

AUDITED CONSOLIDATED FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION

Scripps Health and Affiliates
Years Ended September 30, 2019 and 2018
With Report of Independent Auditors

Ernst & Young LLP



Scripps Health and Affiliates

Audited Consolidated Financial Statements
and Supplementary Information

Years Ended September 30, 2019 and 2018

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Ernst & Young LLP
Suite 1600
4365 Executive Drive
San Diego CA 92121

Tel: +1 858 535 7200
Fax: +1 858 535 7777
ey.com

Report of Independent Auditors

The Board of Trustees
Scripps Health and Affiliates

We have audited the accompanying consolidated financial statements of Scripps Health and Affiliates, which comprise the consolidated statements of financial position as of September 30, 2019 and 2018, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management’s Responsibility for the Financial Statements

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

Auditor’s Responsibility

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

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Scripps Health and Affiliates as of September 30, 2019 and 2018, and the consolidated results of their operations, changes in their net assets, and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Supplementary Information

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying consolidating financial statement information for 2019 and Scripps Health Plan Services financial statements are presented for purposes of additional analysis and are not a required part of the consolidated financial statements for 2019. 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. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Ernst + Young LLP

December 13, 2019

Scripps Health and Affiliates

Consolidated Statements of Financial Position (In Thousands)

	September 30	
	2019	2018
Assets		
Current assets:		
Cash and cash equivalents	\$ 495,944	\$ 373,876
Patient accounts receivable, net	385,215	385,458
Assets limited as to use	9	71,184
Other current assets	184,100	184,001
Total current assets	1,065,268	1,014,519
Assets limited as to use	249,900	199,546
Investments	2,367,235	2,367,418
Property and equipment, net	1,892,905	1,815,970
Other assets	129,614	160,649
Total assets	\$ 5,704,922	\$ 5,558,102
Liabilities and net assets		
Current liabilities:		
Current portion of debt	\$ 121,600	\$ 182,852
Accounts payable	151,746	146,438
Accrued liabilities	300,763	304,739
Total current liabilities	574,109	634,029
Long-term debt, less current portion	786,034	814,118
Other liabilities	126,231	133,707
Total liabilities	1,486,374	1,581,854
Net assets:		
Controlling interests	3,965,116	3,773,397
Non-controlling interests in subsidiaries	3,189	3,481
Without donor restriction	3,968,305	3,776,878
With donor restriction	250,243	199,370
Total net assets	4,218,548	3,976,248
Total liabilities and net assets	\$ 5,704,922	\$ 5,558,102

See accompanying notes.

Scripps Health and Affiliates

Consolidated Statements of Operations

(In Thousands)

	Year Ended September 30	
	2019	2018
Revenues, gains, and other support without donor restrictions:		
Patient service revenue	\$ 2,375,606	\$ 2,244,296
Provider fee	93,107	241,538
Total patient service revenue	2,468,713	2,485,834
Capitation premium	654,637	592,558
Management services	44,414	39,178
Other	134,245	103,542
Net assets released from restrictions used for operations	54,168	21,934
Total operating revenues	3,356,177	3,243,046
Operating expenses:		
Wages and benefits	1,305,310	1,237,813
Supplies	584,980	515,528
Services	1,096,799	1,005,894
Provider fee	73,370	186,285
Depreciation and amortization	168,463	170,905
Interest	23,134	26,623
Restructuring	–	14,272
Total operating expenses	3,252,056	3,157,320
Operating income	104,121	85,726
Nonoperating gains (losses):		
Investment income	89,581	132,497
Contributions	2,694	4,313
Interest rate swaps	(10,387)	4,273
Gain on early extinguishment of debt	45	–
Excess of revenues over expenses	186,054	226,809
Less excess of revenues over expenses attributable to non-controlling interests	(861)	(1,346)
Excess of revenues over expenses attributable to controlling interests	\$ 185,193	\$ 225,463

See accompanying notes.

Scripps Health and Affiliates

Consolidated Statements of Changes in Net Assets (In Thousands)

	Year Ended September 30	
	2019	2018
Change in net assets without donor restrictions:		
Excess of revenues over expenses attributable to controlling interests	\$ 185,193	\$ 225,463
Net assets released from restrictions used for purchases of property and equipment	6,269	28,453
Other	257	539
Increase in net assets without donor restrictions attributable to controlling interests	191,719	254,455
Non-controlling interests:		
Excess of revenues over expenses attributable to non-controlling interests	861	1,346
Distributions to non-controlling members	(1,153)	(1,257)
(Decrease) increase in non-controlling interests	(292)	89
Increase in net assets without donor restrictions	191,427	254,544
Change in net assets with donor restrictions:		
Contributions	106,331	47,198
Investment income	5,774	7,685
Net assets released from restrictions used for operations	(54,168)	(21,934)
Net assets released from restrictions used for purchases of property and equipment	(6,269)	(28,453)
Change in value of deferred gifts	(900)	(327)
Other	105	(8,149)
Increase (decrease) in net assets with donor restrictions	50,873	(3,980)
Total increase in net assets	242,300	250,564
Net assets at beginning of year	3,976,248	3,725,684
Net assets at end of year	\$ 4,218,548	\$ 3,976,248

See accompanying notes.

Scripps Health and Affiliates

Consolidated Statements of Cash Flows (In Thousands)

	Year Ended September 30	
	2019	2018
Operating activities		
Total increase in net assets	\$ 242,300	\$ 250,564
Reconciliation of total increase in net assets to net cash provided by operating activities and nonoperating gains:		
Depreciation and amortization	168,463	170,905
Amortization of debt issuance costs	308	347
Amortization of original issue premium	(539)	(590)
Realized and unrealized gains on investments	(10,137)	(94,401)
Purchases of investments designated as trading	(344,744)	(459,325)
Proceeds from sale of investments designated as trading	355,065	499,657
Interest rate swaps	8,462	(6,878)
Gain on disposal of property	(6,182)	(1,609)
Gain on early extinguishment of debt	(45)	—
Restricted contributions and investment income	(112,280)	(52,700)
Distributions to non-controlling interest	1,153	1,257
Change in assets and liabilities:		
Accounts receivable	243	(16,559)
Other current assets	(99)	(31,796)
Other assets	27,240	(59,383)
Accounts payable and accrued liabilities	5,290	35,278
Other liabilities	(29,141)	15,191
	305,357	249,958
Investing activities		
Purchases of property and equipment	(227,903)	(214,189)
Purchases of investments designated as assets limited as to use	(58,462)	(60,691)
Sales of investments designated as assets limited as to use	79,282	18,435
Net cash used in investing activities	(207,083)	(256,445)

(continued on next page)

Scripps Health and Affiliates

Consolidated Statements of Cash Flows (continued)

(In Thousands)

	Year Ended September 30	
	2019	2018
Financing activities		
Proceeds from restricted contributions and investment income	\$ 115,720	\$ 53,879
Payments on borrowings	(91,070)	(32,393)
Proceeds from sale of donated financial assets	297	3,231
Distributions to non-controlling interest	(1,153)	(1,257)
Net cash provided by financing activities	23,794	23,460
Increase in cash and cash equivalents	122,068	16,973
Cash and cash equivalents at beginning of year	373,876	356,903
Cash and cash equivalents at end of year	\$ 495,944	\$ 373,876
Supplemental disclosure of cash flow information		
Cash paid during the year for interest	\$ 27,630	\$ 29,222
Assets acquired through capital lease or note payable	2,011	1,731
Accrued obligations for property and equipment	32,289	23,045

See accompanying notes.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements

September 30, 2019

1. Organization and Nature of Operations

Scripps Health and Affiliates (Scripps Health) is a California not-for-profit public benefit corporation that provides healthcare services through a network of hospitals and related healthcare operations located in San Diego County.

The accompanying consolidated financial statements for Scripps Health include the financial position and results of operations of Scripps Health Plan Services (SHPS), which was granted a license under the Knox-Keene HealthCare Service Plan Act to operate as a healthcare service plan with waivers in California; Gluck Child Care Center (Gluck), a single member LLC that provides child care services; and Imaging Healthcare Specialists Holding Company (IHS), a single-member LLC and the holding company for Imaging Healthcare Specialists, which provides management services for radiology medical groups.

The entities of Scripps Health are exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code and from state income taxes under Section 23701(d) of the California Revenue and Taxation Code. As single-member limited liability companies, IHS and Gluck are subject to a California annual limited liability company tax.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements include the accounts of the entities that Scripps Health controls (collectively, the “Organization”). All significant transactions among these entities have been eliminated in the accompanying consolidated financial statements.

Use of Estimates

The preparation of the Organization’s consolidated financial statements in conformity with U.S. generally accepted accounting principles (U.S. GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Significant items subject to estimates include the carrying amounts for goodwill and property and equipment; valuation of deferred gifts; valuation allowances for receivables; and liabilities for medical claims incurred but not reported, third-party payables and receivables, and self-insured programs. Actual results could differ from those estimates.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Cash and Cash Equivalents

The Organization considers highly liquid investments with original maturities of three months or less, excluding those whose use is limited, to be cash equivalents. The carrying amount approximates fair value because of the short maturity of the investments.

Healthcare Delivery Revenue and Accounts Receivable

In May 2014, the Financial Accounting Standards Board (the “FASB”) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which superseded virtually all revenue recognition guidance in U.S. GAAP. The Organization adopted the new standard effective October 1, 2018, using full retrospective method. The adoption of the new standard did not have a material impact on our recognition of net revenues. The most significant impact of adopting the new standard is to the presentation of our consolidated income statements, where we no longer present the “Provision for bad debts” as a separate line item and our “Operating revenues” are presented net of estimated implicit price concession revenue deductions.

Patient Service Revenue

The Organization’s patient service revenues are based upon the estimated amounts that we expect to be entitled to receive from patients and third-party payers. Estimates of contractual allowances under managed care and commercial insurance plans are based upon the payment terms specified in the related contractual agreements. Revenues related to uninsured patients and uninsured copayment and deductible amounts for patients who have healthcare coverage may have discounts applied (uninsured discounts and contractual discounts). The Organization also records estimated implicit price concessions (based primarily on historical collection experience) related to uninsured accounts to record self-pay revenues at the estimated amounts expected to collect.

The Organization’s revenues generally relate to contracts with patients in which our performance obligations are to provide healthcare services to the patients. Revenues are recorded during the period our obligations to provide healthcare services are satisfied. The Organization’s performance obligations for inpatient services are generally satisfied over periods that average approximately four to five days, and revenues are recognized based on charges incurred in relation to total expected charges. The Organization’s performance obligations for outpatient services are

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

generally satisfied over a period of less than one day. The contractual relationships with patients, in most cases, also involves a third-party payer (Medicare, Medi-Cal, managed care health plans and commercial insurance companies, including plans offered through the health insurance exchanges) and the transaction prices for the services provided are dependent upon the terms provided by (e.g., Medicare and Medi-Cal) or negotiated with (e.g., managed care health plans and commercial insurance companies) the third-party payers. The payment arrangements with third-party payers for the services we provide to the related patients typically specify payments at amounts less than our standard charges. Medicare generally pays for inpatient and outpatient services at prospectively determined rates based on clinical, diagnostic and other factors. Services provided to patients having Medi-Cal coverage are generally paid at prospectively determined rates per discharge, per identified service or per covered member. Agreements with commercial insurance carriers, managed care and preferred provider organizations generally provide for payments based upon predetermined rates per diagnosis, per diem rates or discounted fee-for-service rates. Management continually reviews the contractual estimation process to consider and incorporate updates to laws and regulations and the frequent changes in managed care contractual terms resulting from contract renegotiations and renewals.

The Organization uses an individual contract approach for a majority of its patient accounts receivables valuations. In the cases where expected reimbursement is not available (i.e., in-house, discharged not final billed, etc.), a portfolio approach is used to account for categories of patient contracts as a collective group. The portfolios consist of major payer classes for inpatient and outpatient revenue. Based on historical collection trends, the Organization believes that revenue recognized by utilizing the portfolio approach approximates the revenue that would have been recognized if an individual contract approach was used.

Laws and regulations governing the Medicare and Medi-Cal programs are complex and subject to interpretation. The Organization is reimbursed by Medicare for cost-reimbursable items at a tentative rate, with final settlement determined after submission of annual cost reports by the Organization and audits thereof by the fiscal intermediary. The adjustments to estimated Medicare and Medi-Cal reimbursement amounts and disproportionate-share funds related primarily to cost reports adjustments to estimated reimbursement amounts resulted in a net decrease to revenues of \$2,005,000 in 2019 and net increase to revenues of \$2,001,000 in 2018.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

The collection of outstanding receivables for Medicare, Medi-Cal, managed care payers, other third-party payers and patients is our primary source of cash and is critical to our operating performance. The primary collection risks relate to uninsured patient accounts, including patient accounts for which the primary insurance carrier has paid the amounts covered by the applicable agreement, but patient responsibility amounts (deductibles and copayments) remain outstanding. Implicit price concessions relate primarily to amounts due directly from patients. Estimated implicit price concessions are recorded for all uninsured accounts, regardless of the aging of those accounts. Accounts are written off when all reasonable internal and external collection efforts have been performed.

Capitation Premium Revenue

Capitation premium revenue is recognized during the period enrollees are entitled to receive services and is generally calculated and paid to the Organization as a fixed premium per enrollee (member) per month. Therefore, there are no accounts receivable from patients related to these types of contracts.

Capitation contracts with managed care payers generally have automatic renewal provisions unless terminated by prior notice to either party. Commercial capitation contracts are generally negotiated annually via the termination notice provision. Medicare HMO capitation is based on a percentage of Medicare revenue and does not require negotiation on an annual basis unless there are material changes in the risk or scope of services. The Organization has agreements with various third parties that govern how financial risk is shared. Estimated amounts to be paid under risk-sharing arrangements of \$13,312,000 and \$11,567,000 as of September 30, 2019 and 2018, respectively, are included in accrued liabilities in the accompanying consolidated statements of financial position.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

The composition of the Organization's revenues by payer are summarized in the following table for the years ended September 30 (in thousands):

	2019	2018
Government	\$ 707,704	\$ 706,765
Contracted	1,622,261	1,442,137
Self-pay and others	45,641	95,394
Patient service revenue	2,375,606	2,244,296
Provider fee	93,107	241,538
Total patient service revenue	2,468,713	2,485,834
Commercial capitation premium revenue	264,677	237,784
Senior capitation premium revenue	389,960	354,774
Capitation premium revenue	654,637	592,558
Total patient service and capitation premium revenue	\$ 3,123,350	\$ 3,078,392

The composition of the Organization's revenues based on business unit type are summarized in the following table for the years ended September 30 (in thousands):

	2019			
	Patient Service Revenue	Provider Fee Revenue	Capitation Premium Revenue	Total Patient Services and Capitation Premium Revenue
Hospital division:				
North San Diego region	\$ 1,426,433	\$ 16,171	\$ 897	\$ 1,443,501
South San Diego region	681,186	76,936	2,485	760,607
Medical foundation	635,347	-	163,696	799,043
Health plan:				
Commercial	-	-	260,924	260,924
Senior	-	-	389,441	389,441
Employee Plan	-	-	76,458	76,458
Accountable Care Organization (ACO)	(5,954)	-	-	(5,954)
Other subsidiaries and joint ventures	18,438	-	-	18,438
Other	18,607	-	-	18,607
Eliminations	(398,451)	-	(239,264)	(637,715)
Total	\$ 2,375,606	\$ 93,107	\$ 654,637	\$ 3,123,350

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

	2018			
	Patient Service Revenue	Provider Fee Revenue	Capitation Premium Revenue	Total Patient Services and Capitation Premium Revenue
Hospital division:				
North San Diego region	\$ 1,327,026	\$ 33,465	\$ 930	\$ 1,361,421
South San Diego region	645,058	208,073	4,597	857,728
Medical foundation	580,651	–	153,781	734,432
Health plan:				
Commercial	–	–	233,692	233,692
Senior	–	–	355,346	355,346
Employee Plan	–	–	71,193	71,193
Other subsidiaries and joint ventures	21,365	–	–	21,365
Other	20,148	–	–	20,148
Eliminations	(349,952)	–	(226,981)	(576,933)
Total	\$ 2,244,296	\$ 241,538	\$ 592,558	\$ 3,078,392

Provider Fee Program

The State of California enacted legislation for a provider fee program to fund certain Medi-Cal coverage expansions. The provider fee program charges hospitals a quality assurance fee that is used to obtain federal matching funds for Medi-Cal with the proceeds redistributed as supplemental payments to California hospitals that treat Medi-Cal patients. The provider fee program that had activity in 2018 and 2019 was the 30-month provider fee program covering the period from January 1, 2017, through June 30, 2019. Historically, the Organization's policy was to record revenue and expense upon approval of the program. During 2018, the Organization determined that, for all provider fee programs through June 30, 2019, the supplemental payments met all criteria related to revenue recognition and the quality assurance fees are both probable and estimable. Accordingly, all related supplemental payments have been recognized as revenue and related quality assurance fees have been recognized as expense as of September 30, 2019 and 2018. Federal and state payments received from these programs are included as provider fee revenue in total patient service revenue, and fees paid or payable to the state and California Health Foundation and Trust (CHFT) are included in provider fee expense in operating expenses. The provider fee program beginning July 1, 2019, has not yet been approved by CMS, and therefore, no amounts have been recognized for the program during the three months ended September 30, 2019.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Provider fee program revenue recorded for the years ended September 30 is summarized below (in thousands):

	<u>2019</u>	<u>2018</u>
Provider fee revenue	\$ 93,107	\$ 241,538
Provider fee expense	(72,250)	(183,990)
CHFT fee	(1,120)	(2,295)
Net operating income from provider fee	<u>\$ 19,737</u>	<u>\$ 55,253</u>

Uncompensated Care

The Organization provides low- and no-cost healthcare services to persons in need. Estimated costs to provide charity care were \$12,609,000 and \$17,988,000 for the years ended September 30, 2019 and 2018, respectively. Charity care is calculated based on a ratio of cost to gross charges. Estimated costs for which the Organization is under reimbursed by various state and county indigent programs were \$126,464,000 (unaudited) and \$111,236,000 (unaudited) for the years ended September 30, 2019 and 2018, respectively, net of Medi-Cal disproportionate share receipts of \$15,916,000 (unaudited) and \$18,333,000 (unaudited) for the years ended September 30, 2019 and 2018, respectively.

Funds received to offset costs of under reimbursed Medi-Cal from the Provider Fee program were \$19,737,000 (unaudited) and \$55,253,000 (unaudited) for the years ended September 30, 2019 and 2018, respectively. Unpaid costs of Medicare were \$292,625,000 (unaudited) and \$303,672,000 (unaudited) for the years ended September 30, 2019 and 2018, respectively.

Management Service Revenue

The Organization's wholly-owned subsidiary, IHS, has a management service agreement with IHS Radiology Medical Group, Inc. in which IHS provides management and administrative services for radiology medical groups. The Organization recorded management service revenue of \$44,414,000 and \$39,178,000 for the years ended September 30, 2019 and 2018, respectively.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Assets Limited as to Use

Assets limited as to use include assets that are held by trustees under indenture agreements, assets limited as to use by donor, assets held in trust for supplemental retirement plans, assets held in trust, and as swap collateral (see Note 5).

Charitable Remainder Trusts

Charitable remainder trusts are arrangements in which a donor establishes and funds an irrevocable trust with specified distributions to be made to a designated beneficiary or beneficiaries over the trust term. For the arrangements for which the Organization serves as trustee (trusteed), the contribution is recognized in the period in which the trust is established. For the arrangements for which another organization serves as the trustee (nontrusteed), the contribution is recognized in the period in which the Organization becomes aware of the arrangement. The assets are recorded at fair value when received or when the Organization is notified of the arrangement. The liability to the designated beneficiary is recorded at the net present value of the estimated future payments to be distributed over the expected life of the beneficiary using discount rates that range between 2.01% to 7.50% at September 30, 2019 and 2018, respectively. The fair value of the trustee arrangements is \$20,496,000 and \$25,818,000 as of September 30, 2019 and 2018, respectively, and is included in assets limited as to use, noncurrent. The net present value of the related liabilities is \$10,272,000 and \$10,637,000 as of September 30, 2019 and 2018, respectively, and is included in other liabilities.

The net beneficial interest in nontrusteed arrangements is \$3,221,000 and \$4,497,000 as of September 30, 2019 and 2018, respectively, and is included in assets limited as to use, noncurrent.

Investments

The Organization classifies its investments in debt and equity securities as trading.

Investments in equity securities with readily determinable fair values and all investments in debt securities are recorded at fair value based on quoted market prices in the consolidated statements of financial position. Investment income or loss on trading securities (including realized and unrealized gains and losses, interest, and dividends) is included as nonoperating gains (losses), within the excess of revenues over expenses, unless the income or loss is restricted by donor or law, in which case the investment income or loss is recorded directly to net assets with donor restrictions.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Alternative investments represent ownership interests in limited partnerships and limited liability companies. Alternative investments are recorded at net asset value, with the related changes in value reported in earnings as investment income.

Inventory

Inventories are stated at the lower of cost or net realizable value, determined using the first-in, first-out method.

Property and Equipment

Property and equipment are recorded at cost when purchased or at fair market value if contributed. Depreciation and amortization of these assets are recorded on a straight-line basis over the period in which the assets are estimated to be in service and of value to the Organization. Leases that have been capitalized are amortized on the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the consolidated statements of operations. Property and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. All of the Organization's capitalized software represents development costs for software that is intended for its internal use. Direct costs of time and material incurred for the development of application software for internal use are capitalized and depreciated using the straight-line method over the estimated useful life of the software, ranging from 3 to 12 years. Costs incurred for upgrades and enhancements that do not result in additional functionality are expensed as incurred.

Goodwill

Goodwill represents the excess of the purchase price over the fair value of net assets acquired. Goodwill is recorded for Scripps Medical Foundation (SMF) and IHS and is evaluated annually for potential impairment (see Note 9).

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Cost of Borrowing

Interest expense is recorded as incurred; however, when money is borrowed for construction or renovation of facilities, the interest cost on that debt during the period of construction is capitalized as part of the asset. Any interest income earned on borrowed funds during construction is accounted for as a reduction of interest cost. Costs associated with issuing debt are recorded as a direct deduction from the debt liability and amortized over the term of the debt using the effective-interest method.

Contributions and Net Assets with Donor Restrictions

Contributions are recorded at estimated fair value as of the date the contribution is received. Unconditional promises (pledges) to contribute cash and other assets are recorded at fair value at the date the promise is received. Pledges and other deferred gifts are discounted to their net present value. In addition, gifts received as irrevocable trusts, which usually provide for payments to the donor until the donor's death, are reduced by the present value of estimated payments to the donor.

Contributions that are not restricted as to use are reported as nonoperating gains in the consolidated statements of operations. If the donor restricts the use of the gift, contributions are reported as increases in net assets with donor restrictions in the consolidated statements of changes in net assets.

Contributions with donor restrictions are generally limited for time or a specific purpose. When restrictions are met, net assets with donor restrictions are transferred to net assets without donor restrictions and recorded as net assets released from restrictions in the consolidated statements of operations and changes in net assets.

Some contributions have been restricted by donors to be maintained in perpetuity. Both the amount to be maintained in perpetuity and the income from such gifts are recorded as net assets with donor restrictions and the income is transferred to net assets without donor restrictions when restrictions are met.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Unbilled Services and Deferred Revenue

The Organization is engaged in contractual research activities and continuing medical education programs. The majority of the contracts have a fixed budget with some variable components and range in duration from a few months to several years. Generally, a portion of the contract fee is paid at the time the contract is initiated, with performance-based installments payable over the contract duration. In general, prerequisites for billings are established by contractual provisions, including predetermined payment schedules, the achievement of contract milestones, or submission of appropriate billing detail. Unbilled services arise when services have been rendered but clients have not been invoiced. Similarly, deferred revenue represents cash receipts for services that have not been rendered. The Organization recognizes net revenue from its contracts based primarily on the individual contract specification such as patient enrollment or related billable activities for the clinical trial. Management believes that this methodology appropriately reflects revenue earned for clinical trials in the period in which services are provided.

Cost of Healthcare Services

The cost of healthcare services is recognized in the period in which services are delivered. Under capitation contracts, the Organization is responsible for the costs of certain services delivered to enrollees, but may not always be the provider of those services. Healthcare service costs are based in part on estimates, including estimates of medical services provided but not yet reported to the Organization. The Organization accrues expenses for medical costs incurred but not yet reported (IBNR) by outside providers using historical studies of claims paid and trend factors. IBNR at September 30, 2019 and 2018, was \$25,839,000 and \$27,401,000, respectively, and is included in accrued liabilities in the accompanying consolidated statements of financial position.

Derivative Instruments

The Organization uses derivative instruments to manage the fluctuations in cash flows resulting from interest rate risk on variable rate debt financing. FASB Accounting Standards Codification Topic (ASC) 815, *Derivatives and Hedging*, requires that all derivative instruments be recorded in the consolidated statements of financial position at fair value. Gains or losses resulting from changes in the values of those derivatives are accounted for depending upon the use of the derivative and whether it qualifies for hedge accounting. The Organization's interest rate swaps do not qualify for hedge accounting, and as such, subsequent changes in fair value of hedge instruments are recognized as nonoperating gains (losses) in the excess of revenues over expenses.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Interest Expense

Interest expense on debt issued for construction projects is capitalized until the projects are placed in service. Interest components include the following for the years ended September 30 (in thousands):

	<u>2019</u>	<u>2018</u>
Total interest costs incurred	\$ 26,346	\$ 29,837
Less capitalized interest	<u>(3,212)</u>	<u>(3,214)</u>
	<u>\$ 23,134</u>	<u>\$ 26,623</u>

Ownership Interests in Other Health-Related Activities

Generally, when the Organization has a controlling ownership interest in health-related activities, the activities are consolidated and a non-controlling interest is recorded in unrestricted net assets.

When there is no controlling ownership interest, but the Organization has significant influence, the activities are accounted for under the equity method, and the income or loss is reflected in other operating revenue. Activities where the Organization does not have significant influence are carried at the lower of cost or estimated net realizable value. Ownership interests in other health-related activities are not significant to the consolidated financial statements.

Operating Income

The Organization's primary purpose is to provide diversified healthcare services to the community it serves. Only those activities directly associated with the furtherance of this purpose are considered operating activities and classified as unrestricted operating revenues and expenses. Operating revenues include those generated from direct patient care, related support services, and other revenues related to the operation of the Organization. Other activities that result in gains or losses unrelated to the Organization's primary purpose are considered to be nonoperating. Nonoperating gains and losses include gifts, grants, and bequests not restricted by donors; investment income; realized and unrealized gains and losses on trading securities; and market adjustments on interest rate swaps. The Organization considers the performance indicator to be the excess of revenues over expenses.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Income Taxes

Scripps Health is generally not subject to federal or state income taxes. However, Scripps Health is subject to income taxes on any net income that is derived from a trade or business, regularly carried on, and not in furtherance of the purpose for which it was granted exemption. Under FASB ASC 740, *Income Taxes*, the tax benefit from uncertain tax positions may be recognized only if it is more likely than not the tax position will be sustained, based solely on its technical merits, with the taxing authority having full knowledge of all relevant information. The Organization records a liability for unrecognized tax benefits from uncertain tax positions as discrete tax adjustments in the first interim period that the more-likely-than-not threshold is not met. The Organization recognizes deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of its assets and liabilities along with net operating loss and tax credit carryovers only for tax positions that meet the more-likely-than-not recognition criteria. No significant tax liability for tax benefits, interest, or penalties was accrued at September 30, 2019 or 2018.

Scripps Health currently files Form 990 (informational return of organizations exempt from income taxes) and Form 990-T (business income tax return for an exempt organization) in the U.S. federal jurisdiction and the state of California. Scripps Health is not subject to income tax examinations prior to 2015 in major tax jurisdictions.

Fair Value of Financial Instruments

The carrying amount reported in the accompanying consolidated statements of financial position for cash and cash equivalents, accounts receivable, accounts payable, and accrued liabilities approximates fair value. The fair value of debt and interest rate derivatives is disclosed in Note 10, and the fair value of assets limited as to use and investments is disclosed in Note 16.

Liquidity Management

As part of its liquidity management, the Organization's strategy is to structure its financial assets to be available to satisfy general operating expenses, current liabilities, and other obligations as they come due. The Organization invests cash in excess of daily requirements in short-term investments and has committed line of credit, as discussed in Note 10, to manage unanticipated liquidity needs.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

The Organization's financial assets available for general operating expenses within one year of September 30, 2019, are as follows (in thousands):

Cash and cash equivalents	\$ 495,944
Patient accounts receivable, net	385,215
Investments	2,367,235
Other current assets	184,100
	<u>\$ 3,432,494</u>

The Organization has other assets limited to use for donor-restricted purposes and debt service.

Adoption of Accounting Pronouncements

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, a new accounting standard that amends the accounting and disclosures of financial instruments, including a provision that requires equity investments (except for investments accounted for under the equity method of accounting) to be measured at fair value, with changes in fair value recognized in current earnings. The new standard is effective for interim and annual periods beginning after December 15, 2018. The Organization is currently evaluating the impact of this new standard on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. ASU 2016-02 amends the existing accounting standards for lease accounting, including requiring lessees to recognize most leases on their balance sheets and making targeted changes to lessor accounting. The new standard requires a modified retrospective transition approach for all leases existing at, or entered into after, the date of initial application, with an option to use certain transition relief. The amendments in this update are effective for fiscal years (and interim reporting periods within fiscal years) beginning after December 15, 2018. The amendments in this update are effective October 1, 2019, and the Organization elected the practical expedient to initially apply the new leasing standard at the effective date. The Organization is finalizing its analysis of certain key assumptions that will be utilized at the transition date, including the incremental borrowing rate. The primary effect of the new standard will be to record right-of-use assets and obligations for current operating leases, which will have a material impact on the consolidated balance sheets and significant incremental disclosures in the notes to consolidated financial statements. The standard will not have a material impact on the Organizations's consolidated results of operations or statement of cash flows.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

3. Patient Accounts Receivable

Significant concentrations of gross accounts receivable relating to patient service revenue consisted of the following payer mix at September 30:

	2019	2018
Government	51%	54%
Contract	38	37
Self-pay and other	11	9

The Organization believes there is no significant credit risk associated with receivables from government programs. Receivables from health maintenance organizations, preferred provider organizations, and others are from various payers who are subject to differing economic conditions and, therefore, do not represent any concentrated risk to the Organization. The Organization continually monitors and adjusts the reserves associated with receivables.

4. Other Current Assets

Other current assets at September 30 are summarized below (in thousands):

	2019	2018
Provider fee receivable	\$ 60,969	\$ 51,223
Inventory	48,538	47,507
Accounts receivable – other	28,894	32,790
Prepaid expenses	24,365	21,622
Medicare Access and CHIP Reauthorization Act receivable (MACRA)	6,898	4,000
Management fee receivable	6,617	6,928
Contract accounts receivable	5,647	5,140
Prepaid insurance	1,259	1,275
Deposits	913	839
Third-party settlements	–	12,677
	\$ 184,100	\$ 184,001

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

5. Assets Limited as to Use

The following is a summary of assets limited as to use at September 30 (in thousands):

	2019	2018
Assets included in net assets with donor restrictions	\$ 225,848	\$ 168,506
Investments held by trustees for debt service	9	71,200
Charitable trusts and life estate tenancies	23,718	30,333
Assets held in trust for supplemental retirement plan	–	358
Other assets limited as to use	334	333
	249,909	270,730
Less amounts held by trustees for debt service required to pay current liabilities	(9)	(71,184)
	\$ 249,900	\$ 199,546

6. Property and Equipment

Property and equipment at September 30 are summarized below (in thousands):

	Estimated Useful Lives	2019	2018
Land	–	\$ 105,795	\$ 112,419
Buildings and improvements	5 to 40 years	1,787,596	1,755,548
Leasehold improvements	5 to 15 years	95,721	94,247
Equipment	5 to 15 years	1,080,797	1,055,911
Capitalized software	1 to 12 years	553,921	456,238
Construction- and software-in-progress	–	183,425	128,769
Capital lease equipment	5 years	14,375	20,455
		3,821,630	3,623,587
Less accumulated depreciation		(1,681,531)	(1,595,450)
Less accumulated amortization – capitalized software		(247,194)	(212,167)
Property and equipment, net		\$ 1,892,905	\$ 1,815,970

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

6. Property and Equipment (continued)

Depreciation expense was \$168,405,000 and \$170,777,000 for the years ended September 30, 2019 and 2018, respectively. Amortization expense on capitalized software was \$35,027,000 and \$34,325,000 for the years ended September 30, 2019 and 2018, respectively.

Construction-in-progress at September 30, 2019 and 2018, is related to various construction and information technology projects. As of September 30, 2019, there is approximately \$251,593,000 (unaudited) of outstanding commitments to complete projects in progress.

7. Other Assets

Other assets at September 30 are summarized below (in thousands):

	<u>2019</u>	<u>2018</u>
Goodwill, net	\$ 41,303	\$ 41,303
Provider fee receivable	38,426	65,510
Cash surrender value of life insurance, net	21,602	20,707
Pledges receivable, net	8,768	12,505
Workers' compensation reinsurance receivable	6,566	6,199
Malpractice reinsurance receivable	5,439	6,207
Intangible assets, net	3,807	3,865
Other	3,703	4,353
	<u>\$ 129,614</u>	<u>\$ 160,649</u>

The net amount of pledges receivable at September 30 is as follows (in thousands):

	<u>2019</u>	<u>2018</u>
Unconditional promises to give	\$ 10,769	\$ 14,978
Less allowance for uncollectible pledges	(705)	(1,253)
Less unamortized discount	(1,296)	(1,220)
Pledges receivable, net	<u>\$ 8,768</u>	<u>\$ 12,505</u>
Amounts due in:		
Less than one year	\$ 3,190	\$ 7,140
One to five years	3,641	3,468
More than five years	1,937	1,897
Total	<u>\$ 8,768</u>	<u>\$ 12,505</u>

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

7. Other Assets (continued)

The fair value of these pledges was determined by calculating the net present value of the estimated future cash flows using discount rates at the date of the pledge ranging from 0.74% to 6.78%.

8. Accrued Liabilities

At September 30, accrued liabilities were comprised of the following (in thousands):

	2019	2018
Accrued payroll and related payroll liabilities	\$ 129,498	\$ 118,766
Accrued retirement plan liabilities	31,390	36,530
Due to medical groups, net	29,488	30,329
Accrued health insurance claims and reserves	25,839	27,401
Accrued employee incentives	16,818	12,186
Third-party risk pool liabilities	13,312	11,567
Accrued malpractice insurance claims and reserves	9,725	11,505
Accrued interest payable	8,239	10,311
Deferred revenue	8,095	10,371
Medicare Shared Savings Plan (MSSP) losses	5,954	–
Accrued workers compensation claims and reserves	5,884	5,955
Accrued group health insurance claims and reserves	5,179	6,254
Unclaimed property liabilities	3,086	2,574
Swap hedge	–	13,202
Other	8,256	7,788
	\$ 300,763	\$ 304,739

9. Goodwill

Impairment assessments of the carrying amount of goodwill are completed annually, or whenever impairment indicators are present for SMF, which includes Scripps Clinic and Scripps Coastal Medical Centers and IHS. No goodwill impairment was recorded during 2019 or 2018. The net balance in goodwill is \$41,303,000 as of September 30, 2019 and 2018.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

10. Debt

A summary of debt at September 30 is as follows (in thousands):

	2019	2018
Tax-exempt bonds sponsored by the California Health Facilities Financing Authority (CHFFA):		
Fixed rate bonds:		
Series 2017 A, principal due in varying annual installments through October 2031; interest payable semiannually at a fixed rate of 2.07% (including unamortized debt issuance costs of \$382 at September 30, 2019)	\$ 159,618	\$ 159,574
Series 2016 A, principal due in varying annual installments through October 2025; interest payable at a fixed rate of 1.44% (including unamortized debt issuance costs of \$64 at September 30, 2019)	42,441	44,970
Series 2016 B, principal due in varying annual installments through October 2025; interest payable semiannually at a fixed rate of 1.84% (including unamortized debt issuance costs of \$189 at September 30, 2019)	69,811	79,774
Series 2012 A, principal due in varying annual installments through November 2040; interest payable at a fixed rate of 4.84%, adjusting annually (including unamortized premium of \$8,843 and unamortized debt issuance costs of \$1,089 at September 30, 2019)	182,754	183,231
Series 2010 A, principal due in varying annual installments through November 2036; interest payable at a fixed rate of 5.00%, adjusting annually (including unamortized discount of \$303 and unamortized debt issuance costs of \$441 at September 30, 2019)	101,847	104,913
Series 2008 A, principal due in varying annual installments through October 2022; interest payable at a fixed rate of 5.10%, adjusting annually The bond was advance refunded in October 2018.	—	69,450

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

10. Debt (continued)

	2019	2018
Variable rate bonds:		
Series 2012 B-C, principal due in varying annual installments through October 2042; Series B (\$60,000), Series C (\$40,000); interest payable weekly at variable interest rates averaging 1.28% during the period from October 1, 2018, through September 30, 2019 (1.19% at September 30, 2019, including unamortized debt issuance costs of \$685 at September 30, 2019)	\$ 99,315	\$ 99,282
Series 2010 B-C, principal due in varying annual installments through October 2040; Series B (\$60,000), Series C (\$40,000); interest payable weekly at variable interest rates averaging 1.31% during the period from October 1, 2018, through September 30, 2019 (1.19% at September 30, 2019, including unamortized debt issuance costs of \$1,413 at September 30, 2019)	98,587	98,536
Series 2008 G, principal due in varying annual installments through October 2019; interest payable weekly, at a variable rate averaging 1.24% during the period from October 1, 2018, through September 30, 2019 (1.05% at September 30, 2019)	475	3,650
Series 2001 A, principal due in varying annual installments through October 2023; interest payable monthly, at a variable rate averaging 1.27% during the period from October 1, 2018, through September 30, 2019 (1.17% at September 30, 2019)	11,100	11,100

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

10. Debt (continued)

	2019	2018
Tax-exempt bonds sponsored by the California Statewide Communities Development Authority:		
Variable rate revenue refunding bonds:		
Series 2007 A State-wide Easy Equipment Program (SWEEP), principal due August 2035; interest payable weekly at a variable interest rate averaging 1.29% during the period from October 1, 2018, through September 30, 2019 (1.15% at September 30, 2019)	\$ 49,995	\$ 49,995
Taxable term loan, principal due in varying annual installments commencing in 2019 through October 1, 2025, interest payable at fixed rate of 2.31% per annum	50,000	50,000
Total fixed and variable rate debt	865,943	954,475
Obligations under capital leases	5,275	6,215
Line of credit	35,976	35,976
Other notes payable	440	304
Total debt	907,634	996,970
Less current liabilities	121,600	182,852
Total long-term debt	\$ 786,034	\$ 814,118

Notes issued under a Master Indenture of Trust, dated as of December 1, 1985, as amended and restated May 1, 1998, and supplemented through February 1, 2017 (Indenture), between members of an Obligated Group created thereby, of which Scripps Health is currently the sole member (the Obligated Group), and the Trustee secure substantially all of the Organization's outstanding debt obligations. In addition, the Organization's payment obligations with respect to bonds issued on its behalf, bond series 2001A, 2007A, and 2008G are secured by credit facilities (principally letters of credit) issued by various banking institutions. At September 30, 2019, amounts available under the credit facilities issued total approximately \$62,534,000. The credit facilities generally fund both principal and interest payments on the bonds when due and also fund optional tenders

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

10. Debt (continued)

from bondholders. Credit facilities are used to reduce overall borrowing costs and, among other things, provide liquidity support in times of market disruption. There were no liquidity draws on the various facilities in 2019 or 2018. Scheduled principal repayments of long-term debt for the next five fiscal years and thereafter are as follows (in thousands):

2020	\$ 35,593
2021	34,674
2022	70,966
2023	35,811
2024	35,878
Thereafter	694,712
	<u>\$ 907,634</u>

As of September 30, 2019, the Organization has \$200,000,000 of bonds (2010B, 2010C, and 2012B, 2012C) that are supported by a liquidity facility that expires on September 30, 2022, and \$86,000,000 of these self-liquidity bonds were classified as current liabilities.

In February 2018, the Organization converted \$100,000,000 of the 2010B-C tax-exempt bonds from credit enhanced liquidity to self-liquidity bonds. As part of this transition, the JP Morgan letter of credit (LOC) supporting the 2010B bonds and the Northern Trust LOC supporting the 2010C bonds were both terminated effective February 28, 2018. Accordingly, at September 30, 2018, \$91,362,000 of the Organization's variable rate demand bonds were classified as current liabilities.

In September 2018, the Organization exercised its option to prepay and redeem Series 2008A bonds maturing on October 1 of the years 2019, 2020, 2021, and 2022 on October 1, 2018, in the principal amount of \$69,405,000, without premium, together with interest accrued to October 1, 2018 (redemption date). Accordingly, the \$58,100,000 has been reclassified from long-term debt to current portion at September 30, 2018. To facilitate this redemption, the Organization wired \$61,153,000 to a trustee-held fund on September 28, 2018.

Bond reserve funds are used to fund principal and interest payments. At September 30, 2019 and 2018, bond reserve funds held by trustees were \$9,000 and \$71,200,000, respectively.

The interest rates on variable debt are reset weekly by the remarketing agent in accordance with the Indenture depending on prevailing market conditions. The rates are highly correlated with the Securities Industry and Financial Markets Association index.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

10. Debt (continued)

In November 2019, the Organization increased its available revolving line of credit facility arrangements to \$200,000,000 from \$150,000,000 at September 30, 2019. Under the interest rate swap agreement for the Series 2008 G bonds, with a current notional amount of \$475,000, the Organization pays a fixed amount of 3.086% and receives a floating rate of 54.70% of London Interbank Offered Rates (LIBOR) plus 0.32%. Under the interest rate swap agreements for the Series 2010 B-C and 2012 B bonds, with a total current notional amount of \$122,000,000, the Organization pays a fixed rate of 3.21% and receives a floating rate of 54.70% of LIBOR plus 0.32%. The Organization has the right to terminate the agreements prior to maturity, and the counterparty has the right to terminate under certain events of default. At September 30, 2019 and 2018, the fair value of these swap agreements was recorded in the accompanying consolidated statements of financial position at \$21,664,000 in other liabilities and \$13,202,000 in accrued liabilities, respectively.

The Organization has no restricted collateral held for the swap counterparty at September 30, 2019 or 2018.

Under the terms of the Indenture and various letter of credit agreements, the Organization is required to meet certain financial ratios. The Indenture also places limits on the Organization's ability to obtain additional borrowings. Under supplemental master indenture implementing amendments, dated August 1, 2008, the Obligated Group instituted a gross revenue pledge.

The Organization maintains a credit facility arrangement that includes revolving lines of credit totaling \$200,000,000. There was \$35,976,000 outstanding under this revolving line of credit at September 30, 2019 and 2018, no amounts are due and payable under this line of credit until the expiration date of September 30, 2022. There are five letters of credit issued under this facility totaling \$7,372,000 at September 30, 2019. As of September 30, 2019, no funds have been drawn on these letters. The CHFFA 2010 B-C and 2012 B-C bonds are supported by the Organization's self-liquidity as evidenced by the revolving line of credit.

Based on the borrowing rates currently available to the Organization for loans with similar terms and maturities, the estimated fair value of long-term debt was approximately \$873,993,000 and \$967,315,000 at September 30, 2019 and 2018, respectively. Long-term debt obligations are considered to be in Level 2 (see Note 16) of the fair value hierarchy.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

11. Other Liabilities

Other liabilities at September 30 are summarized below (in thousands):

	2019	2018
Accrued liability for workers' compensation, net of current portion of \$5,884 and \$5,955 in 2019 and 2018, respectively	\$ 30,279	\$ 31,727
Swap hedge liability	21,664	–
Asset retirement	16,467	15,987
Accrued liability for professional and general liability self-insurance, net of current portion of \$5,201 and \$5,333 in 2019 and 2018, respectively	14,365	14,907
Deferred rent liability	11,627	13,018
Provider fee	10,734	35,379
Accrued liability for physician malpractice, net of current portion of \$4,524 and \$5,774 in 2019 and 2018, respectively	10,651	11,820
Annuity/unit trust liabilities	10,272	10,637
Other	172	232
	\$ 126,231	\$ 133,707

The Organization follows the guidance of FASB ASC 410, *Asset Retirement and Environmental Obligations*. FASB ASC 410 requires that a legal obligation to perform an asset retirement activity that is not conditional on a future event and that is within the control of the Organization be recognized as a liability at fair value if it can be reasonably estimated. Because asbestos abatement is mandated under the laws of the state of California, the Organization will eventually be required to remove and dispose of asbestos in all of its facilities. The Organization has recorded a liability totaling \$16,465,000 and \$15,987,000 at September 30, 2019 and 2018, respectively, which reflects the future value, discounted at an annual rate of 3.0% and 3.5% for 2019 and 2018 respectively, of the estimated asbestos removal and disposal liability.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

12. Retirement Plans

Defined Contribution Savings Plan (401(a) Plan)

The Organization provides a defined contribution savings plan for all eligible employees who have completed six months of service and attained age 21. Plan participants may contribute up to 60% of eligible compensation on an after-tax basis. The Organization matches employee contributions up to 3% of pay with increased matching contribution for employees with ten or more years of service. Employees with ten or more years of service contributing at least 3% receive a 4%, 5%, or 6% matching contribution, depending on their years of service. All eligible employees receive an additional annual contribution of 1% of their eligible compensation. Employee contributions are immediately vested; employer contributions vest on a graded schedule with 100% vesting at three years of service. The Organization recorded plan expense in the amount of \$41,024,000 and \$39,417,000 in 2019 and 2018, respectively.

Nonqualified Supplemental Executive Retirement Plan (SERP)

The Organization maintains a SERP for certain key executives. The SERP provides defined benefits to the participants. The SERP has six participants and has been closed to new membership since 2002. The Plan is actuarially evaluated and involves various assumptions, including the discount rate. Effective April 2014, Scripps Health exercised the right to freeze four of six participants' benefits accrued as of January 1, 2014, under the existing SERP. Entitlement to payment of the benefit, the time and form of benefit payments, and circumstances under which the benefit would be forfeited remain as described in the SERP. In December 2017, the Board voted to approve termination of the SERP. On December 29, 2017, \$6,874,000 was paid out to participants, and on January 25, 2019, \$6,647,000 was paid out to participants as a final payment.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

12. Retirement Plans (continued)

The following summarizes the SERP benefit obligation and funded status for the SERP as of September 30 (in thousands):

	2019	2018
Change in benefit obligation:		
Obligation at beginning of year	\$ 6,544	\$ 14,061
Benefit payments	(6,740)	(8,218)
Interest cost	–	173
Experience loss:		
Census data	196	460
Discount rate change	–	68
Obligation at end of year	\$ –	\$ 6,544

The amount of net pension liability recognized as current liabilities in the consolidated statements of financial position is \$0 and \$6,544,000 as of September 30, 2019 and 2018, respectively.

Executive Deferred Compensation Plan

The Organization has deferred compensation agreements (the “Agreements”) with four executives. The Agreements are structured such that the Organization will have no future obligation to fund any additional amounts beyond an initial \$19,525,000 the Organization set aside to fund the premium payments on various split dollar life insurance policies. The \$19,525,000 was used to prefund the payments for the first seven years of premium funding for these Agreements. The final three annual premium payments for these Agreements are projected to be funded by the future cash surrender value (CSV) of the life insurance products. The cash flows received by the executives following their retirement will be partially funded with loans taken against the CSV of the life insurance contracts, which can be drawn by the executives from ages 65 to 81. Once the insurance contracts mature, Scripps will receive accumulated death benefits less amounts due to each beneficiary under the Agreements.

The Organization has recorded \$749,000 and \$1,136,000 as prepaid insurance contracts and \$21,585,000 and \$19,806,000 of cash surrender value in other assets as of September 30, 2019 and 2018, respectively, in the accompanying consolidated statements of financial position. The Organization recorded benefits expense of \$974,000 and \$493,000 in 2019 and 2018, respectively, related to the Agreements.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

13. Risk Management and Contingencies

Insurance Coverage

The Organization has a comprehensive insurance program designed to safeguard its assets and properties. The Organization takes a large retention for those risks that it can mitigate to offset risk transfer costs. Risk transfer is used to mitigate various exposures and losses to a third-party insurer when it is appropriate. In addition, the Organization purchases excess liability coverage to cover losses that exceed its self-insurance program.

The Organization is self-insured for hospital professional and general liability risks for the first \$2,000,000 of loss per occurrence subject to a self-insurance retention aggregate of \$10,000,000. Losses in excess of this amount are insured through modified claims-made professional liability policies that provide for a seven-year built-in extended reporting period. Total limits purchased for hospital professional liability is \$75,000,000 per occurrence, subject to a \$75,000,000 aggregate. The provision for estimated self-insured professional liability claims includes estimates of the ultimate liability and defense costs for both reported claims and incurred but not reported claims. There is also an additional \$25,000,000 per occurrence and aggregate coverage for catastrophic premises liability loss for both hospital and non-hospital locations for a total of \$100,000,000 per occurrence and aggregate.

The Organization is self-insured for workers' compensation risks for the first \$1,000,000 of loss per occurrence. Losses in excess of this amount are insured through policies of insurance that provide coverage up to statutory amounts. The Part B coverage for workers' compensation, employer's liability, is covered with primary excess occurrence policies totaling \$2,000,000 limits per occurrence and aggregate and additional excess policies in the amount of \$100,000,000 per occurrence and aggregate.

SHPS is insured for managed care liability through a primary policy with limits of \$5,000,000 per occurrence and \$5,000,000 annual aggregate and is insured through excess policies for an additional \$75,000,000 per occurrence and \$75,000,000 aggregate.

Scripps Clinic is insured for professional liability through a master policy with Scripps Clinic Medical Group (SCMG) on a claims-made basis, and Scripps Health is acknowledged as an administrative insured of this policy. Scripps Health employees working in Scripps Clinic are insured under the entity coverage for SCMG with limits of \$5,000,000 per occurrence and \$10,000,000 in annual aggregate subject to a self-insured retention of \$500,000 per claim and \$2,900,000 annual aggregate. Claims-made coverage covers only those claims reported during the policy period, and Scripps Health records an accrual for losses incurred but not reported.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

13. Risk Management and Contingencies (continued)

Scripps Coastal Medical Centers are insured for professional liability through a master policy with San Diego Coastal Medical Group on a claims-made basis, and Scripps Health is acknowledged as an administrative insured of this policy.

Scripps Health employees working in the medical centers are insured in the entity coverage for SCMG with limits of \$1,000,000 per occurrence and \$5,000,000 annual aggregate.

The Organization is self-insured for employee health benefits relating to the Exclusive Provider Organization (EPO), dental and vision plans, and records an accrual for claims incurred but not reported. Stop-loss coverage is maintained that caps the maximum payable per calendar year at \$750,000 per individual.

Legal

The healthcare industry is subject to numerous laws and regulations of federal, state, and local governments. Compliance with these laws and regulations is subject to government review and interpretation, as well as regulatory actions. Claims for payment for services rendered to Medicare and Medi-Cal beneficiaries must meet applicable billing laws and regulations, which, among other things, require that the services be medically necessary, accurately coded, and sufficiently documented in the beneficiaries' medical records. Allegations concerning possible violations of regulations can result in the imposition of significant fines and penalties, as well as significant repayment of previously billed and collected revenues for patient services. Management believes that the Organization is in substantial compliance with all applicable laws and regulations, and it is not aware of any significant allegations of potential wrongdoing, other than as disclosed here. The Organization has received, and is in the process of responding to, requests from governmental agencies that may include the California Department of Public Health and the Office of Civil Rights. The Organization is a party to certain legal and regulatory actions in the ordinary course of business. It is the opinion of management that there will not be a material adverse effect on the consolidated financial position or results of operations of the Organization as a result of such actions.

The Organization is the object of a putative class action lawsuit alleging that the Organization has failed to follow state wage and hour laws regarding payment to employees. The Organization will vigorously defend the claims. An estimate of the possible loss or range of loss cannot be made; however, management does not believe the liability relating to these claims will result in a material impact to the consolidated financial statements.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

13. Risk Management and Contingencies (continued)

Seismic Standards (Unaudited)

The state of California issued seismic safety standards (SB1953) in 1994 that have been amended on several occasions since then. These standards affect all five of the Organization's hospital campuses. Emergency regulations adopted in January 2010 (SB499) as well as the ability to apply for Hazards US (HAZUS) certification have and will continue to provide some legislative relief for the Organization by modifying the level of Structural Performance Category (SPC) and Non-Structural Performance Category (NPC) seismic retrofit required as well as extending the compliance deadlines. The 2007 HAZUS regulations allow for hospitals to meet a standard of 0.75% collapse probability given the ground motions specific to the site, and thus are not as rigorous as the full SB1953 regulations due to more precise estimations. HAZUS specifically addresses SPC requirements. SB499 legislation addresses the NPC requirements and allows for hospitals to delay NPC-3 upgrades until 2030, at which time the work will then be completed or the facility removed from service.

The Organization has received HAZUS relief and SB499 waivers, which reduced total projected costs and extended compliance to 2030. The Organization expended \$35,512,000 (unaudited) to complete all remediation work to meet HAZUS and SB499 requirements.

Subsequent to accomplishing the above tasks related to seismic safety, the state of California adopted a new seismic safety standard, called SPC-4D. SPC-4D is a new performance category that will allow hospitals the possibility of upgrading some current SPC-1 and SPC-2 buildings to a new performance level that is not as rigorous as the current requirement to upgrade to SPC-5. Under SPC-4D, buildings undergoing a retrofit to this level can continue functioning indefinitely (beyond 2030). Investigatory and design work is progressing to establish the viability of applying the SPC-4D regulations to the Organization's campuses. Details, analytical data, and design information is being discussed with the authority having jurisdiction, the California Office of Statewide Health Planning and Development, to approve, in concept, the planned solutions.

In addition, several of the buildings that require compliance with SB1953 are likely to be demolished rather than upgraded as new inpatient facilities are proposed. Scripps Health is in the early stages of these master plan site evaluations and replacement solutions.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

14. Lease Commitments

The Organization leases various facilities under operating leases expiring at various dates through 2043. Total rental expense for operating leases was approximately \$32,316,000 and \$30,659,000 in 2019 and 2018, respectively. The following is a schedule of future minimum lease payments as of September 30, 2019, under operating leases that have initial or remaining terms in excess of one year (in thousands):

2020	\$	32,452
2021		28,156
2022		20,698
2023		17,598
2024		14,745
Thereafter		45,894
	\$	<u>159,543</u>

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

15. Net Assets with Donor Restrictions

Net assets with donor restrictions are restricted for the following purposes or periods as of September 30 (in thousands):

	2019	2018
Subject to expenditure for specific purpose:		
Healthcare operations	\$ 51,708	\$ 13,891
Building, construction, and equipment	32,220	20,032
Research operations	22,582	22,687
Deferred gifts, available for use in future periods	15,612	17,292
Fellowships	3,355	3,076
Education	2,138	2,169
Indigent care	1,138	834
	128,753	79,981
Subject to spending policy and appropriation:		
Investment in perpetuity (including amounts above original gift amount of \$38,278 and \$37,134) which once appropriated, are expendable to support:		
Healthcare operations	52,609	51,378
Research operations	23,708	21,871
Education	21,276	21,341
Indigent care	17,942	17,828
Fellowships	5,147	5,104
Building, construction and equipment	798	806
Deferred gifts	10	1,061
	121,490	119,389
Total net assets with donor restrictions	\$ 250,243	\$ 199,370

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

15. Net Assets with Donor Restrictions (continued)

Net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes or by occurrence of the passage of time or other events specified by donors. During 2019 and 2018, net assets released from donor restrictions comprised of the following (in thousands):

	2019	2018
Purpose restrictions accomplished:		
Healthcare operations	\$ 46,845	\$ 12,289
Building, construction, and equipment	6,220	28,439
Research operations	3,664	3,371
Fellowships	717	882
Education	246	242
Indigent care	127	2,116
	57,819	47,339
 Release of appropriated endowment amounts with purpose restrictions:		
Healthcare operations	978	1,312
Education	715	620
Indigent care	420	640
Research operations	336	286
Fellowships	120	176
Building, construction, and equipment	49	14
	2,618	3,048
 Total restrictions released	\$ 60,437	\$ 50,387

Endowments

The Organization's endowments consist of 89 and 88 individual funds for 2019 and 2018, respectively, established for a variety of purposes. Net assets associated with the endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions.

California Senate Bill No. 1329 enacted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) for California. The Organization is subject to UPMIFA and, thus, classifies amounts in its donor-restricted endowment funds as net assets with donor restrictions because those net assets are time restricted until the Board of Trustees appropriates such amounts for

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

15. Net Assets with Donor Restrictions (continued)

expenditures. Most of those net assets also are subject to purpose restrictions that must be met before reclassifying those net assets to net assets without donor restrictions. The Board of Trustees of the Organization has interpreted as not requiring the maintenance of purchasing power of the original gift amount contributed to an endowment fund, unless a donor stipulates to the contrary. As a result of this interpretation, when reviewing its donor-restricted endowment funds, the Organization considers a fund to be underwater if the fair value of the fund is less than the sum of (a) the original value of initial and subsequent gift amounts donated to the fund and (b) any accumulations to the fund that are required to be maintained in perpetuity in accordance with the direction of the applicable donor gift instrument.

The Organization has interpreted UPMIFA to permit spending from underwater funds in accordance with the prudent measures required under law. In accordance with UPMIFA, the Organization considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds: (1) duration and preservation of the fund, (2) purposes of the Organization and the donor-restricted endowment fund, (3) general economic conditions, (4) possible effect of inflation or deflation, (5) expected total return from income and the appreciation of investments, (6) other resources of the Organization, and (7) investment policies of the Organization.

From time to time, the fair value of assets associated with individual endowment funds may fall below the level that the donor or UPMIFA requires the Organization to retain as a fund of perpetual duration.

The Organization has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of the endowment assets. Under this policy, as approved by the Board of Trustees, the endowment assets are invested in a manner that is intended to produce results that exceed the price and yield results while assuming a moderate level of investment risk. The Organization expects its endowment funds, over time, to provide an average rate of return of approximately 5% over the rate of inflation annually. Actual returns in any given year may vary from this amount.

To satisfy its long-term rate-of-return objectives, the Organization relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). The Organization targets a diversified asset allocation that places an emphasis on equity-based investments to achieve its long-term return objectives within prudent risk constraints.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

15. Net Assets with Donor Restrictions (continued)

The Organization has a policy of appropriating for distribution 4% (with an additional 1% administrative fee) of its endowment fund's average fair value over the prior three-year rolling average market values. In establishing this policy, the Organization considered the long-term expected return on its endowment. Accordingly, over the long term, the Organization expects the current spending policy to allow its endowment to grow at an average of 3% to 4% annually above inflation. This is consistent with the Organization's objective to maintain the purchasing power of the endowment assets held in perpetuity or for a specified term as well as to provide additional real growth through new gifts and investment return. The Organization has a policy that prohibits spending from underwater endowment funds.

Changes in donor restricted endowment funds for the years ended September 30, 2019 and 2018, are as follows (in thousands):

	2019	2018
Donor restricted endowment funds as of beginning of year	\$ 119,389	\$ 124,841
Investment return, net	4,884	6,490
Contributions	449	711
Appropriation of endowment assets for expenditure	(2,618)	(3,048)
Other changes	(614)	(9,605)
Donor restricted endowment funds as of end of year	<u>\$ 121,490</u>	<u>\$ 119,389</u>

In February 2018, the Organization transferred an endowment to another organization as the Organization no longer provided the services for which the monies were donated to support. This transfer included \$5,000,000 of corpus and \$2,330,000 of undistributed accumulated investment earnings thereon.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

16. Fair Value Measurements

The Organization accounts for certain assets and liabilities at fair value. A fair value hierarchy for valuation inputs prioritizes the inputs into three levels based on the extent to which inputs used in measuring fair value are observable in the market. Each fair value measurement is reported in one of the three levels and is determined by the lowest level input that is significant to the fair value measurement in its entirety. These levels are as follows:

Level 1: Quoted prices are available in active markets for identical assets or liabilities as of the measurement date. Financial assets and liabilities in Level 1 include U.S. and foreign equity securities.

Level 2: Pricing inputs are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the asset or liabilities. Financial assets and liabilities in this category generally include U.S. and foreign government securities, asset-backed securities, U.S. and foreign corporate bonds and loans, municipal bonds, commingled funds, interest rate swaps, real estate, real estate held for sale, and annuity/unitrust liabilities.

Level 3: Pricing inputs are generally unobservable for the assets or liabilities and include situations where there is little, if any, market activity for the investment. The inputs into the determination of fair value require management's judgment or estimation of assumptions that market participants would use in pricing the assets or liabilities. The fair values are therefore determined using factors that involve considerable judgment and interpretations, including, but not limited to, private and public comparables, third-party appraisals, discounted cash flow models, and fund manager estimates. There are no Level 3 financial assets or liabilities at September 30, 2019 or 2018.

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

- a) Market approach. Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.
- b) Income approach. Techniques to convert future amounts to a single present amount based on market expectations (including present value techniques, option-pricing, and excess earnings models).

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

16. Fair Value Measurements (continued)

The following represents financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2019 (in thousands). Alternative investments are accounted for using net asset value (NAV) of accounting, which is not a fair value measurement.

	Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	NAV	Valuation Technique (a,b)	
Investments					
Liquid investments:					
Cash equivalents	\$ 899	\$ 899	\$ —	\$ —	a
Equity securities:					
U.S. equity	599,913	599,913	—	—	a
Foreign equity	429,091	429,091	—	—	a
Foreign equity (commingled)	291,005	—	291,005	—	a
	<u>1,320,009</u>	<u>1,029,004</u>	<u>291,005</u>	<u>—</u>	
Fixed income securities:					
U.S. government	70,022	—	70,022	—	a
U.S. government agencies	9,255	—	9,255	—	a
U.S. federal agency mortgage-backed	84,241	—	84,241	—	a
U.S. corporate	447,393	—	447,393	—	a
U.S. corporate (commingled)	272,140	—	272,140	—	a
Foreign corporate	15,997	—	15,997	—	a
	<u>899,048</u>	<u>—</u>	<u>899,048</u>	<u>—</u>	
Other investments:					
Multi-strategy hedge funds	294,421	—	—	294,421	
Private capital funds	50,312	—	—	50,312	
Defensive equity funds (commingled)	46,541	—	46,541	—	
Real estate	5,914	—	5,914	—	a
	<u>397,188</u>	<u>—</u>	<u>52,455</u>	<u>344,733</u>	
Total investments	2,617,144	1,029,903	1,242,508	344,733	
Other assets:					
Real estate held for sale	710	—	710	—	a
Total assets	<u>\$ 2,617,854</u>	<u>\$ 1,029,903</u>	<u>\$ 1,243,218</u>	<u>\$ 344,733</u>	
Other liabilities:					
Swap hedge	\$ 21,664	\$ —	\$ 21,664	\$ —	b
Annuity/unitrust liabilities	10,272	—	10,272	—	b
Total liabilities	<u>\$ 31,936</u>	<u>\$ —</u>	<u>\$ 31,936</u>	<u>\$ —</u>	

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

16. Fair Value Measurements (continued)

The following represents financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2018 (in thousands). Alternative investments are accounted for using net asset value (NAV) of accounting, which is not a fair value measurement.

	Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	NAV	Valuation Technique (a,b)
Investments				
Liquid investments:				
Cash equivalents	\$ 76,659	\$ 76,659	\$ —	a
Equity securities:				
U.S. equity	562,681	562,681	—	a
Foreign equity	433,558	433,558	—	a
Foreign equity (commingled)	288,122	—	288,122	a
	<u>1,284,361</u>	<u>996,239</u>	<u>288,122</u>	
Fixed income securities:				
U.S. government	68,359	—	68,359	a
U.S. government agencies	7,042	—	7,042	a
U.S. federal agency mortgage- backed	70,514	—	70,514	a
U.S. corporate	440,783	—	440,783	a
U.S. corporate (commingled)	242,536	—	242,536	a
Foreign corporate	12,189	—	12,189	a
	<u>841,423</u>	<u>—</u>	<u>841,423</u>	
Other investments:				
Multi-strategy hedge funds	325,408	—	—	325,408
Private capital funds	56,290	—	—	56,290
Defensive equity funds (commingled)	47,198	—	47,198	—
Real estate	6,809	—	6,809	—
	<u>435,705</u>	<u>—</u>	<u>54,007</u>	<u>381,698</u>
Total investments	2,638,148	1,072,898	1,183,552	381,698
Other assets:				
Real estate held for sale	1,460	—	1,460	—
Total assets	<u>\$ 2,639,608</u>	<u>\$ 1,072,898</u>	<u>\$ 1,185,012</u>	<u>\$ 381,698</u>
Current liabilities:				
Swap hedge	\$ 13,202	\$ —	\$ 13,202	\$ —
Other liabilities:				
Annuity/unitrust liabilities	10,637	—	10,637	—
Total liabilities	<u>\$ 23,839</u>	<u>\$ —</u>	<u>\$ 23,839</u>	<u>\$ —</u>

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

16. Fair Value Measurements (continued)

Transfers to/from Levels 1 and 2 are recognized at the end of the reporting period. There were no transfers for the years ended September 30, 2019 or 2018.

As of September 30, 2019 and 2018, the Level 2 instruments listed in the fair value hierarchy table above use the following valuation techniques and inputs:

U.S. Government Securities

The fair value of investments in U.S. government securities, classified as Level 2, was primarily determined using techniques consistent with the market approach. Significant observable inputs to the income approach include data points for benchmark constant maturity curves and spreads.

U.S. and Foreign Corporate Bonds

The fair value of the investments in U.S. and foreign corporate bonds, including mutual and commingled funds that invest primarily in such bonds, classified as Level 2 was primarily determined using techniques that are consistent with the market approach. Significant observable inputs include benchmark yields, reported trades, observable broker/dealer quotes, issuer spreads, and security specific characteristics (such as early redemption options).

Real Estate – Investments and Held for Sale

The fair values of the real estate investments and real estate held for sale were classified as Level 2 and were primarily determined using techniques that are consistent with the market approach. Significant observable inputs include sales of comparable properties, market rents, and market rent growth trends.

Annuity/Unitrust Liabilities

The fair value of the annuity/unitrust liabilities as Level 2 was primarily determined using techniques that are consistent with the income approach. Significant observable inputs to the income approach include data points for benchmark constant maturity curves and spreads.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

16. Fair Value Measurements (continued)

Commingled Funds

The fair value of commingled fund investments classified as Level 2 was determined using fair value. The values for underlying investments are fair value estimates determined either internally or by an external fund manager based on recent filings, operating results, balance sheet stability, growth, and other business and market sector fundamentals. Due to the significant unobservable inputs present in these valuations, Scripps Health classifies all such investments as Level 2.

Swap Hedge

The fair value of the swap hedge liability classified as Level 2 is based on independent valuations obtained and is determined by calculating the fair value of the discounted cash flows of the differences between the fixed interest rate of the interest rate swaps and the counterparty's forward LIBOR curve, which is the input used in the valuation, taking also into account any nonperformance risk.

Included within the assets above are investments in certain entities that report fair value. The following table (in thousands) and explanations identify attributes relating to the nature and risk of such investments:

	September 30, 2019	Unfunded Commitments	Redemption Frequency (if Currently Eligible)	Redemption Notice Period
Commingled:				
Equity securities ⁽¹⁾	\$ 291,005	\$ –	Monthly	10 days
Fixed income securities ⁽²⁾	272,140	–	Daily	15 days
	<u>\$ 563,145</u>	<u>\$ –</u>		
Alternative investments:				
Hedge funds ⁽³⁾	\$ 294,421	\$ –	Monthly to Biennially	45 to 120 days
Private capital ⁽⁴⁾	50,312	127,813	N/A	N/A
Defensive equity (commingled) ⁽⁵⁾	46,541	–	Monthly	5 days
	<u>\$ 391,274</u>	<u>\$ 127,813</u>		

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

16. Fair Value Measurements (continued)

- ⁽¹⁾ Commingled funds: Equity – This category includes investments in commingled funds with underlying investments that are fair value estimates determined either internally or by an external fund manager based on recent filings, operating results, balance sheet stability, growth, and other business and market sector fundamentals. The investments are diversified by geography, sector, and organization. Liquidity is provided on a monthly basis.
- ⁽²⁾ Commingled funds: Fixed income – This category includes investments in one commingled fund with underlying investments that are fair value estimates determined either internally or by an external fund manager based on recent filings, operating results, balance sheet stability, growth, and other business and market sector fundamentals. The investments are diversified by geography, sector, maturity, and issue. Liquidity is provided on a daily basis. As of September 30, 2019, the category consisted of 100% daily liquidity.
- ⁽³⁾ Hedge funds – This category includes investments in thirteen multi-strategy funds with underlying investments that are fair value estimates determined by a third-party administrator based on recent filings, operating results, balance sheet stability, growth, and other business and market sector fundamentals. The investments are diversified by geography, sector, and organization. Liquidity is provided on a monthly, quarterly, annual, and biennial basis. As of September 30, 2019, the category consisted of 30.8% monthly liquidity, 53.8% quarterly liquidity, 7.7% annual liquidity, and 7.7% biannual liquidity.
- ⁽⁴⁾ Private capital – This category includes investments in thirteen private capital funds with underlying investments that are fair value estimates determined either internally or by a third-party administrator based on recent filings, operating results, balance sheet stability, growth, and other business and market sector fundamentals. The investments are diversified by geography, sector, maturity, and issue. All funds have liquidity in excess of one year.
- ⁽⁵⁾ Defensive equity – This category includes an investment in a commingled defensive equity fund with underlying investments that are fair value estimates determined by a third-party administrator as of the end of each calendar month (or more frequently in the event that Interests are purchased or withdrawn intra-month), determined by its assets less its liabilities. The underlying investments consist primarily of money market funds and/or Cash; short-term investments, including U.S. Treasuries and other high-quality government or corporate bonds; and written options. Liquidity is provided on a monthly basis.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

17. Affiliation With Dignity Health

In August 1995, Scripps Health and Dignity Health (formerly Catholic Healthcare West) entered into an affiliation agreement to enhance their mutual ability to serve the San Diego community. Through the affiliation, Dignity Health transferred the sole voting membership of one of its subordinate corporations, Mercy Healthcare San Diego (MHSD), to Scripps Health, along with the responsibility for its operations and governance. MHSD's principal activity is the operation of a hospital and a network of clinics. MHSD was subsequently merged into Scripps Health.

Pursuant to the affiliation agreement, Dignity Health, among other things, obtained the right to receive a 20% interest in the annual change in unrestricted net assets of Scripps Health and the right to 20% of the net proceeds, with certain restrictions, upon the liquidation of Scripps Health. Scripps Health has the right to receive from Dignity Health an amount equal to Dignity Health's percentage interest in (i) the annual capital expenditures of Scripps Health and (ii) the annual amortization of debt principal of Scripps Health. Scripps Health and Dignity Health may make an election annually to receive all or a portion of the accumulated but not previously paid amounts under the affiliation agreement, subject to certain conditions. No payments have ever been paid by either party under these provisions, and as of September 30, 2019, no amounts are due. Of the members of the Scripps Health Board of Trustees, 20% are required to be elected from a slate of nominees proposed by Dignity Health.

18. Rental Income

The Organization leases medical office space to various physicians and other healthcare-related entities under operating leases. The leases provide for minimum rentals and additional amounts for real estate taxes and common area expenses. Total rental income was \$10,524,000 and \$11,254,000 in 2019 and 2018, respectively, and is included in other operating revenue in the consolidated statements of operations.

The following is a schedule of future minimum rentals to be received as of September 30, 2019, under operating leases that have initial or remaining terms in excess of one year (in thousands):

2020	\$	7,103
2021		7,416
2022		6,620
2023		5,022
2024		3,800
	\$	<u>29,961</u>

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

19. Functional Expenses

The Organization groups like expenses into financial statement lines and classifies programmatic expenses by business line. Expenses that are attributable to one or more programs or supporting functions (e.g., depreciation, interest, occupancy expenses, etc.) are allocated based on operating expenses, square footage, and other criteria.

The expenses reported in the consolidated statements of activities for the years ended 2019 and 2018, supported the following programs and functions (in thousands):

	2019								
	Program							Corporate Services	Total
	Hospital Division	Medical Foundation	Subsidiaries	Joint Ventures		Fundraising	Other		
Wages and benefits	\$ 900,257	\$ 244,304	\$ 44,448	\$ 5,723	\$ 6,250	\$ 33,678	\$ (133,783)	\$ 204,433	\$ 1,305,310
Supplies	417,242	154,374	2,762	6,529	730	8,944	(8,447)	2,846	584,980
Services	196,421	538,232	742,579	3,634	2,260	14,214	(516,981)	116,440	1,096,799
Provider fee	73,370	-	-	-	-	-	-	-	73,370
Depreciation and amortization	110,448	20,660	4,829	645	-	3,022	-	28,859	168,463
Interest	19,118	3,517	467	3	-	29	-	-	23,134
Total operating expenses	<u>\$1,716,856</u>	<u>\$ 961,087</u>	<u>\$ 795,085</u>	<u>\$ 16,534</u>	<u>\$ 9,240</u>	<u>\$ 59,887</u>	<u>\$ (659,211)</u>	<u>\$ 352,578</u>	<u>\$ 3,252,056</u>

	2018								
	Program							Corporate Services	Total
	Hospital Division	Medical Foundation	Subsidiaries	Joint Ventures		Fundraising	Other		
Wages and benefits	\$ 862,866	\$ 236,766	\$ 41,569	\$ 5,471	\$ 6,144	\$ 35,044	\$ (129,810)	\$ 179,763	\$ 1,237,813
Supplies	371,527	132,108	2,481	7,221	796	7,266	(7,506)	1,635	515,528
Services	193,625	470,424	676,605	3,432	2,111	15,089	(462,256)	106,864	1,005,894
Provider fee	186,285	-	-	-	-	-	-	-	186,285
Depreciation and amortization	118,345	24,704	5,006	640	-	3,017	-	19,193	170,905
Interest	22,166	4,072	395	(6)	-	35	(39)	-	26,623
Restructuring	-	-	-	-	-	-	-	14,272	14,272
Total operating expenses	<u>\$1,754,814</u>	<u>\$ 868,074</u>	<u>\$ 726,056</u>	<u>\$ 16,758</u>	<u>\$ 9,051</u>	<u>\$ 60,451</u>	<u>\$ (599,611)</u>	<u>\$ 321,727</u>	<u>\$ 3,157,320</u>

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

20. Investment Return

The composition of investment return for the years ended September 30 includes the following (in thousands):

	2019	2018
Nonoperating gains:		
Interest income and dividends	\$ 81,279	\$ 43,439
Net realized gains on sale of investments	22,305	47,502
Realized gain on insurance contracts	1,393	1,780
Net unrealized (losses) gains on trading portfolio	(15,396)	39,776
	89,581	132,497
Other changes in net assets with donor restrictions:		
Interest and dividends	3,939	2,342
Net realized gains	2,010	3,160
Net unrealized (losses) gains	(175)	2,183
	5,774	7,685
 Total investment return	 \$ 95,355	 \$ 140,182

21. Subsequent Events

The Organization has evaluated subsequent events occurring between the end of the most recent fiscal year ended September 30, 2019 and December 13, 2019, the date the accompanying consolidated financial statements were issued.

2010A Bond Refunding

In June 2019, the Organization’s Board of Trustees adopted a resolution authorizing the issuance of fixed rate, tax exempt bonds (the “2019A Refunding Bonds”) through the California Health Facilities Financing Authority (“CHFFA”) in an amount sufficient to refund the 2010A Bonds. As authorized by the resolution, the Organization entered into a commitment to sell the Refunding Bonds to J.P. Morgan through a private placement transaction at a later date. A rate lock agreement was executed concurrently with the bank to fix the bond interest rate at 2.38% in advance of the bond issue date.

Scripps Health and Affiliates

Notes to Consolidated Financial Statements (continued)

21. Subsequent Events (continued)

On November 15, 2019, the Organization issued the 2019A Refunding Bonds in the amount of \$99,360,000 to J.P. Morgan. Proceeds of the new issue were used to fully refund the 2010A Bonds, which were called on the same date. The Refunding Bonds have the same final maturity date and substantially the same amortization schedule as the 2010A Bonds.

Supplementary Information

Scripps Health and Affiliates

2019 Consolidating Statement of Financial Position (In Thousands)

September 30, 2019

	Obligated Group	Hospice	SHPS	IHS	Gluck	Accountable Care	Joint Ventures	Eliminations	Consolidated
Assets									
Current assets:									
Cash and cash equivalents	\$ 366,595	\$ –	\$ 116,992	\$ 10,370	\$ 190	\$ –	\$ 1,797	\$ –	\$ 495,944
Patient accounts receivable, net	413,011	–	6,043	–	–	–	2,238	(36,077)	385,215
Assets limited as to use	9	–	–	–	–	–	–	–	9
Other current assets	174,477	–	33	7,963	5	298	1,321	3	184,100
Total current assets	954,092	–	123,068	18,333	195	298	5,356	(36,074)	1,065,268
Assets limited as to use	248,402	–	303	–	1,195	–	–	–	249,900
Investments	2,367,235	–	–	–	–	–	–	–	2,367,235
Property and equipment, net	1,869,127	69	707	14,251	148	5,968	2,635	–	1,892,905
Other assets	184,061	–	–	10,677	–	–	2,588	(67,712)	129,614
Total assets	\$ 5,622,917	\$ 69	\$ 124,078	\$ 43,261	\$ 1,538	\$ 6,266	\$ 10,579	\$ (103,786)	\$ 5,704,922
Liabilities and net assets									
Current liabilities:									
Current portion of debt	\$ 121,283	\$ –	\$ –	\$ –	\$ –	\$ –	\$ 317	\$ –	\$ 121,600
Accounts payable	148,360	–	2,104	630	14	2	613	23	151,746
Accrued liabilities	248,134	–	79,073	2,618	154	6,188	673	(36,077)	300,763
Total current liabilities	517,777	–	81,177	3,248	168	6,190	1,603	(36,054)	574,109
Long-term debt, less current portion	785,908	–	–	–	–	–	126	–	786,034
Other liabilities	109,811	828	658	1,584	(1,059)	14,394	35	(20)	126,231
Total liabilities	1,413,496	828	81,835	4,832	(891)	20,584	1,764	(36,074)	1,486,374
Net assets:									
Controlling interests	3,960,405	(759)	42,243	38,429	1,265	(14,318)	5,563	(67,712)	3,965,116
Non-controlling interests in subsidiaries	(63)	–	–	–	–	–	3,252	–	3,189
Without donor restriction	3,960,342	(759)	42,243	38,429	1,265	(14,318)	8,815	(67,712)	3,968,305
With donor restriction	249,079	–	–	–	1,164	–	–	–	250,243
Total net assets	4,209,421	(759)	42,243	38,429	2,429	(14,318)	8,815	(67,712)	4,218,548
Total liabilities and net assets	\$ 5,622,917	\$ 69	\$ 124,078	\$ 43,261	\$ 1,538	\$ 6,266	\$ 10,579	\$ (103,786)	\$ 5,704,922

Scripps Health and Affiliates

2019 Consolidating Statement of Operations (In Thousands)

Year Ended September 30, 2019

	Obligated Group	Hospice	SHPS	IHS	Gluck	Accountable Care	Joint Ventures	Eliminations	Consolidated
Revenues, gains, and other support without donor restrictions:									
Patient service revenue	\$ 2,699,557	\$ (112)	\$ –	\$ –	\$ –	\$ (5,954)	\$ 18,550	\$ (336,435)	\$ 2,375,606
Provider fee	93,107	–	–	–	–	–	–	–	93,107
Total patient service revenue	2,792,664	(112)	–	–	–	(5,954)	18,550	(336,435)	2,468,713
Capitation premium	167,078	–	726,822	–	–	–	–	(239,263)	654,637
Management services	–	–	–	44,414	–	–	–	–	44,414
Other	118,025	(8)	22,044	95	1,790	569	25	(8,295)	134,245
Net assets released from restrictions used for operations	54,122	2	–	–	44	–	–	–	54,168
Total operating revenues	3,131,889	(118)	748,866	44,509	1,834	(5,385)	18,575	(583,993)	3,356,177
Operating expenses:									
Wages and benefits	1,328,965	–	16,177	24,463	1,265	2,543	5,723	(73,826)	1,305,310
Supplies	580,456	(4)	189	2,392	150	36	6,529	(4,768)	584,980
Services	854,558	22	731,711	10,579	43	1,651	3,634	(505,399)	1,096,799
Provider fee	73,370	–	–	–	–	–	–	–	73,370
Depreciation and amortization	162,989	10	270	4,247	8	294	645	–	168,463
Interest	22,664	–	394	73	–	–	3	–	23,134
Total operating expenses	3,023,002	28	748,741	41,754	1,466	4,524	16,534	(583,993)	3,252,056
Operating income (loss)	108,887	(146)	125	2,755	368	(9,909)	2,041	–	104,121
Nonoperating gains (losses):									
Investment income	86,538	–	3,043	–	–	–	–	–	89,581
Contributions	2,694	–	–	–	–	–	–	–	2,694
Interest rate swaps	(10,387)	–	–	–	–	–	–	–	(10,387)
Gain on early extinguishment of debt	45	–	–	–	–	–	–	–	45
Excess (deficiency) of revenues over expenses	187,777	(146)	3,168	2,755	368	(9,909)	2,041	–	186,054
Less excess of revenues over expenses attributable to non-controlling interests	–	–	–	–	–	–	(861)	–	(861)
Excess (deficiency) of revenues over expenses attributable to controlling interests	\$ 187,777	\$ (146)	\$ 3,168	\$ 2,755	\$ 368	\$ (9,909)	\$ 1,180	\$ –	\$ 185,193

Scripps Health Plan Services

Statements of Financial Position
(In Thousands)

	September 30	
	2019	2018
Assets		
Current assets:		
Cash and cash equivalents	\$ 116,992	\$ 115,292
Patient accounts receivable, net	6,043	1,439
Other current assets	33	2,527
Total current assets	<u>123,068</u>	<u>119,258</u>
Assets limited as to use	303	303
Property and equipment, net	707	922
Total assets	<u><u>\$ 124,078</u></u>	<u><u>\$ 120,483</u></u>
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 2,104	\$ 1,095
Accrued liabilities	79,073	81,665
Total current liabilities	<u>81,177</u>	<u>82,760</u>
Other liabilities	658	148
Total liabilities	<u>81,835</u>	<u>82,908</u>
Net assets:		
Net assets without donor restrictions	<u>42,243</u>	<u>37,575</u>
Total liabilities and net assets	<u><u>\$ 124,078</u></u>	<u><u>\$ 120,483</u></u>

Scripps Health Plan Services

Statements of Operations and Change in Net Assets (In Thousands)

	Year Ended September 30	
	2019	2018
Revenues, gains, and other support:		
Capitation premium	\$ 726,822	\$ 660,232
Administrative fees from affiliate	14,722	15,180
Other	7,322	7,702
Total operating revenues	748,866	683,114
Operating expenses:		
Medical claims expenses, net	520,019	462,281
Capitated services	203,159	196,656
Wages and benefits	16,177	15,495
Administrative and other	8,428	7,521
Depreciation and amortization	270	290
Interest	394	272
Rent and utilities	294	299
Total operating expenses	748,741	682,814
Operating income	125	300
Nonoperating gains:		
Investment income	3,043	1,666
Excess of revenues over expenses	3,168	1,966
Transfers from affiliates	1,500	2,500
Net assets at beginning of year	37,575	33,109
Net assets at end of year	\$ 42,243	\$ 37,575

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