



TOWER HEALTH AND SUBSIDIARIES

Consolidated Financial Statements and
Supplementary Consolidating Information

June 30, 2018 and 2017

(With Independent Auditors' Report Thereon)

TOWER HEALTH AND SUBSIDIARIES

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KPMG LLP
1601 Market Street
Philadelphia, PA 19103-2499

Independent Auditors' Report

The Board of Directors
Tower Health (formerly Reading Health System):

We have audited the accompanying consolidated financial statements of Tower Health (formerly Reading Health System) and Subsidiaries, which comprise the consolidated balance sheets as of June 30, 2018 and 2017, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

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 Tower Health (formerly Reading Health System) and Subsidiaries as of June 30, 2018 and 2017, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.



Other Matter

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

KPMG LLP

Philadelphia, Pennsylvania
November 21, 2018

TOWER HEALTH AND SUBSIDIARIES

Consolidated Balance Sheets

June 30, 2018 and 2017

(Dollars in thousands)

| Assets | 2018 | 2017 |
|--|--------------|-------------|
| Current assets: | | |
| Cash and cash equivalents | \$ 67,502 | 55,535 |
| Patient accounts receivable , less allowance for uncollectible accounts of \$84,771 and \$34,640, respectively | 314,232 | 123,553 |
| Other receivables | 5,339 | 5,460 |
| Receivables from affiliates | 142 | — |
| Inventories | 37,133 | 15,034 |
| Estimated third-party payor receivables | 14,087 | 7,262 |
| Prepaid expenses and other current assets | 27,763 | 15,101 |
| Assets held for sale | 19,875 | — |
| Assets whose use is limited – required for current liabilities: | | |
| Self-insurance funding arrangements | 7,482 | 7,482 |
| Total current assets | 493,555 | 229,427 |
| Assets whose use is limited: | | |
| Self-insurance funding arrangements | 11,988 | 11,804 |
| Under regulatory requirements | 2,000 | 2,666 |
| By board for capital improvements | 850,868 | 857,972 |
| Total assets whose use is limited, net of current portion | 864,856 | 872,442 |
| Restricted investments | 33,229 | 28,149 |
| Temporarily restricted funds | 372 | 302 |
| Property, plant and equipment, net | 1,054,776 | 834,146 |
| Goodwill | 128,127 | — |
| Investments in joint ventures | 19,940 | 12,317 |
| Other assets | 4,348 | 5,387 |
| Total assets | \$ 2,599,203 | 1,982,170 |

TOWER HEALTH AND SUBSIDIARIES

Consolidated Balance Sheets

June 30, 2018 and 2017

(Dollars in thousands)

| Liabilities and Net Assets | 2018 | 2017 |
|--|--------------|-------------|
| | | |
| Current liabilities: | | |
| Current installments of long-term debt | \$ 5,600 | 5,719 |
| Capital leases | 2,120 | — |
| Accounts payable | 77,589 | 54,756 |
| Estimated third-party payor settlements | 8,965 | 4,112 |
| Current portion of estimated self-insurance costs | 13,669 | 10,885 |
| Accrued expenses | 56,445 | 29,713 |
| Accrued vacation | 40,997 | 30,160 |
| Other current liabilities | 13,202 | 8,906 |
| | 218,587 | 144,251 |
| Total current liabilities | | |
| Long-term debt, net of current portion and unamortized discount/premium and deferred financing costs | 1,126,194 | 568,800 |
| Capital leases, net of current portion | 19,651 | — |
| Accrued pension liabilities | 201,974 | 252,256 |
| Deferred revenue | 5,388 | 42,811 |
| Other liabilities | 1,964 | 2,694 |
| Estimated self-insurance costs, net of current portion | 28,536 | 37,499 |
| Swap contracts | 26,776 | 40,790 |
| | 1,629,070 | 1,089,101 |
| Total liabilities | | |
| Net assets: | | |
| Unrestricted | 935,296 | 862,951 |
| Temporarily restricted | 1,608 | 1,667 |
| Permanently restricted | 33,229 | 28,451 |
| | 970,133 | 893,069 |
| Total net assets | | |
| Total liabilities and net assets | \$ 2,599,203 | 1,982,170 |

See accompanying notes to consolidated financial statements.

TOWER HEALTH AND SUBSIDIARIES

Consolidated Statements of Operations

Years ended June 30, 2018 and 2017

(Dollars in thousands)

| | <u>2018</u> | <u>2017</u> |
|--|-------------------|------------------|
| Unrestricted revenues and other support: | | |
| Net patient service revenue | \$ 1,674,401 | 1,045,331 |
| Provision for uncollectible accounts | <u>(107,871)</u> | <u>(47,592)</u> |
| Net patient service revenue less provision for uncollectible accounts | 1,566,530 | 997,739 |
| Residential revenue | 5,959 | 23,143 |
| Other revenue | <u>48,459</u> | <u>31,474</u> |
| Total revenues and other support | <u>1,620,948</u> | <u>1,052,356</u> |
| Expenses: | | |
| Salaries and benefits | 870,916 | 595,442 |
| Supplies | 260,541 | 160,158 |
| Utilities | 18,514 | 12,465 |
| Interest | 36,580 | 12,524 |
| Depreciation | 90,491 | 84,039 |
| Purchased services | 198,647 | 90,176 |
| Repairs and maintenance | 52,834 | 32,131 |
| Other | 84,630 | 53,475 |
| Transaction related expenses | <u>18,567</u> | <u>2,221</u> |
| Total expenses | <u>1,631,720</u> | <u>1,042,631</u> |
| (Loss) income from operations | <u>(10,772)</u> | <u>9,725</u> |
| Nonoperating gains: | | |
| Investment income | 119,667 | 44,395 |
| Change in fair value of swap contracts, and net of settlement payments | 7,307 | 9,598 |
| Other-than-temporary impairment losses on investments | — | (4,111) |
| Loss on early extinguishment of debt | (4,314) | — |
| Other losses | <u>(3,204)</u> | <u>(7,490)</u> |
| Nonoperating gains, net | <u>119,456</u> | <u>42,392</u> |
| Excess of revenues, gains and other support over expenses | <u>\$ 108,684</u> | <u>52,117</u> |

See accompanying notes to consolidated financial statements.

TOWER HEALTH AND SUBSIDIARIES

Consolidated Statements of Changes in Net Assets

Years ended June 30, 2018 and 2017

(Dollars in thousands)

| | 2018 | 2017 |
|---|-------------|-------------|
| Unrestricted net assets: | | |
| Excess of revenues, gains and other support over expenses | \$ 108,684 | 52,117 |
| Unrealized (losses) gains on investments, net | (70,878) | 37,367 |
| Change in pension liability | 34,887 | 54,056 |
| Net assets released from restriction and other | (348) | (665) |
| Increase in unrestricted net assets | 72,345 | 142,875 |
| Temporarily restricted net assets: | | |
| Contributions | 289 | 1,549 |
| Net assets released from restrictions – for operations | (348) | (248) |
| (Decrease) increase in temporarily restricted net assets | (59) | 1,301 |
| Permanently restricted net assets: | | |
| Contributions | 3,039 | 2,211 |
| Unrealized gains on investments, net | 361 | 1,869 |
| Change in beneficial interest in trusts | 1,378 | 1,018 |
| Increase in permanently restricted net assets | 4,778 | 5,098 |
| Change in net assets | 77,064 | 149,274 |
| Net assets: | | |
| Beginning of year | 893,069 | 743,795 |
| End of year | \$ 970,133 | 893,069 |

See accompanying notes to consolidated financial statements.

TOWER HEALTH AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended June 30, 2018 and 2017

(Dollars in thousands)

| | 2018 | 2017 |
|--|-----------|-----------|
| Cash flows from operating activities: | | |
| Change in net assets | \$ 77,064 | 149,274 |
| Adjustments to reconcile change in net assets to net cash (used in) provided by operating activities: | | |
| Unrealized losses (gains) on investments and beneficial interest in trusts | 73,658 | (40,254) |
| Change in fair value of swap contracts | (14,014) | (18,344) |
| Amortization of bond discount | 65 | 77 |
| Amortization of bond premium | (1,923) | (212) |
| Amortization of deferred financing costs | 448 | 285 |
| Change in pension liability, net | (50,282) | (73,656) |
| Depreciation | 90,491 | 84,039 |
| Amortization of entrance fees | (1,236) | (4,972) |
| Proceeds from entrance fees and deposits | 937 | 6,165 |
| Gain on disposal of fixed assets | (1,115) | — |
| Provision for uncollectible accounts | 107,871 | 47,592 |
| Investment income | (124,186) | (44,048) |
| Equity in earnings of affiliates | (8,875) | (2,987) |
| Restricted contributions | (3,328) | (3,760) |
| Loss on early extinguishment of debt | 4,314 | — |
| Loss on divestiture of affiliate | 6,390 | — |
| Change in cash due to changes in operating assets and liabilities, net: | | |
| Receivable from patients and others | (301,669) | (56,740) |
| Inventories | (3,469) | (907) |
| Prepaid expenses and other assets | (7,416) | 11,470 |
| Accounts payable and other liabilities | 60,097 | 12,207 |
| Estimated self-insurance costs | (6,179) | (12,814) |
| Deferred revenue | 226 | 1,104 |
| Third-party payor settlements | (1,972) | 1,083 |
| Net cash (used in) provided by operating activities | (104,103) | 54,602 |
| Cash flows from investing activities: | | |
| Acquisition of property, plant and equipment | (87,102) | (113,696) |
| Proceeds from the sale of property, plant and equipment | 3,773 | — |
| Divestiture of affiliate | 69,133 | — |
| Acquisition of business, net of cash received | (423,365) | — |
| Investment in equity investees | — | (2,000) |
| Distribution from equity investees | 4,770 | 3,063 |
| Sales of investments and assets whose use is limited, net | 779,290 | 167,460 |
| Purchases of investments and assets whose use is limited, net | (786,617) | (168,027) |
| Net cash used in investing activities | (440,118) | (113,200) |
| Cash flows from financing activities: | | |
| Restricted contributions and investment income received | 3,328 | 2,395 |
| Payments to escrow for debt extinguishment | (48,561) | — |
| Proceeds from long-term debt issuance | 646,651 | — |
| Payment of deferred financing costs | (4,171) | — |
| Repayments of long-term debt | (39,548) | (5,528) |
| Proceeds from bridge loan | (491,018) | — |
| Repayment of bridge loan | 491,018 | — |
| Payments on capital leases | (1,457) | — |
| Refunds of entrance fees and deposits | (54) | (548) |
| Net cash provided by (used in) financing activities | 556,188 | (3,681) |
| Net increase (decrease) in cash and cash equivalents | 11,967 | (62,279) |
| Cash and cash equivalents: | | |
| Beginning of year | 55,535 | 117,814 |
| End of year | \$ 67,502 | 55,535 |
| Supplemental cash flow information: | | |
| Cash paid during the year for interest, net of capitalized interest of \$382 and \$5,790 for 2018 and 2017 | \$ 32,354 | 12,424 |
| Fixed asset additions included in accounts payable and accrued expenses at June 30 | 5,138 | 5,515 |

See accompanying notes to consolidated financial statements.

TOWER HEALTH AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

(1) Organizational Structure and Nature of Operations

Tower Health (formerly Reading Health System) (Parent) is a tax-exempt not-for-profit corporation under Section 501(c)(3) of the Internal Revenue Code. The Parent is located in West Reading, Pennsylvania, and provides inpatient, outpatient and emergency care for residents of the greater Berks, Montgomery, and Chester County areas through its subsidiaries (collectively, the System).

(a) Subsidiaries of the Parent Include:

Reading Hospital (Hospital), a tax-exempt not-for-profit corporation providing acute and post-acute care.

Montgomery/Chester hospitals acquired on October 1, 2017 from Community Health Systems (CHS), are tax-exempt not-for-profit corporations providing acute and post acute care. The five hospitals include: Brandywine Hospital in Coatesville; Chestnut Hill Hospital in Philadelphia; Jennersville Regional Hospital in West Grove; Phoenixville Hospital in Phoenixville and Pottstown Memorial Medical Center in Pottstown (collectively, Montgomery/Chester Hospitals)

Tower Health Medical Group (THMG), formerly Reading Health Physician Network (RHPN), a tax-exempt entity established to assure access to high quality primary care physicians and specialty physicians in sufficient numbers to meet the community needs for charitable, educational, and scientific purposes. THMG also recruits physicians and provides administrative services for the Hospital, including supervision and instruction for medical students completing their residency training. The Montgomery / Chester clinics and practices are part of THMG.

The Highlands at Wyomissing (The Highlands), a not-for-profit corporation, was a fully controlled entity of the Parent through September 30, 2017. The purpose of The Highlands was to operate a continuing care retirement community including residential, recreational and health care facilities and services specially designed to meet the physical, social and psychological needs of elderly persons. The Highlands facility is located in Wyomissing, Pennsylvania, and its residents are principally from the Wyomissing and Reading, Pennsylvania, area. The facility contains 285 residential living units, an 80-bed skilled nursing unit, and 66 personal care units. Certain members of the Board of Directors from the Hospital are also members of the Board of Directors of The Highlands. The Highlands affiliation with the Parent was divested on September 30, 2017. The Parent recorded a loss of \$6,390 in the year ended June 30, 2018 in connection with the divestiture, which is included in transaction related expenses in the accompanying consolidated statements of operations.

Tower Health Partners (THP), formerly Reading Health Partners (RHP), a Pennsylvania limited liability company, was formed to develop a physician network working in conjunction with the Parent to implement a clinical integration program. Clinical integration is the implementation of an active and ongoing program to evaluate and modify practice patterns by the network's physician participants and create a high degree of interdependence and cooperation among the physicians to control costs and improve the quality and efficiency of health care in the community.

Reading Hospital Foundation (RHF), formerly Reading Health System Foundation, a not-for-profit corporation to support research, education, innovation and fund raising in support of the Parent and its subsidiaries, and the community. The Parent is the sole member of RHF.

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Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

Tower Health Enterprises (THE), a Pennsylvania limited liability company, was formed to hold the interest in joint ventures acquired as part of the acquisition on October 1, 2017. These investments are recorded under the equity method of accounting and are included in investments in joint ventures on the accompanying balance sheets, totaling \$3,685 at June 30, 2018.

(b) Other Noncontrolled Entities Include:

The Reading Hospital Surgicenter at Springridge, LLC (Springridge, LLC), a limited liability company, was established to provide ambulatory surgery services to the surrounding community. The Hospital maintains a 50% ownership under the equity method of accounting. In the years ended June 30, 2018 and 2017, the Hospital received distributions of \$3,445 and \$3,063, respectively. This investment is recorded under the equity method of accounting and is included in investments in joint ventures on the accompanying consolidated balance sheets, totaling \$605 and \$1,065 at June 30, 2018 and 2017, respectively.

The Parent, along with several other acute care service hospitals throughout the central Pennsylvania area, contributed capital to form Central Pennsylvania Alliance Laboratories (CPAL), a joint venture to combine laboratory operations. The Parent maintains a 20% ownership interest in CPAL. This investment is recorded under the equity method of accounting and is included in investments in joint ventures on the accompanying consolidated balance sheets, totaling \$350 at both June 30, 2018 and 2017.

The Parent's ownership of Central Pennsylvania Homecare, Inc. (d.b.a. Affilia Home Health, AHH) is 44.1%. AHH provides visiting home nursing services to outpatients of the Hospital and other healthcare providers in the surrounding community. This investment is recorded under the equity method of accounting and is included in investments in joint ventures on the accompanying consolidated balance sheets, totaling \$6,361 and \$6,163 at June 30, 2018 and 2017, respectively. In October 2018, the owners of AHH announced the joint venture will be dissolved as of January 1, 2019.

The Parent is a 20% owner of Quest Behavioral Health, Inc. (Quest). Quest is a not-for-profit corporation providing full service managed behavioral healthcare. This investment is recorded under the equity method of accounting and is included in investments in joint ventures on the accompanying consolidated balance sheets, totaling \$90 and \$84 at June 30, 2018 and 2017, respectively.

Horizon is a for-profit limited liability partnership of which the Parent is a 25% owner. The investment is recorded under the equity method of accounting and is included in investments in joint ventures on the accompanying consolidated balance sheets, totaling \$1,292 and \$1,204 at June 30, 2018 and 2017, respectively.

AllSpire Health Partners, LLC is an alliance of five systems in New Jersey and Pennsylvania for which the Parent is a 20% owner. The consortium will carry out joint activities in traditional areas of patient care services, research and education to enhance the value of health care that communities receive. This investment is recorded under the equity method of accounting and is included in investments in joint ventures on the accompanying consolidated balance sheets, totaling \$602 and \$596 at June 30, 2018 and 2017, respectively.

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Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

AllSpire Health GPO, LLC formed May 31, 2016 is an alliance of the five system's that are part of AllSpire Health Partners, LLC for which the Parent is a 20% owner. The alliance was created to help manage the expenses by group purchasing volumes, streamline suppliers and implementations efficiencies across all partners. The goal is to identify clinical optimization and revenue opportunities to give access of quality products to providers and patients. In the year ended June 30, 2018, the Parent received a distribution of \$1,325. This investment is recorded under the equity method of accounting and is included in investments in joint ventures on the accompanying consolidated balance sheets, totaling \$2,863 and \$854 at June 30, 2018 and 2017, respectively.

UPMC (University of Pittsburgh Medical Center) Health Plan and the Parent created a joint venture on January 1, 2017, of which each member is a 50% equity owner. UPMC Health Plan provides third party administration and flexible spending account administration services for the System. Additional benefits result in enhanced cost savings, value based healthcare to residents and companies in the greater Berks County area and access to the System as an in-network provider. This investment is recorded under the equity method of accounting and is included in investments in joint ventures on the accompanying consolidated balance sheets, \$4,092 and \$2,001 at June 30, 2018 and 2017, respectively.

(2) Summary of Significant Accounting Policies

Basis of Accounting

The accompanying consolidated financial statements have been prepared on the accrual basis of accounting in conformity with U.S. generally accepted accounting principles (GAAP). The significant accounting policies followed by the System are as follows:

(a) Principles of Consolidation

The consolidated financial statements of the System include the accounts of the Parent, the Hospital, Montgomery/Chester Hospitals, THMG, The Highlands, THP, THF, and THE. All entities where the Parent, Hospital, or THE exercises significant influence but for which it does not have control are accounted for under the equity method. All significant intercompany balances and transactions have been eliminated.

(b) Use of Estimates

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(c) Cash and Cash Equivalents

Cash and cash equivalents include investments in highly liquid debt instruments with an original maturity of three months or less. At June 30, 2018 and 2017, the System had cash balances in financial institutions that exceeded federal depository insurance limits. Management believes that the credit risk related to these deposits is minimal.

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Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

(d) Net Patient Service Revenue and Accounts Receivable

The System has agreements with third-party payors that provide for payments at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per-diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered and includes estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. Changes in prior year estimates increased net patient service revenue by \$3,878 and \$6,612 for the years ended June 30, 2018 and 2017, respectively.

The System recognizes patient service revenue associated with services provided to patients who have third-party payor coverage on the basis of contractual rates for the services rendered. For uninsured patients who do not qualify for charity care, the System recognizes revenue based on established rates, subject to certain discounts as determined by the System. An estimated provision for uncollectible accounts is recorded that results in net patient service revenue being reported at the net amount expected to be received. The System has determined that patient service revenue primarily is recorded prior to assessing the patient's ability to pay, and, as such, the entire provision for uncollectible accounts related to patient revenue is recorded as a deduction from patient service revenue in the consolidated statements of operations. Patient service revenue, net of contractual allowances and discounts (but before the provision for uncollectible accounts), for the years ended June 30, 2018 and 2017 from its major payor sources are as follows:

| | 2018 | 2017 |
|----------------------|-------------|-------------|
| Medicare | 35% | 32% |
| Medical assistance | 11 | 11 |
| Blue Cross | 30 | 35 |
| Commercial insurance | 20 | 16 |
| Self-pay | 3 | 4 |
| Other | 1 | 2 |
| | 100% | 100% |

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

Accounts receivable are reduced by an allowance for uncollectible accounts. In evaluating the collectability of accounts receivable, the System analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for uncollectible accounts and provision for uncollectible accounts. Management regularly reviews data about these major payor sources of revenue in evaluating the sufficiency of the allowance for uncollectible accounts. For

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June 30, 2018 and 2017

(Dollars in thousands)

receivables associated with services provided to patients who have third-party coverage, the System analyzes contractually due amounts and provides an allowance for uncollectible accounts and a provision for uncollectible accounts, if necessary (for example, for expected uncollectible deductibles and copayments on accounts for which the third-party payor has not yet paid, or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely). For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the System records a significant provision for uncollectible accounts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates, if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for uncollectible accounts.

(e) Inventories

Inventories are stated at lower of cost (determined by the first-in, first-out method) or market.

(f) Assets Whose Use is Limited

Assets whose use is limited includes designated assets set aside by the Board of Directors for future capital improvements, assets held by trustees under indenture agreements and self-insurance trust arrangements. The Board of Directors retains control over Board-designated assets and may at its discretion subsequently use these assets for other purposes.

Assets whose use is limited includes cash and cash equivalents, marketable securities (including U.S. government and government agencies, corporate, state and local government), marketable equity securities (including common, preferred, and foreign stock), exchange traded/listed mutual funds (including fixed income funds), hedge funds, private equity funds, and limited partnerships.

The Pennsylvania Continuing Care Provider Registration and Disclosure Act requires a statutory reserve equivalent to the greater of the total of debt service payments due during the next 12 months on account of any loan, or 10% of the projected annual operating expenses of the facilities exclusive of depreciation, computed only on the proportional share of financing or operating expenses that is applicable to residents under entrance agreement contracts. For the System, this statutory requirement applies only to The Highlands and there is no statutory reserve requirement as of June 30, 2018 due to the divestiture of the Highlands on September 30, 2017.

In addition, The Pennsylvania Continuing Care Provider Registration and Disclosure Act requires that the provider establish an interest-bearing escrow account with a bank, trust company or other escrow agent approved by the commissioner for any entrance fees or payments that are in excess of 5% of the then existing entrance fee for the unit, which are received by the provider prior to the date the resident is permitted to occupy the living unit in the facilities. As of June 30, 2017, The Highlands maintains an escrow account of \$371 which is included in prepaid expenses and other current assets on the accompanying 2017 consolidated balance sheet.

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Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

(g) Investments and Investment Income

Investments in equity securities with readily determinable fair values and all investments in debt securities are recorded at fair value in the consolidated balance sheets. In the year ended June 30, 2018, the System restructured its unrestricted Long-Term Capital (LTC) investment portfolio by eliminating redundant investment advisors and redeploying investments. As a part of this restructuring, the LTC portfolio was designated as a trading portfolio.

Investment income earned on securities (interest and dividends) is reported in the nonoperating gains (losses) section of the consolidated statements of operations within investment income. Realized gains or losses related to the sale of investments, impairment losses on other than trading investments, and unrealized gains or losses on alternative investments and LTC investments, are included in the nonoperating gains (losses) section of the consolidated statements of operations in investment income unless the income or loss is restricted by donor or law.

Restricted investments and assets held for self-funding arrangements are classified as other than trading, and changes in unrealized gains on these instruments are included in the consolidated statements of changes in net assets. Unrealized losses are included in the consolidated statements of operations within nonoperating gains (losses) as other than temporary impairment on other than trading investments. Prior to the restructuring of the LTC portfolio in the year ended June 30, 2018, unrestricted investments held in the LTC were also classified as other than trading.

The fair value option for financial assets and liabilities permits the System to elect to measure eligible items at fair value on an instrument by instrument basis. If elected, this option requires the System to report the unrealized gains and losses on these instruments as part of the performance indicator. Once elected, the fair value option is irrevocable for that instrument. Alternative investments include investments in managed funds, which include hedge funds, private equities, limited partnerships, and other investments that do not have readily determinable fair values and may be subject to withdrawal restrictions. Investments in hedge funds, private equities, limited partnerships, and other investments in managed funds (collectively Alternative Investments) are accounted for using the fair value option. The unrealized gains or losses from these Alternative Investments are included in the consolidated statements of operations as part of nonoperating gains (losses) within investment income.

(h) Fair Value Measurements

The System follows the provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820, *Fair Value Measurement* (ASC 820), which defines fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date. ASC 820 also establishes a framework for measuring fair value using valuation techniques such as the market approach, cost approach, and income approach, and making disclosures about fair value measurements.

ASC 820 emphasizes that fair value is a market-based measurement, not an entity specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing an asset or liability. As a basis for considering market participant assumptions in fair value measurements, ASC 820 defines a three-level fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from

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sources independent of the reporting entity and the reporting entity's own assumptions about market participants. The fair value hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

Level 1 – Inputs utilized quoted market prices in active markets for identical assets or liabilities that the System has the ability to access.

Level 2 – Inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the asset and liability (other than quoted prices) such as interest rates, foreign exchange rates, and yield curves that are observable at commonly quoted intervals.

Level 3 – Inputs are unobservable inputs for the asset or liability, which is typically based on an entity's own assumptions, as there is little, if any, related market activity.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the Level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest Level input that is significant to the fair value measurement in its entirety. The System's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

Where quoted prices are available in an active market, investments are classified in Level 1 of the valuation hierarchy. Investments in Level 1 include cash, exchange-traded equity securities, and mutual funds with a published daily net asset value or its equivalent (NAV). Investments in Level 2 include financial instruments valued based on quoted market prices for identical securities in markets that are not active, quoted prices for similar securities in markets that are active, broker or dealer quotations or alternative pricing sources with reasonable levels of price transparency. If quoted prices are not available, other accepted valuation methodologies, such as interest rates, observable yield curves and spreads may be used to determine fair value. Level 2 includes state and municipal government securities, corporate and foreign bonds, U.S. Government securities, and certain mutual and fixed income funds that permit daily redemptions but whose NAV is not published. Auction rate securities are estimated using the income approach. This approach uses estimation techniques to determine the estimated future cash flows of the respective asset or liability expected by a market participant and discounts those cash flows back to present value.

The fair values of Alternative Investments have been estimated by management based on all available data, including information provided by third-party pricing vendors, fund managers and general partners. Alternative Investments are recorded at fair value based on the NAV as a practical expedient, as provided by the respective general partner or fund administrator of the individual Alternative Investment funds. The System believes the fair value of Alternative Investments in the consolidated balance sheets is a reasonable estimate of its ownership interest in the Alternative Investment funds. As part of the System's overall valuation process, management evaluates these third-party methodologies to ensure that they are representative of exit prices in the security's principal markets.

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These valuation methods may produce a fair value estimate that may not be reflective of future fair values. Furthermore, while the System believes that its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine fair value could result in a materially different estimate of fair value at the reporting date.

(i) Property, Plant and Equipment

Property, plant and equipment are carried at cost, less accumulated depreciation. Expenditures that substantially increase the useful lives of existing assets are capitalized. Routine maintenance and repairs are expensed as incurred. Depreciation is computed using the straight-line method over the estimated useful lives of each class of depreciable asset. Useful lives range as follows:

| | |
|---|-------------|
| Land improvements | 5–25 years |
| Buildings and building improvements | 10–50 years |
| Fixed equipment | 5–15 years |
| Movable equipment (including software and hardware) | 3–15 years |

During the year ended June 30, 2018, the System changed the estimated useful lives at the Hospital, primarily impacting buildings and building improvements from 10-40 years to 10-50 years. The effect was a decrease in depreciation expense of approximately \$15,000 for the year ended June 30, 2018.

Gains and losses resulting from the retirement or sale of property, plant and equipment are included in the consolidated statements of operations. Interest cost incurred on borrowed funds during the period of construction of capital assets is capitalized as a component of the cost of acquiring those assets. Gifts of long-lived operating assets such as land, buildings or equipment are reported as unrestricted contributions and are excluded from the performance indicator unless explicit donor stipulations specify how the donated asset must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

The System reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Management has reviewed the carrying amount of these assets and has determined that they are not currently impaired.

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(j) Goodwill and Intangible Assets

Goodwill is an asset representing the future economic benefits arising from other assets acquired in a business combination. The System evaluates goodwill for impairment annually and whenever events or changes in circumstances indicate that the value of the asset may be impaired. Impairment testing consists of performing internal qualitative and/or quantitative assessments and considers other publicly available market information. If the carrying amount of the goodwill exceeds the estimated fair value, an impairment charge to current operations is recorded to reduce the carrying value to the estimated fair value. All of the System's goodwill was acquired in the year ended June 30, 2018 as a result of the transaction with CHS. As of June 30, 2018 there was no indication of impairment of goodwill.

(k) Deferred Financing Costs

Deferred financing costs are amortized over the period the debt is outstanding using the straight-line method, which approximates the effective interest method. Amortization of deferred financing costs totaled \$448 and \$285 for the years ended June 30, 2018 and 2017, respectively. Accumulated amortization totaled \$1,602 and \$1,154 as of June 30, 2018 and 2017, respectively.

(l) Estimated Self-Insurance Costs

The provision for estimated self-insured claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported. The System self-insures its medical malpractice, general liability, and workers' compensation risks. Reserve estimates are subject to the impact of changes in claim trends as well as prevailing social, economic, and legal conditions. The ultimate net cost of settling these liabilities may vary from the estimated amounts. Accordingly, reserve estimates are continually reviewed and updated, and any resulting adjustments are reflected in the performance indicator.

(m) Accrued Vacation

The System records a liability for amounts due to employees for future paid leave, which are attributable to services performed in the current and prior periods.

(n) Bond Premiums and Discounts

Bond premiums and discounts are amortized to interest and expensed as direct additions or reductions of the carrying values of the related debt instruments from which the discounts or premiums arose. Bond premiums and discounts are amortized to interest expense over the period during which the debt is outstanding using the straight-line method, which approximates the effective interest method.

(o) Derivative Instruments

The System follows accounting guidance on derivative financial instruments that is based on whether the derivative instrument meets the criteria for designation as an effective cash flow hedge. The process for designating a derivative as an effective hedge includes the assessments of the instrument's effectiveness in risk reduction, matching the derivative instrument to its underlying transactions and the assessment of the probability that the underlying transaction will occur. All of the System's derivative financial instruments are interest rate swap agreements without hedge accounting designation.

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Entering into interest rate swap agreements involves, to varying degrees, elements of credit, default, prepayments, and market risk in excess of the amounts recognized on the consolidated balance sheets. Such risks involved the possibility that there will be no liquid market for these arrangements, the counterparty to these arrangements may default on its obligations to perform, and there may be unfavorable changes in interest rates. The System does not hold derivative instruments for the purpose of managing credit risk and enters into derivative transactions with high quality counterparties.

The interest rate swap agreements entered into by the System are adjusted to market value based upon quotations from the counterparties and a credit valuation adjustment is applied to the valuations of the swaps which takes into consideration counterparty risk of default. The change in market value is recorded in the consolidated statements of operations within excess of revenues, gains (losses), and other support over expenses.

(p) *Temporarily and Permanently Restricted Net Assets*

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

(q) *Residential Revenue and Deferred Revenue*

Entrance fees paid by residents of The Highlands' independent living units are recorded as deferred revenue. Entrance fees are amortized to income using the straight-line method over the estimated remaining life expectancy of the resident for amounts nonrefundable. In addition, for all contracts entered into prior to January 1, 2005, a portion equal to 30% of the entrance fee, referred to as the health fund is reserved to be accounted for individually for each resident/couple and is refundable to the extent not amortized. Amortization of the health fund occurs when a resident utilizes health services (nursing or personal care).

The Highlands' entrance fees are refundable for a period of time up to 50 months. During this time, for refund purposes only, a resident's entrance fee is amortized at the rate of 2% per month for 50 months beginning on the date of occupancy. The Highlands has deferred revenue pertaining to entrance fees of \$37,568 at June 30, 2017. The amount of entrance fees, which is refundable to residents at June 30, 2017 under contractual refund provisions, was approximately \$15,556.

(r) *Other Revenue*

Significant components of other revenue include rental income on leased properties, tuition revenue for The Reading Hospital School of Health Sciences, and cafeteria revenues.

(s) *Donor Restricted Gifts*

Unconditional promises to give cash and other assets to the System are reported at estimated fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at estimated fair value at the date the gift is received.

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Donations are reported as either temporarily or permanently restricted if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of operations as net assets released from restrictions. Donor-restricted donations whose restrictions are met within the same year as received are reported as unrestricted donations in the accompanying consolidated statements of operations.

(t) Income Taxes

The System is a not-for-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code and is exempt from federal income taxes on related income pursuant to Section 501(a) of the Code. On such a basis, the exempt entities do not incur liability for federal income taxes, except in the case of unrelated business income.

The System evaluates uncertain tax positions using a two-step approach for recognizing and measuring tax benefits taken or expected to be taken in an unrelated business activity tax return and disclosures regarding uncertainties in tax positions. No adjustments to the consolidated financial statements were required as a result of this evaluation.

On December 22, 2017, the President signed into law H.R. 1, originally known as the Tax Cuts and Jobs Act. The new law includes several provisions that result in substantial changes to the tax treatment of tax-exempt organizations and their donors. The System has reviewed these provisions and the potential impact and concluded the enactment of H.R. 1 will not have a material impact on the operations of the System.

(u) Uncompensated Care and Community Service

The System provides services to patients who meet the criteria of its charity service policy without charge or at amounts less than the established rates. Criteria for charity care consider the patient's family income, family size, and ability to pay. Individuals who qualify for charity care do not have insurance or other coverage.

The System maintains records to identify and monitor the level of charity care and community service it provides. These records include the amount of charges foregone based on established rates for services, and supplies furnished under its charity care, community service policies, and the estimated cost of those services.

Charges foregone for uncompensated care as determined in accordance with the System's policies were approximately \$16,621 and \$9,244 in the years ended June 30, 2018 and 2017, respectively. Direct and indirect costs to provide these services were approximately \$4,955 and \$3,005 for the years ended June 30, 2018 and 2017, respectively. The estimated costs were based on a calculation, which multiplied the cost to charge ratio by the gross charges associated with providing uncompensated care to patients. The cost to charge ratio was obtained from the System's most recently filed Medicare cost report.

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Additionally, the System sponsors certain other service programs and charity services, which provide substantial benefit to the broader community. Such programs include services to needy populations requiring special services and support, community service programs and charity services, as well as health promotion and education.

The System's community service includes the Medical Assistance program, which makes payment for services provided to families with dependent children, the aged, the blind, and the permanently and totally disabled, whose income and resources are insufficient to meet the costs of necessary medical services. Payments from the Medical Assistance program are generally less than the System's cost of providing the service.

In addition, community service represents the cost to deliver services to the community, net of any payment received for those services. Included in these services are the System's subsidies of outpatient clinics, education of medical professionals who work with various health care providers in the community upon graduation and community mental health programs. The System also sponsors health fairs and other wellness programs throughout the community.

(v) Excess of Revenue, Gains and Other Support over Expenses

The consolidated statements of operations include the excess of revenues, gains and other support over expenses. Changes in unrestricted net assets that are excluded from this performance indicator, consistent with industry practice, include changes in unrealized gains (losses) on marketable securities classified as other than trading securities, adjustments for defined benefit and other postretirement benefits, and contributions of long-lived assets (including assets acquired using contributions, which by donor-restriction were to be used for the purposes of acquiring such assets).

(w) Future Service Obligations

The Highlands' annually calculates the present value of the net cost of future services using a discount rate of 5.5% and compares that amount with the balance of deferred revenue from entrance fees. If the present value of the net cost of future services and the use of facilities exceeds the deferred revenue from entrance fees, a liability would be recorded (obligation to provide future services and use of facilities) with the corresponding charge to income. As a result of the calculation, the present value of the net cost of future services did not exceed deferred revenue; accordingly, no obligation was recorded at June 30, 2017. The System divested of the Highlands on September 30, 2017.

(x) Recent Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, (ASU 2014-09) which changes the requirements for recognizing revenue when entities enter into contracts with customers. Under ASU 2014-09, an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects what it expects in exchange for the goods or services. It also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In December 2016, the FASB issued ASU No. 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*, (ASU 2016-20) which serves to narrow aspects of the guidance issued in ASU 2014-09. The adoption of

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ASU 2014-09 is effective for annual and interim periods beginning after December 15, 2017 and early adoption is not permitted. The System adopted ASU 2014-09 and ASU 2016-20, effective July 1, 2018 using the modified retrospective method. The System is finalizing the impact of ASU 2014-09 and ASU 2016-20, and does not expect that the adoption of these ASUs will not have a material impact on the System's consolidated financial position and results of operations.

In April 2015, the FASB issued ASU No. 2015-03, *Simplifying the Presentation of Debt Issuance Costs*, (ASU 2015-03). This ASU requires an entity to present debt issuance costs as a direct deduction from the carrying amount of the related debt liability, consistent with debt discounts. The costs will continue to be amortized to interest expense using the effective interest method. The adoption of ASU 2015-03 is effective for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years, with early adoption permitted. This ASU requires retrospective application to all prior periods presented in the financial statements. On July 1, 2016, the System adopted this guidance.

In January 2016, the FASB issued ASU No 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities* (ASU 2016-01), which changes the income statement impact of equity investments held by an entity, and the recognition of changes in fair value of financial liabilities when the fair value option is elected. The adoption of ASU 2016-01 is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted for fiscal years beginning after December 15, 2017. The System is currently assessing the impact of the adoption of ASU 2016-01 and the impact it will have on the System's consolidated financial condition and results of operations.

In February 2016, the FASB issued ASU No. 2016-02, *Leases* (ASU 2016-02), which will require lessees to recognize most leases on-balance sheet, increasing their reported assets and liabilities – sometimes very significantly. This update was developed to provide financial statement users with more information about an entity's leasing activities, and will require changes in processes and internal controls. The adoption of ASU 2016-02 is effective for annual and interim periods beginning after December 15, 2018, and will require application of the new guidance at the beginning of the earliest comparable period presented. Early adoption is permitted. The System is currently assessing the impact of the adoption of ASU No. 2016-02, which is expected to have a material impact on the System's consolidated financial condition and results of operations.

In August 2016, the FASB issued ASU 2016-14, *Presentation of Financial Statements for Not- For-Profit Entities*, which will require not-for-profit entities to revise financial presentation to include: net asset classifications, provide quantitative and qualitative information as to available resources and management of liquidity and liquidity risk, information on investment expenses and returns, and the presentation of operating cash flows. The standard aims to help the reader of the financial statements to better understand the financial position of the organization and enhance consistency among similar organizations. ASU 2016-14 is effective for annual periods beginning after December 15, 2017. Early adoption is permitted. The System is currently assessing the impact ASU 2016-14 will have on its consolidated financial condition and results of operations.

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(3) Acquisition of CHS Entities

On October 1, 2017, the Montgomery/Chester Hospitals and related physician clinics and practices were acquired from CHS. The total consideration paid was \$423,377. The total consideration paid was allocated to net tangible assets and liabilities assumed based upon the estimated fair values. The excess of the consideration price over the estimated fair value of the net tangible assets acquired and liabilities assumed was recorded as goodwill. The allocation of the consideration paid to property, plant and equipment was based upon valuation data and estimates. Goodwill recognized from the acquisition is the result of (i) the expected savings to be realized from achieving certain efficiencies and economies of scale with increased quality and access at a lower cost of care and (ii) anticipated long-term improvements in core businesses of the Montgomery/Chester Hospitals and related physician clinics and practices.

The acquisition purchase price of \$423,377 was financed with proceeds from a bridge loan borrowing of \$491,018 with the remaining proceeds used for the general working capital needs of the System. The bridge loan was repaid in connection the issuance of Berks County Municipal Authority Hospital Revenue Bond Series of 2017 on October 31, 2017 (note 8).

For the year ended June 30, 2018, the System incurred acquisition costs of \$6,856, consisting of investment banking, legal, accounting and other costs associated with the transaction, which is included in acquisition and transaction related expenses on the accompanying consolidated statements of operations. The System also incurred \$4,171 of deferred financing costs associated with the debt financings in the year ended June 30, 2018, which has been capitalized and treated a reduction in long-term debt on the accompanying consolidated balance sheets.

The consideration price and related fair value allocation of the assets acquired and liabilities assumed in the acquisition, which resulted in goodwill totaling \$128,127, are summarized as follows:

| | | |
|---|----|----------------|
| Cash and cash equivalents | \$ | 12 |
| Inventories | | 18,831 |
| Prepaid expenses and other current assets | | 5,230 |
| Property, plant and equipment | | 298,045 |
| Goodwill | | 128,127 |
| Investments in joint ventures | | 3,518 |
| Accrued vacation | | (7,145) |
| Other current liabilities | | (13) |
| Capital lease obligations | | (23,228) |
| | | <hr/> |
| Net assets acquired | \$ | <u>423,377</u> |

The 2018 consolidated statement of operations include the results of operations of the Montgomery/Chester Hospitals and related physician clinics and practices from October 1, 2017. Total revenues and other support attributable to the Montgomery/Chester Hospitals in the accompanying 2018 consolidated statement of operations was \$471,865.

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The pro forma combined results as though the acquisition date occurred at the beginning of the fiscal year 2017 are summarized as follows:

| | <u>June 30, 2018</u> | <u>June 30, 2017</u> |
|----------------------------------|----------------------|----------------------|
| | <i>(Unaudited)</i> | |
| Total revenues and other support | \$ 1,800,425 | 1,705,096 |
| Loss from operations | (26,465) | (7,211) |

(4) Pending Transactions

On October 2, 2018, the System announced an agreement to acquire Premier Urgent Care, which operates nineteen urgent care locations. The nineteen sites are located primarily in the System's southeast service area, including Chester, Montgomery and Bucks County, with one location in Berks County and one in Delaware.

On November 12, 2018, the System announced an agreement to sell an undeveloped 80 acre parcel of land in Spring Township, Pennsylvania. The System's overall ownership of the parcel is approximately 103 acres and will retain approximately 23 acres. The land has been reclassified to assets held for sale at June 30, 2018 on the accompanying consolidated balance sheet.

(5) Net Patient Service Revenue

The System has agreements with third-party payors that provide for payments at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows.

(a) Medicare and Managed Medicare

Inpatient acute care and rehabilitation services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Outpatient services are reimbursed by Medicare under the Ambulatory Payment Classification System. The System is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by the System and audits thereof by the Medicare fiscal intermediary. The System's classification of patients under the Medicare program and the appropriateness of their admission are subject to medical necessity reviews by independent organizations under contract with the Center for Medicare and Medicaid Services (CMS). The System has received settlements on Medicare cost reports through June 30, 2015.

(b) Medicaid and Managed Medicaid

On December 29, 2010, the Pennsylvania Department of Human Services (DHS) received approval from the Centers for Medicare & Medicaid Services for the state plan amendments pursuant to Act 49 of 2010, passed by the Pennsylvania General Assembly on July 3, 2010, which established a new inpatient hospital fee for service payment system, new supplemental payments and the waiver to establish the statewide Quality Care Assessment. DHS also received approval on final language for the

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DHS contracts with managed care organizations. The estimated net impact on the System for the years ended June 30, 2018 and 2017, was \$17,494 and \$9,479, respectively, (based on total payment increases of \$43,087 and \$25,117, offset by assessments of \$25,593 and \$15,638, respectively).

(c) Nongovernmental Payors

Inpatient services rendered by nongovernmental payors are reimbursed at negotiated rates. The System continues to be reimbursed for outpatient services at a negotiated percentage of covered charges.

(d) Workers' Compensation

The payment method by which all employers and/or insurers of workers' compensation policies will pay for the services provided by health care providers to employees covered by workers' compensation is a percentage of the Medicare payment for these services.

(e) Other Contractual Arrangements

The System has various payment agreements with preferred provider organizations and health maintenance organizations. The basis for payment under these agreements includes discounts from established charges.

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. Compliance with these laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at the time. Recently, government activity has increased with respect to investigations and allegations concerning possible violations by health care providers of fraud and abuse statutes and regulations, which could result in the imposition of significant fines and penalties as well as significant repayments for patient services previously billed.

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(6) Assets Whose Use is Limited and Investments

Assets whose uses are limited and that are required for obligations classified as current liabilities are reported as current assets. The composition of assets whose uses are limited at June 30, is set forth in the following tables.

| | 2018 | 2017 |
|---|------------|---------|
| Self-insurance funding arrangements: | | |
| Cash and cash equivalents | \$ 351 | 142 |
| U.S. government securities | 10,717 | 8,980 |
| Corporate bonds | 7,887 | 9,713 |
| Equity mutual funds | 515 | 451 |
| Total assets whose use is limited under self-insurance funding arrangements | \$ 19,470 | 19,286 |
| By board for capital improvements and under regulatory requirements: | | |
| Cash and cash equivalents | \$ 14,858 | 20,657 |
| State, municipal government, and auction rate securities | — | 8,158 |
| Common, foreign, and preferred stock | 16,416 | 11,694 |
| Equity mutual funds | 351,505 | 375,114 |
| Fixed income mutual funds | 328,914 | 276,961 |
| Hedge, private equity, common collective trust funds | 141,175 | 168,054 |
| Total assets whose use is limited by the board for capital improvements and under regulatory requirements | \$ 852,868 | 860,638 |
| Temporarily restricted investments: | | |
| Cash and cash equivalents | \$ 372 | 302 |
| Restricted investments: | | |
| Cash and cash equivalents | \$ 327 | 27 |
| U.S. government securities | — | 2,492 |
| Corporate and foreign bonds | — | 1,220 |
| Common, foreign, and preferred stock | — | 6,544 |
| Equity mutual funds | 12,081 | 2,257 |
| Fixed income mutual funds | 3,834 | — |
| Beneficial interest in trusts | 16,987 | 15,609 |
| Total restricted investments | \$ 33,229 | 28,149 |

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A summary of the System's total investment return for the years ended June 30 as reflected in the consolidated statements of operations and consolidated statements of changes in net assets is as follows:

| | 2018 | 2017 |
|--|-------------|-------------|
| Interest, dividends, and realized gains on investments, net | \$ 124,186 | 32,054 |
| Change in unrealized (losses) gains on nonalternative investments, net | (77,120) | 39,236 |
| Change in unrealized gains on Alternative Investments, net | 2,084 | 12,341 |
| Other-than-temporary impairment losses | — | (4,111) |

The System's investments include a variety of financial instruments; the related values as presented in the consolidated financial statements are subject to various market fluctuations, which include changes in the equity markets, interest rate environment and general economic conditions.

The System performs an annual impairment analysis of its investments. On June 30, 2017, nonalternative investments with a fair value of \$186,326 were in an unrealized loss position totaling \$4,111. The unrealized losses on these investments were caused by general market conditions particularly in the commodities and emerging markets sectors. These investments were written down and shown as other-than-temporary impairment losses on investments in the consolidated statements of operations.

In the year ended June 30, 2018, the System restructured its unrestricted Long-Term Capital (LTC) investment portfolio by eliminating redundant investment advisors and redeploying investments. This redeployment created approximately \$85 million of one-time realized gains for the year ended June 30, 2018.

The following table presents cost and fair value of assets whose use is limited and investments for June 30, 2018:

| | Fair value | Cost |
|--|-------------------|-------------|
| Cash and cash equivalents | \$ 15,908 | 15,908 |
| Corporate and foreign bonds | 7,887 | 7,956 |
| Common, foreign, and preferred stock | 16,416 | 16,244 |
| U.S. government securities | 10,717 | 10,818 |
| Equity mutual funds | 364,101 | 357,890 |
| Fixed income mutual funds | 332,748 | 340,408 |
| Hedge, private equity, and common collective trust funds | 141,175 | 120,366 |
| Beneficial interest in trusts | 16,987 | 14,528 |
| Total | \$ 905,939 | 884,118 |

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The following table presents cost and fair value of assets whose use is limited and investments for June 30, 2017:

| | Fair value | Cost |
|--|-------------------|-------------|
| Cash and cash equivalents | \$ 21,128 | 21,128 |
| State, municipal government, and auction rate securities | 8,158 | 8,588 |
| Corporate and foreign bonds | 10,933 | 10,957 |
| Common, foreign, and preferred stock | 18,238 | 14,556 |
| U.S. government securities | 11,472 | 11,481 |
| Equity mutual funds | 377,822 | 307,235 |
| Fixed income mutual funds | 276,961 | 272,667 |
| Hedge, private equity, and common collective trust funds | 168,054 | 139,548 |
| Beneficial interest in trusts | 15,609 | 13,370 |
| Total | \$ 908,375 | 799,530 |

The following table represents the fair value measurement levels for all assets and liabilities, which the System has recorded at fair value on a recurring basis:

| | Fair value June 30, 2018 | 2018 | | |
|--|-------------------------------------|---|--|--|
| | | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant other unobservable inputs (Level 3) |
| Assets: | | | | |
| Cash and cash equivalents | \$ 15,908 | 15,908 | — | — |
| Corporate and foreign bonds | 7,887 | — | 7,887 | — |
| Common, foreign and preferred stock | 16,416 | 16,416 | — | — |
| U.S. government securities | 10,717 | — | 10,717 | — |
| Equity mutual funds | 364,101 | 364,101 | — | — |
| Fixed income funds | 332,748 | 332,748 | — | — |
| Hedge, private equity, and common collective trust funds (1) | 141,175 | — | — | — |
| Beneficial interest in trusts | 16,987 | — | — | 16,987 |
| Total investments | \$ 905,939 | 729,173 | 18,604 | 16,987 |
| Liabilities: | | | | |
| Swap contracts | \$ 26,776 | — | 26,776 | — |

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(Dollars in thousands)

The following table represents the fair value measurement levels for all assets and liabilities, which the System has recorded at fair value on a recurring basis:

| | Fair value June 30, 2017 | 2017 | | |
|--|-----------------------------|---|---|---|
| | | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant other unobservable inputs (Level 3) |
| Assets: | | | | |
| Cash and cash equivalents | \$ 21,128 | 21,128 | — | — |
| State, municipal government, and auction rate securities | 8,158 | — | 8,158 | — |
| Corporate and foreign bonds | 10,933 | — | 10,933 | — |
| Common, preferred, and foreign stock | 18,238 | 18,238 | — | — |
| U.S. government securities | 11,472 | — | 11,472 | — |
| Equity mutual funds | 377,822 | 369,600 | 8,222 | — |
| Fixed income funds | 276,961 | 269,196 | 7,765 | — |
| Hedge, private equity, and common collective trust funds (1) | 168,054 | — | — | — |
| Beneficial interest in trusts | 15,609 | — | — | 15,609 |
| Total investments | \$ <u>908,375</u> | <u>678,162</u> | <u>46,550</u> | <u>15,609</u> |
| Liabilities: | | | | |
| Swap contracts | \$ 40,790 | — | 40,790 | — |

- (1) Certain investments that are measured at fair value using the net asset value per share (or its equivalent) practical expedient have not been categorized in the fair value hierarchy. The fair value amounts presented in this table are intended to permit reconciliation of the fair value hierarchy to the amounts presented in the consolidated balance sheets.

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Following is the summary of the inputs and valuation techniques as of and for the years ended 2018 and 2017 for valuing Level 2 financial instruments:

| Financial instrument | Input | Valuation technique |
|--|---------------|----------------------------|
| State, municipal government, and auction rate securities | Broker/dealer | Income |
| Corporate and foreign bonds | Broker/dealer | Market |
| U.S. government securities | Broker/dealer | Market |
| Equity mutual funds and fixed income funds | NAV | Market/income |
| Swap contracts | Broker/dealer | Market |

The following table represents the change in fair value for which fair value was measured under Level 3:

| | Beneficial interests in trust |
|--------------------------------|--------------------------------------|
| Fair value at June 30, 2016 | \$ 14,591 |
| Net change in unrealized gains | <u>1,018</u> |
| Fair value at June 30, 2017 | 15,609 |
| Net change in unrealized gains | <u>1,378</u> |
| Fair value at June 30, 2018 | \$ <u><u>16,987</u></u> |

Transfers between levels occur when there is a change in the observability of significant inputs. A transfer between Level 1 and Level 2 generally occurs when the availability of quoted prices changes or when market activity of an investment significantly changes to active or inactive. A transfer between Level 2 and Level 3 generally occurs when the underlying inputs become, or can no longer be, corroborated with market observable data. Transfers between levels are recognized on the date they occur. For the years ended June 30, 2018 and 2017, no transfers were made between any Levels.

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(Dollars in thousands)

The System holds instruments recorded at net asset value per share (or its equivalent) as a practical expedient and that do not have a readily determinable value as follows as of June 30:

| <u>2018</u> | <u>Fair value</u> | <u>Unfunded commitments</u> | <u>Redemption frequency (if eligible)</u> | <u>Redemption notice period</u> |
|--------------------------------|-------------------|-----------------------------|---|---------------------------------|
| | (In millions) | | | |
| b – Event driven hedge funds | \$ 0.1 | — | Quarterly | 65-70 days |
| d – Multi-strategy hedge funds | 62.0 | 1.4 | Quarterly, annually | 60 days |
| e – Real assets | 7.0 | 0.8 | Annually | 90 days |
| f – Real estate funds | 29.8 | 18.2 | N/A | N/A |
| g – Private equity funds | 42.3 | 19.4 | N/A | N/A |
| Total | <u>\$ 141.2</u> | <u>39.8</u> | | |

| <u>2017</u> | <u>Fair value</u> | <u>Unfunded commitments</u> | <u>Redemption frequency (if eligible)</u> | <u>Redemption notice period</u> |
|-------------------------------------|-------------------|-----------------------------|--|---------------------------------|
| | (In millions) | | | |
| a – Equity long/short hedge funds | \$ 11.3 | — | Monthly, quarterly, annually | 45–65 days |
| b – Event driven hedge funds | 8.7 | — | Quarterly, annual rolling | 60–65 days |
| c – Global opportunities hedge fund | 7.8 | — | Monthly | 5–45 days |
| d – Multi-strategy hedge funds | 47.2 | — | Quarterly, semi-annually, annually, on anniversary, biannually | 45–70 days |
| e – Real assets | 12.4 | 0.8 | Annually | 90 days |
| f – Real estate funds | 38.8 | 22.4 | N/A | N/A |
| g – Private equity funds | 41.9 | 13.3 | N/A | N/A |
| Total | <u>\$ 168.1</u> | <u>36.5</u> | | |

- a. This class includes investments in hedge funds that invest both long and short in U.S. and foreign common stocks. Management of the hedge funds has the ability to shift investments from value to growth strategies, from small to large capitalization stocks and from a net long position to a net short position. The fair values of the investments in this class have been estimated using the net asset value per share of the investments as a practical expedient.

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- b. This class includes investments in hedge funds that invest in equities and bonds to profit from economic, political and government driven events. A majority of the investments are targeted at economic policy decisions. The fair values of the investments in this class have been estimated using the net asset value per share of the investments as a practical expedient.
- c. This class includes investments in hedge funds that hold investments in U.S. and non-U.S. common stocks in the health care, energy, information technology, utilities and telecommunications sectors. The fair values of the investments in this class have been estimated using the net asset value per share of the investments as a practical expedient.
- d. This class invests in hedge funds that pursue multiple strategies to diversify risks and reduce volatility. The fair values of the investments in this class have been estimated using the net asset value per share of the investments as a practical expedient. The remaining restriction period for these investments ranges from quarterly to annually.
- e. This class includes funds with direct investments in global and energy infrastructure as well as in base and precious metals and investment securities of miners and associated mining equipment. The fair values of the investments in this class have been estimated using the net asset value per share of the investments as a practical expedient.
- f. This class includes real estate funds that invest in U.S. and non-U.S. residential and commercial properties as well as distressed real estate. The fair values of the investments in this class have been estimated using the net asset value of the System's ownership interest in partners' capital as a practical expedient. As of June 30, 2018 and 2017, certain investments in these funds have a 90-day redemption notice, but the fund manager can only accommodate redemption requests as liquid assets allow, approximately \$5,200 and \$8,500, respectively. The remaining funds will receive distributions from each fund as the underlying investments of the funds are liquidated. It is estimated that the underlying assets of these funds will be liquidated over the next 7 to 10 years, although these funds may liquidate early in the event of purchase by a third party or initial public offering. The fair values of the investments in this class have been estimated using the net asset value of the System's ownership interest in partners' capital as a practical expedient.
- g. This class includes private equity funds. These investments cannot be redeemed with the funds. Instead, the nature of the investments in this class is that distributions are received through the liquidation of the underlying assets of the fund. These funds are managed by one of the System's advisors with particular private equity experience in secondary market dealing. These funds could be subject to redemption to a third party buyer, but at June 30, 2018 and 2017, no funds were currently being evaluated this way. The fair values of the investments in this class have been estimated using the net asset value of the System's ownership interest in partners' capital as a practical expedient.

TOWER HEALTH AND SUBSIDIARIES
Notes to Consolidated Financial Statements
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(7) Property, Plant and Equipment

Property, plant and equipment and related accumulated depreciation at June 30 consists of the following:

| | <u>2018</u> | <u>2017</u> |
|--|----------------------------|-----------------------|
| Land and land improvements | \$ 100,223 | 75,226 |
| Buildings and improvements | 893,959 | 771,378 |
| Fixed equipment | 406,847 | 405,037 |
| Movable equipment (includes software and hardware) | 598,485 | 531,043 |
| Construction in progress | <u>58,557</u> | <u>24,978</u> |
| Property, plant and equipment before depreciation | 2,058,071 | 1,807,662 |
| Less accumulated depreciation | <u>(1,003,295)</u> | <u>(973,516)</u> |
| Property, plant and equipment, net | <u><u>\$ 1,054,776</u></u> | <u><u>834,146</u></u> |

As of June 30, 2018, assets under capital leases consist of medical buildings with an acquired fair value of \$20,227 and accumulated amortization of \$1,192. Assets under capital leases are included in property, plant and equipment on the accompanying consolidated balance sheets.

Depreciation expense relating to property, plant and equipment was \$90,491 and \$84,039 for the years ended June 30, 2018 and 2017, respectively.

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(8) Long-term Debt

Long-term debt at June 30, 2018 consists of the following:

| | Carrying value | Fair value (Level 2) |
|---|---------------------------|-------------------------------------|
| Berks County Municipal Authority Hospital Revenue Bond Series of 2017, net of unamortized discount and premium | \$ 694,940 | 686,633 |
| Berks County Municipal Authority Hospital Revenue Bond Series of 2012, net of unamortized discount and premium | 266,757 | 259,720 |
| Berks County Municipal Authority Hospital Revenue Bond Series of 2009, net of unamortized discount | 53,635 | 56,478 |
| Term loans | 125,165 | 125,165 |
| Total long-term debt | 1,140,497 | \$ <u>1,127,996</u> |
| Less: amounts due within one year | (5,600) | |
| Less: deferred financing costs, net | (8,703) | |
| Long-term debt, net of current portion | \$ <u>1,126,194</u> | |

Long-term debt at June 30, 2017 consists of the following:

| | Carrying value | Fair value (Level 2) |
|---|---------------------------|-------------------------------------|
| Berks County Municipal Authority Hospital Revenue Bond Series of 2012, net of unamortized discount and premium | \$ 300,998 | 308,544 |
| Berks County Municipal Authority Hospital Revenue Bond Series of 2009, net of unamortized discount | 102,280 | 112,054 |
| Term loans | 176,221 | 176,221 |
| Total long-term debt | 579,499 | \$ <u>596,819</u> |
| Less: amounts due within one year | (5,719) | |
| Less: deferred financing costs, net | (4,980) | |
| Long-term debt, net of current portion | \$ <u>568,800</u> | |

Under the terms of the various debt agreements, the System is required to maintain certain deposits with a trustee. Such deposits are included in assets whose use is limited in the accompanying consolidated balance sheets.

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

| | | |
|---|----|-----------|
| 2019 | \$ | 5,600 |
| 2020 | | 6,588 |
| 2021 | | 3,997 |
| 2022 | | 6,025 |
| 2023 | | 13,756 |
| Thereafter | | 1,045,730 |
| Total long-term debt | | 1,081,696 |
| Plus: unamortized net premium/discounts | | 58,801 |
| Less: deferred financing costs, net | | (8,703) |
| Long term-debt, net of unamortized premiums/discount and deferred financing costs | \$ | 1,131,794 |

The Parent, the Hospital, and the Montgomery/Chester Hospitals (collectively, the Obligated Group) have borrowed funds through revenue bonds issued by the Berks County Municipal Authority (Authority). The proceeds originally were used in part to finance certain facilities of the Obligated Group. The revenue bonds are secured by a pledge of revenue of the Obligated Group. For accounting purposes, the revenue bonds are treated as though they are the debt of the entity which received the proceeds.

(a) Berks County Municipal Authority Hospital Revenue Bond Series of 2017

On October 31, 2017, the Authority issued \$590,500 of Revenue Bonds (2017) for the purpose of repaying the bridge loan (note 2) and refunding the 2009 A-3 bonds. The net original issuance premium associated with the issuance was \$56,151.

The Series 2017 bonds are comprised of \$161,400 of serial bonds and \$429,100 of term bonds. The serial bonds are due in annual installments payable on November 1, 2021 through November 1, 2039 with payments ranging from \$1,770 to \$13,715. The term bonds are due on November 1, 2042, 2047 and 2050 with total payments of \$43,185, \$196,320, and \$189,595, respectively. The effective interest rate ranges from 4% to 5% on the serial bonds and 3.75% to 5% on the term bonds.

On December 27, 2017, Berks County Municipal Authority issued \$50,000 of Variable Rate Serial Revenue bonds (2017 A) for the purpose of refunding the Authority Series 2016B. Mandatory annual principal redemptions by the System for the Series 2017 A bonds due November 1, 2022 through November 1, 2035, range from \$2,475 to \$5,025 with final maturity on November 1, 2035. Interest on these bonds is calculated on a SIFMA Municipal Index rate plus a fixed spread of 0.75%. The SIFMA Municipal Index Rate at June 30, 2018 and 2017 was 1.510% and 0.91%, respectively.

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(b) Berks County Municipal Authority Hospital Revenue Bond Series of 2012

On June 28, 2012, the Authority issued \$473,275 of Revenue Bonds in four series, 2012 A, B, C, and D.

The Authority issued \$160,065 of Fixed Rate Serial Revenue Bonds (2012 A) for the purpose of refunding the then-existing Dauphin County General Authority Hospital Revenue Bond Series 1994A, and Berks County Bond Series 1998 and 2008. Mandatory annual principal redemptions by the System for the 2012 A bonds due November 1, 2039 through November 1, 2044, range from \$7,590 to \$33,555 with final maturity on November 1, 2044. Effective interest rate of the bonds range from 4.23% to 4.50%.

The Authority issued \$91,775 of Variable Rate Serial Revenue bonds (2012 B) for the purpose of refunding the Series 2009 A-5 bonds. Mandatory annual principal redemptions by the System for the 2012 B bonds due November 1, 2035 through November 1, 2039, range from \$3,225 to \$24,955 with final maturity on November 1, 2039. Interest on these bonds is calculated on a SIFMA Municipal Index rate plus a fixed spread of 1.50%. The SIFMA Municipal Index rate at June 30, 2018 and 2017, was 1.510% and 0.91%, respectively.

The Authority issued a \$47,235 Floating Rate Bond (2012 C) used to refund the then-existing Series 2009 A-4 bonds and a \$174,000 Floating Rate Bond (2012 D) used to refund the then-existing Series 2009 A-1 and A-2 bonds. Both Series 2012 C and 2012 D bonds were privately placed with commercial banks. Mandatory monthly principal redemptions by the System for the Series 2012 C bonds commenced on August 1, 2012 through July 1, 2022, and range from \$39 to \$129 with final maturity date on July 1, 2022. Interest on these bonds is calculated using a one-month London Interbank Offered Rate Index rate (LIBOR) plus a fixed spread of 1.20% with the sum multiplied by a factor of 70.0%. The one-month LIBOR rate at June 30, 2018 and 2017, was 2.09% and 1.23%, respectively.

(c) Berks County Municipal Authority Hospital Revenue Bond Series of 2009

The Series 2009 A-3 bonds were issued on July 15, 2009. The Authority issued \$133,665 of Fixed Rate Revenue Bonds, Series 2009 A-3 for the primary purpose of redeeming \$115,520 of the then-existing Series 2001 bonds and \$14,965 for major renovation projects.

The Series 2009 A-3 bonds are comprised of \$44,285 of serial bonds and \$89,380 of term bonds. The serial bonds are due in installments payable November 1, 2009, through 2019, with payments ranging from \$120 to \$4,895. The term bonds are due on November 1 of 2024, 2031, and 2039, with payments ranging from \$820 to \$9,380. The effective interest rate ranges from 3% to 5% on the serial bonds and 5.25% to 5.75% on the term bonds.

During the fiscal year ended June 30, 2018, in connection with the issuance of the Series 2017 bonds, the System advance refunded a portion of the Series 2009 A-3 bonds by in-substance defeasance. The System funded an escrow account of \$48,561 and in connection with this transaction, the System recognized \$4,314 as a loss on early extinguishment of debt in the consolidated statements of operations. As of June 30, 2018, \$44,675 of the original debt remained outstanding, but was

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considered to be extinguished by the System. Such debt will be paid to bondholders from escrow accounts funded at the transaction date.

(d) Term Loans

Effective May 16, 2016, the System refinanced the Series 2012 D bonds by the securing term bank loans in four series, 2016 A, B, C, and D with a notional amount of \$175,165. All 2016 series nonsyndicate bank loans are direct bank loans with a maturity of seven years.

Series 2016A with a notional amount of \$50,165 has an interest rate calculated at 67% of 1-month LIBOR plus a fixed spread of 0.58%. Principal installments of \$2,485 begin in November 1, 2022 followed by a full redemption of the balances in May 2023.

Series 2016B with a notional amount of \$50,000 has an interest rate calculated at 70% of 1-month LIBOR plus a fixed spread of 0.65%. Principal installments of \$2,475 begin November 1, 2022 followed by a full redemption of the balance in May 2023. Series 2016B was refunded on December 27, 2017.

Series 2016C with a notional amount of \$25,000 has an interest rate calculated at 70% of 1-month LIBOR plus a fixed spread of 0.84%. Principal installments of \$1,240 begin November 1, 2022 followed by a full redemption of the balance in May 2023.

Series 2016D with a notional amount of \$50,000 has an interest rate calculated at 67% of 1-month LIBOR plus a fixed spread of 0.675%. Principal installments of \$2,475 begin in November 1, 2022 followed by a full redemption of the balance in May 2023.

The one-month LIBOR rate at June 30, 2018 and 2017, was 2.09% and 1.23%, respectively.

Effective retroactive to January 1, 2004, the Hospital replaced NMG Limited Partnership as the borrower on three promissory notes (NMG Loans). The Hospital was previously the guarantor for the notes. Mandatory annual principal redemptions by the Hospital for the notes for the 2016-2020 period range from \$309 to \$276 in 2020. The interest rate is calculated based upon the one-month LIBOR plus a spread of 1.70%. The NMG Loans were repaid during the year ended June 30, 2018.

(e) Line of Credit

At June 30, 2018 and 2017, the Hospital has an unused line of credit in the amount of \$10,000. Letter of credit draws or direct borrowings from this facility are charged an interest rate of 1-month LIBOR plus 1.50%. Total combined open and undrawn letters of credit at both June 30, 2018 and 2017 amounted to \$3,095. During 2018, no new letters of credit were opened.

(f) Covenants

The various agreements place limits on the incurrence of additional borrowings and require that the System satisfy certain measures of financial performance as long as the debt is outstanding. These covenants apply to the Obligated Group and include, but are not limited to: a long-term debt service coverage ratio of 1.1 (measured quarterly) and 80 days cash on hand (measured annually at June 30).

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(9) Interest Rate Swaps

The System utilizes derivative instruments, such as interest rate swaps, to manage certain interest rate exposures. Derivative instruments are viewed as risk management tools by the System and are not used for trading and speculative purposes.

When quoted market prices are not available, the valuation of derivative instruments is determined using widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each leg of the derivative. This analysis reflects the contractual terms of the derivatives, including interest rate curves and implied volatilities. The estimates of fair value valuation are made by swap counterparties using a standardized methodology based on observable market inputs. As part of the System's overall valuation process, management evaluates this counterparty valuation methodology to ensure that it is representative of exit prices in the principal markets. These future net cash flows, however, are susceptible to change primarily due to fluctuations in interest rates. As a result, the estimated values of these derivatives will change over time as cash is received and paid and as interest rates change. As these changes occur, they may have a positive or negative impact on estimated valuations.

The System has classified its interest rate swaps in Level 2 of the fair value hierarchy, as the significant inputs to the overall valuations are based on market-observable data or information derived from or corroborated by market-observable data. For over-the-counter derivatives that trade in liquid markets such as interest rate swaps, model inputs (i.e., contractual terms, market prices, yield curves, credit curves, and measures of volatility) can generally be verified, and model selection does not involve significant management judgment.

The fair market value of the swap contracts were as follows as of June 30:

| Classification of derivatives included in liabilities on the consolidated balance sheets | Fair market value | |
|---|--------------------------|---------------|
| | 2018 | 2017 |
| Derivatives not designated as hedging instrument: | | |
| 2008 bond issuance | \$ (3,730) | (1,787) |
| 2005 bond issuance | 1,588 | 2,685 |
| 2002 bond issuance | 13,256 | 17,665 |
| 2001 bond issuance | 15,166 | 21,331 |
| 1997 bond issuance | — | 17 |
| 1992 bond issuance | 496 | 791 |
| Term loans | — | 88 |
| Total swap contracts | <u>\$ 26,776</u> | <u>40,790</u> |

Changes in fair value of swap contracts on the consolidated balance sheets totaled a gain of \$14,014 and \$18,344 for the years ended June 30, 2018 and 2017, respectively. The net amount paid or received under the swap contracts is recorded in the consolidated statements of operations as net cash settlement payments. Net payments totaled \$6,707 and \$8,746 for the years ended June 30, 2018 and 2017, respectively.

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No new swaps were initiated in the fiscal years ending June 30, 2018 and 2017.

Two interest rate swaps associated with the 1997 bond issuance expired in the fiscal year ended June 30, 2018. Two interest rate swaps associated with Term Loans were terminated during the fiscal year ended June 30, 2018 when the NMG Loans were paid off. No interest rate swaps expired or were terminated in the fiscal year ended June 30, 2017.

In connection with the 2008 bond issuance, the System entered into two interest rate basis swap agreements with a third party by which the System pays SIFMA and receives an average of 0.85% of three-month LIBOR with a third party. Notional amounts of these basis swaps are \$152,210 and \$157,320, respectively, and the three-month LIBOR rate at June 30, 2018 and 2017, was 2.337% and 1.298%, respectively. The SIFMA Municipal Index Rate at June 30, 2018 and 2017 was 1.510% and 0.91%, respectively.

In connection with the 2005 bond issuance, the System entered into an interest rate swap agreement with a third party. The swap economically converts the variable rate obligation of the 2005 bonds to a fixed rate of 3.584%. Notional amount of the swap is \$24,000.

In connection with the 2001 and 2002 bonds issuances, the System entered into two interest rate swap agreements with a third party. The swaps economically convert the variable rate obligations of the 2001 and 2002 bonds to a fixed rate of 4.30% and 4.69%, respectively. Notional amounts of the 2001 and 2002 bond issuance swaps are \$108,105 and \$62,445, respectively.

In connection with the 2002 bond issuance, the System entered into two interest rate swap agreements with a third party. One of these swaps expired in FY2018. The remaining swap effectively converts the variable rate obligation of the Series A bonds to a fixed rate of 4.69%. Notional amounts of the swap is \$3,815.

In connection with the 1997 bond issuance, the System entered into an interest rate swap agreement with a third party that was effective as of May 26, 2005. This swap expired in FY2018.

In connection with the 1992 bond issuance, the System entered into an interest rate swap agreement with a third party, which was effective as of May 26, 2005. The swap effectively converts the variable rate obligation of the bonds to a fixed rate of 3.607%. Notional amount of the swap is \$5,900.

In connection with the NMG Loans, the System assumed two interest rate swap agreements with a third party. The swaps effectively convert the variable obligations to fixed rates of 9.13% for the \$2,100 note and 9.06% for the \$2,000 note. The fair value of the interest rate swap agreements is the amount at which they would be settled based on estimates of market rates, which was a liability of \$0 and \$88 at June 30, 2018 and 2017, respectively. These swaps were paid out and terminated in the year ended June 30, 2018 with a payment of \$73 as part of paying off the NMG Loans.

The change in the fair value of the interest rate swap agreements and the net settlement payments associated with these swaps are recorded in nonoperating gains (losses) on the consolidated statements of operations.

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(10) Retirement Plans

Prior to June 30, 2016, substantially all employees of the System were covered under a qualified noncontributory defined benefit pension plan (the Plan). Pension costs are funded as accrued except when not permitted by regulations, such as full funding limitations. Unfunded prior service costs are amortized over an initial term of thirty years.

The System has effectively transitioned the Plan into a defined contribution plan as of June 30, 2016. Employees hired on or after July 1, 2013 have been enrolled in the defined contribution plan. Previous defined benefit participants hired on or before June 30, 2013, continued to accrue benefits in the existing defined benefit plan until June 30, 2016. As of July 1, 2016, all vested participant defined benefits remain accrued, but all current employees have now converted to and began to accumulate funds under the defined contribution plan. This action has effectively frozen the defined benefit plan as of June 30, 2016.

In the year ended June 30, 2018, the System completed a pension terminated vested lump-sum pension payout derisking strategy. Terminated vested plan participants with a pension plan benefit accrual of \$150 thousand or less were offered a voluntary lump-sum buyout. 418 plan participants accepted the voluntary offer. Plan assets paid out \$17,705 to settle lump-sums reducing the pension liability by \$19,300.

Obligations and funded status at June 30 for the Plan:

| | <u>2018</u> | <u>2017</u> |
|--|-------------------|-----------------|
| Change in projected benefit obligation: | | |
| Benefit obligation at beginning of year | \$ 672,408 | 692,973 |
| Service cost | — | — |
| Interest cost | 26,037 | 26,026 |
| Actuarial gain | (34,420) | (27,526) |
| Benefits paid | <u>(37,822)</u> | <u>(19,065)</u> |
| Benefit obligation at end of year | <u>\$ 626,203</u> | <u>672,408</u> |
| Change in plan assets: | | |
| Fair value of plan assets at beginning of year | \$ 420,152 | 367,061 |
| Actual return on assets | 27,628 | 48,604 |
| Employer contributions | 14,270 | 23,552 |
| Benefits paid | <u>(37,822)</u> | <u>(19,065)</u> |
| Fair value of plan assets at end of year | <u>\$ 424,228</u> | <u>420,152</u> |

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Amounts recognized in the consolidated balance sheets at June 30 consist of:

| | 2018 | 2017 |
|--|-------------|-------------|
| Accrued pension | \$ 201,974 | 252,256 |
| Total accrued liability | \$ 201,974 | 252,256 |
| Amounts recognized in net assets consist of: | | |
| Net actuarial loss | \$ 229,453 | 264,340 |
| Pension cost charged to net assets | \$ 229,453 | 264,340 |

Net periodic (benefit) cost components at June 30 include the following:

| | 2018 | 2017 |
|---|-------------|-------------|
| Interest cost on projected benefit obligation | \$ 26,037 | 26,026 |
| Expected return on plan assets | (33,256) | (29,533) |
| Amortization of net loss | 6,094 | 7,459 |
| Net periodic pension (benefit) cost | \$ (1,125) | 3,952 |

In connection with the System's adoption of ASU 2017-07 in 2017, the service cost component of the net periodic pension (benefit) cost are included in salaries and benefits in the accompanying statements of operations and the remaining components are included in nonoperating losses for the years ended June 30, 2018 and June 30, 2017. There was no service cost associated with the Plan for the years ended June 30, 2018 and June 30, 2017.

Other changes in plan assets and benefit obligations recognized in unrestricted net assets as of June 30:

| | 2018 | 2017 |
|---|-------------|-------------|
| Net gain | \$ (28,793) | (46,597) |
| Amortization of net loss | (6,094) | (7,459) |
| Total recognized in unrestricted net assets | \$ (34,887) | (54,056) |

The amount expected to be amortized from unrestricted net asset to net periodic pension cost in nonoperating gains (losses) during fiscal year 2019 is \$5,296.

TOWER HEALTH AND SUBSIDIARIES
Notes to Consolidated Financial Statements
June 30, 2018 and 2017
(Dollars in thousands)

Weighted average assumptions used to determine benefit obligations at June 30:

| | <u>2018</u> | <u>2017</u> |
|-------------------------------|-------------|-------------|
| Discount rate | 4.29 % | 3.94 % |
| Rate of compensation increase | N/A | N/A |
| Measurement date | 6/30/2018 | 6/30/2017 |

Weighted average assumptions used to determine net periodic benefit cost for years ended June 30:

| | <u>2018</u> | <u>2017</u> |
|--|-------------|-------------|
| Discount rate | 3.94 % | 3.80 % |
| Expected long-term return on plan assets | 8.00 % | 8.00 % |
| Rate of compensation increase | N/A | N/A |

To develop the expected long-term rate of return on assets assumption, the System considered the historical returns and the future expectations for returns for each asset class, as well as the target asset allocation of the pension portfolio.

(a) Plan Assets

The Plan's weighted average actual asset allocations and target allocations as of June 30 by asset category are as follows:

| | <u>2018</u> | |
|--|----------------|----------------|
| | <u>Target</u> | <u>Actual</u> |
| Asset category: | | |
| Cash and cash equivalents | — % | 2.1 % |
| Equities, including mutual funds | 45.0 | 22.2 |
| Fixed income, including mutual funds, state, municipal government, and auction rate securities | 20.0 | 23.7 |
| Alternative investments (1) | 35.0 | 52.0 |
| | <u>100.0 %</u> | <u>100.0 %</u> |

| | <u>2017</u> | |
|--|----------------|----------------|
| | <u>Target</u> | <u>Actual</u> |
| Asset category: | | |
| Cash and cash equivalents | — % | 1.3 % |
| Equity mutual funds | 45.0 | 19.4 |
| Fixed income, including mutual funds, state, municipal government, and auction rate securities | 32.5 | 21.0 |
| Equities | — | 2.4 |
| Alternative investments (1) | 22.5 | 55.9 |
| | <u>100.0 %</u> | <u>100.0 %</u> |

TOWER HEALTH AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

(1) Note: Long/Short Equity and Private Equity are classified as Alternative Investments.

The overall investment objective of the Plan is to provide a return on investment consistent with the Plan's spending needs and to prevent erosion of purchasing power by inflation. Achievement of the return will be sought from an investment strategy that provides an opportunity for superior returns within acceptable levels of risk and volatility of returns. The following tables represent the fair value measurement levels for the Plan's investments:

| | Fair value June 30, 2018 | 2018 | | |
|--|--------------------------------|---|---|---|
| | | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant other unobservable inputs (Level 3) |
| Cash and cash equivalents | \$ 9,113 | 9,113 | — | — |
| State, municipal government, and auction rate securities | 4,525 | — | 4,525 | — |
| Equity mutual funds | 54,094 | 54,094 | — | — |
| Equities | 40,059 | 40,059 | — | — |
| Fixed income mutual funds | 95,995 | 95,995 | — | — |
| Hedge, private equity, and common collective trust funds (1) | 220,442 | — | — | — |
| Total investments | \$ 424,228 | 199,261 | 4,525 | — |

TOWER HEALTH AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

| | Fair value June 30, 2017 | 2017 | | |
|--|--------------------------------|---|---|---|
| | | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant other unobservable inputs (Level 3) |
| Cash and cash equivalents | \$ 5,366 | 5,366 | — | — |
| State, municipal government, and auction rate securities | 5,880 | — | 5,880 | — |
| Equity mutual funds | 81,645 | 81,645 | — | — |
| Equities | 10,280 | 10,280 | — | — |
| Fixed income mutual funds | 82,154 | 82,154 | — | — |
| Hedge, private equity, and common collective trust funds (1) | 234,827 | — | — | — |
| Total investments | \$ 420,152 | 179,445 | 5,880 | — |

(1) Certain investments that are measured at fair value using the net asset value per share (or its equivalent) practical expedient have not been categorized in the fair value hierarchy. The fair value amounts presented in this table are intended to permit reconciliation of the fair value hierarchy to the amounts presented in the consolidated balance sheets.

Transfers between levels occur when there is a change in the observability of significant inputs. A transfer between Level 1 and Level 2 generally occurs when the availability of quoted prices changes or when market activity of an investment significantly changes to active or inactive. A transfer between Level 2 and Level 3 generally occurs when the underlying inputs become, or can no longer be, corroborated with market observable data. Transfers between levels are recognized on the date they occur. For the years ended June 30, 2018 and 2017, no transfers were made between Levels.

TOWER HEALTH AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

The Plan holds investments that calculate net asset value per share (or its equivalent) and do not have a readily determinable value are as follows as of June 30:

| <u>2018</u> | <u>Fair value</u> | <u>Unfunded commitments</u> | <u>Redemption frequency (if eligible)</u> | <u>Redemption notice period</u> |
|-------------------------------------|-------------------|-----------------------------|---|---------------------------------|
| | (In millions) | | | |
| a - Equity long/short hedge funds | \$ 53.3 | — | Quarterly, annually | 45–90 days |
| b - Global opportunities hedge fund | 0.1 | — | Quarterly, annually | 60–120 days |
| c - Multi-strategy hedge funds | 30.5 | 0.2 | Annually, biannually | 30–90 days |
| d - Real assets | 15.3 | 6.3 | Weekly, Monthly | 5–30 days |
| e - Long only funds | 85.8 | — | Monthly | 15–30 days |
| f - Real estate funds | 9.0 | 7.7 | N/A | N/A |
| g - Private equity funds | 26.4 | 16.3 | N/A | N/A |
| Total | <u>\$ 220.4</u> | <u>30.5</u> | | |

| <u>2017</u> | <u>Fair value</u> | <u>Unfunded commitments</u> | <u>Redemption frequency (if eligible)</u> | <u>Redemption notice period</u> |
|-------------------------------------|-------------------|-----------------------------|---|---------------------------------|
| | (In millions) | | | |
| a - Equity long/short hedge funds | \$ 49.5 | — | Quarterly, annually | 45–90 days |
| b - Global opportunities hedge fund | 13.2 | — | Quarterly, annually | 60–120 days |
| c - Multi-strategy hedge funds | 33.9 | — | Annually, biannually | 30–90 days |
| d - Real assets | 25.8 | 3.8 | Weekly, Monthly | 5–30 days |
| e - Long only funds | 83.4 | — | Monthly | 15–30 days |
| f - Real estate funds | 9.7 | 6.7 | N/A | N/A |
| g - Private equity funds | 19.3 | 12.8 | N/A | N/A |
| Total | <u>\$ 234.8</u> | <u>23.3</u> | | |

- a. This class includes investments in hedge funds that invest both long and short in U.S. and foreign common stocks. Management of the hedge funds has the ability to shift investments from value to growth strategies, from small to large capitalization stocks and from a net long position to a net short position. The fair values of the investments in this class have been estimated using the net asset value per share of the investments as a practical expedient.
- b. This class includes investments in hedge funds that hold investments in U.S. and non-U.S. common stocks in the health care, energy, information technology, utilities and telecommunications sectors. The fair values of the investments in this class have been estimated using the net asset value per share of the investments as a practical expedient.
- c. This class invests in hedge funds that pursue multiple strategies to diversify risks and reduce volatility. The fair values of the investments in this class have been estimated using the net asset

TOWER HEALTH AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

value per share of the investments as a practical expedient. The remaining restriction period for these investments ranges from quarterly to biennially.

- d. This class includes funds with direct investments in commodities and energy master limited partnerships. The fair values of the investments in this class have been estimated using the net asset value per share of the investments as a practical expedient.
- e. This class invests in domestic and international hedge funds that pursue a long only equity bias. The fair values of the investments in this class have been estimated using the net asset value per share of the investments as a practical expedient.
- f. This class includes real estate funds that invest in U.S. and non-U.S. residential and commercial properties as well as distressed real estate. The fair values of the investments in this class have been estimated using the net asset value of the System's ownership interest in partners' capital as a practical expedient. It is estimated that the underlying assets of these funds will be liquidated over the next 7 to 10 years, although these funds may liquidate early in the event of purchase by a third party or initial public offering.
- g. This class includes private equity funds. These investments cannot be redeemed with the funds. Instead, the nature of the investments in this class is that distributions are received through the liquidation of the underlying assets of the fund. These funds could be subject to redemption to a third party buyer, but at June 30, 2018 and 2017, no funds were currently being evaluated this way. The fair values of the investments in this class have been estimated using the net asset value of the System's ownership interest in partners' capital as a practical expedient.

(b) Contributions

The System expects to contribute the minimum required contribution during the fiscal year 2019 to the Plan, which is estimated to be \$18,168. For the years ended June 30, 2018 and 2017, the System contributed \$14,270 and \$23,552, respectively to the Plan. For the years ended June 30, 2018 and 2017, the System contributed \$41,001 and \$10,866, respectively to the defined contribution plan and \$1,763 and \$1,504, respectively to the nonqualified deferred compensation plan.

(c) Estimated Future Benefit Payments

The following benefit payments are expected to be paid for the fiscal years ending June 30:

| | | |
|------------|----|---------|
| 2019 | \$ | 22,946 |
| 2020 | | 24,642 |
| 2021 | | 26,294 |
| 2022 | | 27,768 |
| 2023 | | 29,139 |
| Thereafter | | 163,883 |

TOWER HEALTH AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

(11) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes at June 30:

| | 2018 | 2017 |
|------------------------------|-------------|-------------|
| Various health care services | \$ 1,608 | 1,667 |

Permanently restricted net assets at June 30 are restricted to:

| | 2018 | 2017 |
|--|-------------|-------------|
| Permanent endowment funds, the interest and dividend income from which is expendable to support health care services | \$ 16,242 | 12,842 |
| Funds held in trust by others | 16,987 | 15,609 |
| Total permanently restricted net assets | \$ 33,229 | 28,451 |

(12) Insurance Arrangements

The System participates in the Pennsylvania Medical Care Availability and Reduction of Error Fund or Mcare Fund established under the Commonwealth of Pennsylvania. The Mcare Fund presently provides coverage excess of up to \$500 to the System's primary per occurrence retention (which is currently \$500) with annual aggregate coverage of \$1,500.

The System established a self-insurance trust fund to provide protection against professional liability claims. The trust is actuarially funded on an annual basis to provide single limit professional liability coverage of \$500 per occurrence and \$4,500 in the annual aggregate for the Hospital and certain employees. For incidents occurring since April 30, 2009, the System purchased commercial insurance to provide coverage on a claims-made basis in an amount up to \$25,000 in excess of a total retention of \$3,000, \$500 primary; \$500 Mcare excess and a \$2,000 self-insured buffer. Claim liabilities are presented gross of any insurance recoveries. Claim liabilities are discounted at an interest rate of 3% for years ended June 30, 2018 and 2017, and decreased the undiscounted liability as of June 30, 2018 and 2017 by \$2,889 and \$2,885, respectively. For the years ended June 30, 2018 and 2017, the insurance recoverable amount was \$3,500 and \$3,500, respectively, which is included in other receivables and other assets on the consolidated balance sheets. Funding requirements of the plan are subject to increase depending on the plan's claim experience. Premium payments for the Mcare Fund are based upon each individually licensed healthcare provider's rating with the Joint Underwriters Association and the amount of the surcharge to be assessed is determined by the Mcare Fund on an annual basis. The System's annual surcharge premium for participation in the Mcare Fund was \$3,220 and \$1,729 for the years ended June 30, 2018 and 2017, respectively.

During the fiscal year ended June 30, 2018, in conjunction with the acquisition of the Montgomery/Chester Hospitals, Tower Health formed a captive Reciprocal Risk Retention Group (RRG) subsidiary for the

TOWER HEALTH AND SUBSIDIARIES

Notes to Consolidated Financial Statements

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(Dollars in thousands)

purpose of self-insuring malpractice at the Montgomery/Chester Hospitals. Statutory funding of \$ 2,000 and a first year's premium in the amount of \$3,955 were paid during the 2018 fiscal year. Statutory funding is included in assets under regulatory requirements on the consolidated balance sheets.

Additionally, the System self-insures its workers' compensation and minor general liability risks. The System's self-insurance plan has been reviewed and approved by the Commissioner of Insurance of Pennsylvania. The System purchases excess workers' compensation insurance for all controlled entities of the hospital with statutory limits over a self-retention of \$1,000 per occurrence subject to a policy maximum of \$1,000 for the policy period. Workers' compensation liabilities are discounted at an interest rate of 3% for the years ended June 30, 2018 and 2017, and decreased the undiscounted liability as of June 30, 2018 and 2017 by \$2,269 and \$2,421, respectively. The System had established a trust fund for the payment of workers' compensation benefits and, in the year ended June 30, 2016, the assets in this trust fund were replaced with a surety bond providing liability coverage and all fund assets previously held by the trust were returned to the System.

Reserves for self-insurance claims at June 30 are summarized as follows:

| | <u>2018</u> | <u>2017</u> |
|---|------------------|-----------------|
| Professional liability claims payable | \$ 31,580 | 36,400 |
| Workers' compensation | 10,625 | 11,984 |
| Total self-insurance claims reserve | 42,205 | 48,384 |
| Less: current portion | <u>(13,669)</u> | <u>(10,885)</u> |
| Self-insurance claims reserve, net of current portion | <u>\$ 28,536</u> | <u>37,499</u> |

Subsequent to June 30, 2018, a decision was made to extend the RRG coverage not only to the Montgomery/Chester Hospitals' professional liabilities, but to cover Reading hospital and all affiliates as well. All reserves and liabilities accrued to Reading Hospital will be borne by the existing self-insurance coverages and, beginning in the second quarter of fiscal 2019, all new malpractice liabilities will accrue to the RRG.

(13) Commitment and Contingencies

(a) Operating and Capital Leases

The System leases equipment and facilities under operating and capital leases expiring at various dates. Total rental expense under all operating leases was \$26,382 and \$13,716 for the years ended June 30, 2018 and 2017, respectively.

TOWER HEALTH AND SUBSIDIARIES
Notes to Consolidated Financial Statements
June 30, 2018 and 2017
(Dollars in thousands)

The following table summarizes future minimum rental commitments under noncancelable operating leases with initial or remaining terms of more than one year and capital leases for the fiscal years ending June 30:

| | Capital leases | Operating leases |
|--|---------------------------|-----------------------------|
| 2019 | \$ 2,120 | \$ 18,817 |
| 2020 | 2,163 | 14,826 |
| 2021 | 2,206 | 11,387 |
| 2022 | 2,250 | 8,234 |
| 2023 | 2,295 | 7,876 |
| Thereafter | 17,997 | 43,598 |
| Total future minimum lease payments | \$ 29,031 | \$ 104,738 |
| Less: amount representing interest | (7,260) | |
| Total capital leases | 21,771 | |
| Less: current portion | (2,120) | |
| Total capital leases, net of current portion | \$ 19,651 | |

The capital leases represent the present value of future minimum lease payments, bear imputed interest at 4.33%, and mature at dates ranging from 2028 to 2031.

(b) Litigation

The System and its controlled entities are involved in certain litigation, which involves professional and general liability. In the opinion of management and legal counsel, the ultimate liability, if any, will not have a material effect on the consolidated financial condition of the Parent and its subsidiaries.

(c) Regulatory Compliance

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. Compliance with such laws and regulations can be subject to government review and interpretation as well as significant regulatory action, including fines, penalties, and exclusion from the Medicare and Medicaid programs.

(14) Concentrations

(a) Concentrations of Credit Risk

Financial instruments, which potentially subject the System to concentrations of credit risk, consist primarily of cash, cash equivalents, investments, and accounts receivable.

Management periodically evaluates the credit standing of the financial institutions with which the System maintains its cash, cash equivalents, and investments. Amounts held in its accounts often exceed the federally insured levels.

TOWER HEALTH AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

The fair value of the System's investments is subject to various market fluctuations, which include changes in the interest rate environment and general economic conditions.

The System grants credit to its patients and other third-party payors, primarily Medicare, Medical Assistance, Blue Cross, and various commercial insurance companies. The System maintains reserves for potential credit losses and such losses have historically been within management's expectations. The mix of net receivables from patients and third-party payors as of June 30, 2018 and 2017 was as follows:

| | 2018 | 2017 |
|----------------------|-------------|-------------|
| Medicare | 24 % | 25 % |
| Medical assistance | 19 | 18 |
| Blue Cross | 16 | 24 |
| Commercial insurance | 20 | 19 |
| Self-pay | 16 | 12 |
| Other | 5 | 2 |
| | 100 % | 100 % |

The activity in the allowance for uncollectible accounts is summarized as follows for the years ended June 30:

| | 2018 | 2017 |
|---|-------------|-------------|
| Beginning balance | \$ 34,640 | 38,194 |
| Provision for uncollectible accounts, net of recoveries | 107,871 | 47,592 |
| Write offs | (57,740) | (51,146) |
| Ending balance | \$ 84,771 | 34,640 |

(b) Unions and Collective Bargaining

As of June 30, 2018, approximately 7% of the System's employees are subject to collective bargaining agreements with various unions. Two of the three collective bargaining agreements are currently being negotiated. The other bargaining agreement expires in 2021.

TOWER HEALTH AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

(15) Functional Expenses

The System considers health program services and general/administrative to be its primary functional categories for purposes of expense classification. General/administrative includes information systems, general corporate management, advertising and marketing. Functional categories of expenses for the years ended June 30 are as follows:

| | <u>2018</u> | <u>2017</u> |
|---------------------------|---------------------|------------------|
| Health program services | \$ 1,529,215 | 977,133 |
| General/administrative | <u>102,505</u> | <u>65,498</u> |
| Total functional expenses | <u>\$ 1,631,720</u> | <u>1,042,631</u> |

(16) Certain Significant Risks and Uncertainties

The Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010 (collectively, Health Care Reform), enacted in March 2010, have changed and will continue to make broad-based changes to the U.S. health care system which could significantly affect the U.S. economy and which the System expects will continue to impact the System's business operations and financial results. Since its enactment in 2010, key components of Health Care Reform have been phased in, including health insurance exchanges (Public Exchanges), new Medicare products, and the individual coverage mandate. Although Health Care Reform is to be phased in through 2018, many significant changes occurred in 2014. The System is dedicating material resources to monitor the potential impacts of Health Care Reform as well as state level health care reform. While the federal government has issued a number of regulations implementing Health Care Reform, certain significant parts of Health Care Reform, including aspects of Public Exchanges, Medicaid expansion, enforcement related reporting for the individual and employer mandates, and the implementation of Medicare Advantage, require further guidance and clarification at the federal level and/or in the form of regulations and actions by state legislatures to implement the law. The federal government also has announced significant changes to and/or delays in effective dates of various aspects of Health Care Reform, and it is likely that further changes will be made at the federal and/or state level based on implementation experience. As a result, key aspects and impacts of Health Care Reform will not be known for several years, and given the inherent difficulty of foreseeing how individuals and businesses will respond to the choices afforded them by Health Care Reform, the System cannot predict the full effect Health Care Reform will have on the System. It is reasonably possible that Health Care Reform, in the aggregate, could have an adverse effect on the System's business operations and financial results.

Federal budget negotiations, ongoing regulatory changes to Health Care Reform, pending efforts in the U.S. Congress to amend or restrict funding for various aspects of Health Care Reform and litigation challenging aspects of the law continue to create uncertainty about the ultimate impact of Health Care Reform.

TOWER HEALTH AND SUBSIDIARIES

Notes to Consolidated Financial Statements

June 30, 2018 and 2017

(Dollars in thousands)

In addition, the federal and state governments continue to enact or seriously consider many other broad-based legislative and regulatory proposals that have impacted or could materially impact various aspects of the health care system. The System cannot predict whether pending or future federal or state legislation, will change various aspects of the health care system or Health Care Reform or the impact those changes will have on the System's business operations or financials results, but the effects could be adverse.

(17) Subsequent Events

The System has evaluated subsequent events from the consolidated balance sheet date through November 21, 2018, the date at which the consolidated financial statements were available to be issued, and determined there are no other items to disclose.

TOWER HEALTH AND SUBSIDIARIES

Consolidating Balance Sheet Information

June 30, 2018

(Dollars in thousands)

| | Parent | Hospital | Montgomery/ Chester Hospitals | THP | THMG | RHF | THE | Consolidating and eliminating entries | Tower Health consolidated |
|---|--------------|----------|-------------------------------------|-----|----------|---------|-------|--|---------------------------------|
| Current assets: | | | | | | | | | |
| Cash and cash equivalents | \$ 98,549 | (16,367) | (14,614) | — | (66) | — | — | — | 67,502 |
| Patient accounts receivable, less allowance for uncollectible accounts of \$84,771 | — | 138,446 | 151,764 | — | 24,022 | — | — | — | 314,232 |
| Other receivables | 327 | 1,145 | 565 | 47 | 3,073 | 182 | — | — | 5,339 |
| Receivable from affiliates | 5,095 | (6,962) | 19,649 | (1) | (10,397) | (1,642) | — | (5,600) | 142 |
| Inventories | — | 16,542 | 20,032 | — | 559 | — | — | — | 37,133 |
| Estimated third-party payor receivables | — | 7,876 | 6,211 | — | — | — | — | — | 14,087 |
| Prepaid expenses and other current assets | 2,179 | 19,502 | 4,878 | 7 | 1,197 | — | — | — | 27,763 |
| Assets held for sale | 19,875 | — | — | — | — | — | — | — | 19,875 |
| Assets whose use is limited – required for current liabilities: | | | | | | | | | |
| Self-insurance funding arrangements | — | 7,482 | — | — | — | — | — | — | 7,482 |
| Total current assets | 126,025 | 167,664 | 188,485 | 53 | 18,388 | (1,460) | — | (5,600) | 493,555 |
| Assets whose use is limited: | | | | | | | | | |
| Self-insurance funding arrangements | — | 11,988 | — | — | — | — | — | — | 11,988 |
| Under regulatory requirements | 2,000 | — | — | — | — | — | — | — | 2,000 |
| By board for capital improvements | 850,820 | 48 | — | — | — | — | — | — | 850,868 |
| Total assets whose use is limited, net of current portion | 852,820 | 12,036 | — | — | — | — | — | — | 864,856 |
| Restricted investments | — | — | — | — | — | 33,229 | — | — | 33,229 |
| Temporarily restricted investments | — | 372 | — | — | — | — | — | — | 372 |
| Long-term receivables from affiliates | 389,973 | — | — | — | — | — | — | (389,973) | — |
| Property, plant and equipment, net | 16,121 | 726,867 | 302,344 | 830 | 8,614 | — | — | — | 1,054,776 |
| Goodwill | — | — | 128,127 | — | — | — | — | — | 128,127 |
| Investments in joint ventures | 15,650 | 605 | — | — | — | — | 3,685 | — | 19,940 |
| Other assets | — | 3,195 | — | — | 114 | 1,039 | — | — | 4,348 |
| Total assets | \$ 1,400,589 | 910,739 | 618,956 | 883 | 27,116 | 32,808 | 3,685 | (395,573) | 2,599,203 |

TOWER HEALTH AND SUBSIDIARIES

Consolidating Balance Sheet Information

June 30, 2018

(Dollars in thousands)

| | Parent | Hospital | Montgomery/ Chester Hospitals | THP | THMG | RHF | THE | Consolidating and eliminating entries | Tower Health consolidated |
|---|--------------|----------|-------------------------------------|-----|----------|---------|-------|--|---------------------------------|
| Current liabilities: | | | | | | | | | |
| Current installments of long-term debt | \$ 5,600 | — | — | — | — | — | — | — | 5,600 |
| Capital leases | — | — | 2,120 | — | — | — | — | — | 2,120 |
| Accounts payable | — | 47,669 | 27,297 | 82 | 2,542 | (1) | — | — | 77,589 |
| Estimated third-party settlements | — | 4,099 | 4,866 | — | — | — | — | — | 8,965 |
| Current portion of estimated self-insurance costs | — | 13,669 | — | — | — | — | — | — | 13,669 |
| Accrued expenses | 7,266 | 15,806 | 11,359 | 98 | 21,916 | — | — | — | 56,445 |
| Accrued vacation | — | 19,933 | 8,740 | 33 | 12,291 | — | — | — | 40,997 |
| Current installments of long-term affiliated payables | — | 5,600 | — | — | — | — | — | (5,600) | — |
| Other current liabilities | — | 11,472 | 1,344 | 34 | 352 | — | — | — | 13,202 |
| Total current liabilities | 12,866 | 118,248 | 55,726 | 247 | 37,101 | (1) | — | (5,600) | 218,587 |
| Long-term debt, net of current portion and unamortized discount/premium | 1,126,194 | — | — | — | — | — | — | — | 1,126,194 |
| Capital leases | — | — | 19,651 | — | — | — | — | — | 19,651 |
| Accrued pension liabilities | — | 201,974 | — | — | — | — | — | — | 201,974 |
| Deferred revenue | — | 5,388 | — | — | — | — | — | — | 5,388 |
| Other liabilities | — | 1,692 | 181 | 23 | 56 | 12 | — | — | 1,964 |
| Estimated self-insurance costs, net of current portion | 50 | 28,486 | — | — | — | — | — | — | 28,536 |
| Swap contracts | 26,776 | — | — | — | — | — | — | — | 26,776 |
| Long-term affiliates payables, net of current portion | — | 389,973 | — | — | — | — | — | (389,973) | — |
| Total liabilities | 1,165,886 | 745,761 | 75,558 | 270 | 37,157 | 11 | — | (395,573) | 1,629,070 |
| Net assets (deficit): | | | | | | | | | |
| Unrestricted | 234,703 | 164,606 | 543,391 | 613 | (10,041) | (1,661) | 3,685 | — | 935,296 |
| Temporarily restricted | — | 372 | 7 | — | — | 1,229 | — | — | 1,608 |
| Permanently restricted | — | — | — | — | — | 33,229 | — | — | 33,229 |
| Total net assets (deficit) | 234,703 | 164,978 | 543,398 | 613 | (10,041) | 32,797 | 3,685 | — | 970,133 |
| Total liabilities and net assets (deficit) | \$ 1,400,589 | 910,739 | 618,956 | 883 | 27,116 | 32,808 | 3,685 | (395,573) | 2,599,203 |

See accompanying independent auditors' report.

TOWER HEALTH SYSTEM AND SUBSIDIARIES

Consolidating Statement of Operations Information

Year ended June 30, 2018

(Dollars in thousands)

| | Parent | Hospital | Montgomery/ Chester Hospitals | THP | THMG | RHF | Highlands | THE | Consolidating and eliminating entries | Tower Health consolidated |
|--|------------|-----------|-------------------------------------|-------|-----------|-------|-----------|-----|--|---------------------------------|
| Unrestricted revenues and other support: | | | | | | | | | | |
| Net patient service revenue | \$ — | 1,012,462 | 504,198 | — | 192,318 | — | 1,189 | — | (35,766) | 1,674,401 |
| Provision for uncollectible accounts | — | (58,106) | (38,969) | — | (10,796) | — | — | — | — | (107,871) |
| Net patient service revenue less provision for uncollectible accounts | — | 954,356 | 465,229 | — | 181,522 | — | 1,189 | — | (35,766) | 1,566,530 |
| Residential revenue | — | — | — | — | — | — | 5,959 | — | — | 5,959 |
| Other revenue | 6,132 | 33,279 | 6,636 | 3,355 | 4,118 | 197 | 402 | 167 | (5,827) | 48,459 |
| Total revenues and other support | 6,132 | 987,635 | 471,865 | 3,355 | 185,640 | 197 | 7,550 | 167 | (41,593) | 1,620,948 |
| Expenses: | | | | | | | | | | |
| Salaries and benefits | — | 447,495 | 195,954 | 1,992 | 260,273 | 488 | 3,157 | — | (38,443) | 870,916 |
| Supplies | — | 156,417 | 94,071 | 9 | 9,489 | 7 | 548 | — | — | 260,541 |
| Utilities | — | 11,855 | 5,572 | — | 845 | — | 242 | — | — | 18,514 |
| Interest | — | 18,448 | 17,845 | — | — | — | 287 | — | — | 36,580 |
| Depreciation | — | 70,836 | 16,242 | 830 | 1,621 | — | 962 | — | — | 90,491 |
| Purchased services | 166 | 71,097 | 100,822 | 452 | 25,499 | 34 | 639 | — | (62) | 198,647 |
| Repairs and maintenance | — | 39,207 | 12,152 | 557 | 760 | 46 | 112 | — | — | 52,834 |
| Other | 18 | 52,567 | 18,461 | 315 | 15,500 | 229 | 628 | — | (3,088) | 84,630 |
| Transaction related expenses | 6,390 | 9,352 | 2,825 | — | — | — | — | — | — | 18,567 |
| Total expenses | 6,574 | 877,274 | 463,944 | 4,155 | 313,987 | 804 | 6,575 | — | (41,593) | 1,631,720 |
| Income (loss) from operations | (442) | 110,361 | 7,921 | (800) | (128,347) | (607) | 975 | 167 | — | (10,772) |
| Nonoperating (losses) gains: | | | | | | | | | | |
| Investment income | 117,292 | (306) | — | — | — | — | 2,681 | — | — | 119,667 |
| Change in fair value of swap contracts and net of settlement payments | 7,308 | (1) | — | — | — | — | — | — | — | 7,307 |
| Loss on early extinguishment of debt | (4,314) | — | — | — | — | — | — | — | — | (4,314) |
| Other (losses) gains | — | (3,232) | 7 | — | — | — | 21 | — | — | (3,204) |
| Nonoperating (losses) gains, net | 120,286 | (3,539) | 7 | — | — | — | 2,702 | — | — | 119,456 |
| Excess (deficiency) of revenues, (losses) gains, and other support over expenses | \$ 119,844 | 106,822 | 7,928 | (800) | (128,347) | (607) | 3,677 | 167 | — | 108,684 |

See accompanying independent auditors' report.

TOWER HEALTH AND SUBSIDIARIES

Consolidating Balance Sheet Information

June 30, 2017

(Dollars in thousands)

| | Parent | Hospital | THP | THMG | RHF | Highlands | Consolidating and eliminating entries | Tower Health consolidated |
|---|--------------|-----------|-------|--------|---------|-----------|--|---------------------------------|
| Current assets: | | | | | | | | |
| Cash and cash equivalents | \$ — | 54,055 | — | 8 | — | 1,472 | — | 55,535 |
| Patient accounts receivable, less allowance for uncollectible accounts of \$34,640 | — | 107,932 | — | 12,024 | — | 3,597 | — | 123,553 |
| Other receivables | 20 | 1,796 | — | 3,644 | — | — | — | 5,460 |
| Receivable from affiliates | 153,113 | (144,788) | — | (2) | (1,043) | (378) | (6,902) | — |
| Inventories | — | 14,859 | — | — | — | 175 | — | 15,034 |
| Estimated third-party payor receivables | — | 7,262 | — | — | — | — | — | 7,262 |
| Prepaid expenses and other current assets | — | 14,301 | — | 560 | — | 240 | — | 15,101 |
| Assets whose use is limited – required for current liabilities: | | | | | | | | |
| Self-insurance funding arrangements | — | 7,482 | — | — | — | — | — | 7,482 |
| Total current assets | 153,133 | 62,899 | — | 16,234 | (1,043) | 5,106 | (6,902) | 229,427 |
| Assets whose use is limited: | | | | | | | | |
| Self-insurance funding arrangements | — | 11,804 | — | — | — | — | — | 11,804 |
| Under regulatory requirements | — | — | — | — | — | 2,666 | — | 2,666 |
| By board for capital improvements | 802,460 | 54 | — | — | — | 55,458 | — | 857,972 |
| Total assets whose use is limited, net of current portion | 802,460 | 11,858 | — | — | — | 58,124 | — | 872,442 |
| Restricted investments | — | 28,149 | — | — | — | — | — | 28,149 |
| Temporarily restricted investments | — | 249 | — | — | — | 53 | — | 302 |
| Long-term receivables from affiliates | 499,111 | — | — | — | — | — | (499,111) | — |
| Property, plant and equipment, net | 38,654 | 736,730 | 1,659 | 6,147 | — | 50,956 | — | 834,146 |
| Investments in joint ventures | 11,252 | 1,065 | — | — | — | — | — | 12,317 |
| Other assets | — | 5,329 | — | 111 | — | (53) | — | 5,387 |
| Total assets | \$ 1,504,610 | 846,279 | 1,659 | 22,492 | (1,043) | 114,186 | (506,013) | 1,982,170 |

TOWER HEALTH AND SUBSIDIARIES

Consolidating Balance Sheet Information

June 30, 2017

(Dollars in thousands)

| | Parent | Hospital | THP | THMG | RHF | Highlands | Consolidating and eliminating entries | Tower Health consolidated |
|---|--------------|----------|-------|---------|---------|-----------|--|---------------------------------|
| Current liabilities: | | | | | | | | |
| Current installments of long-term debt | \$ 5,380 | 339 | — | — | — | — | — | 5,719 |
| Accounts payable | (3) | 51,907 | 95 | 1,509 | — | 1,248 | — | 54,756 |
| Estimated third-party settlements | — | 4,112 | — | — | — | — | — | 4,112 |
| Current portion of estimated self-insurance costs | — | 10,845 | — | — | — | 40 | — | 10,885 |
| Accrued expenses | 3,701 | 12,296 | 96 | 13,153 | — | 467 | — | 29,713 |
| Accrued vacation | — | 19,088 | 81 | 10,447 | — | 544 | — | 30,160 |
| Current installments of long-term affiliated payables | — | 5,380 | — | — | — | 1,522 | (6,902) | — |
| Other current liabilities | — | 8,567 | 262 | 44 | — | 33 | — | 8,906 |
| Total current liabilities | 9,078 | 112,534 | 534 | 25,153 | — | 3,854 | (6,902) | 144,251 |
| Long-term debt, net of current portion and unamortized discount/premium | 568,125 | 675 | — | — | — | — | — | 568,800 |
| Accrued pension liabilities | — | 252,256 | — | — | — | — | — | 252,256 |
| Deferred revenue | — | 4,494 | — | — | — | 38,317 | — | 42,811 |
| Other liabilities | — | 2,173 | 20 | 114 | 11 | 376 | — | 2,694 |
| Estimated self-insurance costs, net of current portion | — | 37,499 | — | — | — | — | — | 37,499 |
| Swap contracts | 40,702 | 88 | — | — | — | — | — | 40,790 |
| Long-term affiliates payables, net of current portion | — | 467,140 | — | — | — | 31,971 | (499,111) | — |
| Total liabilities | 617,905 | 876,859 | 554 | 25,267 | 11 | 74,518 | (506,013) | 1,089,101 |
| Net assets (deficit): | | | | | | | | |
| Unrestricted | 886,705 | (60,645) | 1,105 | (2,775) | (1,054) | 39,615 | — | 862,951 |
| Temporarily restricted | — | 1,614 | — | — | — | 53 | — | 1,667 |
| Permanently restricted | — | 28,451 | — | — | — | — | — | 28,451 |
| Total net assets (deficit) | 886,705 | (30,580) | 1,105 | (2,775) | (1,054) | 39,668 | — | 893,069 |
| Total liabilities and net assets (deficit) | \$ 1,504,610 | 846,279 | 1,659 | 22,492 | (1,043) | 114,186 | (506,013) | 1,982,170 |

See accompanying independent auditors' report.

TOWER HEALTH AND SUBSIDIARIES

Consolidating Statement of Operations Information

Year ended June 30, 2017

(Dollars in thousands)

| | Parent | Hospital | THP | THMG | RHF | Highlands | Consolidating and eliminating entries | Tower Health consolidated |
|---|-----------|----------|-------|----------|-------|-----------|--|---------------------------------|
| Unrestricted revenues and other support: | | | | | | | | |
| Net patient service revenue | \$ — | 950,498 | — | 121,074 | — | 4,009 | (30,250) | 1,045,331 |
| Provision for uncollectible accounts | — | (43,713) | — | (3,879) | — | — | — | (47,592) |
| Net patient service revenue less provision for uncollectible accounts | — | 906,785 | — | 117,195 | — | 4,009 | (30,250) | 997,739 |
| Residential revenue | — | — | — | — | — | 23,143 | — | 23,143 |
| Other revenue | (11) | 30,018 | 3,568 | 3,515 | — | 1,542 | (7,158) | 31,474 |
| Total revenues and other support | (11) | 936,803 | 3,568 | 120,710 | — | 28,694 | (37,408) | 1,052,356 |
| Expenses: | | | | | | | | |
| Salaries and benefits | — | 452,907 | 2,514 | 160,786 | 469 | 13,199 | (34,433) | 595,442 |
| Supplies | — | 150,830 | 9 | 6,993 | 2 | 2,324 | — | 160,158 |
| Utilities | — | 10,946 | — | 554 | — | 965 | — | 12,465 |
| Interest | — | 11,327 | — | — | — | 1,197 | — | 12,524 |
| Depreciation | — | 77,908 | 830 | 1,569 | — | 3,732 | — | 84,039 |
| Purchased services | — | 75,849 | 611 | 11,391 | 2 | 2,383 | (60) | 90,176 |
| Repairs and maintenance | — | 30,895 | 100 | 587 | 58 | 491 | — | 32,131 |
| Other | — | 38,530 | 131 | 15,336 | 29 | 2,364 | (2,915) | 53,475 |
| Acquisition related expenses | — | 2,221 | — | — | — | — | — | 2,221 |
| Total expenses | — | 851,413 | 4,195 | 197,216 | 560 | 26,655 | (37,408) | 1,042,631 |
| Income (loss) from operations | (11) | 85,390 | (627) | (76,506) | (560) | 2,039 | — | 9,725 |
| Nonoperating (losses) gains: | | | | | | | | |
| Investment income | 44,020 | (2,585) | — | — | — | 2,960 | — | 44,395 |
| Change in fair value of swap contracts and net of settlement payments | 9,584 | 14 | — | — | — | — | — | 9,598 |
| Other-than-temporary impairment losses on investments | (4,111) | — | — | — | — | — | — | (4,111) |
| Other (losses) gains | — | (6,976) | — | (403) | (2) | (109) | — | (7,490) |
| Nonoperating (losses) gains, net | 49,493 | (9,547) | — | (403) | (2) | 2,851 | — | 42,392 |
| Excess (deficiency) of revenues, (losses) gains, and other support over expenses | \$ 49,482 | 75,843 | (627) | (76,909) | (562) | 4,890 | — | 52,117 |

See accompanying independent auditors' report.