>2017</u> |
|---|---------------------|------------------|
| Patient services | \$ 893,695 | 895,310 |
| Administrative and general | 281,873 | 266,422 |
| Other healthcare-related activities | 115,563 | 105,913 |
| Real property investment and management | <u>26,944</u> | <u>28,746</u> |
| Total | <u>\$ 1,318,075</u> | <u>1,296,391</u> |

(u) Performance Indicator

The QHS performance indicator is the excess of revenues over expenses. The indicator excludes net unrealized gains (losses) on other-than-trading securities, net assets released from restrictions used for capital expenditures, and pension-related changes other than net periodic pension cost.

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(v) Recent Accounting Pronouncements

In November 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2015-17, *Income Taxes (Topic 740)*. To simplify the presentation of deferred income taxes, the standard requires entities to classify all deferred income tax liabilities and assets as noncurrent in the consolidated balance sheet. Historically, deferred tax liabilities and assets have been classified as current or noncurrent based on the classification of the related asset or liability for financial reporting. The standard is effective for the QHS's fiscal year ended June 30, 2018 and has been applied retrospectively to all periods presented.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers*. This guidance will enhance the comparability of revenue recognition practices and will be applied to all contracts with customers. Expanded disclosures related to the nature, amount, timing, and uncertainty of revenue that is recognized are requirements under the amended guidance. This guidance will be effective for the QHS's fiscal year ending June 30, 2019 and may be applied retrospectively. Management does not expect this new standard to significantly change the timing of revenue recognition, but new disclosures will be required.

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments – Overall (Subtopic 825-10)*. The guidance requires entities to measure equity investments that are not accounted for under the equity method or do not result in consolidation to be recorded at fair value and recognize any changes in fair value to excess of revenue over expenses. This guidance will be effective for the QHS's fiscal year ending June 30, 2020. The guidance requires the use of the cumulative effect transition method, except for equity securities without readily determinable fair values, for which the standard requires the application of the prospective transition method. QHS is currently evaluating the impact of adopting this guidance on the consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, *Leases*. ASU No. 2016-02 amends the FASB Accounting Standards Codification and created Topic 842, *Leases*. Under Topic 842, lessees are required to recognize assets and liabilities on the balance sheet for most leases and provides for enhanced disclosures. Leases will continue to be classified as either finance or operating. This guidance will be effective for the QHS's fiscal year ending June 30, 2020. QHS is currently evaluating the impact of the adoption of this standard on the consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*. This guidance reduces the number of net asset classes presented on the balance sheet from three to two; requires presentation of expenses by their functional and natural classification in one location in the financial statements; and requires quantitative and qualitative information about management of liquid resources and availability of financial assets to meet cash needs within one year of the balance sheet date. This guidance will be effective for the QHS's fiscal year ending June 30, 2019. QHS is currently evaluating the impact of adopting this guidance on the consolidated financial statements.

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(2) Investments and Assets Whose Use is Limited or Restricted and Fair Value Measurements

Investments including assets whose use is limited or restricted at June 30, 2018 and 2017 were as follows:

| | <u>2018</u> | <u>2017</u> |
|--|---------------------|---------------------|
| Investments at fair value: | | |
| Mutual funds | \$ 285,252 | 301,667 |
| Debt securities | 164,534 | 167,713 |
| Money market funds | 100,496 | 89,830 |
| Equity securities | <u>92,342</u> | <u>75,449</u> |
| Total investments at fair value | <u>642,624</u> | <u>634,659</u> |
| Investments using equity method: | | |
| Common trust funds | 561,430 | 506,921 |
| Private equities and other limited partnerships | <u>165,681</u> | <u>153,185</u> |
| Total investments using equity method | <u>727,111</u> | <u>660,106</u> |
| Total investments and assets whose use is limited or restricted | \$ <u>1,369,735</u> | \$ <u>1,294,765</u> |

Common trust funds, private equities and other limited partnerships consist of hedge fund, real asset, and private equity pools which include but are not limited to both direct and commodity linked equities, public real estate, infrastructure investments, innovation, early state, venture growth, restructurings/distressed equity and buyouts. Ownership percentages range from less than 1% to 22%.

At June 30, 2018, QHS was committed to invest approximately \$59,153 of additional capital in various private equity investments.

The classification of investments in the consolidated balance sheets as of June 30, 2018 and 2017 was as follows:

| | <u>2018</u> | <u>2017</u> |
|--|--------------------|--------------------|
| Total investments | \$ 1,369,735 | 1,294,765 |
| Less assets whose use is limited or restricted | <u>(69,426)</u> | <u>(77,693)</u> |
| Total unrestricted investments | 1,300,309 | 1,217,072 |
| Less current portion | <u>(1,212,017)</u> | <u>(1,145,999)</u> |
| Noncurrent portion | \$ <u>88,292</u> | \$ <u>71,073</u> |

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Assets whose use is limited or restricted at June 30, 2018 and 2017 consisted of the following:

| | <u>2018</u> | <u>2017</u> |
|---|------------------|-----------------|
| Money market funds | \$ 49,272 | 57,404 |
| Investments | <u>20,154</u> | <u>20,289</u> |
| Total assets whose use is limited or restricted | 69,426 | 77,693 |
| Less current portion | <u>(16,063)</u> | <u>(14,116)</u> |
| Noncurrent portion | <u>\$ 53,363</u> | <u>63,577</u> |

QHS maximizes the use of observable inputs and minimizes the use of unobservable inputs when measuring fair value. The hierarchy places the highest priority on unadjusted quoted market prices in active markets for identical assets or liabilities (Level 1 measurements) and assigns the lowest priority to unobservable inputs (Level 3 measurements). The three levels of inputs within the hierarchy are defined as follows:

Level 1 – Quoted (unadjusted) prices for identical assets or liabilities in active markets

Level 2 – Other observable inputs, either directly or indirectly, including:

- Quoted prices for similar assets or liabilities in active markets
- Quoted prices for identical or similar assets in nonactive markets (few transactions, limited information, noncurrent prices, high variability over time, etc.)
- Inputs other-than-quoted prices that are observable for the asset (interest rates, yield curves, volatilities, default rates, etc.)
- Inputs that are derived principally from or corroborated by other observable market data

Level 3 – Unobservable inputs that cannot be corroborated by observable market data

Fair values of other-than-trading and trading securities are based on quoted market prices, where available. The custodian obtains one price for each security primarily from a third-party pricing service (pricing service), which generally uses Level 1 or Level 2 inputs for the determination of fair value. The pricing service normally derives the security prices from recently reported trades for identical or similar securities, making adjustments through the reporting date based upon available observable market information. In the absence of a vendor, system trade/cost, or broker price for debt instruments, the pricing staff will price the security using the investment manager's price or last known price. As QHS is responsible for the determination of fair value, it performs periodic analyses on the prices received from the pricing service to determine whether the prices are reasonable estimates of fair value. As a result of the reviews, QHS has not historically adjusted the prices obtained from the pricing service.

In the instances in which the inputs used to measure the fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest-level input that is

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significant to the fair value measurement in its entirety. The assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset.

QHS targets an investment mix in cash and cash equivalents, fixed income securities, equity securities, real assets, and private equities. The QHS investment strategy is to generate a return that is sufficient to meet its current and expected future financial requirements, with an acceptable level of risk. QHS has engaged a number of investment managers to implement various investment strategies to achieve the desired asset class mix, liquidity, and risk diversification objectives.

There were no reclassifications between Level 1 and Level 2 investments in 2018 and 2017.

The following tables present information about the fair value of the QHS financial instruments as of June 30, 2018 and 2017, according to the valuation techniques QHS used to determine their fair values:

| | Fair value measurements at June 30, 2018 | | | |
|---|---|----------------|----------------|--------------|
| | Level 1 | Level 2 | Level 3 | Total |
| Assets: | | | | |
| Cash and cash equivalents – money market funds | \$ 25,446 | — | — | 25,446 |
| Investments and assets whose use is limited or restricted: | | | | |
| Trading securities: | | | | |
| Money market funds | 51,146 | — | — | 51,146 |
| Debt securities | 26,673 | 137,861 | — | 164,534 |
| Equity securities – Domestic mid-cap | 92,342 | — | — | 92,342 |
| Mutual funds – fixed income | 106,531 | — | — | 106,531 |
| Total trading securities | 276,692 | 137,861 | — | 414,553 |
| Other-than-trading securities: | | | | |
| Money market funds | 49,350 | — | — | 49,350 |
| Mutual funds: | | | | |
| Mid-cap equities | 82,799 | — | — | 82,799 |
| Real assets | 71,084 | — | — | 71,084 |
| International equities | 24,838 | — | — | 24,838 |
| Total other-than-trading securities | 228,071 | — | — | 228,071 |
| Total investments and assets whose use is limited or restricted | \$ 504,763 | 137,861 | — | 642,624 |
| Liabilities: | | | | |
| Other long-term liabilities – interest rate swap liabilities | \$ — | 10,947 | — | 10,947 |

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| | Fair value measurements at June 30, 2017 | | | |
|---|--|---------|---------|---------|
| | Level 1 | Level 2 | Level 3 | Total |
| Assets: | | | | |
| Cash and cash equivalents – money market funds | \$ 17,869 | — | — | 17,869 |
| Investments and assets whose use is limited or restricted: | | | | |
| Trading securities: | | | | |
| Money market funds | 32,352 | — | — | 32,352 |
| Debt securities | 37,806 | 129,907 | — | 167,713 |
| Equity securities – Domestic mid-cap | 75,449 | — | — | 75,449 |
| Mutual funds – fixed income | 114,331 | — | — | 114,331 |
| Total trading securities | 259,938 | 129,907 | — | 389,845 |
| Other-than-trading securities: | | | | |
| Money market funds | 57,478 | — | — | 57,478 |
| Mutual funds: | | | | |
| Mid-cap equities | 72,451 | — | — | 72,451 |
| Real assets | 70,074 | — | — | 70,074 |
| International equities | 44,811 | — | — | 44,811 |
| Total other-than-trading securities | 244,814 | — | — | 244,814 |
| Total investments and assets whose use is limited or restricted | \$ 504,752 | 129,907 | — | 634,659 |
| Liabilities: | | | | |
| Other long-term liabilities – interest rate swap liabilities | \$ — | 17,141 | — | 17,141 |

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

Money Market Funds – Fair value estimates for money market funds are based on observed transactions.

Debt Securities – This category includes investments in U.S. government, corporate, and other bond securities, U.S. dollar and non-U.S. dollar-denominated securities, and money market instruments. The estimated fair values of U.S. government obligations, corporate, and other debt securities are based on quoted market prices and/or other market data for the same or comparable instruments and transactions in

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establishing prices. Due to the nature of pricing fixed income securities, management has classified the debt securities as Levels 1 and 2.

Equity Securities – This category includes investments in both domestic equity securities of large-cap and mid-cap companies as well as domestic and foreign equities in developed and developing countries. Fair value estimates for publicly traded securities are based on quoted market prices.

Mutual Funds – This category includes investments in domestic, international equities and bonds, and commodities. The estimated fair value of mutual funds is based on quoted market prices.

Interest Rate Swap Liabilities – The fair values of interest rate swaps are estimated using the terms of the swaps and publicly available market yield curves. Because the swaps are unique and are not actively traded, the fair values are classified as Level 2 estimates.

Investments and assets whose use is limited or restricted classified as other-than-trading securities at June 30, 2018 and 2017 consisted of the following:

| | <u>Cost</u> | <u>Gross unrealized gains</u> | <u>Gross unrealized losses</u> | <u>Fair value</u> |
|--------------------|--------------------------|---------------------------------------|--|-----------------------|
| 2018: | | | | |
| Money market funds | \$ 49,350 | — | — | 49,350 |
| Mutual funds | <u>155,509</u> | <u>26,243</u> | <u>(3,031)</u> | <u>178,721</u> |
| Total investments | \$ <u><u>204,859</u></u> | <u><u>26,243</u></u> | <u><u>(3,031)</u></u> | <u><u>228,071</u></u> |
| 2017: | | | | |
| Money market funds | \$ 57,478 | — | — | 57,478 |
| Mutual funds | <u>166,912</u> | <u>23,091</u> | <u>(2,667)</u> | <u>187,336</u> |
| Total investments | \$ <u><u>224,390</u></u> | <u><u>23,091</u></u> | <u><u>(2,667)</u></u> | <u><u>244,814</u></u> |

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The total return on the investment portfolios for the years ended June 30, 2018 and 2017 was comprised of the following:

| | <u>2018</u> | <u>2017</u> |
|--|-------------------|----------------|
| Total investment income, net: | | |
| Interest and dividend income | \$ 15,005 | 10,674 |
| Realized gain – net of expenses | 8,225 | 14,034 |
| Unrealized gain on trading securities | 12,171 | 1,665 |
| Equity in earnings of limited liability entities | <u>65,763</u> | <u>101,284</u> |
| Total unrestricted investment income, net | \$ <u>101,164</u> | <u>127,657</u> |
| Other changes in unrestricted net assets – net unrealized gain on unrestricted investments | \$ 2,751 | 16,705 |
| Other changes in temporarily restricted net assets: | | |
| Investment gain | 290 | 813 |
| Net unrealized gain on investments | <u>892</u> | <u>754</u> |
| Total temporarily restricted investment gain, net | \$ <u>1,182</u> | <u>1,567</u> |

For the years ended June 30, 2018 and 2017, gross proceeds from sales of other-than-trading investments were \$25,000 and \$14,000, resulting in gross realized gains of \$3,694 and \$4,104, respectively. QHS uses the average cost method to determine the cost basis for securities sold.

(3) Land, Buildings, and Equipment

Land, buildings, and equipment at June 30, 2018 and 2017 consisted of the following:

| | <u>2018</u> | <u>2017</u> |
|--|-------------------|------------------|
| Land and land improvements | \$ 106,298 | 105,897 |
| Buildings and leasehold improvements | 549,890 | 540,288 |
| Equipment and furnishings | 792,607 | 725,146 |
| Equipment under capital leases | 8,515 | 2,365 |
| Construction in progress | <u>47,584</u> | <u>76,881</u> |
| Total | 1,504,894 | 1,450,577 |
| Less accumulated depreciation and amortization | <u>(861,586)</u> | <u>(794,023)</u> |
| Land, buildings, and equipment, net | \$ <u>643,308</u> | <u>656,554</u> |

Depreciation and amortization expense was \$72,880 and \$62,772 for the years ended June 30, 2018 and 2017, respectively.

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(4) Debt

Debt at June 30, 2018 and 2017 consisted of the following:

| | <u>2018</u> | <u>2017</u> |
|---|-------------------|------------------|
| Special Purpose Revenue Bonds 2015 Series A, serial and term, fixed interest rates ranging from 3.00% to 5.00%, with final maturity in July 2040, including unamortized bond premium at June 30, 2018 and 2017 of \$21,259 and \$23,586, respectively | \$ 219,119 | 225,831 |
| Special Purpose Revenue Bonds 2015 Series B, windows rate mode, variable interest rate (average interest rate of 1.58% in 2018 and 1.12% in 2017), final maturity in July 2039 | 52,320 | 54,815 |
| Special Purpose Revenue Bonds 2015 Series C, windows rate mode, variable interest rate (average interest rate of 1.58% in 2018 and 1.12% in 2017), final maturity in July 2039 | 52,320 | 54,815 |
| Special Purpose Revenue Bonds 2015 Series D, fixed interest rate of 4.464%, with final maturity in July 2045 | 80,110 | 80,110 |
| Loan agreement with bank, variable interest rate (average interest rate of 2.39% in 2018 and 1.44% in 2017), with final maturity in January 2025 | 75,000 | 75,000 |
| Capital lease and other obligations | 4,533 | 11 |
| Deferred financing fees | <u>(4,815)</u> | <u>(4,923)</u> |
| Total | 478,587 | 485,659 |
| Less current portion | (10,562) | (9,386) |
| Less long-term debt subject to short-term remarketing arrangements and associated deferred financing fees | <u>(98,487)</u> | <u>(103,380)</u> |
| Total noncurrent portion | \$ <u>369,538</u> | <u>372,893</u> |

The Series 2015A Bonds are tax-exempt serial and term bonds with fixed interest rates. Interest is paid semi-annually. The Series 2015A serial bonds mature annually through 2030, with principal payments ranging from \$4,385 to \$10,020. The serial bonds maturing on or after July 1, 2026 are subject to optional redemption on or after July 1, 2025 at a redemption price equal to 100% of the principal amount being redeemed plus accrued interest to the redemption date. The Series 2015A term bonds mature on July 1, 2035 and 2040, with principal payments of \$60,105 and \$45,705, respectively. The bonds maturing on July 1, 2035, have five annual mandatory sinking fund installments ranging from \$10,645 to \$13,465, commencing July 1, 2031. The bonds maturing on July 1, 2040, have five annual mandatory sinking fund installments ranging from \$5,000 to \$15,290, commencing July 1, 2036.

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The Series 2015B and 2015C Bonds are tax-exempt variable interest rate, initially windows rate mode bonds. Windows rate interest is paid monthly and calculated based on the windows rate spread plus each weekly Securities Industry & Financial Markets Association (SIFMA) index. The bonds are redeemed by application of sinking fund installments ranging from \$4,410 to \$4,990 through July 2039. The Obligated Group has several options of variable interest rate conversions and the option to redeem the bonds prior to their stated maturity date of July 1, 2039.

While in the windows rate mode, the holders of the Series 2015B and 2015C Bonds have the option to tender the bonds for redemption. Once tendered, the remarketing agent has 30 days to identify a purchaser for the bonds. In the event of a failed remarketing, the Obligated Group has the following options during the funding window (day 31 through day 210): call the bonds and issue refunding bonds, convert the bonds to another interest rate mode, remarket the bonds with a revised windows rate spread, or use available funds to redeem the bonds.

The Series 2015D Bonds are taxable bonds with a fixed interest rate. Interest is paid semi-annually and principal is due on July 1, 2045. The bonds are subject to earlier redemption at the option of the Obligated Group, at a make-whole redemption price, determined by an independent accounting firm or financial advisor, plus accrued interest to the redemption date.

The bank loan bears a variable interest rate, either a base or LIBOR rate option, for up to five tranches. Interest is payable monthly or every 90 days, depending on the option. Principal is due on January 29, 2025 and may be prepaid with prior written notice.

The Obligated Group maintains interest rate swap agreements whereby the Obligated Group pays fixed interest rates to counterparties. The interest rate differential paid or received is recognized during the term of the agreements. The interest rate swap agreements expire in the years 2024 through 2029, or earlier if the Obligated Group exercises early termination provisions. At June 30, 2018, the notional swap amounts were \$73,465, \$41,900, and \$28,250. The notional amounts decrease annually based on the originally scheduled principal payments of the respective refunded bond series.

During the years ended June 30, 2018 and 2017, the change in the fair value of the liabilities associated with the swap agreements discussed above resulted in gains of \$6,194 and \$9,568, respectively, which were recognized in nonoperating income. The fair value of liabilities associated with the swaps as of June 30, 2018 and 2017 was \$10,947 and \$17,141, respectively, and was included in other long-term liabilities.

The Series 2015A, 2015B, 2015C, and 2015D Bonds, bank loan and interest rate swap agreements are secured under a Master Trust Indenture (MTI). The gross revenues of the Obligated Group are pledged as security for the obligations. The MTI limits the ability of the Obligated Group to incur additional indebtedness, make certain other commitments or dispose of certain assets. A minimum debt service coverage ratio must be maintained.

QHS incurred total interest costs of \$18,034 and \$17,866 during 2018 and 2017, respectively, of which \$559 and \$773 was capitalized in construction in progress in 2018 and 2017, respectively.

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At June 30, 2018, contractually stated debt maturities are as follows:

| | Revenue bonds and bank loan | Capital leases and other obligations | Total |
|------------------------------|--|---|----------------|
| Year ending June 30: | | | |
| 2019 | \$ 9,600 | 962 | 10,562 |
| 2020 | 9,885 | 991 | 10,876 |
| 2021 | 10,180 | 1,020 | 11,200 |
| 2022 | 10,560 | 1,050 | 11,610 |
| 2023 | 10,935 | 510 | 11,445 |
| Thereafter | <u>406,450</u> | <u>—</u> | <u>406,450</u> |
| Long-term debt payments | 457,610 | 4,533 | 462,143 |
| Plus net unamortized premium | 21,259 | — | 21,259 |
| Less deferred financing fees | <u>(4,815)</u> | <u>—</u> | <u>(4,815)</u> |
| Total | \$ <u>474,054</u> | <u>4,533</u> | <u>478,587</u> |

Series 2015B and 2015C variable rate demand obligations, while subject to long-term amortization periods, may be put at the option of the bondholders in the event of a failed bond remarketing. To the extent that bondholders may, under terms of the debt, put their bonds back to QHS and the repayment terms could be due within one year, the principal amount of such bonds has been classified as a current liability in the consolidated balance sheets. QHS has taken steps to provide various sources of liquidity in the event the bonds fail to remarket, including identifying alternate sources of financing and maintaining internally designated assets as a source of self-liquidity.

The estimated fair value of the fixed interest rate bonds with an aggregate carrying value of \$299,229 was \$296,287 at June 30, 2018. The estimated fair value of the fixed interest rate bonds with an aggregate carrying value of \$305,941 was \$306,050 at June 30, 2017. The carrying values of the variable interest rate bonds, bank loans and capital leases approximated their fair values at June 30, 2018 and 2017. The fair value of these debt instruments is deemed a Level 2 measurement.

At June 30, 2018, QHS has a \$1,000 standby letter of credit related to QHS's self-insured workers' compensation program.

QHS has entered into an agreement with a lender for an unsecured revolving line of credit facility in the maximum principal amount of \$25,000 expiring July 1, 2023, to be made available to QHS for general corporate purposes. The revolving line of credit facility bears a variable interest rate, either a prime or LIBOR rate option. Interest is payable quarterly in arrears if a prime rate is selected or at the end of each LIBOR period not to exceed a three-month period if a LIBOR rate is selected. There were no outstanding borrowings under the credit facility at June 30, 2018.

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(5) Self-Insurance Programs

(a) *General and Professional Liability Reserve*

QHS maintains a funded self-insurance program for its general and professional liability exposure. This self-insured program is funded through QIE. Premiums are determined based on the QHS loss experience, as well as insurance industry data.

QHS recorded a reserve for losses and loss adjustment expenses for the estimated reported and unreported losses incurred through June 30, 2018 and 2017. The reserve for unpaid losses and loss adjustment expenses was determined by QHS using estimates from independent consulting actuaries, based on industry and hospital-specific data. The general and professional liability reserve was \$20,073 and \$16,617 at June 30, 2018 and 2017, respectively, and was recorded in other long-term liabilities at June 30, 2018 and 2017.

QHS has excess general and professional insurance coverage through reinsurance agreements with unrelated insurers for amounts exceeding \$2,000 per occurrence. The reinsurance agreements do not relieve QHS from its obligations should the third-party reinsurers not be able to meet the obligations assumed under the reinsurance agreements.

(b) *Workers' Compensation Reserve*

QHS is self-insured for workers' compensation losses up to \$400 per occurrence. Losses above this amount are insured with an independent excess carrier. QHS had workers' compensation reserves of \$7,272 and \$6,601 at June 30, 2018 and 2017, respectively, and was included in other current liabilities at June 30, 2018 and 2017.

(c) *Medical Reserve*

QHS has a self-funded medical benefits plan covering substantially all of its employees. The medical reserve was \$8,970 and \$7,418 at June 30, 2018 and 2017, respectively, and was included in other current liabilities at June 30, 2018 and 2017.

(6) Restricted Net Assets

Temporarily restricted net assets at June 30, 2018 and 2017 were available for the following purposes:

| | <u>2018</u> | <u>2017</u> |
|------------------------------------|------------------|---------------|
| Education and research | \$ 2,397 | 4,252 |
| Indigent care and other | 9,974 | 10,002 |
| Facility replacement and expansion | <u>9,789</u> | <u>7,949</u> |
| Total | <u>\$ 22,160</u> | <u>22,203</u> |

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Permanently restricted net assets at June 30, 2018 and 2017 were restricted to investment in perpetuity, the income from which is expendable to support the following purposes:

| | <u>2018</u> | <u>2017</u> |
|---|-------------------|----------------|
| Indigent care | \$ 3,787 | 3,787 |
| Education and research | 1,334 | 1,334 |
| Restricted for NHCH hospital operations | 109,175 | 108,517 |
| Other | <u>830</u> | <u>830</u> |
| Total | <u>\$ 115,126</u> | <u>114,468</u> |

The net assets restricted for NHCH hospital operations relate to a beneficial interest in a trust. QHS expects to receive periodic distributions from the trust to support NHCH's operations. According to the terms of the trust agreement, annual distributions shall not exceed 5% of the principal balance allocable to each beneficiary.

In accordance with the Uniform Prudent Management Institutional Funds Act (UPMIFA), QHS considers only permanently restricted net assets as donor-restricted endowment funds. In accordance with UPMIFA and when applicable, QHS considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds: a) the duration and preservation of the fund, b) the purposes of QHS and the endowment fund, c) general economic conditions, d) the possible effect of inflation and deflation, e) the expected total return from income and the appreciation of investments, f) other resources of QHS, and g) the investment policies of QHS. Amounts relating to investment income, net appreciation/depreciation and amounts appropriated for expenditure were not material during 2018 and 2017.

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor requires QHS to retain as a fund of perpetual duration. Deficiencies of this nature are reported as adjustments in unrestricted net assets.

(7) Employee Benefit Plans

Eligible employees of QHS are covered by The Queen's Health Systems Pension Plan (the Plan), which is a noncontributory defined benefit pension plan. Pension benefits are provided to participants under several types of retirement options based upon years of continuous service, age, and compensation. Retirement benefits are paid to pensioners or beneficiaries in various forms of joint and survivor annuities, including a lump-sum payment option. The funding policy is to contribute amounts as deemed necessary on an actuarial basis to provide assets sufficient to meet the benefits to be paid to Plan members.

QHS has three unfunded postretirement welfare plans, covering substantially all of its employees, that provide medical benefits (until age 65), drug and vision benefits, and life insurance benefits. The postretirement medical and drug and vision plans are contributory and also contain other cost-sharing features, such as deductibles and coinsurance.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

The changes in benefit obligations, changes in plan assets, and funded status of the pension and postretirement plans with the amounts recognized in the consolidated balance sheets as of June 30, 2018 and 2017 were as follows:

| | Pension benefits | | Other postretirement benefits | |
|---|-------------------------|-------------|--|-------------|
| | 2018 | 2017 | 2018 | 2017 |
| Change in benefit obligations: | | | | |
| Benefit obligations – | | | | |
| beginning of year | \$ 466,854 | 468,287 | 44,151 | 43,271 |
| Service cost | 21,013 | 19,081 | 1,798 | 1,720 |
| Interest cost | 16,130 | 14,972 | 1,569 | 1,421 |
| Actuarial gain | (16,444) | (21,055) | (2,093) | (1,349) |
| Benefits paid | (19,950) | (14,431) | (1,068) | (912) |
| Benefit obligation – end of year | 467,603 | 466,854 | 44,357 | 44,151 |
| Change in plan assets: | | | | |
| Fair value of plan assets – | | | | |
| beginning of year | 289,951 | 262,439 | — | — |
| Actual return on plan assets | 20,632 | 23,713 | — | — |
| Employer contributions | 57,721 | 18,230 | 1,068 | 912 |
| Benefits paid | (19,950) | (14,431) | (1,068) | (912) |
| Fair value of plan assets – end of year | 348,354 | 289,951 | — | — |
| Funded status | \$ (119,249) | (176,903) | (44,357) | (44,151) |
| Amounts recognized in the consolidated balance sheets consisted of: | | | | |
| Other current liabilities | \$ — | — | (1,313) | (1,211) |
| Pension and other postretirement benefits | (119,249) | (176,903) | (43,044) | (42,940) |
| Net amounts recognized | \$ (119,249) | (176,903) | (44,357) | (44,151) |

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

Amounts recognized in unrestricted net assets at June 30, 2018 and 2017 were as follows:

| | Pension benefits | | Other postretirement benefits | |
|-----------------------------|-------------------------|----------------|--|--------------|
| | <u>2018</u> | <u>2017</u> | <u>2018</u> | <u>2017</u> |
| Prior service (credit) cost | \$ (7,008) | (7,951) | 71 | 162 |
| Net loss | <u>113,907</u> | <u>137,518</u> | <u>4,758</u> | <u>7,049</u> |
| Total | \$ <u>106,899</u> | <u>129,567</u> | <u>4,829</u> | <u>7,211</u> |

Amounts recognized in unrestricted net assets at June 30, 2018 that are expected to be recognized as components of benefit cost in the year ending June 30, 2019 are as follows:

| | Pension benefits | | Other postretirement benefits | |
|---|-------------------------|-----------------|--|----------------|
| | <u>2018</u> | <u>2017</u> | <u>2018</u> | <u>2017</u> |
| Other changes in plan assets and benefit obligations recognized in other changes in unrestricted net assets: | | | | |
| Net actuarial gain | \$ (14,342) | (26,256) | (2,093) | (1,349) |
| Prior service cost | 943 | 943 | (91) | (141) |
| Recognized loss | <u>(9,269)</u> | <u>(12,602)</u> | <u>(198)</u> | <u>(332)</u> |
| Total recognized in other changes in unrestricted net assets | \$ <u>(22,668)</u> | <u>(37,915)</u> | <u>(2,382)</u> | <u>(1,822)</u> |

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

Components of net periodic pension cost and amounts recognized in other changes in unrestricted net assets, but not yet included in net periodic benefit costs were as follows:

| | Pension benefits | | Other postretirement benefits | |
|------------------------------------|-------------------------|---------------|--|--------------|
| | 2018 | 2017 | 2018 | 2017 |
| Net periodic pension costs: | | | | |
| Service cost | \$ 21,013 | 19,081 | 1,798 | 1,720 |
| Interest cost | 16,130 | 14,972 | 1,569 | 1,421 |
| Expected return on plan assets | (22,734) | (18,513) | — | — |
| Amortization of prior service cost | (943) | (943) | 91 | 141 |
| Recognized net actuarial loss | 9,269 | 12,602 | 198 | 332 |
| Net periodic pension costs | \$ <u>22,735</u> | <u>27,199</u> | <u>3,656</u> | <u>3,614</u> |

Weighted average assumptions used to determine benefit obligations and net periodic benefit cost at June 30, 2018 and 2017 were as follows:

| | Pension benefits | | Other postretirement benefits | |
|--------------------------------|-------------------------|-------------|--|-------------|
| | 2018 | 2017 | 2018 | 2017 |
| Benefit obligation: | | | | |
| Discount rate | 4.18 % | 4.07 % | 4.18 % | 4.07 % |
| Rate of compensation increase | 3.25 | 3.25 | — | — |
| Net periodic benefit cost: | | | | |
| Discount rate | 4.07 | 4.02 | 4.07 | 4.01 |
| Discount rate - service cost | 4.23 | 4.24 | 4.23 | 4.22 |
| Discount rate - interest cost | 3.53 | 3.26 | 3.60 | 3.33 |
| Expected return on plan assets | 7.00 | 7.00 | — | — |
| Rate of compensation increase | 3.25 | 3.25 | — | — |

The accumulated benefit obligation for the Plan was \$416,070 and \$421,354 at June 30, 2018 and 2017, respectively.

The long-term rate of return of the Plan is management's estimate of the return on the plan assets over a long-time horizon. Based upon the current policy allocations and historical returns, the expected long-term rate of return for fiscal year 2018 was 7.0%. The expected long-term rate of return for fiscal year 2019 will be 6.5%.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

The annual rate of increase in the per capita cost of medical benefits (i.e., health care cost trend rate) was assumed to be 6.75% in 2018, declining by 0.25% to 0.50% per year through 2025, and then remaining at 4.5% thereafter. A one-percentage point increase or decrease in this rate would increase or decrease the Plan's accumulated postretirement benefit obligation by \$232 and \$197, respectively, as of June 30, 2018, and the Plan's service cost and interest cost component of net periodic postretirement benefit cost for the year ended June 30, 2018, by \$34 and \$32, respectively. QHS anticipates making contributions of \$65,200 to the pension plan and \$1,340 to the postretirement benefit plan during fiscal year 2019. The future estimated benefit payments for each plan are as follows:

| | <u>Pension benefits</u> | <u>Other postretirement benefits</u> |
|----------------------|-----------------------------|--|
| Year ending June 30: | | |
| 2019 | \$ 21,650 | 1,340 |
| 2020 | 21,806 | 1,542 |
| 2021 | 23,013 | 1,735 |
| 2022 | 23,893 | 1,919 |
| 2023 | 24,839 | 2,101 |
| 2024–2028 | 140,021 | 12,890 |

The primary objective of the Plan investments is to prudently fund the liabilities for benefits under the Plan. The Plan's investment strategy is to structure an investment program that most efficiently matches investment risks and return characteristics with the Plan's objectives. Volatility and uncertainty of investment results are managed through asset allocation and diversification. The Plan's investment policy permits investments in cash and cash equivalents, fixed income securities, equity securities, real return assets, tactical assets, hedge funds, and private equities. The Plan's asset allocation at June 30, 2018 and 2017, and the target allocations were as follows:

| | <u>Target range</u> | <u>2018 actual</u> | <u>2017 actual</u> |
|--------------------------------|---------------------|------------------------|------------------------|
| Cash and cash equivalents | —% | 2.2 % | 3.4 % |
| Fixed income securities (a) | 26–36 | 28.7 | 29.0 |
| Domestic equities (b) | 3–22 | 24.9 | 25.1 |
| Real return investments (c) | 3–12 | 8.5 | 8.8 |
| Hedge fund investments (d) | 6–14 | 8.9 | 9.3 |
| Private equity investments (e) | 3–11 | 5.4 | 4.1 |
| International equities (f) | 16–24 | 21.4 | 20.3 |
| Total | | <u>100.0 %</u> | <u>100.0 %</u> |

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

- (a) This category includes investments in U.S. government and corporate bond securities, mortgage and other asset-backed securities, U.S. dollar and non-U.S. dollar-denominated securities, and money market instruments.
- (b) This category includes investments primarily in domestic equity securities of large-cap and mid-cap companies.
- (c) This category includes investments in real estate, inflation protected bonds, global equities, and commodities.
- (d) This category includes investments in direct hedge funds or hedge funds of funds that employ various strategies, consisting of, but not limited to, long/short equity, opportunistic/macro, distressed securities, merger arbitrage/event driven, short selling, credit investing, real estate, restructuring, and value strategies.
- (e) This category includes, but is not limited to, equity securities and equity-related investments, purchase or provision of subordinated debt securities/loans, and mezzanine investments.
- (f) This category includes investments in non-U.S. companies.

The following tables present information about the fair value of the QHS pension plan assets as of June 30, 2018 and 2017, according to the valuation techniques QHS used to determine their fair values:

| Asset category | Fair value measurements at June 30, 2018 | | | |
|---|---|----------------|----------------|----------------|
| | Level 1 | Level 2 | Level 3 | Total |
| Cash and cash equivalents, primarily money market funds | \$ 7,725 | — | — | 7,725 |
| Mutual funds: | | | | |
| Fixed income | — | — | — | — |
| Domestic equities | 11,914 | — | — | 11,914 |
| Real assets | 12,468 | — | — | 12,468 |
| Domestic debt securities | 15,980 | 41,984 | — | 57,964 |
| Domestic equity securities | 13,285 | — | — | 13,285 |
| Total | \$ 61,372 | 41,984 | — | 103,356 |

Equity method investments of \$244,998 are excluded from the table above.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

| <u>Asset category</u> | <u>Fair value measurements at June 30, 2017</u> | | | |
|---|---|----------------|----------------|--------------|
| | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Total</u> |
| Cash and cash equivalents, primarily money market funds | \$ 6,445 | — | — | 6,445 |
| Mutual funds: | | | | |
| Fixed income | 1,810 | — | — | 1,810 |
| Domestic equities | 10,371 | — | — | 10,371 |
| Real assets | 11,960 | — | — | 11,960 |
| Domestic debt securities | 25,318 | 27,623 | — | 52,941 |
| Domestic equity securities | 10,275 | — | — | 10,275 |
| Total | \$ 66,179 | 27,623 | — | 93,802 |

Equity method investments of \$196,149 are excluded from the table above.

There were no reclassifications between Level 1 and Level 2 investments in 2018 and 2017.

See note 2 for the definition of the three levels within the fair value hierarchy and the methods and assumptions used to estimate the fair value of cash and cash equivalents, money market funds, mutual funds, equity securities, and debt securities. Real return, hedge funds, and private equity investments are valued at estimated fair values using certain factors, including their proportionate share of the respective entities' fair value as recorded in the respective entities' financial statements.

Certain executives participate in a nonqualified, unfunded pension plan. At June 30, 2018 and 2017, the benefit liability related to this plan was \$542 and \$924, respectively. Benefit expense related to this plan was \$183 and \$162 for the years ended June 30, 2018 and 2017, respectively.

Certain key executives are covered by a nonqualified, unfunded supplemental executive retirement plan. At June 30, 2018 and 2017, the benefit liability related to this plan was \$3,435 and \$3,747, respectively. Benefit expense related to this plan was \$189 and \$179 for the years ended June 30, 2018 and 2017, respectively.

QHS has defined contribution retirement plans (the Retirement Plans) that cover substantially all employees and provide participants the ability to make pretax deduction contributions for deposit into retirement savings accounts. The participants' contributions are matched at a percentage of their total contributions and up to annual dollar limits per participant as defined by the Retirement Plans. The QHS expense relating to the Retirement Plans was approximately \$17,822 and \$16,370 for the years ended June 30, 2018 and 2017, respectively.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

(8) Income Taxes

QIE, QDC, and DLS are subject to federal and state income taxes. At June 30, 2018, these companies had operating loss carryforwards for income tax purposes of approximately \$14,453 that expire through 2027. At June 30, 2018, QHS had net operating loss carryforwards of \$3,507 related to its unrelated business income. The net operating loss carryforwards expire through 2037.

In December 2017, the U.S. government enacted comprehensive tax legislation, the Tax Cuts and Jobs Act (the Act), which significantly revises the ongoing U.S. corporate income tax law by lowering the U.S. federal corporate income tax rate from 35% to 21%, implementing a territorial tax system and setting limitations on deductibility of certain costs (e.g., interest expense and executive compensation), among other things. QIE, QDC and DLS accounted for the effects of the Act in fiscal year 2018.

The components of income tax expense for the years ended June 30, 2018 and 2017 were as follows:

| | <u>2018</u> | <u>2017</u> |
|---------------------------------------|-----------------|--------------|
| Current income tax expense | \$ 1,749 | 3,660 |
| Deferred income tax expense (benefit) | <u>2,635</u> | <u>(209)</u> |
| Total | <u>\$ 4,384</u> | <u>3,451</u> |

For the years ended June 30, 2018 and 2017, the effective tax rate differed from the statutory rate primarily due to tax credits, the impact from the change in the federal income tax rate and a valuation allowance established for net operating losses and foreign tax credits of QDC.

At June 30, 2018 and 2017, deferred income tax assets and liabilities resulted principally from operating loss carryforwards and from temporary differences for fixed assets, intangible assets, allowance for uncollectible accounts, pension costs, and accrued vacation. Deferred income tax assets and liabilities as of June 30, 2018 and 2017 were as follows:

| | <u>2018</u> | <u>2017</u> |
|---------------------------------|-----------------|----------------|
| Deferred income tax assets | \$ 12,498 | 19,848 |
| Deferred income tax liabilities | <u>(1,014)</u> | <u>(1,827)</u> |
| | 11,484 | 18,021 |
| Less valuation allowance | <u>(4,651)</u> | <u>(6,739)</u> |
| Net deferred income tax assets | <u>\$ 6,833</u> | <u>11,282</u> |

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

In assessing the deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax-planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the benefits of these deductible differences will be realized, net of the existing valuation allowances at June 30, 2018. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

(9) Operating Leases

(a) As Lessor

Rental revenues are received from operating leases. The lease terms range from monthly tenancy to 72 remaining years and provide for periodic rent escalation and renegotiation, reimbursement of certain operating costs, and contingent rents based on the lessee's sales or production. Contingent rental revenues of \$15,779 and \$14,569 were recognized in 2018 and 2017, respectively.

Office space in buildings owned by QHS is leased to physicians and other tenants under operating leases. QHS also maintains operating leases for land and leasehold interests. At June 30, 2018 and 2017, the basis for land, leasehold interests, and buildings under operating leases was approximately \$219,042 and \$217,255, respectively, and the related accumulated depreciation was approximately \$97,916 and \$90,882, respectively.

Future minimum rental income under noncancelable operating leases at June 30, 2018 is as follows:

| | | |
|----------------------|----|-------------------------|
| Year ending June 30: | | |
| 2019 | \$ | 48,031 |
| 2020 | | 45,814 |
| 2021 | | 45,947 |
| 2022 | | 44,834 |
| 2023 | | 45,075 |
| Thereafter | | <u>1,109,786</u> |
| | \$ | <u><u>1,339,487</u></u> |

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

(b) As Lessee

QHS leases office space, land, and equipment under operating leases expiring through 2042. Future minimum lease payments under noncancelable operating leases at June 30, 2018 are as follows:

| Year ending June 30: | |
|----------------------|-------------------------|
| 2019 | \$ 6,019 |
| 2020 | 5,600 |
| 2021 | 4,589 |
| 2022 | 3,176 |
| 2023 | 2,585 |
| Thereafter | <u>10,827</u> |
| | \$ <u><u>32,796</u></u> |

QHS also pays additional amounts for common area maintenance charges, real property taxes, and certain building operating costs. Rent expense during 2018 and 2017 under these leases was approximately \$12,939 and \$12,013, respectively.

(10) Commitments and Contingencies

At June 30, 2018, there were several legal and compliance actions pending against QHS that arose in the normal course of business. The ultimate resolution of such actions cannot presently be determined. In the opinion of management, based upon current facts and circumstances, the resolution of these matters is not expected to have a material adverse effect on the consolidated financial statements. There were also certain actions alleging malpractice. These actions are covered under the QHS self-insurance program for general and professional liability exposure (note 5).

At June 30, 2018, QHS had commitments for facilities construction and equipment purchases for approximately \$55,109.

QMC has various collective bargaining agreements with the Hawaii Nurses Association (HNA) and an agreement with the Teamsters Union. The HNA agreements cover approximately 1,800 employees and expire at various times from October 2018 through June 2021. The Teamsters Union agreement covers approximately 700 employees and expires in June 2019.

MGH and NHCH have collective bargaining agreements with United Public Workers, International Longshore and Warehouse Union and HNA, respectively. These agreements cover a total of approximately 100 employees and expire in July 2021, August 2019 and March 2019, respectively.

(11) Subsequent Events

QHS has evaluated subsequent events from the balance sheet date through October 24, 2018, the date at which the consolidated financial statements were issued, and determined that there are no items to disclose.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Combined Balance Sheet Information
for the Members of The Queen's Health Systems Credit Group

June 30, 2018

(In thousands)

Assets

| | |
|--|---------------------|
| Current assets: | |
| Cash and cash equivalents | \$ 115,650 |
| Receivables – net | 205,001 |
| Due from affiliates | 7,629 |
| Inventories | 19,908 |
| Investments | 1,212,017 |
| Assets whose use is limited or restricted – current | 16,063 |
| Prepaid expenses and other assets | 17,823 |
| | <hr/> |
| Total current assets | 1,594,091 |
| Investments – less current portion | 88,292 |
| Assets whose use is limited or restricted – less current portion | 53,363 |
| Land, buildings, and equipment – net | 642,360 |
| Goodwill | 7,619 |
| Deferred income tax asset | 6,833 |
| Straight-line rents receivable | 65,861 |
| Beneficial interests in trusts | 109,245 |
| Other assets | 63,264 |
| | <hr/> |
| Total | <u>\$ 2,630,928</u> |

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Combined Balance Sheet Information
for the Members of The Queen's Health Systems Credit Group

June 30, 2018

(In thousands)

Liabilities and Net Assets

Current liabilities:

| | |
|---|---------------------|
| Accounts payable and other accrued liabilities | \$ 88,864 |
| Accrued salaries and benefits | 70,209 |
| Other current liabilities | 17,896 |
| Due to government reimbursement programs – current | 8,254 |
| Short-term and long-term debt – current | 10,562 |
| Long-term debt subject to short-term remarketing arrangements | 98,487 |
| Due to affiliates - current | <u>13,269</u> |
| Total current liabilities | 307,541 |
| Long-term debt – less current portion | 369,538 |
| Pension and postretirement liabilities | 167,389 |
| Due to government reimbursement programs – less current portion | 11,313 |
| Due to affiliates - less current portion | 10,000 |
| Other long-term liabilities | <u>44,857</u> |
| Total liabilities | <u>910,638</u> |
| Net assets: | |
| Unrestricted | 1,583,004 |
| Temporarily restricted | 22,160 |
| Permanently restricted | <u>115,126</u> |
| Total net assets | <u>1,720,290</u> |
| Total | <u>\$ 2,630,928</u> |

This balance sheet information of the Members of The Queen's Health Systems Credit Group (Credit Group) include the accounts of The Queen's Health Systems (Parent), The Queen's Medical Center, Queen's Development Corporation, Diagnostic Laboratory Services, Inc., Molokai General Hospital and North Hawaii Community Hospital, each of which are members of the Credit Group, as defined in the Master Trust Indenture executed in 2015. Effective fiscal year 2018, Queen Emma Land Company is also a Designated Affiliate under the Master Trust Indenture and is included in the Credit Group. Pursuant to the Master Trust Indenture and related agreements, the combined Credit Group financial statement information is presented as of and for the year ended June 30, 2018. Certain organizations controlled by the Parent are not members of the Credit Group. This combined balance sheet information does not include the accounts of these nonobligated, controlled affiliates and, accordingly, is not presented in accordance with U.S. generally accepted accounting principles. This combined balance sheet information is included for additional analysis and is not a required part of the basic 2018 consolidated financial statements. It should be read in conjunction with the 2018 consolidated financial statements of The Queen's Health Systems and subsidiaries.

See accompanying independent auditors' report.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Combined Statement of Operations and Changes in Net Assets Information
for the Members of The Queen's Health Systems Credit Group

Year ended June 30, 2018

(In thousands)

| | |
|---|------------------|
| Unrestricted operating revenues: | |
| Net patient service revenues | \$ 1,225,984 |
| Rental revenues | 85,082 |
| Other | 51,075 |
| | <u>1,362,141</u> |
| Total unrestricted operating revenues | 1,362,141 |
| Net assets released from restrictions | <u>7,997</u> |
| Total unrestricted operating revenues and other support | <u>1,370,138</u> |
| Unrestricted operating expenses: | |
| Salaries, wages, and employee benefits | 713,165 |
| Supplies | 230,814 |
| Purchased services | 105,939 |
| Depreciation and amortization | 73,352 |
| Professional fees | 60,287 |
| Sustainability fees and taxes – other than income taxes | 51,921 |
| Rent and utilities | 33,657 |
| Interest | 16,742 |
| Other | 28,065 |
| | <u>1,313,942</u> |
| Total unrestricted operating expenses | 1,313,942 |
| Operating income | <u>56,196</u> |
| Nonoperating income (expense): | |
| Investment income, net | 101,081 |
| Income tax expense | (4,384) |
| Gain on interest rate swap | 6,194 |
| Other expense | (6,247) |
| | <u>96,644</u> |
| Total nonoperating income, net | 96,644 |
| Excess of revenues over expenses, carried forward | <u>152,840</u> |

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Combined Statement of Operations and Changes in Net Assets Information
for the Members of The Queen's Health Systems Credit Group

Year ended June 30, 2018

(In thousands)

| | |
|---|----------------------------|
| Excess of revenues over expenses, brought forward | \$ 152,840 |
| Other changes: | |
| Net assets released from restrictions for capital expenditures | 1,256 |
| Net unrealized gain on investments | 2,751 |
| Pension related changes other than net periodic pension cost | 23,449 |
| Transfers from affiliates and other changes, net | <u>5,574</u> |
| Total other changes | <u>33,030</u> |
| Increase in unrestricted net assets | <u>185,870</u> |
| Temporarily restricted net assets: | |
| Gifts and grants | 6,723 |
| Investment gains, net | 1,182 |
| Net assets released from restrictions used for capital expenditures | (1,256) |
| Net assets released from restrictions used for operating expenses | (6,707) |
| Transfers to affiliates, net | (6,508) |
| Other changes, net | <u>15</u> |
| Decrease in temporarily restricted net assets | <u>(6,551)</u> |
| Permanently restricted net assets: | |
| Cash distributions from perpetual trusts | (1,290) |
| Other changes, net | <u>1,948</u> |
| Increase in permanently restricted net assets | <u>658</u> |
| Increase in net assets | 179,977 |
| Net assets – beginning of year | 979,359 |
| Inclusion of net assets of Queen Emma Land Company– beginning of year | <u>560,954</u> |
| Net assets – end of year | \$ <u><u>1,720,290</u></u> |

This combined statement of operations and changes in net assets information of the Members of The Queen's Health Systems Credit Group (Credit Group) include the accounts of The Queen's Health Systems (Parent), The Queen's Medical Center, Queen's Development Corporation, Diagnostic Laboratory Services, Inc., Molokai General Hospital, and North Hawaii Community Hospital, each of which are members of the Credit Group, as defined in the Master Trust Indenture executed in 2015. Effective fiscal year 2018, Queen Emma Land Company is also a Designated Affiliate under the Master Trust Indenture and is included in the Credit Group. Pursuant to the Master Trust Indenture and related agreements, the combined Credit Group financial statement information is presented as of and for the year ended June 30, 2018. Certain organizations controlled by the Parent are not members of the Credit Group. This combined statement of operations and changes in net assets information does not include the accounts of these nonobligated, controlled affiliates and, accordingly, is not presented in accordance with U.S. generally accepted accounting principles. This combined statement of operations and changes in net assets information is included for additional analysis and is not a required part of the basic 2018 consolidated financial statements. It should be read in conjunction with the 2018 consolidated financial statements of The Queen's Health Systems and subsidiaries.

See accompanying independent auditors' report.