



THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Consolidated Financial Statements
and Credit Group Schedules

June 30, 2019 and 2018

(With Independent Auditors' Report Thereon)

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

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Honolulu, HI 96813-6400

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, 2019 and 2018, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

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, 2019 and 2018, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.



Emphasis of Matters

As discussed in Note 1 to the consolidated financial statements, on July 1, 2018, The Queen's Health Systems and its subsidiaries adopted Financial Accounting Standards Board Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and ASU No. 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities (Topic 958)*. Our opinion is not modified with respect to these matters.

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, 2019 included in Schedules 1, 2, and 3 is presented for purposes of additional analysis and is not a required part of the 2019 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 2019 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 2019 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 18, 2019

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Consolidated Balance Sheets

June 30, 2019 and 2018

(In thousands)

Assets	2019	2018
Current assets:		
Cash and cash equivalents	\$ 221,922	135,974
Receivables – less allowances for uncollectible accounts of \$52,484 in 2018	189,853	206,253
Inventories	17,756	19,908
Investments	1,233,395	1,212,017
Assets whose use is limited or restricted – current	32,176	16,063
Prepaid expenses and other assets	13,567	15,129
Total current assets	1,708,669	1,605,344
Investments – less current portion	120,845	88,292
Assets whose use is limited or restricted – less current portion	21,602	53,363
Land, buildings, and equipment, net	646,321	643,308
Goodwill, net	6,857	7,619
Other Intangibles, net	1,055	3,538
Deferred income tax asset	6,671	6,833
Straight-line rents receivable	69,359	65,861
Beneficial interests in trusts	107,939	109,245
Other assets	31,538	31,972
Total	\$ 2,720,856	2,615,375
Liabilities and Net Assets		
Current liabilities:		
Accounts payable and other accrued liabilities	\$ 93,825	89,233
Accrued salaries and benefits	80,655	74,800
Other current liabilities	23,252	17,917
Due to government reimbursement programs – current	17,223	8,254
Long-term debt – current	11,186	10,562
Long-term debt subject to short-term remarketing arrangements	93,616	98,487
Total current liabilities	319,757	299,253
Long-term debt – less current portion	363,970	369,538
Pension and postretirement liabilities	109,090	167,389
Due to government reimbursement programs – less current portion	7,406	11,313
Other long-term liabilities	53,057	51,058
Total liabilities	853,280	898,551
Net assets:		
Without donor restrictions	1,732,583	1,579,538
With donor restrictions	134,993	137,286
Total net assets	1,867,576	1,716,824
Total	\$ 2,720,856	2,615,375

See accompanying notes to consolidated financial statements.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Consolidated Statements of Operations

Years ended June 30, 2019 and 2018

(In thousands)

	<u>2019</u>	<u>2018</u>
Unrestricted operating revenues:		
Net patient service revenues	\$ 1,280,670	1,225,984
Rental revenues	85,222	85,082
Other	53,825	51,359
	<hr/>	<hr/>
Total unrestricted operating revenues	1,419,717	1,362,425
Net assets released from restrictions	<hr/>	<hr/>
	7,257	7,997
	<hr/>	<hr/>
Total operating revenues and other support	1,426,974	1,370,422
	<hr/>	<hr/>
Unrestricted operating expenses:		
Salaries, wages, and employee benefits	726,286	716,760
Supplies	229,224	230,836
Purchased services	103,788	103,248
Depreciation and amortization	73,465	72,880
Professional fees	59,662	61,380
Sustainability fees and taxes – other than income taxes	49,054	52,299
Rent and utilities	36,345	33,658
Interest	17,553	17,475
Other	29,342	29,539
	<hr/>	<hr/>
Total unrestricted operating expenses	1,324,719	1,318,075
	<hr/>	<hr/>
Operating income	102,255	52,347
	<hr/>	<hr/>
Nonoperating income (expense):		
Investment income, net	92,602	101,164
Income tax expense	(1,421)	(4,384)
(Loss) gain on interest rate swap	(1,893)	6,194
Other expense	(3,817)	(3,219)
	<hr/>	<hr/>
Total nonoperating income, net	85,471	99,755
	<hr/>	<hr/>
Excess of revenues over expenses	\$ <u>187,726</u>	<u>152,102</u>

See accompanying notes to consolidated financial statements.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Consolidated Statements of Changes in Net Assets

Years ended June 30, 2019 and 2018

(In thousands)

	Without donor restrictions	With donor restrictions	Total
Net assets – June 30, 2017	\$ 1,399,980	136,671	1,536,651
Excess of revenues over expenses	152,102	—	152,102
Net unrealized gain on investments	2,751	1,182	3,933
Pension related changes other than net periodic pension cost	23,449	—	23,449
Gifts and grants	—	6,723	6,723
Net assets released from restrictions used for capital expenditures	1,256	(1,256)	—
Net assets released from restrictions used for operating expenses	—	(6,707)	(6,707)
Cash distributions from perpetual trusts	—	(1,290)	(1,290)
Other changes, net	—	1,963	1,963
Increase in net assets	<u>179,558</u>	<u>615</u>	<u>180,173</u>
Net assets – June 30, 2018	<u>1,579,538</u>	<u>137,286</u>	<u>1,716,824</u>
Excess of revenues over expenses	187,726	—	187,726
Net unrealized (loss) gain on investments	(15,889)	635	(15,254)
Pension related changes other than net periodic pension cost	(24,259)	—	(24,259)
Gifts and grants	—	9,695	9,695
Net assets released from restrictions used for capital expenditures	5,467	(5,467)	—
Net assets released from restrictions used for operating expenses	—	(5,933)	(5,933)
Cash distributions from perpetual trusts	—	(1,324)	(1,324)
Other changes, net	—	101	101
Increase (decrease) in net assets	<u>153,045</u>	<u>(2,293)</u>	<u>150,752</u>
Net assets – June 30, 2019	\$ <u><u>1,732,583</u></u>	<u><u>134,993</u></u>	<u><u>1,867,576</u></u>

See accompanying notes to consolidated financial statements.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended June 30, 2019 and 2018

(In thousands)

	<u>2019</u>	<u>2018</u>
Cash flows from operating activities:		
Increase in net assets	\$ 150,752	180,173
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Net realized and unrealized gains on investments	(57,704)	(89,802)
Loss (gain) on interest rate swaps	1,893	(6,194)
Depreciation and amortization	73,465	72,880
Provision for bad debts	—	61,323
Amortization of bond premium	(2,241)	(2,327)
Gain on disposition of land, buildings, and equipment	(589)	(1,979)
Pension related changes other than net periodic pension cost	24,259	(23,449)
Deferred income taxes	162	2,635
Change in value of beneficial interests in trusts	1,306	(424)
Changes in operating assets and liabilities:		
Receivables	12,902	(48,382)
Due to government reimbursement programs	5,062	(1,423)
Accounts payable and accrued salaries, benefits, and other liabilities	(61,460)	(45,683)
Other assets and liabilities	12,228	(1,132)
Net cash provided by operating activities	<u>160,035</u>	<u>96,216</u>
Cash flows from investing activities:		
Purchases of investments and assets whose use is limited or restricted	(283,984)	(232,019)
Proceeds from sales and maturities of investments and assets whose use is limited or restricted	303,405	246,854
Purchases of land, buildings, and equipment	(83,224)	(45,080)
Proceeds from sales of land, buildings, and equipment	1,456	102
Net cash used in investing activities	<u>(62,347)</u>	<u>(30,143)</u>
Cash flows from financing activities:		
Repayment of debt	(10,740)	(10,102)
Dividend distribution to noncontrolling interest holder	(1,000)	(800)
Net cash used in financing activities	<u>(11,740)</u>	<u>(10,902)</u>
Increase in cash and cash equivalents	85,948	55,171
Cash and cash equivalents – beginning of year	<u>135,974</u>	<u>80,803</u>
Cash and cash equivalents – end of year	\$ <u><u>221,922</u></u>	<u><u>135,974</u></u>
Supplemental cash flow information:		
Interest paid – net of amounts capitalized	\$ 19,344	20,153
Income taxes paid	1,430	2,751
Supplemental disclosures of noncash investing and financing activities:		
Purchase of buildings and equipment included in accounts payable and other accrued liabilities at year-end	\$ 10,659	15,976
Capital expenditures funded by capital lease borrowings	2,989	6,150

See accompanying notes to consolidated financial statements.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(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, QEL 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).

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

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

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

(c) *Prior Period Reclassifications*

Certain prior period amounts have been reclassified to conform to the current period presentation.

(d) *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.

(e) *Receivables for Patient Services*

Accounts receivable primarily comprise amounts due for healthcare services from patients and third-party payors and are recorded net of amounts for contractual adjustments, implicit price concessions and bad debts.

(f) *Inventories*

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

(g) *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 net assets without donor restrictions. 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.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(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 are written down to estimated fair value in the period the OTTI is recognized. In fiscal year ended June 30, 2019, there was one such impairment that resulted in a write down of \$465. There were no such impairment charges in the year ended June 30, 2018.

(h) 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, 2019 and 2018.

(i) 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.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

(j) Goodwill

During the year ended June 30, 2019, QHS has elected the goodwill alternative treatment under Accounting Standards Update (ASU) No. 2019-06, *Extending the Private Company Accounting Alternatives on Goodwill and Certain Intangible Assets to Not-for-Profit Entities*. Goodwill is amortized on a straight-line basis over 10 years. Goodwill is tested for impairment when a triggering event occurs that indicates that the fair value of the reporting unit may be below its carrying amount.

(k) 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.

(l) Beneficial Interests in Trusts

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

(m) 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.

(n) 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.

(o) 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.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

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, 2019. QHS does not believe it is subject to audit by taxing jurisdictions for periods prior to fiscal year ended June 30, 2015.

(p) Contributions and Donor 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.

(q) 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.

(r) Recently Adopted Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued ASU No. 2014-09, *Revenue from Contracts with Customers*. This standard enhances the comparability of revenue recognition practices and is to be applied to all contracts with customers. This guidance was adopted by QHS on July 1, 2018 using the modified retrospective method applied to contracts which were not completed as of that date. The adoption did not impact QHS's previously reported financial results nor did it result in a cumulative effect adjustment to retained earnings as of July 1, 2018.

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 consolidated 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 was adopted by QHS for the fiscal year ended June 30, 2019.

In May 2019, the FASB issued ASU No. 2019-06, *Intangibles – Goodwill and Other (Topic 350), Business Combinations (Topic 805), and Not-for-Profit Entities (Topic 958): Extending the Private Company Accounting Alternatives on Goodwill and Certain Identifiable Intangible Assets to Not-for-Profit Entities (NFPs)*. The amendments in ASU No. 2019-06 extend the scope of the goodwill accounting alternative provided in ASU No. 2014-02 and the intangible asset accounting alternative provided in ASU No. 2014-18 to not-for-profit entities. The goodwill accounting alternative allows not-for-profit entities to amortize goodwill on a straight-line basis over 10 years or less, test for impairment at the entity level and test goodwill for impairment when a triggering event occurs, the intangible asset accounting alternative will allow certain intangibles to be combined with goodwill and amortized. As noted above, QHS elected the goodwill accounting alternative for the year ended June 30, 2019.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

(s) Recently Issued Accounting Pronouncements

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 (ASC) and created Topic 842, *Leases*. Under Topic 842, lessees are required to recognize right-of-use (ROU) assets and lease liabilities on the balance sheet for most leases and provides for enhanced disclosures. Leases will continue to be classified as either financing or operating. This guidance will be effective for QHS's fiscal year ending June 30, 2020. Upon adoption, certain qualitative and quantitative disclosures are required along with modified retrospective recognition and measurement of impacted leases. Upon adoption, QHS anticipates material additions to the consolidated balance sheet of ROU assets, offset by the associated liabilities. QHS is currently evaluating the impact of adopting this guidance on the consolidated financial statements.

In March, 2017, the FASB issued ASU No. 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*, which amends the requirements in ASC Topic 715 related to the income statement presentation of the components of net periodic benefit cost for an entity's sponsored defined benefit pension and other postretirement plans. This guidance will be effective for QHS's fiscal year ending June 30, 2020. ASU No. 2017-07 requires entities to (1) disaggregate the current-service-cost component from the other components of net benefit cost (the other components) and present it with other current compensation costs for related employees in the income statement and (2) present the other components elsewhere in the income statement and outside of income from operations if such a subtotal is presented. The ASU also requires entities to disclose the income statement lines that contain the other components if they are not presented on appropriately described separate lines. QHS is currently evaluating the impact of adopting this guidance on the consolidated financial statements.

In June, 2018, the FASB issued ASU No. 2018-08, *Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*. This guidance will be effective for QHS's fiscal year ending June 30, 2020. This ASU includes specific criteria to consider when determining whether a contract or agreement should be accounted for as a contribution or as an exchange transaction, and provides a framework for determining whether a contribution is conditional or unconditional. QHS is currently evaluating the impact of adopting this guidance on the consolidated financial statements.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

(2) Revenue Recognition

(a) *Patient Service Revenue*

Patient service revenue is reported at the amount that reflects the consideration to which QHS expects to be entitled to in exchange for providing patient care. These amounts are due from patients, third-party payors (including health insurers and government programs) and others and includes variable consideration for retroactive adjustments due to settlement of audits, reviews and investigations. Generally, QHS bills patients and third-party payors several days after the services are performed and/or the patient is discharged from the facility. Revenue is recognized as performance obligations are satisfied.

Performance obligations are determined based on the nature of the services provided by QHS and are recognized either over time or at a point in time. Generally, performance obligations satisfied over time relate to patients in hospitals or clinics receiving inpatient or outpatient services. Revenue for performance obligations satisfied over time is recognized based on actual charges incurred through a point in time in relation to total actual charges incurred. QHS believes that this method provides useful depiction of the provision of services over the term of the performance obligation based on the inputs needed to satisfy the obligation. QHS measures an inpatient performance obligation from the time of admission to the time of discharge, and an outpatient performance obligation from the start of the outpatient service to the completion of the outpatient service. Revenue for the performance obligation satisfied at a point in time are recognized when goods or services are provided to patients and customers and there is no requirement to provide additional goods or services.

As all of our performance obligations relate to contracts with a duration of less than one year, we have elected to apply the optional exemption contained in ASC 606-10-50-14a. Under this exemption, QHS is not required to disclose the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied or partially unsatisfied at the end of the reporting period.

QHS uses a portfolio approach to account for categories of patient contracts as collective groups rather than recognizing revenue on an individual contract basis. The portfolios consist of major payor classes for inpatient and outpatient revenue. The financial statement impact of using this approach is not materially different from an individual contract approach.

QHS determines the transaction price based on the total standard charges for goods and services provided by various elements of variable consideration, including contractual adjustments, discounts provided to uninsured patients in accordance with QHS policy, and implicit price concessions provided to uninsured patients. As agreements with third-party payors provide for payments at amounts less than established charges, QHS determines its estimate of contractual adjustments and discounts based on recent negotiated reimbursement amounts, actual payments received and historical trends for every payor-source category. Management reviews and updates these calculations monthly. Subsequent changes to the estimate of the transaction price are generally recorded as adjustments to patient service revenue in the period of the change. Additional revenue due to changes in estimates of implicit price concessions, discounts, and contractual adjustments for prior years were not significant for 2019 or 2018. Subsequent changes that are determined to be the result of an adverse change in the patient's ability to pay are recorded as bad debt expense. The difference between the standard

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rates and the amounts actually collected on patient accounts is charged off against these contractual allowances and allowances for doubtful accounts.

(b) Government Reimbursement Programs

QHS renders services to patients under contractual agreements with the Medicare and Medicaid programs. Medicare acute inpatient services are reimbursed based on clinical, diagnostic, and other factors. Medicaid 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.

Settlements with third-party payors for retroactive adjustments due to audits, review, or investigations are considered variable consideration and are included in the determination of estimated transaction price for providing patient care. These settlements are estimated based on the terms of the payment agreement with the payor, correspondence from the payor, and QHS' historic settlement activity, including an assessment to ensure that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the retroactive adjustment is subsequently resolved. Estimated settlements are adjusted in future periods as adjustments become known (i.e., as new information becomes available) or as years are settled or are no longer subject to such audits, reviews, and investigations. 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 amounted to \$255 and \$1,152 for the years ended June 30, 2019 and 2018, respectively.

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. There can be no assurance that regulatory authorities will not challenge QHS's compliance with these laws and regulations, and it is not possible to determine the impact (if any) such claims or penalties would have upon QHS.

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 \$73,575 and \$64,467, and are reported in net patient service revenues for the years ended June 30, 2019 and 2018, respectively. Sustainability fees paid by QHS were \$27,810 and \$31,645, and are reported in

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sustainability fees and taxes – other than income taxes for the years ended June 30, 2019 and 2018, respectively. Amounts under this program are subject to annual determination by the State of Hawaii. A similar program has been established for calendar year 2020.

(c) Other Programs

Payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations provide for payment using prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates. In addition, the contracts QHS has with commercial payers also provide for retroactive audit and review of claims.

(d) Charity Care

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. Therefore, QHS has determined it has provided implicit price concessions to uninsured patients and patients with other uninsured balances (for example, copays and deductibles). The implicit price concessions included in estimating the transaction price represent the difference between amounts billed to patients and the amounts QHS expects to collect based on its collection history with those patients. 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 estimated costs and expenses incurred to provide charity care were \$1,995 and \$2,489 for the years ended June 30, 2019 and 2018, respectively.

(e) Accounts Receivable for Patient Services

Accounts receivable comprises the following components at June 30, 2019 and 2018:

	<u>2019</u>	<u>2018</u>
Patient receivables	\$ 173,510	258,737
Contract assets	16,343	—
Allowance for uncollectible accounts	<u>—</u>	<u>(52,484)</u>
Total	<u>\$ 189,853</u>	<u>206,253</u>

Contract assets are related to in-house patients who were provided services during the reporting period but were not discharged as of the reporting date and for which QHS does not have the right to bill.

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(f) Concentration of Credit Risk

Significant concentrations of patient accounts receivable at June 30, 2019 and 2018 included the following:

	<u>2019</u>	<u>2018</u>
Medicare	34 %	34 %
Medicaid	18	18
Hawaii Medical Service Association	12	12

(g) Net Patient Service Revenue Disaggregated by Payor

Net patient service revenue disaggregated by payor for the years ended June 30, 2019 and 2018 is presented based on an allocation of the estimated transaction price between the primary patient classifications of insurance coverage:

	<u>2019</u>	<u>2018</u>
Medicare	\$ 433,943	417,257
Medicaid	266,176	231,300
Hawaii Medical Services Association	378,151	345,685
Other	<u>202,400</u>	<u>231,742</u>
Total	<u>\$ 1,280,670</u>	<u>1,225,984</u>

(h) Net Patient Service Revenue Disaggregated by Lines of Service

Net patient service revenue disaggregated by line of service for the years ended June 30, 2019 and 2018 is presented based on the transaction price between lines of service:

	<u>2019</u>	<u>2018</u>
Inpatient services	\$ 759,682	741,827
Outpatient services, including emergency services	421,172	389,637
All other	<u>99,816</u>	<u>94,520</u>
	<u>\$ 1,280,670</u>	<u>1,225,984</u>

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(i) Rental Revenues

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).

(3) 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, 2019 and 2018 were as follows:

	<u>2019</u>	<u>2018</u>
Investments at fair value:		
Mutual funds	\$ 276,255	285,252
Debt securities	179,548	164,534
Equity securities	83,268	92,342
Money market funds	<u>68,938</u>	<u>100,496</u>
Total investments at fair value	<u>608,009</u>	<u>642,624</u>
Investments using equity method:		
Common trust funds	594,250	561,430
Private equities and other limited partnerships	<u>205,759</u>	<u>165,681</u>
Total investments using equity method	<u>800,009</u>	<u>727,111</u>
Total investments and assets whose use is limited or restricted	\$ <u><u>1,408,018</u></u>	\$ <u><u>1,369,735</u></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, 2019, QHS was committed to invest approximately \$38,165 of additional capital in various private equity investments.

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The classification of investments in the consolidated balance sheets as of June 30, 2019 and 2018 was as follows:

	<u>2019</u>	<u>2018</u>
Total investments	\$ 1,408,018	1,369,735
Less assets whose use is limited or restricted	<u>(53,778)</u>	<u>(69,426)</u>
Total unrestricted investments	1,354,240	1,300,309
Less current portion	<u>(1,233,395)</u>	<u>(1,212,017)</u>
Noncurrent portion	<u>\$ 120,845</u>	<u>88,292</u>

Assets whose use is limited or restricted at June 30, 2019 and 2018 consisted of the following:

	<u>2019</u>	<u>2018</u>
Money market funds	\$ 32,409	49,272
Investments	<u>21,369</u>	<u>20,154</u>
Total assets whose use is limited or restricted	53,778	69,426
Less current portion	<u>(32,176)</u>	<u>(16,063)</u>
Noncurrent portion	<u>\$ 21,602</u>	<u>53,363</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

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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 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 2019 and 2018.

The following tables present information about the fair value of the QHS financial instruments as of June 30, 2019 and 2018, according to the valuation techniques QHS used to determine their fair values:

	Fair value measurements at June 30, 2019			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash and cash equivalents – money market funds	\$ 41,980	—	—	41,980
Investments and assets whose use is limited or restricted:				
Trading securities:				
Money market funds	34,393	—	—	34,393
Debt securities	40,658	138,890	—	179,548
Equity securities – domestic mid-cap	83,268	—	—	83,268
Mutual funds – fixed income	96,124	—	—	96,124
Total trading securities	254,443	138,890	—	393,333

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	Fair value measurements at June 30, 2019			
	Level 1	Level 2	Level 3	Total
Other-than-trading securities:				
Money market funds	\$ 34,545	—	—	34,545
Mutual funds:				
Mid-cap equities	80,752	—	—	80,752
Real assets	74,661	—	—	74,661
International equities	24,718	—	—	24,718
Total other-than-trading securities	214,676	—	—	214,676
Total investments and assets whose use is limited or restricted	\$ 469,119	138,890	—	608,009
Liabilities:				
Other long-term liabilities – interest rate swap liabilities	\$ —	12,841	—	12,841

	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

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	Fair value measurements at June 30, 2018			
	Level 1	Level 2	Level 3	Total
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	\$ —	10,948	—	10,948

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 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.

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Investments and assets whose use is limited or restricted classified as other-than-trading securities at June 30, 2019 and 2018 consisted of the following:

	<u>Cost</u>	<u>Gross unrealized gains</u>	<u>Gross unrealized losses</u>	<u>Fair value</u>
2019:				
Money market funds	\$ 34,545	—	—	34,545
Mutual funds	<u>172,975</u>	<u>10,360</u>	<u>(3,204)</u>	<u>180,131</u>
Total investments	\$ <u>207,520</u>	<u>10,360</u>	<u>(3,204)</u>	<u>214,676</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>204,859</u>	<u>26,243</u>	<u>(3,031)</u>	<u>228,071</u>

The total return on the investment portfolios for the years ended June 30, 2019 and 2018 was comprised of the following:

	<u>2019</u>	<u>2018</u>
Total investment income, net:		
Interest and dividend income	\$ 19,128	15,005
Realized gain – net of expenses	25,538	8,225
Unrealized (loss) gain on trading securities	(1,240)	12,171
Equity in earnings of limited liability entities	<u>49,176</u>	<u>65,763</u>
Total unrestricted investment income, net	\$ <u>92,602</u>	<u>101,164</u>
Other changes in net assets without donor restrictions – net unrealized (loss) gain on unrestricted investments	\$ (15,889)	2,751
Other changes in net assets with donor restrictions:		
Investment gain	\$ 516	290
Net unrealized gain on investments	<u>119</u>	<u>892</u>
Total donor restricted investment gain, net	\$ <u>635</u>	<u>1,182</u>

For the years ended June 30, 2019 and 2018, gross proceeds from sales of other-than-trading investments were \$6,400 and \$25,000, resulting in gross realized gains of \$1,675 and \$3,694, respectively. QHS uses the average cost method to determine the cost basis for securities sold.

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(4) Liquidity and Availability of Financial Assets

QHS monitors the availability of resources required to meet its operating needs and other contractual commitments on a day-to-day basis, as well as on a longer-term lookout period. It is QHS' policy to structure its financial assets to be available as its general expenditures, liabilities, and other obligations come due.

The following reflects QHS's financial assets as of June 30, 2019:

	2019
Cash and cash equivalents	\$ 221,922
Receivables, net	189,853
Other current assets	31,323
Investments	1,354,240
Assets whose use is limited or restricted	53,778
Total financial assets	1,851,116
Less amounts not available to be used within one year:	
Prepaid assets included in other current assets	(13,567)
Investments with redemption limitations greater than one year	(120,845)
Assets whose use is limited or restricted	(21,602)
Total financial assets available to meet general expenditures within one year	\$ 1,695,102

QHS has various sources of liquidity at its disposal, including cash and cash equivalents, certificates of deposit, marketable debt and equity securities, and a \$25,000 line of credit.

(5) Land, Buildings, and Equipment

Land, buildings, and equipment at June 30, 2019 and 2018 consisted of the following:

	2019	2018
Land and land improvements	\$ 113,093	106,298
Buildings and leasehold improvements	570,482	549,890
Equipment and furnishings	833,339	792,607
Equipment under capital leases	8,791	8,515
Construction in progress	39,414	47,584
Total	1,565,119	1,504,894
Less accumulated depreciation and amortization	(918,798)	(861,586)
Land, buildings, and equipment, net	\$ 646,321	643,308

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Depreciation and amortization expense was \$73,465 and \$72,880 for the years ended June 30, 2019 and 2018, respectively.

(6) Debt

Debt at June 30, 2019 and 2018 consisted of the following:

	<u>2019</u>	<u>2018</u>
Special Purpose Revenue Bonds 2015 Series A, serial and term, fixed interest rates ranging from 4.00% to 5.00%, with final maturity in July 2040, including unamortized bond premium at June 30, 2019 and 2018 of \$19,019 and \$21,259, respectively	\$ 212,199	219,119
Special Purpose Revenue Bonds 2015 Series B, windows rate mode, variable interest rate (average interest rate of 2.00% in 2019 and 1.58% in 2018), final maturity in July 2039	49,860	52,320
Special Purpose Revenue Bonds 2015 Series C, windows rate mode, variable interest rate (average interest rate of 2.00% in 2019 and 1.58% in 2018), final maturity in July 2039	49,860	52,320
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 3.27% in 2019 and 2.39% in 2018), with final maturity in January 2025	75,000	75,000
Capital lease and other obligations	6,446	4,533
Deferred financing fees	<u>(4,703)</u>	<u>(4,815)</u>
Total	468,772	478,587
Less current portion	(11,186)	(10,562)
Less long-term debt subject to short-term remarketing arrangements and associated deferred financing fees	<u>(93,616)</u>	<u>(98,487)</u>
Total noncurrent portion	\$ <u>363,970</u>	<u>369,538</u>

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 \$4,680 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 \$4,920 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, 2019, the notional swap amounts were \$68,065, \$36,475, and \$26,100. The notional amounts decrease annually based on the originally scheduled principal payments of the respective refunded bond series.

During the years ended June 30, 2019 and 2018, the change in the fair value of the liabilities associated with the swap agreements discussed above resulted in (losses) gains of \$(1,893) and \$6,194, respectively, which were recognized in nonoperating income. The fair value of liabilities associated with the swaps as of June 30, 2019 and 2018 was \$12,841 and \$10,948, 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 \$17,953 and \$18,034 during 2019 and 2018, respectively, of which \$400 and \$559 was capitalized in construction in progress in 2019 and 2018, respectively.

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At June 30, 2019, contractually stated debt maturities are as follows:

	<u>Revenue bonds and bank loan</u>	<u>Capital leases and other obligations</u>	<u>Total</u>
Year ending June 30:			
2020	\$ 9,885	1,301	11,186
2021	10,180	1,091	11,271
2022	10,560	1,288	11,848
2023	10,935	822	11,757
2024	11,340	355	11,695
Thereafter	<u>395,110</u>	<u>1,589</u>	<u>396,699</u>
Long-term debt payments	448,010	6,446	454,456
Plus net unamortized premium	19,019	—	19,019
Less deferred financing fees	<u>(4,703)</u>	<u>—</u>	<u>(4,703)</u>
Total	<u>\$ 462,326</u>	<u>6,446</u>	<u>468,772</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 \$292,309 was \$301,734 at June 30, 2019. 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 carrying values of the variable interest rate bonds, bank loans, and capital leases approximated their fair values at June 30, 2019 and 2018. The fair value of these debt instruments is deemed a Level 2 measurement.

At June 30, 2019, 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, 2019.

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Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

(7) 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, 2019 and 2018. 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 \$18,959 and \$20,073 at June 30, 2019 and 2018, respectively, and was recorded in other long-term liabilities at June 30, 2019 and 2018.

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 \$8,585 and \$7,272 at June 30, 2019 and 2018, respectively, and was included in other current liabilities at June 30, 2019 and 2018.

(c) *Medical Reserve*

QHS has a self-funded medical benefits plan covering substantially all of its employees. The medical reserve was \$12,634 and \$8,970 at June 30, 2019 and 2018, respectively, and was included in other current liabilities at June 30, 2019 and 2018.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

(8) Net Assets With Donor Restrictions

Donor restricted net assets consist of donations and other funds where donors have placed specific purpose or time restrictions on the use of funds, or where donors have stipulated that the funds are to be maintained by QHS in perpetuity. When a stipulated time restriction ends or purpose restriction is accomplished, the net assets are reclassified to net assets without donor restriction and reported in the consolidated statements of changes in net assets as net assets released from restrictions. Earnings on donor restricted net assets held in perpetuity are considered without donor restriction, unless otherwise restricted by the donor. Net assets with donor restrictions at June 30, 2019 and 2018 were available for the following purposes:

	<u>2019</u>	<u>2018</u>
Education and research	\$ 2,206	2,397
Indigent care and other	11,407	9,974
Facility replacement and expansion	<u>7,480</u>	<u>9,789</u>
Total	<u>\$ 21,093</u>	<u>22,160</u>

Net assets with donor restriction to be held by QHS in perpetuity at June 30, 2019 and 2018, the income from which is expendable to support the following purposes are as follows:

	<u>2019</u>	<u>2018</u>
Indigent care	\$ 3,787	3,787
Education and research	1,334	1,334
Restricted for NHCH hospital operations	107,949	109,175
Other	<u>830</u>	<u>830</u>
Total	<u>\$ 113,900</u>	<u>115,126</u>

The net assets with donor restrictions 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 net assets with donor restrictions to be held by QHS in perpetuity 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 2019 and 2018.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

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 net assets without donor restrictions.

(9) 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.

On April 8, 2019, a plan amendment was adopted to freeze pension benefit accruals for certain employees effective January 1, 2020. As a result, QHS recognized a pension curtailment gain of \$3,639 in the year ended June 30, 2019.

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 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, 2019 and 2018 were as follows:

	Pension benefits		Other postretirement benefits	
	2019	2018	2019	2018
Change in benefit obligations:				
Benefit obligations –				
beginning of year	\$ 467,603	466,854	44,357	44,151
Service cost	19,639	21,013	1,590	1,798
Interest cost	17,883	16,130	1,725	1,569
Actuarial (gain) loss	42,340	(16,444)	5,309	(2,093)
Benefits paid	(24,353)	(19,950)	(1,054)	(1,068)
Impact of plan curtailment	(20,335)	—	—	—
Benefit obligation – end of year	<u>502,777</u>	<u>467,603</u>	<u>51,927</u>	<u>44,357</u>

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

	Pension benefits		Other postretirement benefits	
	2019	2018	2019	2018
Change in plan assets:				
Fair value of plan assets –				
beginning of year	\$ 348,354	289,951	—	—
Actual return on plan assets	26,924	20,632	—	—
Employer contributions	98,872	57,721	1,054	1,068
Benefits paid	(24,353)	(19,950)	(1,054)	(1,068)
Fair value of plan assets –				
end of year	449,797	348,354	—	—
Funded status	\$ (52,980)	(119,249)	(51,927)	(44,357)
Amounts recognized in the consolidated balance sheets consisted of:				
Other current liabilities	\$ —	—	(1,522)	(1,313)
Pension and other postretirement benefits	(52,980)	(119,249)	(50,405)	(43,044)
Net amounts recognized	\$ (52,980)	(119,249)	(51,927)	(44,357)

Amounts recognized in net assets without donor restrictions at June 30, 2019 and 2018 were as follows:

	Pension benefits		Other postretirement benefits	
	2019	2018	2019	2018
Prior service (credit) cost	\$ (2,426)	(7,008)	—	71
Net loss	127,893	113,907	10,043	4,758
Total	\$ 125,467	106,899	10,043	4,829

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

Amounts recognized in net assets without donor restrictions at June 30, 2019 that are expected to be recognized as components of benefit cost in the year ending June 30, 2020 are as follows:

	Pension benefits		Other postretirement benefits	
	2019	2018	2019	2018
Other changes in plan assets and benefit obligations recognized in other changes in net assets without donor restrictions:				
Prior service cost	\$ 3,639	—	—	—
Net actuarial loss (gain)	20,838	(14,342)	5,309	(2,093)
Amortization of prior service cost	943	943	(71)	(91)
Amortization of recognized loss	(6,852)	(9,269)	(24)	(198)
Total recognized in other changes in net assets without donor restrictions	\$ 18,568	(22,668)	5,214	(2,382)

Components of net periodic pension cost were as follows:

	Pension benefits		Other postretirement benefits	
	2019	2018	2019	2018
Net periodic pension costs:				
Service cost	\$ 19,639	21,013	1,590	1,798
Interest cost	17,883	16,130	1,725	1,569
Expected return on plan assets	(25,758)	(22,734)	—	—
Amortization of prior service cost	(943)	(943)	71	91
Amortization of net actuarial loss	6,852	9,269	24	198
Recognized curtailment gain	(3,639)	—	—	—
Net periodic pension costs	\$ 14,034	22,735	3,410	3,656

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

Weighted average assumptions used to determine benefit obligations and net periodic benefit cost at June 30, 2019 and 2018 were as follows:

	Pension benefits		Other postretirement benefits	
	2019	2018	2019	2018
Benefit obligation:				
Discount rate	3.53 %	4.18 %	3.54 %	4.18 %
Rate of compensation increase	3.25	3.25	—	—
Net periodic benefit cost:				
Discount rate	4.18	4.07	4.18	4.07
Discount rate – service cost	4.24	4.23	4.25	4.23
Discount rate – interest cost	3.92	3.53	3.95	3.60
Expected return on plan assets	6.50	7.00	—	—
Rate of compensation increase	3.25	3.25	—	—

The accumulated benefit obligation for the Plan was \$461,474 and \$416,070 at June 30, 2019 and 2018, 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 2019 was 6.5%.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(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 6.5% in 2019, 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 \$111 and \$89, respectively, as of June 30, 2019, and the Plan's service cost and interest cost component of net periodic postretirement benefit cost for the year ended June 30, 2019, by \$15 and \$12, respectively. QHS anticipates making contributions of \$-0- to the pension plan and \$1,549 to the postretirement benefit plan during fiscal year 2020. The future estimated benefit payments for each plan are as follows:

	<u>Pension benefits</u>	<u>Other postretirement benefits</u>
Year ending June 30:		
2020	\$ 22,784	1,549
2021	22,124	1,742
2022	22,800	1,932
2023	23,527	2,115
2024	24,470	2,302
2025–2029	128,994	13,737

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, 2019 and 2018, and the target allocations were as follows:

	<u>Target range</u>	<u>2019 actual</u>	<u>2018 actual</u>
Cash and cash equivalents	—%	2.5 %	2.2 %
Fixed income securities (a)	26%–36%	33.0	28.7
Domestic equities (b)	3%–22%	24.6	24.9
Real return investments (c)	3%–12%	7.7	8.5
Hedge fund investments (d)	6%–14%	7.1	8.9
Private equity investments (e)	3%–11%	5.9	5.4
International equities (f)	16%–24%	19.2	21.4
Total		<u>100.0 %</u>	<u>100.0 %</u>

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(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, 2019 and 2018 according to the valuation techniques QHS used to determine their fair values:

Asset category	Fair value measurements at June 30, 2019			
	Level 1	Level 2	Level 3	Total
Cash and cash equivalents, primarily money market funds	\$ 10,598	—	—	10,598
Mutual funds:				
Domestic equities	14,055	—	—	14,055
Real assets	16,022	—	—	16,022
Domestic debt securities	43,173	58,008	—	101,181
Domestic equity securities	14,642	—	—	14,642
Total	\$ 98,490	58,008	—	156,498

Equity method investments of \$293,299 are excluded from the table above.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

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:				
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.

There were no reclassifications between Level 1 and Level 2 investments in 2019 and 2018.

See note 3 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, 2019 and 2018, the benefit liability related to this plan was \$940 and \$542, respectively. Benefit expense related to this plan was \$138 and \$183 for the years ended June 30, 2019 and 2018, respectively.

Certain key executives are covered by a nonqualified, unfunded supplemental executive retirement plan. At June 30, 2019 and 2018, the benefit liability related to this plan was \$3,504 and \$3,435, respectively. Benefit expense related to this plan was \$199 and \$189 for the years ended June 30, 2019 and 2018, 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 \$18,703 and \$17,822 for the years ended June 30, 2019 and 2018, respectively.

(10) Income Taxes

QIE, QDC, and DLS are subject to federal and state income taxes. At June 30, 2019, these companies had operating loss carryforwards for income tax purposes of approximately \$16,575 that expire through 2038. At June 30, 2019, QHS had net operating loss carryforwards of \$6,310 related to its unrelated business income. The net operating loss carryforwards expire through 2038.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

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, 2019 and 2018 were as follows:

	2019	2018
Current income tax expense	\$ 890	1,749
Deferred income tax expense	531	2,635
Total	\$ 1,421	4,384

For the years ended June 30, 2019 and 2018, 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, 2019 and 2018, 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, 2019 and 2018 were as follows:

	2019	2018
Deferred income tax assets	\$ 12,157	12,498
Deferred income tax liabilities	(871)	(1,014)
	11,286	11,484
Less valuation allowance	(4,615)	(4,651)
Net deferred income tax assets	\$ 6,671	6,833

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, 2019. 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.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

(11) Expenses by Functional Classification

Expenses incurred during the years ended June 30, 2019 and 2018 were for the following programs and support services:

	2019				Total
	Patient services	Other healthcare related activities	Real property investment and management	Administrative and general	
Salaries, wages, and employee benefits	\$ 521,759	61,322	1,596	141,609	726,286
Supplies	193,980	30,531	97	4,616	229,224
Purchased services	49,310	11,706	3,862	38,910	103,788
Depreciation and amortization	43,140	4,857	7,479	17,989	73,465
Professional fees	44,857	1,830	448	12,527	59,662
Sustainability fees and taxes – other than income taxes	1,041	5,452	13,436	29,125	49,054
Rent and utilities	5,014	4,984	2,653	23,694	36,345
Interest	121	—	—	17,432	17,553
Other	8,112	2,419	(975)	19,786	29,342
Total	\$ 867,334	123,101	28,596	305,688	1,324,719

2018	
Patient services	\$ 893,695
Other healthcare-related activities	115,563
Real property investment and management	26,944
Administrative and general	281,873
Total	\$ 1,318,075

(12) 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 \$16,345 and \$15,779 were recognized in 2019 and 2018, 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, 2019 and 2018, the basis for land, leasehold interests, and buildings under operating leases was approximately \$219,740 and \$219,042, respectively, and the related accumulated depreciation was approximately \$104,908 and \$97,916, respectively.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

Future minimum rental income under noncancelable operating leases at June 30, 2019 is as follows:

Year ending June 30:		
2020	\$	47,393
2021		47,620
2022		46,587
2023		46,268
2024		44,944
Thereafter		<u>1,071,464</u>
	\$	<u><u>1,304,276</u></u>

(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, 2019 are as follows:

Year ending June 30:		
2020	\$	5,097
2021		4,453
2022		3,042
2023		1,874
2024		1,584
Thereafter		<u>12,363</u>
	\$	<u><u>28,413</u></u>

QHS also pays additional amounts for common area maintenance charges, real property taxes, and certain building operating costs. Rent expense during 2019 and 2018 under these leases was approximately \$13,653 and \$12,939, respectively.

(13) Commitments and Contingencies

At June 30, 2019, 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 7).

At June 30, 2019, QHS had commitments for facilities construction and equipment purchases for approximately \$93,182.

THE QUEEN'S HEALTH SYSTEMS AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2019 and 2018

(Dollars in thousands)

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 August 2020 through April 2022. The Teamsters Union agreement covers approximately 700 employees and expires in June 2022.

MGH and NHCH have collective bargaining agreements with United Public Workers, International Longshore and Warehouse Union, and HNA. These agreements cover a total of approximately 200 employees and expire in July 2021, August 2022, and March 2022, respectively.

(14) Subsequent Events

QHS has evaluated subsequent events from the balance sheet date through October 18, 2019, 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, 2019

(In thousands)

Assets

Current assets:

Cash and cash equivalents	\$ 196,437
Receivables – net	189,349
Due from affiliates	9,945
Inventories	17,756
Investments	1,233,395
Assets whose use is limited or restricted – current	32,176
Prepaid expenses and other assets	<u>16,420</u>
Total current assets	1,695,478
Investments – less current portion	120,845
Assets whose use is limited or restricted – less current portion	21,602
Land, buildings, and equipment – net	645,555
Goodwill, net	6,857
Other Intangibles, net	1,055
Deferred income tax asset	6,671
Straight-line rents receivable	69,359
Beneficial interests in trusts	107,939
Other assets	<u>57,539</u>
Total	<u>\$ 2,732,900</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, 2019

(In thousands)

Liabilities and Net Assets

Current liabilities:

Accounts payable and other accrued liabilities	\$ 93,538
Accrued salaries and benefits	72,359
Other current liabilities	23,230
Due to government reimbursement programs – current	17,223
Long-term debt – current	11,186
Long-term debt subject to short-term remarketing arrangements	93,616
Due to affiliates – current	<u>13,879</u>

Total current liabilities 325,031

Long-term debt – less current portion	363,970
Pension and postretirement liabilities	109,090
Due to government reimbursement programs – less current portion	7,406
Due to affiliates – less current portion	10,000
Other long-term liabilities	<u>46,191</u>

Total liabilities 861,688

Net assets:

Without donor restrictions	1,736,219
With donor restrictions	<u>134,993</u>

Total net assets 1,871,212

Total \$ 2,732,900

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, 2019. 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 2019 consolidated financial statements. It should be read in conjunction with the 2019 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 Information
for the Members of The Queen's Health Systems Credit Group

Year ended June 30, 2019

(In thousands)

Unrestricted operating revenues:	
Net patient service revenues	\$ 1,280,670
Rental revenues	85,222
Other	<u>53,491</u>
Total unrestricted operating revenues	1,419,383
Net assets released from restrictions	<u>7,257</u>
Total unrestricted operating revenues and other support	<u>1,426,640</u>
Unrestricted operating expenses:	
Salaries, wages, and employee benefits	722,435
Supplies	229,195
Purchased services	102,935
Depreciation and amortization	73,225
Professional fees	58,386
Sustainability fees and taxes – other than income taxes	48,654
Rent and utilities	36,343
Interest	17,553
Other	<u>33,474</u>
Total unrestricted operating expenses	<u>1,322,200</u>
Operating income	<u>104,440</u>
Nonoperating income (expense):	
Investment income, net	92,090
Income tax expense	(1,421)
Gain on interest rate swap	(1,893)
Other expense	<u>(4,319)</u>
Total nonoperating income, net	<u>84,457</u>
Excess of revenues over expenses	\$ <u><u>188,897</u></u>

This statement of operations 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, 2019. Certain organizations controlled by the Parent are not members of the Credit Group. This combined statement of operations 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 is included for additional analysis and is not a required part of the basic 2019 consolidated financial statements. It should be read in conjunction with the 2019 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 Changes in Net Assets Information
for the Members of The Queen's Health Systems Credit Group

Year ended June 30, 2019

(In thousands)

	<u>Without donor restrictions</u>	<u>With donor restrictions</u>	<u>Total</u>
Net assets – June 30, 2018	\$ 1,583,004	137,286	1,720,290
Excess of revenues over expenses	188,897	—	188,897
Net unrealized (loss) gain on investments	(15,889)	635	(15,254)
Pension related changes other than net periodic pension cost	(24,259)	—	(24,259)
Gifts and grants	—	9,695	9,695
Net assets released from restrictions used for capital expenditures	5,467	(5,467)	—
Net assets released from restrictions used for operating expenses	—	(5,933)	(5,933)
Cash distributions from perpetual trusts	—	(1,324)	(1,324)
Transfers to affiliates, net	(1,001)	—	(1,001)
Other changes, net	—	101	101
	<u>153,215</u>	<u>(2,293)</u>	<u>150,922</u>
Net assets – June 30, 2019	\$ <u>1,736,219</u>	<u>134,993</u>	<u>1,871,212</u>

This statement of 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, 2019. Certain organizations controlled by the Parent are not members of the Credit Group. This combined statement of 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 changes in net assets information is included for additional analysis and is not a required part of the basic 2019 consolidated financial statements. It should be read in conjunction with the 2019 consolidated financial statements of The Queen's Health Systems and subsidiaries.

See accompanying independent auditors' report.