

CONSOLIDATED FINANCIAL STATEMENTS
AND SUPPLEMENTARY INFORMATION

Southwest Community Health System and Subsidiaries
Years Ended December 31, 2017 and 2016
With Report of Independent Auditors

Ernst & Young LLP



Building a better
working world

Southwest Community Health System and Subsidiaries

Consolidated Financial Statements
and Supplementary Information

Years Ended December 31, 2017 and 2016

Contents

Report of Independent Auditors.....	1
Consolidated Financial Statements	
Consolidated Balance Sheets	3
Consolidated Statements of Operations and Changes in Net Assets	5
Consolidated Statements of Cash Flows.....	7
Notes to Consolidated Financial Statements.....	8
Supplementary Information	
Report of Independent Auditors on Supplementary Information	38
Consolidating Balance Sheet – December 31, 2017.....	39
Consolidating Statement of Operations and Changes in Unrestricted Net Assets – Year Ended December 31, 2017	41
Consolidating Balance Sheet – December 31, 2016.....	42
Consolidating Statement of Operations and Changes in Unrestricted Net Assets – Year Ended December 31, 2016	44



Ernst & Young LLP
Suite 1800
950 Main Avenue
Cleveland, OH 44113-7214

Tel: +1 216 861 5000
Fax: +1 216 583 2013
ey.com

Report of Independent Auditors

The Board of Trustees
Southwest Community Health System

We have audited the accompanying consolidated financial statements of Southwest Community Health System and Subsidiaries, which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the 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 Southwest Community Health System and Subsidiaries at December 31, 2017 and 2016, and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Ernst + Young LLP

April 10, 2018

Southwest Community Health System and Subsidiaries

Consolidated Balance Sheets

	December 31	
	2017	2016
	<i>(In Thousands)</i>	
Assets		
Current assets:		
Cash and cash equivalents	\$ 22,739	\$ 29,410
Patient accounts receivable, net of allowances for bad debts of \$35,692 in 2017 and \$32,357 in 2016	33,791	33,105
Other receivables, net	2,131	4,605
Inventories	8,646	7,555
Prepaid expenses	10,325	9,771
Investments for current use	6,310	6,252
Total current assets	83,942	90,698
Investments:		
Board-designated	226,031	184,410
Self-insurance reserve funds	9,936	10,388
	235,967	194,798
Property, plant, and equipment, net	186,404	200,192
Other assets	6,637	5,699
Total assets	\$ 512,950	\$ 491,387

	December 31	
	2017	2016
	<i>(In Thousands)</i>	
Liabilities and net assets		
Current liabilities:		
Accounts payable	\$ 13,492	\$ 16,718
Accrued compensation and related liabilities	26,092	22,779
Other accrued liabilities	9,874	9,903
Drawable credited earnings due to UHHS	5,127	3,026
Estimated amounts payable to third-party payors	2,696	4,143
Current portion of long-term liabilities	2,860	2,826
Total current liabilities	<u>60,141</u>	<u>59,395</u>
Long-term liabilities:		
Revenue bonds	152,420	155,012
Notes payable and capital leases	1,841	2,081
Accrued retirement benefits	41,560	53,420
Other liabilities	19,747	18,546
Total long-term liabilities	<u>215,568</u>	<u>229,059</u>
Total liabilities	<u>275,709</u>	<u>288,454</u>
Net assets:		
Unrestricted	233,128	198,655
Temporarily restricted	3,925	4,090
Permanently restricted	188	188
Total net assets	<u>237,241</u>	<u>202,933</u>
Total liabilities and net assets	<u>\$ 512,950</u>	<u>\$ 491,387</u>

See accompanying notes.

Southwest Community Health System and Subsidiaries

Consolidated Statements of Operations
and Changes in Net Assets

	Year Ended December 31	
	2017	2016
	<i>(In Thousands)</i>	
Unrestricted revenue		
Net patient service revenue	\$ 376,582	\$ 353,464
Provision for bad debts	(20,828)	(20,084)
Net patient service revenue less provision for bad debts	<u>355,754</u>	<u>333,380</u>
Other revenue	11,789	12,296
Total unrestricted revenue	<u>367,543</u>	<u>345,676</u>
Expenses		
Salaries, wages, and benefits	163,957	153,717
Supplies, insurance, and other	158,316	144,628
Depreciation and amortization	24,816	24,956
Interest	6,153	6,047
Total expenses	<u>353,242</u>	<u>329,348</u>
Income from operations	<u>14,301</u>	<u>16,328</u>
Nonoperating gains (losses):		
Tax levy receipts	847	789
Investment income	8,913	674
Other – net	(4,106)	(4,575)
Total nonoperating gains (losses), net	<u>5,654</u>	<u>(3,112)</u>
Excess of revenue over expenses before		
drawable credited earnings due to UHHS	19,955	13,216
Drawable credited earnings due to UHHS	<u>(5,127)</u>	<u>(3,026)</u>
Excess of revenue over expenses	<u>14,828</u>	<u>10,190</u>
Net change in unrealized gains on		
other-than-trading investments	16,978	6,781
Net assets released from restrictions for capital	772	3,194
Pension adjustment	1,895	(7,930)
Increase in unrestricted net assets	<u>34,473</u>	<u>12,235</u>
Unrestricted net assets at beginning of year	<u>198,655</u>	<u>186,420</u>
Unrestricted net assets at end of year	<u>233,128</u>	<u>198,655</u>

Southwest Community Health System and Subsidiaries

Consolidated Statements of Operations
and Changes in Net Assets (continued)

	Year Ended December 31	
	2017	2016
	<i>(In Thousands)</i>	
Temporarily restricted net assets		
Contributions	\$ 351	\$ 463
Net investment income (loss)	273	(84)
Net assets released from restrictions	(789)	(3,220)
Decrease in temporarily restricted net assets	(165)	(2,841)
Temporarily restricted net assets at beginning of year	4,090	6,931
Temporarily restricted net assets at end of year	3,925	4,090
Permanently restricted net assets		
Permanently restricted net assets at beginning of year	188	188
Permanently restricted net assets at end of year	188	188
Net assets at end of year	<u>\$ 237,241</u>	<u>\$ 202,933</u>

See accompanying notes.

Southwest Community Health System and Subsidiaries

Consolidated Statements of Cash Flows

	Year Ended December 31	
	2017	2016
	<i>(In Thousands)</i>	
Operating activities		
Increase in net assets	\$ 34,308	\$ 9,394
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Net realized and unrealized gains on investments	(19,809)	(3,114)
Depreciation and amortization	25,539	25,578
Provision for bad debts	20,828	20,084
Pension adjustment	(1,895)	7,930
Restricted contributions	(351)	(463)
Changes in operating assets and liabilities:		
Patient accounts receivable	(21,514)	(18,119)
Other assets	829	(2,435)
Other noncurrent assets	(938)	628
Accrued retirement benefits	(9,965)	(10,132)
Accounts payable	(3,226)	1,287
Other current liabilities	1,871	2,023
Other long-term liabilities	1,201	(1,865)
Net cash provided by operating activities	<u>26,878</u>	<u>30,796</u>
Investing activities		
Purchases of property, plant, and equipment	(11,751)	(20,469)
Purchases of investments	(99,784)	(183,129)
Sales of investments	78,366	183,829
Net cash used in investing activities	<u>(33,169)</u>	<u>(19,769)</u>
Financing activities		
Principal payments on long-term debt	(2,832)	(2,779)
Restricted contributions	351	463
Drawable credited earnings due to/from UHHS	2,101	(47)
Net cash used in financing activities	<u>(380)</u>	<u>(2,363)</u>
Net (decrease) increase in cash and cash equivalents	(6,671)	8,664
Cash and cash equivalents at beginning of year	29,410	20,746
Cash and cash equivalents at end of year	<u>\$ 22,739</u>	<u>\$ 29,410</u>

See accompanying notes.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (Dollars in Thousands)

December 31, 2017

1. Summary of Organization and Accounting Policies

Southwest Community Health System's (the System) purpose is to participate in and promote activities related to the delivery of health care services and other services which are related to or supportive of these activities. The System is a not-for-profit corporation under federal income tax laws. A brief summary of each of the organizations for which the System is the sole member and parent organization follows:

Southwest General Health Center – Southwest General Health Center (the Health Center) is a not-for-profit corporation that was organized to establish, operate, and maintain a hospital and other health care facilities. The Health Center offers a full range of services at its main campus located in Middleburg Heights, Ohio and a wide variety of outpatient services at its nearby medical centers in Brunswick and Strongsville. The Health Center is the sole shareholder of Southwest General Medical Group, a physician corporation. A wholly owned subsidiary of the Health Center, Southwest Holdings, Inc. (Holdings), was incorporated to engage in for-profit activities. Holdings' main activity is operating a retail pharmacy on the hospital campus.

Southwest Community Health Foundation – Southwest Community Health Foundation (the Foundation) is a not-for-profit corporation that was organized to develop and operate fund-raising activities, capital-giving programs, deferred-giving programs, and to support community health care projects.

The consolidated financial statements include the accounts of the Health Center (the Obligated Group) and the Foundation (the Non-Obligated Group), which has no liability under the Master Trust Indenture amended and restated as of December 1, 2012, between the Health Center and the Huntington National Bank, as Trustee. All significant intercompany accounts and transactions are eliminated upon consolidation.

A summary of significant accounting policies of the System follows:

Use of Estimates – The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Estimates also affect the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

1. Summary of Organization and Accounting Policies (continued)

Concentration of Credit Risk – The Health Center provides patient care services primarily to residents of Cuyahoga and Medina counties, Ohio. Concentration of credit risk relating to patient accounts receivable is limited to some extent by the diversity and number of patients and payors. Patient accounts receivable consist of amounts due from government programs, commercial insurance companies, private pay patients, and other insurance programs. Medicare and Medicaid represented approximately 30% and 5%, respectively, at December 31, 2017, and 32% and 6%, respectively, at December 31, 2016, of patient accounts receivable. One commercial payor represented approximately 15% of patient accounts receivable at both December 31, 2017 and 2016. Excluding these payors, no one payor source represents more than 10% of patient accounts receivable at December 31, 2017 and 2016.

Net Patient Service Revenue – Net patient service revenue is stated at the estimated net realizable amounts from patients, third-party payors and others, including retroactive adjustments under reimbursement agreements with third-party payors. The Health Center has agreements with certain third-party payors that provide for payments to the Health Center at amounts different from its established rates.

The Health Center is paid a prospectively determined rate for the majority of inpatient acute care, transitional care, and certain outpatient services provided. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Provision for estimated retroactive adjustments, if any, resulting from changes in diagnostic related group (DRG) assignment, regulatory matters, or other retroactive adjustments under reimbursement agreements are accrued on an estimated basis in the period the related services are provided. Any changes in these estimated amounts are recorded in operations as final settlements are determined.

Certain other Medicare and Medicaid outpatient services are reimbursed at established fee schedules. The Health Center is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by the Health Center and audits thereof by the Medicare and Medicaid Administrative Contractors.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

1. Summary of Organization and Accounting Policies (continued)

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. The Health Center believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. Compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs.

The Health Center also enters into payment agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for payments to the Health Center under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates. Provision for estimated retroactive adjustments, if any, resulting from regulatory matters or other adjustments under payment agreements are estimated in the period the related services are provided.

For uninsured patients who do not qualify for charity care, the System recognizes revenue based on established rates, subject to certain discounts as determined by the System. An estimated provision for bad debts is recorded that results in net patient service revenue being reported at the net amount expected to be received. The System has determined, based on an assessment at the consolidated level, that patient service revenue is primarily recorded prior to assessing the patient's ability to pay and as such, the entire provision for bad debts related to patient service revenue is recorded as a deduction from patient service revenue in the accompanying consolidated statements of operations and changes in net assets.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

1. Summary of Organization and Accounting Policies (continued)

Bad Debt – The Health Center maintains an allowance for bad debts based on the expected collectibility of patient accounts receivable. The allowance for bad debts is based upon management’s assessment of historical and expected net collections considering historical business and economic conditions, trends in health care coverages, and other collection indicators. Periodically through the year, management assesses the adequacy of the allowance for bad debts based upon historical write-off experience by payor category. The results of this review are then used to make modifications to the provision for bad debts to establish an appropriate allowance for the uncollectible receivables. After satisfaction of amounts due from insurance, the Health Center follows established guidelines for placing certain past due patient balances with collection agencies, subject to the terms of certain restrictions on collection efforts as determined by the Health Center.

Charity Care and Community Benefit – The Health Center treats all patients requiring hospital care regardless of their ability to pay. The Health Center provides care to patients who meet certain criteria under its charity care assistance policy without charge or at amounts less than its established rates. Because the Health Center does not pursue collection of amounts determined to qualify for charity care, they are not reported as revenue. The cost of charity care provided in 2017 and 2016 approximated \$1,148 and \$1,756, respectively. To offset the cost of charity care, the System received reimbursement through the State of Ohio’s Hospital Care Assurance Program of \$907 and \$497 in 2017 and 2016, respectively. The Health Center estimated these costs by calculating a ratio of cost to gross charges and then multiplying that ratio by the gross uncompensated charges associated with providing care to charity patients. In addition to providing direct charity care to patients in furtherance of its exempt purpose to benefit the community, the Health Center operates an Emergency Trauma Center 24 hours a day; operates a free clinic for the working uninsured; provides various community screenings for detection of disease and to promote health and wellness; and operates a community outreach program to bring health care services and support to homes. In addition, the Health Center has a second emergency department in Brunswick, Ohio that is open 24 hours a day.

Cash and Cash Equivalents – The System considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents, excluding investments held by Board designation or other arrangements.

Inventories – Inventories (primarily supplies and pharmaceuticals) are stated at the lower of cost, determined on the first-in, first-out method, or net realizable value.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

1. Summary of Organization and Accounting Policies (continued)

Investments and Investment Income – Investments in equity securities and mutual funds and all investments in debt securities are measured at fair value in the consolidated balance sheets. Investment income or loss (including realized gains and losses on investments determined by the average cost method, other-than-temporary losses on other-than-trading investments due to declines in investment market values, interest, and dividends) is included in the excess of revenue over expenses unless the income or loss is restricted by donor or law. Changes in the unrealized gains and losses on investments which are classified as other-than-trading are excluded from the excess of revenue over expenses.

The System reviews other-than-trading investments for impairment conditions that indicate that an other-than-temporary decline in market value has occurred and an unrealized investment loss should be recognized. In conducting this review, various factors are considered, which individually or in combination, indicate that a decline is other-than-temporary. These factors include specific information pertaining to an individual company or a particular industry, general market conditions that reflect prospects for the economy as a whole, the recommendations of advisors, the length of time and extent to which the market value has been less than cost and the intent and ability of management to hold such investments until value has returned. There were no losses recorded for other-than-temporary decline in the value of investments in 2017 and 2016.

As part of its investment portfolio, the System has an approximate 3.47% and 3.28% ownership interest at December 31, 2017 and 2016, respectively, in a limited partnership (LP) that invests in publicly traded equities with readily determinable values. The System's investment in the LP is \$7,929 and \$6,669 at December 31, 2017 and 2016, respectively, and is included in board-designated investments in the consolidated balance sheets. The System accounts for its investment in the LP using the equity method of accounting based on net asset value information provided by the partnership and has recorded its share of the LP's net gain of \$1,260 and \$1,129 in 2017 and 2016, respectively, in investment income.

Fair Value Measurement – Fair value measurements are defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

1. Summary of Organization and Accounting Policies (continued)

The framework for measuring fair value is comprised of a three-level valuation hierarchy based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

- Level 1 – Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 – Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Property, Plant, and Equipment – Property, plant, and equipment are recorded at cost. Depreciation is computed using the straight-line method based on the estimated useful lives of the assets which range from 3 to 40 years. Depreciation on the Health Center's medical office buildings of \$723 in 2017 and \$837 in 2016, is classified as a component of nonoperating gains (losses) in the consolidated statements of operations and changes in net assets. Expenditures which substantially increase the useful lives of existing assets are capitalized. Routine maintenance and repairs are expensed as incurred. Leased equipment is amortized using the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment.

Excess of Revenue Over Expenses – The consolidated statements of operations and changes in net assets include excess of revenue over expenses, which is the System's performance indicator. Changes in unrestricted net assets which are excluded from the excess of revenue over expenses, consistent with industry practice, include change in unrealized gains and losses on other-than-trading investments, certain pension adjustments, and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purpose of acquiring such assets).

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

1. Summary of Organization and Accounting Policies (continued)

Derivative Instruments – The System recognizes all derivative instruments in the financial statements at fair value. The System participates in interest rate swap contracts that are considered derivative financial instruments. The interest rate swap contracts are not designated as hedges. Changes in fair value of the derivative financial instruments are recognized in the consolidated statements of operations and changes in net assets as a component of investment income.

Temporarily Restricted Net Assets – Temporarily restricted net assets are used to differentiate resources, the use of which is restricted by donors or grantors to a specific time period or purpose, from resources on which no restrictions have been placed or that arise from the general operations of the System. Temporarily restricted gifts, grants, and bequests are recorded as an addition to temporarily restricted net assets in the period received, less related allowances provided for uncollectible amounts. Resources restricted by donors or grantors for specific operating purposes are reported in unrestricted revenue to the extent expended within the period. Temporarily restricted net assets are primarily restricted for health care programs, capital expenditures, research and education, and community benefit programs.

Permanently Restricted Net Assets – Permanently restricted net assets are held in perpetuity, as restricted by donors and are restricted for health care programs.

Donations Other Than Cash – Donated supplies, securities, and equipment are recorded at fair market value at the date of donation. No amounts have been reflected in the consolidated financial statements for donated services. The System pays for most services requiring specific expertise. However, many individuals volunteer their time and perform a variety of tasks that assist the System with various programs.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

1. Summary of Organization and Accounting Policies (continued)

Nonoperating Gains (Losses), Net – Gains and losses not directly related to the ongoing operations of the System are reported as nonoperating. Other net nonoperating gains (losses) are summarized as follows:

	Year Ended December 31	
	2017	2016
Medical office buildings, net of rental revenue of \$1,526 in 2017 and \$1,523 in 2016	\$ (1,995)	\$ (1,778)
Pension expense	(1,335)	(1,969)
Payments to counterparty on swap agreements	(286)	(354)
Community outreach services	(490)	(474)
	\$ (4,106)	\$ (4,575)

Recent Accounting Pronouncements – In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*, which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance, and requires significantly expanded disclosures about revenue recognition. The core principle of the revenue model is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance in ASU 2014-09, including subsequent amendments, is effective for the System as of January 1, 2018.

The System adopted ASU 2014-09 on January 1, 2018 using the modified retrospective method of transition. The System’s process for implementation began with a preliminary evaluation of ASU 2014-09 and considered subsequent interpretations by the FASB Transition Resource Group for Revenue Recognition and the American Institute of Certified Public Accountants. The System performed an analysis of revenue streams and transactions under ASU 2014-09. In particular, for net patient service revenue, the System performed an analysis into the application of the portfolio approach as a practical expedient to group patient contracts with similar characteristics, such that revenue for a given portfolio would not be materially different than if it were evaluated on a contract-by-contract basis. Upon adoption, the majority of what is currently classified as provision for bad debts and presented as a reduction to net patient service revenue on the consolidated statements of operations and changes in net assets will be treated as a price concession that reduces

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

1. Summary of Organization and Accounting Policies (continued)

the transaction price, which is reported as net patient service revenue. The new standard also requires enhanced disclosures related to the disaggregation of revenue and significant judgments made in measurement and recognition. The impact of adopting ASU 2014-09 is not material to the consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments*, that will require entities to measure equity investments that do not result in consolidation and are not accounted for under the equity method at fair value and recognize any changes in fair value in excess of revenues over expenses. The guidance is effective for the System for reporting periods beginning after December 15, 2017. The System is currently evaluating the impact this standard will have on its consolidated financial statements and will adopt the provision upon the effective date.

In February 2016, the FASB issued ASU 2016-02, *Leases*. This ASU requires lessees to recognize assets and liabilities on the balance sheet for leases with lease terms greater than 12 months. The recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification as a finance or operating lease. This amends current guidance that requires only capital leases to be recognized on the lessee balance sheet. ASU 2016-02 will also require additional disclosures on the amount, timing and uncertainty of cash flows arising from leases. The guidance is effective for the System for reporting periods beginning after December 15, 2018, with early adoption permitted. The System is currently evaluating the impact that ASU 2016-02 will have on its consolidated financial statements and will adopt the provisions upon the effective date.

In August 2016, the FASB issued ASU 2016-14, *Presentation of Financial Statements for Not-for-Profit Entities*. This standard intends to make certain improvements to the current reporting requirements for not-for-profit entities. This standard sets forth changes to net asset classification requirements and the information presented about a not-for-profit entity's liquidity, financial performance and cash flows. ASU 2016-14 is effective for the System for annual reporting periods beginning after December 15, 2017, and interim periods beginning after December 15, 2018. The System is currently evaluating the impact that ASU 2016-14 will have on its financial statements and will adopt the provisions upon the effective date.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

1. Summary of Organization and Accounting Policies (continued)

In March 2017, the FASB issued ASU 2017-07, *Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. This ASU requires the service cost component of net periodic benefit cost related to defined benefit pension and postretirement benefit plans to be reported in the same financial statement line as other compensation costs arising from services rendered during the period. The other components of net periodic benefit cost are required to be presented separately from service costs and outside of operating income in the statement of operations. Only the service cost component of net periodic benefit cost will be eligible for capitalization in assets. The System adopted the provisions of ASU 2017-07 for the year-ended December 31, 2017, and retrospectively adjusted all periods presented in the consolidated financial statements, for the exception of the guidance limiting the capitalization of net periodic benefit costs in assets which is required to be applied prospectively. The impact of adopting ASU 2017-17 for the System when applied retrospectively to the year ended December 31, 2016 decreased salaries, wages and benefits expense on the consolidated statement of operations as presented herein by \$1,969, with a corresponding increase to operating income and increase to net nonoperating losses. The adoption of ASU 2017-07 had no impact on excess of revenue over expenses or net assets.

2. Net Patient Service Revenue and Patient Receivables

Net patient service revenue before the provision for bad debts by major payor source for the years ended December 31, are as follows:

	2017		2016	
Medicare	\$ 135,276	36%	\$ 132,654	37%
Medicaid	24,383	6	23,615	7
Managed care and commercial	199,913	53	191,812	54
Self-pay	17,010	5	5,383	2
	\$ 376,582	100%	\$ 353,464	100%

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

2. Net Patient Service Revenue and Patient Receivables (continued)

For patient accounts receivable associated with self-pay patients, including patients with deductible and copayment balances for which third-party coverage provides for a portion of the services provided, the System records an estimated provision for bad debts in the year of service. The allowance for bad debts for self-pay patients as a percentage of self-pay accounts receivable decreased from 83% at December 31, 2016 to 80% at December 31, 2017. Self-pay write-offs were \$17,494 in 2017 and \$5,394 in 2016. The System does not maintain a material allowance for bad debts from third-party payors.

3. Investments

The composition of investments at December 31 was as follows:

	2017	2016
Investments:		
Cash	\$ 1,212	\$ 8,894
Money market funds	9,305	5,581
Fixed income securities:		
U.S. government agencies	33,187	34,613
U.S. corporate	27,938	23,995
Common stocks:		
U.S.	9,320	7,844
Mutual funds:		
Fixed income	40,306	39,840
Equity	102,066	65,706
Commingled funds	11,014	7,908
Limited partnership	7,929	6,669
Total investments	\$ 242,277	\$ 201,050

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

3. Investments (continued)

Total investment return is comprised of the following for the years ended December 31:

	2017	2016
Nonoperating gains (losses):		
Interest income and dividends	\$ 5,146	\$ 3,850
Net realized gains (losses) on sales of investments	990	(4,494)
Equity method investment income (loss)	1,767	1,633
Change in unrealized gains on trading investments	201	(382)
Derivative gain	809	67
Total investment income	8,913	674
Other changes in net assets:		
Net change in unrealized gains on other-than-trading investments and restricted investment income	17,251	6,697
Total investment return	\$ 26,164	\$ 7,371

With the exception of certain board-designated mutual funds, all investments are managed by professional asset managers. Because the asset managers have discretion to buy and sell individual securities, these investments are accounted for as trading securities. Investments not managed by professional asset managers are controlled by the System and are accounted for as other-than-trading. Net unrealized gains on other-than-trading investments (37 funds with a fair value of \$142,372) were \$25,862 at December 31, 2017. Net unrealized gains on other-than-trading investments (34 funds with a fair value of \$110,011) were \$8,611 at December 31, 2016.

4. Fair Value

The carrying values of cash and cash equivalents, accounts receivable, and accounts payable are reasonable estimates of fair value due to the short-term nature of these financial instruments. Investments, other than the limited partnership investment, are recorded at their fair value. At December 31, 2017 and 2016, the fair value of the System's long-term debt as estimated by discounted cash flow analyses using current borrowing rates for similar types of borrowing arrangements and adjusted for credit was \$167,295 and \$166,045, respectively (see Note 8). Long-term debt would be classified as Level 2 in the fair value hierarchy. Other noncurrent assets and liabilities have carrying values that approximate fair value.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

4. Fair Value (continued)

The following tables present the financial instruments carried at fair value on a recurring basis at December 31 by valuation hierarchy:

	2017		
	Level 1	Level 2	Total
Assets			
Investments:			
Cash	\$ 1,212	\$ –	\$ 1,212
Money market funds	–	9,305	9,305
Fixed income securities:			
U.S. government agencies	–	33,187	33,187
U.S. corporate	–	27,938	27,938
Common stocks:			
U.S.	9,320	–	9,320
Mutual funds:			
Fixed income	40,306	–	40,306
Equity	102,066	–	102,066
Total assets at fair value	<u>\$ 152,904</u>	<u>\$ 70,430</u>	<u>\$ 223,334</u>
Liabilities			
Interest rate swap	\$ –	\$ 2,300	\$ 2,300
Total liabilities at fair value	<u>\$ –</u>	<u>\$ 2,300</u>	<u>\$ 2,300</u>

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

4. Fair Value (continued)

	2016		
	Level 1	Level 2	Total
Assets			
Investments:			
Cash	\$ 8,894	\$ —	\$ 8,894
Money market funds	—	5,581	5,581
Fixed income securities:			
U.S. government agencies	—	34,613	34,613
U.S. corporate	—	23,995	23,995
Common stocks:			
U.S.	7,844	—	7,844
Mutual funds:			
Fixed income	39,840	—	39,840
Equity	65,706	—	65,706
Total assets at fair value	<u>\$ 122,284</u>	<u>\$ 64,189</u>	<u>\$ 186,473</u>
Liabilities			
Interest rate swap	\$ —	\$ 3,109	\$ 3,109
Total liabilities at fair value	<u>\$ —</u>	<u>\$ 3,109</u>	<u>\$ 3,109</u>

Financial instruments at December 31 are reflected in the consolidated balance sheets as follows:

	2017	2016
Investments measured at fair value	\$ 223,334	\$ 186,473
Commingled funds measured at net asset value	11,014	7,908
Limited partnership investment accounted for under the equity method	7,929	6,669
Total investments	<u>\$ 242,277</u>	<u>\$ 201,050</u>

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

4. Fair Value (continued)

The following is a description of the System's valuation methodologies for assets and liabilities measured at fair value:

Fair value for Level 1 is based upon quoted market prices.

Fair value for Level 2 U.S. government agencies and U.S. corporate securities are valued on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets. Inputs are obtained from various sources including market participants, dealers, and brokers. Fair value for Level 2 money market funds are valued using broker quotes that utilize observable market inputs.

The fair values of interest rate swaps were determined based on the present value of future cash flows using discount rates appropriate with the risks involved and adjusted for credit. The valuations include a credit spread adjustment to market interest rate curves to appropriately reflect nonperformance risk. The credit spread adjustment is derived from other comparably rated entities' bonds recently priced in the market.

Commingled investment funds are valued using, as a practical expedient, the net asset value as provided by the respective investment companies and partnerships. There are no significant redemption restrictions on the commingled investment funds.

The System held no assets or liabilities at fair value which would be subject to Level 3 measurements as of December 31, 2017 or 2016.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the System believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

5. Property, Plant, and Equipment

Property, plant, and equipment at December 31 consist of the following:

	<u>2017</u>	<u>2016</u>
Land and land improvements	\$ 15,379	\$ 15,345
Buildings and fixed equipment	313,206	309,590
Movable equipment	144,056	151,709
Construction in progress	6,933	6,374
	<u>479,574</u>	<u>483,018</u>
Accumulated depreciation	293,170	282,826
	<u>\$ 186,404</u>	<u>\$ 200,192</u>

6. Temporarily and Permanently Restricted Net Assets

Temporarily and permanently restricted net assets at December 31 are available for the following purposes:

	<u>2017</u>	<u>2016</u>
Health care programs	\$ 260	\$ 221
Capital expenditures	2,487	3,069
Research and education	291	241
Other	1,075	747
	<u>\$ 4,113</u>	<u>\$ 4,278</u>

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

7. Partnering Agreement With University Hospitals Health System, Inc.

Effective July 1, 1997, the System (excluding the Foundation) entered into a Partnering Agreement (the Partnering Agreement) with University Hospitals Health System, Inc. (UHHS). UHHS owns and operates a large integrated delivery system. Under a five-year Partnering Agreement, UHHS brought the Rainbow Babies and Children, MacDonald Women's and Seidman Cancer programs (UHHS Programs) to the Health Center's facilities. Upon the closing of the Partnering Agreement in 1997, UHHS transferred \$20 million of unrestricted funds to the Health Center. At the end of the initial five-year term, the Partnering Agreement was automatically extended for an additional ten-year term. Under the Partnering Agreement, UHHS obtained 50% representation on the Health Center's Board of Directors, and the System obtained two seats on UHHS's Board of Directors. If at such time the System (excluding the Foundation) votes to merge with UHHS, an additional \$20 million, as adjusted (Additional Commitment Amount), shall be transferred to the System even if the community delegates reject the merger recommendation. Effective January 1, 2011, the System's Partnering Agreement with UHHS was renewed for an additional ten years. At the end of the ten-year renewal term, 2020, UHHS or the System may terminate the Partnering Agreement. Upon termination of the Partnering Agreement, the System is required to return all funds transferred by UHHS or provide certain assets of equal value, pay any outstanding drawable credited earnings, and cease using the names associated with the UHHS Programs.

On an annual basis, UHHS shares 50% of the annual net income or loss of the Health Center (exclusive of tax levy receipts), one-half of which is immediately due and payable. The remaining one-half of earnings is credited against (losses added to) the Additional Commitment Amount. The Additional Commitment Amount bears interest at a rate of 6% per annum, compounded annually. In 2017, the Additional Commitment Amount was fully funded and as a result the full 50% is immediately due and payable to UHHS and UHHS no longer has any additional commitment owed under the Partnering Agreement.

Drawable credited earnings due to UHHS were \$5,127 and \$3,026 at December 31, 2017 and 2016, respectively.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

8. Debt

A summary of long-term debt at December 31, is as follows:

	Type	2017	2016
Series 2012A revenue bonds	Fixed	\$ 50,985	\$ 51,690
Series 2012B revenue bonds	Variable	11,493	12,450
Series 2012C revenue bonds	Variable	15,568	16,015
Series 2012D revenue bonds	Variable	7,605	7,605
Series 2012E revenue bonds	Variable	7,240	7,240
Series 2011 revenue bonds	Fixed	62,335	62,635
Notes payable and capital leases		2,081	2,497
		157,307	160,132
Less:			
Unamortized premium		(1,122)	(1,172)
Unamortized debt issuance costs		1,308	1,385
Current portion		2,860	2,826
		\$ 154,261	\$ 157,093

In November 2012, the Health Center through the City of Middleburg Heights, Ohio, issued \$54,355 of Hospital Facilities Revenue and Refunding Bonds, Series 2012A (Series 2012A Bonds). The Series 2012A Bonds are payable from the general revenue of the Health Center. A portion of the proceeds from the issuance of the Series 2012A Bonds were used to reimburse the Health Center for prior capital expenditures. The remaining portion of the proceeds from the sale of the Series 2012A Bonds were used to partially fund the second phase of the master facility project to build a private-room patient bed tower. The Series 2012A Bonds bear fixed interest rates which will average 4.47% and have a final maturity of 2047.

In November 2012, the Health Center through the City of Middleburg Heights, Ohio, issued \$16,282 of Series 2012B Bonds. The Series 2012B Bonds are payable from the general revenue of the Health Center. The private placement bonds were purchased by a bank. The proceeds from the issuance of the Series 2012B Bonds were used to extinguish the outstanding variable rate Series 2009 Bonds. The Series 2012B Bonds bear variable interest rates based upon LIBOR and have interest payments due semiannually and principal payments due annually. At December 31, 2017, the interest rate was 1.42%. The Series 2012B Bonds have a final maturity of 2028.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

8. Debt (continued)

In November 2012, the Health Center through the City of Middleburg Heights, Ohio, issued \$16,878 of Series 2012C Bonds. The Series 2012C Bonds are payable from the general revenue of the Health Center. The private placement bonds were purchased by a bank. The proceeds from the issuance of the Series 2012C Bonds were used to partially fund the second phase of the master facility project to build a private-room patient bed tower. The Series 2012C Bonds bear variable interest rates based upon LIBOR. At December 31, 2017, the interest rate was 1.69%.

In November 2012, the Health Center through the County of Medina, Ohio, executed \$7,605 of Series 2012D Bonds and \$7,240 of Series 2012E Bonds to refinance the Variable Rate Demand Revenue Bonds, Series 2007A (Series 2007A Bonds) and of Variable Rate Demand Taxable Revenue Bonds, Series 2007B (Series 2007B Bonds), which were used to finance construction of the Brunswick Medical Center. The Series 2012D Bonds and the Series 2012E Bonds are payable from the general revenue of the Health Center as were the Series 2007A Bonds and the Series 2007B Bonds. The private placement bonds were purchased by a bank. The Series 2012D Bonds and Series 2012E Bonds bear variable interest rates that are based on LIBOR. The Series 2012D and Series 2012E Bonds have a semiannual interest payment schedule and an annual principal payment schedule. The 15 annual principal payments commence August 1, 2023. At December 31, 2017, the interest rates for the Series 2012D and Series 2012E Bonds were 1.46% and 1.93%, respectively.

In December 2011, the Health Center through the City of Middleburg Heights, Ohio, issued \$63,045 of Hospital Facilities Revenue and Refunding Bonds, Series 2011 (Series 2011 Bonds). The Series 2011 Bonds are payable from the general revenue of the Health Center. A portion of the proceeds from the sale of the Series 2011 Bonds were used to refund the outstanding fixed-rate Series 1995 Bonds. The remaining portion of the proceeds from the sale of the Series 2011 Bonds were used to fund the facility project to expand the emergency department and critical care unit. The Series 2011 Bonds bear fixed interest rates which will average 5.19% and have a final maturity of 2041.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

8. Debt (continued)

The System is subject to certain restrictive covenants, including provisions relating to maintaining certain debt ratios and other matters. The System is in compliance with debt covenants at December 31, 2017.

Combined current aggregate maturities of bonds payable and capital leases, the Series 2012A, 2012B, 2012C, 2012D, 2012E, and the Series 2011 Bonds for five years subsequent to December 31, 2017, are as follows: 2018 – \$2,860; 2019 – \$2,948; 2020 – \$3,031; 2021 – \$3,227; 2022 – \$3,342.

The System paid interest of \$6,128 in 2017 and \$6,037 in 2016.

In March 2013, the System executed a bank agreement for a \$7,000 line of credit. There have not been any draws on the line of credit and the amount due under the line of credit is \$0 at December 31, 2017 and 2016. In December 2017, the System renewed that line of credit with an increase to \$10,000 which will expire on December 31, 2022.

9. Interest Rate Swap

The System utilizes interest rate swaps to manage the overall cost of debt and risk profile related to its long-term debt. The swaps utilized include (i) fixed payor swaps, whereby the System receives a floating rate and pays a fixed rate to either hedge against rising interest rates or achieve a lower overall cost of debt relative to traditional fixed-rate structures and (ii) basis swaps whereby the System receives a floating rate based on a taxable index (LIBOR) and pays a floating rate based on a tax-exempt index (SIFMA) designed to reduce interest costs associated with its traditional fixed rate debt. The fair value of all interest rate swap agreements is determined by relevant factors such as dealer price quotations and valuation pricing models. The swap agreements are not designated as hedging instruments.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

9. Interest Rate Swap (continued)

The following table summarizes the System's interest rate swap agreements:

Swap Type	Expiration Date	System Pays	System Receives	Notional Amount at	
				December 31, 2017	December 31, 2016
Fixed-payor	2037	3.49%	70% of LIBOR	\$ 7,605	\$ 7,605
Fixed-payor	2037	4.925%	100% of LIBOR	7,240	7,240
Fixed spread basis	2041	SIFMA index	67% of LIBOR +.72596%	31,168	31,318
				\$ 46,013	\$ 46,163

The following table summarizes the location and fair value for the System's interest rate swap agreements:

	Derivatives Liability			
	December 31, 2017		December 31, 2016	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives not designated as hedging instruments				
Interest rate swap agreements	Other long-term liabilities	\$ (3,804)	Other long-term liabilities	\$ (4,063)
	Other assets	1,504	Other assets	954

The following table summarizes the location and amounts of cash settlements and changes in fair value on the System's interest rate swap agreements:

	Location of Gain (Loss) Recognized	Year Ended December 31	
		2017	2016
Derivatives not designated as hedging instruments			
Payments to counterparty	Other net nonoperating gains (losses)	\$ (286)	\$ (354)
Changes in fair value	Investment income (loss)	809	67

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

10. Retirement Plan

The System has a noncontributory defined benefit retirement plan covering substantially all System employees. Benefits for employees are based on a percentage of annual compensation and years of service. The System's funding policy is to contribute amounts sufficient to provide for future benefits and to meet minimum Employee Retirement Income Security Act of 1974 (ERISA) funding requirements.

Effective January 1, 2015, the plan benefit formula changed from a final average compensation formula to a cash balance for participants whose age plus years of service are 75 or more as of January 1, 2009 (grandfathered group). The grandfathered group employees' final averages compensation benefit was frozen at December 31, 2014, with the cash balance formula starting January 1, 2015. As of December 31, 2015, the plan was completely frozen (i.e., no future cash balance compensation credits will be provided to participants).

For year-end 2016, the System adopted a change in the method it uses to estimate the interest cost component of net periodic benefit cost for its defined benefit pension plan. Historically, the interest cost component was estimated using a single weighted-average discount rate derived from the yield curve used to measure the benefit obligation at the beginning of the period. Beginning in 2017, the System used a spot rate approach by applying the specific spot rates along the yield curve to the relevant projected cash flows in the estimation of the interest components of benefit cost, resulting in a more precise measurement. This change does not affect the measurement of total benefit obligations. The change is accounted for as a change in estimate that is inseparable from change in accounting principle and, accordingly, is accounted for prospectively starting in 2017. The spot rates used to determine interest costs range from 1.27% to 4.44% for the plan. The reduction in interest costs for 2017 associated with this change in estimate is \$800. The defined benefit retirement plan was completely frozen as of December 31, 2015 and will no longer provide any future benefit accruals and will therefore not have a service cost component as part of the net periodic benefit cost.

Included in unrestricted net assets are unrecognized actuarial losses that have not yet been recognized in net periodic benefit cost of \$73,756 and \$75,651 at December 31, 2017 and 2016, respectively. The actuarial loss expected to be recognized during the year ending December 31, 2018 is \$2,324.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

10. Retirement Plan (continued)

Changes in plan assets and benefit obligations recognized in unrestricted net assets during December 31 included:

	2017	2016
Changes recognized in unrestricted net assets:		
Current year actuarial gain	\$ 514	\$ 10,019
Amortization of actuarial loss	(2,409)	(2,089)
Total	<u>\$ (1,895)</u>	<u>\$ 7,930</u>

A summary of the changes in the benefit obligation and plan assets and the resulting funded status of the pension plan are as follows:

	December 31	
	2017	2016
Change in benefit obligation:		
Benefit obligation at beginning of year	\$ 160,042	\$ 154,815
Service cost	—	—
Interest cost	5,741	6,823
Actuarial losses	8,472	4,346
Benefits paid	(6,076)	(5,942)
Benefit obligation at end of year	<u>168,179</u>	160,042
Change in plan assets:		
Fair value of plan assets at beginning of year	106,622	99,193
Actual return on plan assets	14,773	1,271
Employer contributions	11,300	12,100
Benefits paid	(6,076)	(5,942)
Fair value of plan assets at end of year	<u>126,619</u>	106,622
Underfunded status of the plan	<u>(41,560)</u>	(53,420)
Accrued retirement benefits	<u>\$ (41,560)</u>	<u>\$ (53,420)</u>
Accumulated benefit obligation	<u>\$ 168,179</u>	<u>\$ 160,042</u>

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

10. Retirement Plan (continued)

	Year Ended December 31	
	2017	2016
Components of net periodic benefit cost:		
Interest cost	\$ 5,741	\$ 6,823
Expected return on assets	(6,815)	(6,942)
Amortization of net actuarial loss	2,409	2,088
	<u>\$ 1,335</u>	<u>\$ 1,969</u>

The components of net periodic benefit cost are included in other nonoperating gains and losses in the consolidated statements of operations and changes in net assets.

	December 31	
	2017	2016
Weighted-average assumptions used to determine the benefit obligation at year-end:		
Discount rate	3.68%	4.16%
Expected return on plan assets	6.25	6.25

	December 31	
	2017	2016
Weighted-average assumptions used to determine net periodic benefit cost for the year ended:		
Discount rate	4.16%	4.50%
Expected return on plan assets	6.25	6.25

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

10. Retirement Plan (continued)

Plan assets by investment category are as follows:

	December 31	
	2017	2016
Cash and cash equivalents	–%	1%
Equity investments	55	53
Fixed income investments	34	34
Alternative investments	11	12
	100%	100%

The plan’s investment strategy is long-term oriented, which the plan manages through a target investment allocation. Plan assets are selected by various professional asset managers following System investment guidelines. The plan’s investment guidelines target allocation ranges of the investment pool to various asset classes including equity investments (40% to 70% target), fixed income investments (20% to 40% target), alternative investments (5% to 25% target) and cash and cash equivalents (0% target) and are designed to diversify the portfolio in a way that achieves an efficient trade-off between long-term return and risk while providing adequate liquidity to meet near-term expenses and obligations. The plan’s expected long-term rate of return is determined based upon its historical returns as well as expected future returns based upon targeted long-term returns of 9% to 11% for equity securities and 3% to 5% for debt securities. The System expects to contribute approximately \$5,000 to the plan in 2018.

Future expected benefits payments during the years ending December 31 are as follows: 2018 – \$6,121; 2019 – \$6,747; 2020 – \$7,192; 2021 – \$7,697; 2022 – \$8,207; and 2023 through 2027 – \$46,028.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

10. Retirement Plan (continued)

The following tables present the investments in the defined benefit pension as of December 31, measured at fair value on a recurring basis based on the fair value hierarchy:

	December 31, 2017		
	Level 1	Level 2	Total
Assets			
Cash and investments:			
Money market funds	\$ –	\$ 1,291	\$ 1,291
Fixed income securities:			
U.S. treasuries	487	–	487
U.S. government agencies	–	23,706	23,706
U.S. corporate	–	18,003	18,003
Common stocks:			
U.S.	5,947	–	5,947
Mutual funds:			
Equity	57,313	–	57,313
Total assets at fair value	<u>\$ 63,747</u>	<u>\$ 43,000</u>	<u>\$ 106,747</u>

	December 31, 2016		
	Level 1	Level 2	Total
Assets			
Cash and investments:			
Money market funds	\$ –	\$ 2,215	\$ 2,215
Fixed income securities:			
U.S. treasuries	487	–	487
U.S. government agencies	–	18,258	18,258
U.S. corporate	–	17,230	17,230
Common stocks:			
U.S.	5,062	–	5,062
Mutual funds:			
Equity	41,471	–	41,471
Total assets at fair value	<u>\$ 47,020</u>	<u>\$ 37,703</u>	<u>\$ 84,723</u>

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued) (Dollars in Thousands)

10. Retirement Plan (continued)

Total plan assets in the defined benefit pension as of December 31, 2017 and 2016 are comprised of the following:

	<u>2017</u>	<u>2016</u>
Investments measured at fair value	\$ 106,747	\$ 84,723
Commingled funds measured at net asset value	6,337	9,291
Alternative investments measured at net asset value	13,535	12,608
Total investments	<u>\$ 126,619</u>	<u>\$ 106,622</u>

Fair value methodologies for Level 1 and Level 2 are consistent with the inputs described in Note 4.

Fixed income securities include debt obligations of the U.S. government and various agencies, and U.S. corporations. The composition of these securities represents an expected return and risk profile that is commensurate with broadly defined fixed income indexes such as the Barclays Capital U.S. Aggregate Index.

Equity securities include investments of publicly traded common stocks of U.S. corporations, the majority of which represent actively traded and liquid securities that are traded on many of the world's major exchanges and include large-, mid-, and small-capitalization securities. The composition of these securities represent an expected return and risk profile that is commensurate with broadly defined equity indexes such as the Russell 1000 Index, the Russell 2500 Index and the Morgan Stanley Capital International (MSCI) EAFE (Europe, Australasia, Far East) Index.

Alternative investments include hedge funds that are meant to provide equity-like returns with fixed-income-like levels of risk. Included in this category are investments that are diversified across various strategies and may consist of long/short equity funds and other opportunistic funds. The underlying investments in such funds may include publicly traded and privately held equity and debt instruments issued by U.S. and international corporations as well as various derivatives based on these securities. No significant redemption restrictions or remaining investment commitments apply to the System's investments in these funds; however, the Fund Manager would evaluate such features or restrictions, as applicable, to estimate fair value.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

10. Retirement Plan (continued)

The System offers a defined contribution plan. Under the plan, employees voluntarily contribute a percentage of their annual salary. In 2017 and 2016, the System matched 50% of the employee's contributions up to an additional 6% of the employee's annual salary. Benefit expense in connection with the defined contribution plan was \$2,382 in 2017 and \$2,206 in 2016.

11. Professional and General Liability Insurance

Prior to August 1, 2011, the System provided coverage for professional liability, general liability and workers' compensation through a combination of self-insured retentions and commercial insurance policies. Effective August 1, 2011, the System entered into a participation agreement with Western Reserve Assurance Co., Ltd., an offshore captive insurance company (Western Reserve) which is a wholly owned subsidiary of UHHS. The System consolidates the assets and liabilities held in its segregated portfolio operated by Western Reserve on the System's behalf. Segregated portfolios, by law, do not have access or rights to the assets of any other segregated portfolio operated by Western Reserve. The participation agreement with Western Reserve provides for primary professional liability and primary general liability insurance coverage on a claims-made basis for substantially all of the System. The System purchases commercial insurance policies for automobile liability; heliport operations liability; commercial property liability; and excess workers' compensation. Western Reserve provides excess liability for the above risks through reinsurance agreements in place with unrelated commercial insurance companies. The System has stop-loss insurance for workers' compensation and employee health care claims.

Through Western Reserve, the System has set aside investments for the payment of the Health Center's professional liability claims, expenses, and settlements based on actuarial funding recommendations. The investments are \$14,572 (\$4,636 included in investments for current use) and \$14,347 (\$4,621 included in investments for current use) at December 31, 2017 and 2016, respectively. The provision for estimated self-insured professional liability claims includes estimates of the ultimate costs for both reported claims and claims incurred but not reported. Liability claims have been asserted that are in various stages of processing or are in litigation and are discounted at a rate of 0% for 2017 and 2016. There may also be incurred but unreported incidents, which may result in the assertion of additional claims. The System's recorded reserve for professional liability, including both the Health Center and Southwest General Medical Group, was \$17,081 and \$15,790 at December 31, 2017 and 2016, respectively, and is included in other accrued liabilities and other liabilities on the consolidated balance sheets. The System's recorded

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

11. Professional and General Liability Insurance (continued)

reserve for workers' compensation claims was \$841 and \$699 at December 31, 2017 and 2016, respectively, and is included in other accrued liabilities and other liabilities on the consolidated balance sheets. The System's recorded reserve for employee health care was \$1,550 and \$1,476 at December 31, 2017 and 2016, respectively, and is included in other accrued liabilities on the consolidated balance sheets.

12. Commitments

The System leases certain office space and equipment, which are accounted for as operating leases.

Rental expense, including items rented on a month-to-month basis, under operating leases was \$4,284 in 2017 and \$3,011 in 2016. Future minimum rental payments under noncancelable operating leases are as follows: 2018 – \$3,416; 2019 – \$2,562; 2020 – \$1,424; 2021 – \$1,074; and 2022 – \$338.

Total minimum lease rentals, exclusive of System occupied space in System-owned medical office buildings, to be received under current noncancelable leases as of December 31, 2017, are \$740 in 2018, \$436 in 2019, \$241 in 2020 and insignificant thereafter. Rental revenue of \$1,526 in 2017 and \$1,523 in 2016 is included in other net nonoperating gains (losses).

13. Income Taxes

The System has been granted tax-exempt status under Section 501(c)(3) of the Internal Revenue Code and therefore is not subject to federal income taxes on related income. Management is not aware of any situation that would have an adverse impact on the System's tax-exempt status.

Southwest Community Health System and Subsidiaries

Notes to Consolidated Financial Statements (continued)

(Dollars in Thousands)

14. Functional Expenses

The System provides health care services to patients within its geographic location. Functional expenses related to providing these services are as follows:

	Year Ended December 31	
	2017	2016
Health care services	\$ 289,678	\$ 273,691
General and administrative	63,564	55,657
	\$ 353,242	\$ 329,348

15. Subsequent Events

The System evaluated events and transactions occurring subsequent to December 31, 2017 through April 10, 2018, the date of issuance of the consolidated financial statements. During this period, there were no subsequent events requiring recognition or disclosure in the consolidated financial statements.

Supplementary Information



Ernst & Young LLP
Suite 1800
950 Main Avenue
Cleveland, OH 44113-7214

Tel: +1 216 861 5000
Fax: +1 216 583 2013
ey.com

Report of Independent Auditors on Supplementary Information

The Board of Trustees
Southwest Community Health System

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The accompanying consolidating balance sheets and statements of operations and changes in unrestricted net assets are presented for purposes of additional analysis and are not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audits 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

April 10, 2018

Southwest Community Health System and Subsidiaries

Consolidating Balance Sheet

December 31, 2017

	Obligated Group	Non-Obligated Group	Consolidating Eliminations	Consolidated Total
	<i>(In Thousands)</i>			
Assets				
Current assets:				
Cash and cash equivalents	\$ 22,399	\$ 340	\$ –	\$ 22,739
Patient accounts receivable, net	33,791	–	–	33,791
Other receivables, net	1,841	290	–	2,131
Due from affiliated organizations	16	–	(16)	–
Inventories	8,598	48	–	8,646
Prepaid expenses	10,310	15	–	10,325
Investments for current use	6,310	–	–	6,310
Total current assets	83,265	693	(16)	83,942
Investments:				
Board-designated	222,209	3,822	–	226,031
Self-insurance reserve funds	9,936	–	–	9,936
	232,145	3,822	–	235,967
Property, plant, and equipment, net	186,389	15	–	186,404
Other assets	5,559	1,078	–	6,637
Total assets	\$ 507,358	\$ 5,608	\$ (16)	\$ 512,950

	Obligated Group	Non-Obligated Group	Consolidating Eliminations	Consolidated Total
	<i>(In Thousands)</i>			
Liabilities and net assets				
Current liabilities:				
Accounts payable	\$ 13,474	\$ 18	\$ –	\$ 13,492
Due to affiliated organizations	–	16	(16)	–
Accrued compensation and related liabilities	25,975	117	–	26,092
Other accrued liabilities	9,848	26	–	9,874
Drawable credited earnings due to UHHS	5,127	–	–	5,127
Estimated amounts payable to third-party payors	2,696	–	–	2,696
Current portion of long-term liabilities	2,860	–	–	2,860
Total current liabilities	<u>59,980</u>	<u>177</u>	<u>(16)</u>	<u>60,141</u>
Long-term liabilities:				
Revenue bonds	152,420	–	–	152,420
Notes payable and capital leases	1,841	–	–	1,841
Accrued retirement benefits	41,560	–	–	41,560
Other liabilities	19,747	–	–	19,747
Total long-term liabilities	<u>215,568</u>	<u>–</u>	<u>–</u>	<u>215,568</u>
Total liabilities	<u>275,548</u>	<u>177</u>	<u>(16)</u>	<u>275,709</u>
Net assets:				
Unrestricted	231,728	1,400	–	233,128
Temporarily restricted	82	3,843	–	3,925
Permanently restricted	–	188	–	188
Total net assets	<u>231,810</u>	<u>5,431</u>	<u>–</u>	<u>237,241</u>
Total liabilities and net assets	<u>\$ 507,358</u>	<u>\$ 5,608</u>	<u>\$ (16)</u>	<u>\$ 512,950</u>

Southwest Community Health System and Subsidiaries

Consolidating Statement of Operations and Changes in Unrestricted Net Assets

Year Ended December 31, 2017

	Obligated Group	Non-Obligated Group	Consolidating Eliminations	Consolidated Total
	<i>(In Thousands)</i>			
Unrestricted revenue				
Net patient service revenue	\$ 376,582	\$ —	\$ —	\$ 376,582
Provision for bad debts	(20,828)	—	—	(20,828)
Net patient service revenue less provision for bad debts	355,754	—	—	355,754
Other revenue	11,186	603	—	11,789
Total unrestricted revenue	366,940	603	—	367,543
Expenses				
Salaries, wages, and benefits	163,616	341	—	163,957
Supplies, insurance, and other	158,136	180	—	158,316
Depreciation and amortization	24,808	8	—	24,816
Interest	6,153	—	—	6,153
Total expenses	352,713	529	—	353,242
Income from operations	14,227	74	—	14,301
Nonoperating gains (losses):				
Tax levy receipts	847	—	—	847
Investment income	8,913	—	—	8,913
Other – net	(4,106)	—	—	(4,106)
Total nonoperating gains (losses), net	5,654	—	—	5,654
Excess of revenue over expenses before drawable credited earnings due to UHHS	19,881	74	—	19,955
Drawable credited earnings due to UHHS	(5,127)	—	—	(5,127)
Excess of revenue over expenses	14,754	74	—	14,828
Net change in unrealized gains on other-than-trading investments	16,881	97	—	16,978
Net assets released from restrictions for capital	772	—	—	772
Pension adjustment	1,895	—	—	1,895
Increase in unrestricted net assets	34,302	171	—	34,473
Unrestricted net assets at beginning of year	197,426	1,229	—	198,655
Unrestricted net assets at end of year	<u>\$ 231,728</u>	<u>\$ 1,400</u>	<u>\$ —</u>	<u>\$ 233,128</u>

Southwest Community Health System and Subsidiaries

Consolidating Balance Sheet

December 31, 2016

	Obligated Group	Non-Obligated Group	Consolidating Eliminations	Consolidated Total
	<i>(In Thousands)</i>			
Assets				
Current assets:				
Cash and cash equivalents	\$ 28,498	\$ 912	\$ —	\$ 29,410
Patient accounts receivable, net	33,105	—	—	33,105
Other receivables, net	4,231	374	—	4,605
Due from affiliated organizations	—	35	(35)	—
Inventories	7,507	48	—	7,555
Prepaid expenses	9,771	—	—	9,771
Investments for current use	6,252	—	—	6,252
Total current assets	89,364	1,369	(35)	90,698
Investments:				
Board-designated	181,480	2,930	—	184,410
Self-insurance reserve funds	10,388	—	—	10,388
	191,868	2,930	—	194,798
Property, plant, and equipment, net	200,169	23	—	200,192
Other assets	4,464	1,235	—	5,699
Total assets	<u>\$ 485,865</u>	<u>\$ 5,557</u>	<u>\$ (35)</u>	<u>\$ 491,387</u>

	Obligated Group	Non-Obligated Group	Consolidating Eliminations	Consolidated Total
	<i>(In Thousands)</i>			
Liabilities and net assets				
Current liabilities:				
Accounts payable	\$ 16,692	\$ 26	\$ –	\$ 16,718
Due to affiliated organizations	35	–	(35)	–
Accrued compensation and related liabilities	22,690	89	–	22,779
Other accrued liabilities	9,890	13	–	9,903
Drawable credited earnings due to UHHS	3,026	–	–	3,026
Estimated amounts payable to third-party payors	4,143	–	–	4,143
Current portion of long-term liabilities	2,826	–	–	2,826
Total current liabilities	59,302	128	(35)	59,395
Long-term liabilities:				
Revenue bonds	155,012	–	–	155,012
Notes payable and capital leases	2,081	–	–	2,081
Accrued retirement benefits	53,420	–	–	53,420
Other liabilities	18,546	–	–	18,546
Total long-term liabilities	229,059	–	–	229,059
Total liabilities	288,361	128	(35)	288,454
Net assets:				
Unrestricted	197,426	1,229	–	198,655
Temporarily restricted	78	4,012	–	4,090
Permanently restricted	–	188	–	188
Total net assets	197,504	5,429	–	202,933
Total liabilities and net assets	\$ 485,865	\$ 5,557	\$ (35)	\$ 491,387

Southwest Community Health System and Subsidiaries

Consolidating Statement of Operations and Changes in Unrestricted Net Assets

Year Ended December 31, 2016

	Obligated Group	Non-Obligated Group	Consolidating Eliminations	Consolidated Total
	<i>(In Thousands)</i>			
Unrestricted revenue				
Net patient service revenue	\$ 353,464	\$ —	\$ —	\$ 353,464
Provision for bad debts	(20,084)	—	—	(20,084)
Net patient service revenue less provision for bad debts	333,380	—	—	333,380
Other revenue	11,288	1,008	—	12,296
Total unrestricted revenue	344,668	1,008	—	345,676
Expenses				
Salaries, wages, and benefits	153,345	372	—	153,717
Supplies, insurance, and other	144,322	306	—	144,628
Depreciation and amortization	24,948	8	—	24,956
Interest	6,047	—	—	6,047
Total expenses	328,662	686	—	329,348
Income from operations	16,006	322	—	16,328
Nonoperating gains (losses):				
Tax levy receipts	789	—	—	789
Investment income	674	—	—	674
Other – net	(4,575)	—	—	(4,575)
Total nonoperating (losses) gains, net	(3,112)	—	—	(3,112)
Excess of revenue over expenses before drawable credited earnings due to UHHS				
	12,894	322	—	13,216
Drawable credited earnings due to UHHS	(3,026)	—	—	(3,026)
Excess of revenue over expenses	9,868	322	—	10,190
Net change in unrealized gains on other-than-trading investments				
	6,810	(29)	—	6,781
Net assets released from restrictions for capital	3,194	—	—	3,194
Pension adjustment	(7,930)	—	—	(7,930)
Increase in unrestricted net assets	11,942	293	—	12,235
Unrestricted net assets at beginning of year	185,484	936	—	186,420
Unrestricted net assets at end of year	<u>\$ 197,426</u>	<u>\$ 1,229</u>	<u>\$ —</u>	<u>\$ 198,655</u>

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2018 Ernst & Young LLP.
All Rights Reserved.

ey.com

