
SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2017



Postlethwaite & Netterville

A Professional Accounting Corporation

www.pncpa.com

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

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INDEPENDENT AUDITORS' REPORT

The Board of Trustees
Southwest Louisiana Health Care System, Inc.

We have audited the accompanying consolidated financial statements of Southwest Louisiana Health Care System, Inc. and its affiliates (the System), which comprise the consolidated balance sheets as of December 31, 2017 and 2016, 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 financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Southwest Louisiana Health Care System, Inc. and its affiliates as of December 31, 2017 and 2016, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Postlethwaite & Netterville

Baton Rouge, Louisiana
April 13, 2018

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2017 AND 2016

ASSETS

<i>(in thousands)</i>	<u>2017</u>	<u>2016</u>
<u>CURRENT ASSETS</u>		
Cash and cash equivalents	\$ 34,131	\$ 39,121
Cash and cash equivalents - restricted	9,283	7,351
Patient accounts receivable, net of allowances for contractual adjustments and doubtful accounts of approximately \$96,749 and \$108,736 at December 31, 2017 and 2016, respectively	32,811	29,589
Assets limited as to use - current portion	7,439	10,889
Inventory	6,460	6,111
Short-term investments	62	58
Other current assets	8,451	6,871
Total current assets	<u>98,637</u>	<u>99,990</u>
<u>ASSETS LIMITED AS TO USE</u>		
Held by trustee in accordance with bond indentures	15,864	19,360
Internally designated for malpractice claims	1,737	1,659
Internally designated for the Foundation	1,316	1,454
Total assets whose use is limited	<u>18,917</u>	<u>22,473</u>
Less: amounts required to meet current liabilities	<u>(7,439)</u>	<u>(10,889)</u>
Noncurrent assets limited as to use	<u>11,478</u>	<u>11,584</u>
<u>PROPERTY AND EQUIPMENT, net</u>		
Total property and equipment, net	<u>131,762</u>	<u>117,398</u>
<u>OTHER ASSETS</u>		
Other	<u>4,603</u>	<u>4,736</u>
Total other assets	<u>4,603</u>	<u>4,736</u>
TOTAL ASSETS	<u><u>\$ 246,480</u></u>	<u><u>\$ 233,708</u></u>

The accompanying notes are an integral part of these consolidated statements.

LIABILITIES AND NET ASSETS

(in thousands)

	<u>2017</u>	<u>2016</u>
<u>CURRENT LIABILITIES</u>		
Current portion of long-term debt	\$ 7,635	\$ 6,900
Accrued interest payable	419	438
Accounts payable	17,483	13,754
Accrued compensation and benefits	17,036	16,784
Estimated third-party payor settlements	6,055	4,903
Other accrued expenses	24,465	28,884
Credit balances in patient accounts receivable	777	1,569
Total current liabilities	<u>73,870</u>	<u>73,232</u>
<u>LONG-TERM LIABILITIES</u>		
Long-term debt, net of current portion	101,839	95,552
Other long-term liabilities	3,470	3,720
Total long-term liabilities	<u>105,309</u>	<u>99,272</u>
Total liabilities	<u>179,179</u>	<u>172,504</u>
<u>TOTAL NET ASSETS</u>		
Noncontrolling interest	717	764
Controlling interest - unrestricted	66,362	59,817
Controlling interest - temporarily restricted	222	623
Total net assets	<u>67,301</u>	<u>61,204</u>
TOTAL LIABILITIES AND NET ASSETS	<u>\$ 246,480</u>	<u>\$ 233,708</u>

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

YEARS ENDED DECEMBER 31, 2017 AND 2016

(in thousands)

	<u>2017</u>	<u>2016</u>
<u>CHANGES IN UNRESTRICTED NET ASSETS</u>		
<u>OPERATING REVENUES</u>		
Patient service revenue net of contractual allowances	\$ 364,737	\$ 362,851
Less: provision for doubtful accounts	<u>(20,705)</u>	<u>(34,019)</u>
Net patient service revenue	344,032	328,832
Other operating revenues	<u>12,646</u>	<u>13,987</u>
Total operating revenues	<u>356,678</u>	<u>342,819</u>
 <u>OPERATING EXPENSES</u>		
Salaries and wages	151,514	148,352
Employee benefits	31,004	31,984
Contract labor	8,294	6,549
Supplies	79,363	75,427
Professional fees	4,964	5,502
Service contracts	7,478	6,881
Purchased services	26,988	27,129
Management fees	1,471	1,480
Depreciation	13,936	13,116
Interest expense	5,100	4,640
Insurance	4,992	5,111
Other	<u>16,321</u>	<u>14,017</u>
Total operating expenses	<u>351,425</u>	<u>340,188</u>
 INCOME FROM OPERATIONS	<u>5,253</u>	<u>2,631</u>
 <u>NONOPERATING REVENUES</u>		
Contributions	253	328
Other revenues - net	<u>906</u>	<u>338</u>
	<u>1,159</u>	<u>666</u>
 REVENUES OVER EXPENSES	6,412	3,297
 Change in fair value of investments	64	37
Net assets released from restriction	<u>584</u>	<u>239</u>
 CHANGE IN UNRESTRICTED NET ASSETS	<u>7,060</u>	<u>3,573</u>
 <u>CHANGES IN TEMPORARILY RESTRICTED NET ASSETS</u>		
Contributions	183	227
Net assets released from restriction	<u>(584)</u>	<u>(239)</u>
Total changes in temporarily restricted net assets	<u>(401)</u>	<u>(12)</u>
 CHANGE IN NET ASSETS	6,659	3,561
 Increase in net assets - noncontrolling interest	<u>515</u>	<u>540</u>
 Increase in net assets - controlling interest	<u>\$ 6,144</u>	<u>\$ 3,021</u>

The accompanying notes are an integral part of these consolidated statements.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS
YEARS ENDED DECEMBER 31, 2017 AND 2016

<i>(in thousands)</i>	<u>Controlling Interest</u>		<u>Noncontrolling Interest</u>	<u>Total Net Assets</u>
	<u>Unrestricted Net Assets</u>	<u>Temporarily Restricted Net Assets</u>		
<u>Balance at December 31, 2015</u>	\$ 56,784	\$ 635	\$ 908	\$ 58,327
Cash paid to minority shareholders	-	-	(684)	(684)
Increase (decrease) in net assets for the year ended December 31, 2016	<u>3,033</u>	<u>(12)</u>	<u>540</u>	<u>3,561</u>
<u>Balance at December 31, 2016</u>	59,817	623	764	61,204
Cash paid to minority shareholders	-	-	(562)	(562)
Increase (decrease) in net assets for the year ended December 31, 2017	<u>6,545</u>	<u>(401)</u>	<u>515</u>	<u>6,659</u>
<u>Balance at December 31, 2017</u>	<u>\$ 66,362</u>	<u>\$ 222</u>	<u>\$ 717</u>	<u>\$ 67,301</u>

The accompanying notes are an integral part of these consolidated statements.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2017 AND 2016

<i>(in thousands)</i>	<u>2017</u>	<u>2016</u>
<u>CASH FLOWS FROM OPERATING ACTIVITIES</u>		
Change in net assets	\$ 6,659	\$ 3,561
Adjustments to reconcile the changes in net assets to net cash provided by operating activities:		
Depreciation and amortization	14,171	13,327
Net unrealized gains on investments	(64)	(37)
Provision for doubtful accounts	20,705	34,019
Changes in operating assets and liabilities:		
Restricted cash	(1,932)	(1,633)
Patient accounts receivable	(24,719)	(32,914)
Inventories and other current assets	(1,929)	(782)
Other assets	133	(162)
Accounts payable and accrued expenses	(457)	(4,548)
Third party payor settlements	1,152	288
Changes in other liabilities	(250)	(33)
Net cash provided by operating activities	<u>13,469</u>	<u>11,086</u>
<u>CASH FLOWS FROM INVESTING ACTIVITIES</u>		
Acquisitions of property and equipment	(23,724)	(25,498)
Sale of investments	1,572	548
Purchase of investments	(1,614)	(280)
Change in assets whose use is limited	3,630	1,318
Net cash used in investing activities	<u>(20,136)</u>	<u>(23,912)</u>
<u>CASH FLOWS FROM FINANCING ACTIVITIES</u>		
Principal payments on revenue bonds and notes	(7,606)	(5,857)
Proceeds from issuance of revenue bonds	10,000	-
Cash paid to minority shareholders	(562)	(684)
Deferred financing costs paid	(155)	-
Net cash provided by (used in) financing activities	<u>1,677</u>	<u>(6,541)</u>
NET DECREASE IN CASH AND CASH EQUIVALENTS	(4,990)	(19,367)
Unrestricted cash and cash equivalents at beginning of year	<u>39,121</u>	<u>58,488</u>
Unrestricted cash and cash equivalents at end of year	<u>\$ 34,131</u>	<u>\$ 39,121</u>
<u>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</u>		
Cash paid during the year for interest, net of capitalized interest	<u>\$ 4,908</u>	<u>\$ 4,429</u>
Property and equipment acquired with financing	<u>\$ 4,576</u>	<u>\$ 3,497</u>

The accompanying notes are an integral part of these consolidated statements.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of significant accounting policies

Southwest Louisiana Health Care System, Inc. (the System) was organized as a Louisiana non-profit corporation for the purpose of conducting charitable, scientific, and educational activities. The System or the Hospital is designated as the “sole member” of its affiliates with the exception of several joint ventures, and, through the actions of its Board of Trustees, has the power to change or elect the Board of Trustees, approve certain corporate actions, and amend the articles of incorporation of its affiliates, thereby functioning in the capacity of the sole shareholder.

The accounting and reporting policies of the System conform to accounting principles generally accepted in the United States of America and the prevailing practices within the healthcare industry. The significant accounting policies used by the System in preparing and presenting its consolidated financial statements are summarized as follows:

Principles of consolidation

The consolidated financial statements include the Southwest Louisiana Hospital Association, d/b/a Lake Charles Memorial Hospital (the Hospital), the major operating unit in the System. The Hospital provides a wide range of inpatient and outpatient services through a 336-bed acute care facility, a 29 bed long term acute care facility, and satellite locations. Also included in the consolidated financial statements is Memorial Medical Group, LLC, a wholly-owned corporation formed for the purpose of entering into for-profit healthcare ventures, and the Southwest Louisiana Hospital Association Foundation, Inc. Through these entities, the System provides integrated healthcare services in southwest Louisiana.

The System is also a 51% owner in an MRI joint venture, which began operations in January of 2006. The joint venture is consolidated in the accompanying financial statements due to the System’s ownership percentage exceeding 50%.

The System established the Southwest Louisiana Hospital Association Foundation, Inc. The Foundation is organized as a non-profit corporation established to operate exclusively for the charitable, benevolent, educational and scientific purposes of Lake Charles Memorial Hospital. The Foundation has received exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code.

During 2013, the System entered into discussions with the LSU System and the State of Louisiana to lease the assets and be responsible for the operations of W.O. Moss Regional Hospital (Moss). A memorandum of understanding (MOU) was approved by the LSU Board of Supervisors, and a cooperative endeavor agreement (CEA) outlining the terms of the agreement was signed on June 24, 2013. MOUs have been signed in 2016 and 2017 that modify some of the terms of the CEA. This agreement was amended and restated in October of 2014. The Moss campus is now operated as an outpatient facility only and the activities of this campus are included in the accompanying financial statements.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of significant accounting policies (continued)

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Cash and cash equivalents

Cash and cash equivalents includes all unrestricted checking accounts and certain investments in highly liquid debt instruments which had maturities of three months or less at the time of purchase. Cash and cash equivalents does not include cash that has been excluded for certain potential expenses.

Short-term investments

Short-term investments include all stock (See Note 4).

Investments and investment income

The System follows the provisions of the accounting guidance contained in the Accounting Standards Codification (ASC) for investments in equity securities with readily determinable fair values and all investments in debt securities which requires them to be measured at fair value in the balance sheets.

Investment income or loss (including realized gains and losses on investments, interest, and dividends) is recorded as an increase in unrestricted net assets, unless the use is restricted by the donor or law. Investment income on proceeds of borrowings that are held by a trustee, to the extent not capitalized, are reported as other operating revenues. Unrealized gains and losses on investments are excluded from the excess of revenues over expenses unless the investments are trading securities.

Donated investments are recorded at their market value at the date of receipt, which is then treated as cost. Realized gains and losses on dispositions are based on the net proceeds and the adjusted cost basis of the securities sold, using the specific identification method. These realized gains and losses flow through the System's yearly activities.

Assets limited as to use

Assets limited as to use primarily include assets held by trustees under indenture agreements and designated assets set aside by the Board of Trustees, over which the Board retains control and may at its discretion subsequently use for other purposes. Amounts required to meet current liabilities of the System have been reclassified in the consolidated balance sheets.

Patient accounts receivable

The System provides credit in the normal course of operations to patients located primarily in southwestern Louisiana and to third-party payors conducting operations in these areas. Due to the Hospital's geographic location, the System participates in multiple states' Medicaid programs to cover patients who are admitted from states in close proximity to Louisiana.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of significant accounting policies (continued)

Patient accounts receivable (continued)

The System maintains allowances for contractual adjustments and doubtful accounts based on management's assessment of collectability, current economic conditions, and prior experience. The System determines if patient accounts receivable are past-due based on the discharge date; however, the System does not charge interest on past-due accounts but has entered into an agreement with a third party vendor who charges a monthly fee to the patient on extended payment plans. The System charges off patient accounts receivable if management considers the collection of the outstanding balances to be doubtful.

In evaluating the collectability of accounts receivable, the System analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. Management regularly reviews data about these major payor sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts. For receivables associated with services provided to patients who have third-party coverage, the System analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for doubtful accounts, if necessary. For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the System records a significant provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

Inventories

Inventories consist primarily of drugs, medical supplies, and general supplies and are stated at the lower of cost (using the first-in, first-out method) or net realizable value.

Property and equipment

Property and equipment are stated at historical cost. Donated property is recorded at its estimated fair value on the date of receipt, which is then treated as cost. Additions, renewals, and betterments that extend the lives or increase the value of assets are capitalized. Maintenance and repair expenditures are expensed as incurred.

Depreciation has been provided using the straight-line method over the estimated useful lives of the related assets, which range from 2 to 40 years. Equipment under capital lease obligations is amortized using the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment.

When assets are retired or otherwise disposed of, the costs and related accumulated depreciation are removed from the accounts, and any resulting gains and losses are recognized in the System's yearly operations.

Other assets

Other assets consist primarily of investments in affiliated entities, including Lake Charles Pharmaceutical Supply Company, LLC (50% ownership), Lake Charles Health Plan (50% ownership), Louisiana Pet Imaging of Lake Charles, LLC (24.5% ownership), and Shareport, LLC, (18.6% ownership). The System accounts for investments in affiliated entities of which it owns more than 20% but not more than 50%, using the equity method.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of significant accounting policies (continued)

Costs of borrowing

Interest costs incurred on borrowed funds during the period of construction of capital assets are capitalized as a component of the cost of acquiring those assets. Financing costs are amortized to interest expense on a straight-line basis over the period that the related obligation is outstanding.

Temporarily and permanently restricted net assets

Temporarily restricted net assets are those whose use by the System has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the System in perpetuity. The System did not have any permanently restricted net assets at December 31, 2017 or 2016.

Income from operations

The consolidated statements of operations include the line item entitled "income from operations." Income from operations includes, but is not limited to, patient revenues, investment income from unrestricted assets, cafeteria revenues, insurance proceeds, medical office rental revenues, and other government subsidies. Changes in unrestricted net assets which are excluded from income from operations include contributions, unrealized gains, and other non-operating activities.

Net patient service revenue and third-party settlements

The System has agreements with third-party payors that provide for payments to the System at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period that the related services are rendered and adjusted in future periods as final settlements are determined or as years are no longer subject to examination. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. Consequently, there is at least a reasonable possibility that recorded estimates could change by a material amount.

The System applies the Accounting Standards Update (ASU) 2011-07, Healthcare Entities (Topic 954), "Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Healthcare Entities," which requires certain healthcare entities to present the provision for doubtful accounts relating to patient service revenue as a deduction from patient service revenue in the statements of operations rather than as an operating expense.

The System applied the principles surrounding balance sheet offsetting during the years ended December 31, 2017 and 2016. Therefore, the third-party receivables and payables are presented separately on the accompanying consolidated balance sheets.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of significant accounting policies (continued)

Charity care

The System provides care to patients who meet certain criteria established under its charity care policy without expected reimbursements or at reimbursement rates substantially lower than its usual and customary charges. The related amounts are not reported as net revenues because the System does not pursue collection of amounts determined to qualify as charity care.

Donor-restricted gifts

Unconditional promises to give cash and other assets to the System are reported at their fair values at the date the promises are received. Conditional promises to give and indications of intentions to give are reported at their fair values at the date the gifts are received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statements of operations as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying financial statements.

Employee health benefit claims

The provision for accrued and unpaid medical claims includes estimates of claims related to its employees who participate in the group health care benefit plan. Such provisions are estimated by management and include amounts for claims filed and not paid and an estimate of claims incurred but not filed at year end.

Professional liability claims

The provision for estimated malpractice claims includes estimates of the ultimate cost for both reported claims, including costs to defend claims, and claims incurred but not reported. The System has not experienced material losses from professional liability claims in the past.

Income taxes

The Hospital and certain affiliates are non-profit organizations as described in Section 501(c)(3) of the Internal Revenue Code and are exempt from federal and state income taxes on related income pursuant to Section 501(a) of the Internal Revenue Code. Certain other affiliates are for-profit taxpaying entities. Federal income tax liabilities generated by the System's taxable activities, if any, are insignificant. Accordingly, no provision for income taxes on related income has been included in the consolidated financial statements.

The System applies the accounting guidance related to accounting for uncertainty in income taxes, which sets out a consistent framework to determine the appropriate level of tax reserves to maintain for uncertain tax positions. The System recognizes the effect of income tax positions only if the positions are more likely than not of being sustained. Recognized income tax positions are recorded at the largest amount that is greater than 50% likely of being realized. Changes in the recognition or measurement are reflected in the period in which the change in judgment occurs. The System has evaluated its position regarding the accounting for uncertain income tax positions and does not believe that it has any material uncertain tax positions.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of significant accounting policies (continued)

New Accounting Pronouncement

In July 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2015-11, *Inventory (Topic 330), Simplifying the Measurement of Inventory*. This update requires an entity that determines the cost of inventory by methods other than last-in, first-out and the retail inventory method to measure inventory at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The Company adopted this ASU prospectively effective January 1, 2017. The adoption of this standard did not have a material impact on the System's consolidated financial statements.

Accounting Pronouncements Issued But Not Yet Adopted

FASB has issued ASU No. 2016-14, "Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities." Under the ASU, the number of net asset classes is decreased from three to two; enhanced disclosures of underwater endowments are required; reporting of expenses by function and nature, as well as an analysis of expenses by both function and nature is required; and qualitative information in the notes to the financial statements on how an entity manages its liquid available resources and liquidity risks is required. This standard is effective for fiscal years beginning after December 15, 2017. Early application of the standard is permitted.

FASB has issued ASU No. 2014-09, "Revenue from Contracts with Customers," to update its revenue recognition standard to clarify the principles of recognizing revenue and eliminate industry-specific guidance as well as help financial statement users better understand the nature, amount, timing, and uncertainty of revenue that is recognized. Because the System is a conduit bond obligor (has issued debt that is publicly traded), this standard will be effective for periods beginning after December 15, 2017.

In February 2016, the FASB issued ASU No. 2016-02, "Leases." This accounting standard requires lessees to recognize assets and liabilities related to lease arrangements longer than 12 months on the balance sheet as well as additional disclosures. The updated guidance is effective for annual periods beginning after December 15, 2018.

The System is currently assessing the impact of these pronouncements on its consolidated financial statements.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

2. Current operating environment

Although not fully effective until future years, as enacted, the Affordable Care Act will change how health care services are covered, delivered and reimbursed. The Affordable Care Act provides for significant reductions in the growth of Medicare spending and reductions in Medicare and Medicaid disproportionate share hospital payments. Any shortfalls, now or in the future, whether as a result of the economic downturn, the expansion of Medicaid coverage under the Affordable Care Act, or otherwise, could result in additional reductions to Medicare or Medicaid payments.

The CEA related to the Moss campus provides for reimbursement for indigent patient care and effectively mitigates reductions in Medicaid reimbursements. As a result of the CEA signed in June 2013 and last amended September 2014 and further clarified by a MOU in 2016 and 2017, the Hospital received approximately \$30,974,000 and \$38,248,000 in CEA related payments during 2017 and 2016, respectively. The System recognized \$40,625,000 and \$47,129,000 as uncompensated care revenue related to services provided under that CEA during 2017 and 2016, respectively. The remainder of the revenue has been deferred and the unearned income is included in other accrued expenses and other long-term liabilities at December 31, 2017 and 2016. Except for approximately \$3,750,000 and \$11,750,000 in 2017 and 2016, respectively, which includes prepaid rent paid to LSU (see Note 10) in accordance with the CEA and unearned income paid to the Hospital under the CEA that is attributable to future periods, revenue is recognized on a monthly basis over the State fiscal year, which ends June 30, 2018.

The System also received approximately \$356,000 in 2017 and \$754,000 in 2016 of meaningful use proceeds which have been recorded in other operating revenues in the accompanying consolidated financial statements.

During 2015, the System became a member of the Gulf South Quality Network (GSQN), aimed at providing a physician network engaged in the process of clinical integration. The System has signed a clinical integration agreement through GSQN.

During 2016 new laws were enacted in the State of Louisiana. These laws temporarily eliminate sales tax exemptions and exclusions on certain transactions, including medical devices and other medical related items, from April 1, 2016 through June 30, 2018. Thus, these items will be subject to five percent state sales taxes from April 1, 2016 through June 30, 2016, and will then be subject to three percent state sales tax from July 1, 2016 through June 30, 2018. The impact to the System was approximately \$1.9 million during 2017.

The System received \$14,546 and \$550,087 in 2017 and 2016, respectively, from claims relating to the 2010 Deepwater Horizon oil spill in the Gulf of Mexico. These funds do not have any restrictions associated with their expenditure.

In February of 2018, Governor John Bel Edwards called a special session on the Louisiana Legislature to address an estimated \$1 billion shortfall for the State of Louisiana's 2019 fiscal year. No budget cuts affecting The System were made during the State's fiscal year ending June 30, 2018, and a requested cost increase was not granted. However, it is possible that cuts affecting the System will be made during upcoming sessions. Should additional sources of revenue or alternative cuts not be identified by the State legislature, the System's continued participation in the CEA may not be feasible.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

3. Net patient service revenue

The System has agreements with governmental and other third-party payors that provide for payments to the System at amounts different from its established rates. Contractual adjustments under third-party reimbursement programs represent the differences between the System's billings at established rates for services and amounts reimbursed by third-party payors. A summary of the basis of reimbursement with third-party payors follows:

- *Medicare* - inpatient acute and sub acute care services, psychiatric services, outpatient services, and home health services rendered to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Certain costs (Graduate Medical Education costs and for Medicare beneficiaries' bad debt) related to Medicare beneficiaries are paid based on a cost reimbursement methodology. The System is paid for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by the System and audits thereof by the Medicare fiscal intermediary.
- *Medicaid* - inpatient services rendered to Medicaid program beneficiaries are reimbursed at a prospectively determined rate-per-diem. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Certain extraordinary inpatient costs for children under the age of one are eligible for additional reimbursement. Some outpatient services are reimbursed at a prospectively determined fee schedule. Where no fee schedule has been developed, outpatient services are paid based on a cost reimbursement methodology. The System is paid for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by the System and audits thereof by the Medicaid fiscal intermediary.
- *Commercial and HMO* - the System has entered into agreements with certain commercial insurance carriers, health maintenance organizations, and preferred provider organizations. Payment methodologies under these agreements include prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

Revenue from the Medicare and Medicaid programs accounted for approximately 39% and 25%, respectively, of the System's net patient revenue for the year ended December 31, 2017, and 38% and 19%, respectively, of the System's net patient revenue, for the year ended December 31, 2016. Amounts receivable or payable under reimbursement agreements with the Medicare and Medicaid programs are subject to examination and retroactive adjustments. Provisions for estimated retroactive adjustments under such programs are provided for in the period the related services are rendered and adjusted in future periods as final settlements are determined. The settlements payable were approximately \$6,055,000 and \$4,903,000 at December 31, 2017 and 2016, respectively. There were no recorded settlements receivable at December 31, 2017 or 2016. Net patient service revenue increased approximately \$608,000 in 2017 and decreased approximately \$384,000 in 2016 due to prior-year retroactive adjustments in excess of amounts previously estimated.

As of December 31, 2017, final settlements had been made by the Medicaid program for all years ended through December 31, 2011, and final settlements had been made by the Medicare program for all years ended through December 31, 2013. Since the laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

3. Net patient service revenue (continued)

Presented below is a summary of net patient service revenue for the years ended December 31, 2017 and 2016 (in thousands):

	<u>2017</u>	<u>2016</u>
Gross patient service revenue	\$ 1,139,109	\$ 1,073,745
Less: contractual adjustments and other deductions	(774,372)	(710,894)
Less: provision for doubtful accounts	(20,705)	(34,019)
Net patient service revenue	<u>\$ 344,032</u>	<u>\$ 328,832</u>

4. Investments/Assets limited as to use

The composition of assets limited as to use at December 31, 2017 and 2016 is set forth in the following tables. Investments are stated at fair value (in thousands).

	<u>2017</u>	<u>2016</u>
Assets held by the trustee in accordance with bond indenture agreements:		
Cash and cash equivalents	\$ 9,190	\$ 12,681
U.S. Government agencies	9	14
Investment agreements	6,665	6,665
	<u>15,864</u>	<u>19,360</u>
Less: amount classified as current	(7,439)	(10,889)
	<u>\$ 8,425</u>	<u>\$ 8,471</u>
	<u>2017</u>	<u>2016</u>
Assets internally designated by the Board of Trustees for professional liability claims and other matters:		
Cash and cash equivalents	\$ 1,495	\$ 1,725
Equity mutual funds	355	302
U.S. Government agencies	1,203	1,086
	<u>\$ 3,053</u>	<u>\$ 3,113</u>
Total non-current assets limited as to use	<u>\$ 11,478</u>	<u>\$ 11,584</u>

Use of the above funds is limited by trust indentures as well as internal designations. The bond trust funds of \$15,864,000 and \$19,360,000 in 2017 and 2016, respectively, are generally limited to payment of debt service, maintenance of reserve funds, and security for bondholders. Use of the professional liability funds of \$1,737,000 and \$1,659,000 in 2017 and 2016, respectively, is limited by the Board of Trustees for the payment of professional liability claims and related expenses. Funds totaling \$1,316,000 and \$1,454,000, in 2017 and 2016, respectively are designated for the Hospital's foundation. The trust indenture authorizes the deposit of certain funds into investment agreements maintained with financial institutions. The funds deposited into these agreements are generally unsecured and redemption of the investments depends solely on the financial condition of the financial institutions, which hold the investments, and their ability to pay their obligations. The System had approximately \$6,665,000 of these types of investments at December 31, 2017 and 2016.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

4. Investments/Assets limited as to use (continued)

Included in short-term investments is an investment in stock which totaled approximately \$62,000 and \$58,000 as of December 31, 2017 and 2016, respectively.

The System recognized investment revenues of approximately \$554,000 and \$582,000 during the years ended December 31, 2017 and 2016, respectively. These amounts are classified as other operating revenues in the consolidated statements of operations.

5. Property and equipment

Property and equipment at December 31, 2017 and 2016 consisted of the following (in thousands):

	<u>2017</u>	<u>2016</u>
Land and land improvements	\$ 18,678	\$ 18,429
Buildings and improvements	187,505	176,818
Equipment, furniture, and fixtures	<u>172,854</u>	<u>165,025</u>
	379,037	360,272
Less: accumulated depreciation	<u>(259,391)</u>	<u>(249,686)</u>
	119,646	110,586
Construction-in-progress	<u>12,116</u>	<u>6,812</u>
Property and equipment, net	\$ <u><u>131,762</u></u>	\$ <u><u>117,398</u></u>

Depreciation expense amounted to approximately \$13,936,000 and \$13,116,000 during the years ended December 31, 2017 and 2016, respectively.

The Board has approved a series of construction and renovation projects throughout the Hospital. Several of those projects were in progress in 2016 and 2017 and will continue into future years. See Note 14 regarding these construction commitments outstanding at December 31, 2017.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

6. Long-term liabilities

A summary of long-term liabilities at December 31 is as follows (in thousands):

	<u>2017</u>	<u>2016</u>
Hospital Revenue Bonds (Series 1992A); term bonds due at various dates through December 1, 2018, at a rate of 6.5%.	\$ 2,145	\$ 4,160
Hospital Revenue Bonds (Series 2007); term bonds due annually on December 1st through December 1, 2034, at rates ranging from 6.25% to 6.375%.	62,790	63,485
Hospital Revenue Bonds (Series 2013A); term bonds due annually on December 1st through December 1, 2018, at a rate of 2.78%.	1,500	2,865
Hospital Revenue Bonds (Series 2014); term bonds due annually on January 1st through January 1, 2024, at a rates ranging from 2.34% to 3.70%.	6,480	7,405
Term loan due in monthly installments through December of 2016 at 3.50% (Nurse Call System).	-	40
Term loan due in monthly installments through July of 2017 at 3.50% (18th St. land)	-	101
Hospital Revenue Bonds (Series 2015); term bonds due at various dates through January 1, 2025, at rates ranging from 2.00% to 2.85%.	9,506	10,000
Hospital Revenue Bonds (Series 2015A); term bonds due at various dates through October 1, 2025, at rates ranging from 2.309% to 2.914%.	10,000	10,000
Promissory note of up to \$6,000,000, due in monthly installments through June of 2020 at 3.69% (Nelson Rd).	4,365	6,000
Promissory note of up to \$3,600,000, due in monthly installments through December 5, 2024 at the WSJ Prime rate, 4.75% at December 31, 2017 (Oak Park Blvd Floors 2 & 3).	3,150	-
Hospital Revenue Bonds (Series 2017); term bonds due at various dates through October 1, 2027, at rates ranging from 2.45% to 3.30%.	10,000	-
Promissory note of \$1,700,000, due in monthly installments through June 20, 2020 at 4% (Linear Accelerator).	1,016	-
	<u>110,952</u>	<u>104,056</u>
Less: current portion of long-term liabilities	(7,635)	(6,900)
Less: unamortized debt issuance costs	(1,483)	(1,615)
Add: unamortized bond discounts and premiums, net	5	11
Long-term liabilities, net	<u>\$ 101,839</u>	<u>\$ 95,552</u>

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

6. Long-term liabilities (continued)

The System has a \$3,000,000 line of credit, secured by medical equipment. The line of credit has a fixed interest rate of 4.0% and matures on May 30, 2018. As amounts are drawn on the line, they convert to promissory notes and are included in the above notes payable summary. The amount of unused line of credit was \$1,984,000 and \$2,858,000 at December 31, 2017 and 2016, respectively.

The System capitalized interest expense of \$577,000 and \$1,078,000 in 2017 and 2016, respectively, in connection with its construction-in-progress projects.

The restricted group (currently comprised of the System, the Hospital, SWLHS, LLC. and Lake Charles Medical Services, LLC.) is required to maintain certain deposits in accordance with bond agreements, and such deposits are included with assets limited as to use. The revenue bond indentures also place limits on the incurrence of additional borrowings, place limits on the amount of assets that can be disposed of outside the normal course of business, and require the restricted group to satisfy measures of financial performance as long as the bonds are outstanding. The System was in compliance with these covenants at December 31, 2017.

The long-term debt obligations are scheduled to mature as follows (in thousands):

Year ending December 31st,		Bonds & Notes Payable
2018	\$	7,635
2019		9,483
2020		9,659
2021		10,218
2022		10,888
Thereafter		63,069
		110,952
Less: unamortized debt issuance costs		(1,483)
Add: unamortized bond discount and premiums, net		5
Total long-term debt	\$	<u>109,474</u>

Hospital Revenue Bonds (Series 1992):

The Series 1992 tax-exempt bonds were issued by the Memorial Hospital Service District of the Parish of Calcasieu, Louisiana, on behalf of the System. The payments to the bondholders are funded and guaranteed by the System under loan agreements with the trustees of the respective bond issues. The loan agreements are collateralized by the Hospital's gross receipts.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

6. Long-term liabilities (continued)

Hospital Revenue Bonds (Series 1992): (continued)

The Series 1992 bonds were issued to establish an irrevocable escrow to advance refund certain previous bonds, to provide funds for the System's additions and improvements, and to retire existing equipment notes. Payments of principal and interest on these bonds are insured under a municipal bond insurance policy. A portion of these bonds were defeased by the 2007 bond series, and are no longer outstanding at December 31, 2017, while the remaining portion carries an interest rate of 6.5% and matures on December 1, 2018.

Hospital Revenue Bonds (Series 2007):

During November of 2007, the Hospital completed an offering of \$69,775,000 of hospital revenue and refunding bonds. The Series 2007 bonds are fixed rate term bonds with rates ranging from 6.250% to 6.375% and are scheduled to mature at various times through December 1, 2034. The bonds are collateralized by the Hospital's gross receipts and a collateral mortgage on System property. The proceeds of the Series 2007 bonds were used, along with other available funds, to advance refund previous bond issues and to provide funds for new capital improvements.

Hospital Revenue Bonds (Series 2013A):

During October of 2013, the Hospital completed an offering of \$6,275,000 of hospital revenue and refunding bonds. The Series 2013A bonds are fixed rate term bonds a rate of 2.78% and are scheduled to mature at December 1, 2018. The bonds are collateralized by the Hospital's gross receipts. The proceeds of the Series 2013A bonds were used, along with other available funds, to advance refund the 1993 bond issue.

Hospital Revenue Bonds (Series 2014):

During January of 2014, the Hospital completed an offering of \$10,000,000 of hospital revenue and refunding bonds. The Series 2014 bonds are fixed rate term bonds with rates ranging from 2.34% to 3.70% and are scheduled to mature at January 1, 2024. The bonds are collateralized by the Hospital's gross receipts, the mortgage over facilities, and the UCC fixture filing. The proceeds of the Series 2014 bonds were used, along with other available funds, to fund construction projects.

Hospital Revenue Bonds (Series 2015)

During February of 2015, the Hospital completed an offering of \$10,000,000 of hospital revenue bonds for the purpose of providing funds for acquisition, construction, renovation and equipping of hospital facilities and paying costs of issuing the bonds. The Series 2015 bonds are fixed rate term bonds with rates ranging from 2.00% to 2.85% and are scheduled to mature at January 1, 2025. The bonds are collateralized by the Hospital's gross receipts, the mortgage over facilities, and the UCC fixture filing. The proceeds of the Series 2015 bonds were used, along with other available funds, to fund construction projects.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

6. Long-term liabilities (continued)

Hospital Revenue Bonds (Series 2015A):

During October of 2015, the Hospital completed an offering of \$10,000,000 of hospital revenue bonds for the purpose of providing funds for the renovation of the kitchen and loading dock adjacent to the back area of the kitchen at the hospital's main campus, construction of a free-standing inpatient and outpatient psychiatric facility at the Gauthier Road campus, and paying costs of issuing the bonds. The Series 2015A bonds are fixed rate term bonds with rates ranging from 2.309% to 2.914% and are scheduled to mature at October 1, 2025. The bonds are collateralized by the Hospital's gross receipts, the mortgage over facilities, and the UCC fixture filing. The proceeds of the Series 2015 bonds were used, along with other available funds, to fund construction projects.

Hospital Revenue Bonds (Series 2017):

During December 2017, the Hospital completed an offering of \$10,000,000 of hospital revenue bonds for the purpose of providing funds for the completion of existing hospital capital projects at the hospital's main campus, Gauthier Road campus, and paying costs of issuing the bonds. The Series 2017 bonds are fixed rate term bonds with rates ranging from 2.45% to 3.30% and are scheduled to mature at October 1, 2027. The bonds are collateralized by the Hospital's gross receipts, the mortgage over facilities, and the UCC fixture filing. The proceeds of the Series 2017 bonds are being used, along with other available funds, to fund construction projects.

7. Insurance programs

Any exposure under \$100,000 per claim for professional liability is covered by the System. Additional professional liability coverage is provided by the Louisiana Patient's Compensation Fund up to the present statutory maximum of \$500,000 per claim (exclusive of additional amounts for future medical expense provided by law). The preceding policies are on an occurrence basis. The System has employed independent actuaries to estimate the ultimate costs, if any, of the settlement of such claims.

The System is self-insured for group health insurance and pays all claims up to \$200,000 per person. A stop loss policy pays claims in excess of this amount. The System is also self-insured for workers' compensation liability up to the deductible of its excess workers' compensation policy of \$750,000 per claim.

The System has reflected its estimate of the ultimate liability for known and incurred, but not reported, claims in the accompanying financial statements.

8. Retirement plans

The Hospital has a defined contribution plan under IRS Code Section 401(a) that covers substantially all full-time employees who are over the age of twenty-one and who have met eligibility requirements. Discretionary contributions by the Hospital include matching contributions to the employee 401(a) plan up to certain limits of compensation. Total contributions were approximately \$2,288,000 and \$2,293,000 for the years ended December 31, 2017 and 2016, respectively.

The Hospital also maintains a pretax retirement plan under code Section 403(b) in which substantially all of the employees of the System can participate. All contributions to the 403(b) are made by employees through tax deferred contributions and the employees are 100% vested in these amounts from the inception of their participation.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

9. Business and credit concentrations

Financial instruments which potentially subject the System to concentrations of credit risk consist principally of unsecured accounts receivable and temporary cash investments.

The System maintains its cash investments with several financial institutions operating primarily in southern Louisiana. The balances, at times, may exceed federally insured limits. Management believes the credit risk associated with these deposits is minimal.

The System grants credit to patients, substantially all of whom are regional residents. The System generally does not require collateral or other security in extending credit to patients; however, it routinely obtains assignment of (or is otherwise entitled to receive) patients' benefits payable under their health insurance programs, plans, or policies (e.g., Medicare, Medicaid, and commercial insurance policies).

The mix of receivables from patients and third-party payors at December 31, 2017 and 2016 was as follows:

	<u>2017</u>	<u>2016</u>
Medicare	31.65%	27.76%
Medicaid	22.29%	25.10%
Commercial insurance and managed care organizations	30.89%	28.86%
Self-pay patients and other	15.17%	18.28%
	<u>100.00%</u>	<u>100.00%</u>

10. Leases

The Hospital leases various pieces of equipment and operating facilities under operating leases (including the Moss campus) which expire at various dates through the year ending December 31, 2023. Total rental expenses under these leases totaled approximately \$2,889,000 and \$2,895,000 during the years ended December 31, 2017 and 2016, respectively.

The following is a schedule by year of future minimum lease payments required under all of these operating leases which have initial or remaining non-cancelable lease terms in excess of one year (in thousands):

<u>Year ending December 31st</u>	<u>Amount</u>
2018	\$ 2,863
2019	2,668
2020	2,487
2021	2,487
2022	2,487
Thereafter	1,244
	<u>\$ 14,236</u>

11. Classification of expenses

The following table approximates the classification of operating expenses incurred during the years ended December 31, 2017 and 2016 (in thousands):

	<u>2017</u>	<u>2016</u>
Patient related services	\$ 295,197	\$ 285,758
General and administrative expenses	56,228	54,430
Total operating expenses	<u>\$ 351,425</u>	<u>\$ 340,188</u>

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

12. Disclosures about the fair value of financial instruments

In Accordance with the *Fair Value Measurements and Disclosure* topic of the Financial Accounting Standards Board (FASB) ASC, disclosure of fair value information about financial instruments, whether or not recognized in the balance sheets is required. Fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. Fair value is best determined based upon quoted market prices. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instruments. Therefore, the aggregate fair value amounts presented do not represent the underlying value of the System.

The fair value guidance provides a consistent definition of fair value. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

Fair Value Hierarchy

In accordance with this guidance, the System groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1 – Valuation is based on quoted prices in active markets for identical assets or liabilities that the System has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 - Valuation is based on inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

Level 3 - Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

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.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

12. Disclosures about the fair value of financial instruments (continued)

The following methods and assumptions were used by the System in estimating its fair value disclosures for financial instruments:

Cash and cash equivalents - the carrying amounts approximate fair values because of the short maturity of these instruments.

Assets limited as to use and short-term investments - the carrying amounts reported on the balance sheets are fair values based on quoted market prices. The guaranteed investment contracts are deposits in an entity with guaranteed interest rates over the life of the respective bond issues and have no secondary market. Therefore, cash flow projections are used to measure fair value and are substantially the same as cost.

Mortgage backed securities – the carrying amounts reported are estimated based on quoted market prices for securities with similar characteristics.

Long-term liabilities - the fair value of the Hospital's revenue bonds are estimated based on current traded value. The fair value of the hospital's remaining long term debt is estimated using discounted cash flow analyses, based on the hospital's current incremental borrowing rates for similar types of borrowing arrangements.

The Hospital's financial instruments whose estimated fair value differs from its carrying amount are summarized as follows at December 31st:

	<u>2017</u>		<u>2016</u>	
	<u>Carrying Amount</u>	<u>Estimated Fair Value</u>	<u>Carrying Amount</u>	<u>Estimated Fair Value</u>
Long-term liabilities (in thousands)	\$ <u>110,957</u>	\$ <u>114,671</u>	\$ <u>104,067</u>	\$ <u>108,331</u>

Limitations - fair value estimates are made at a specific point in time, based on relevant market information about the financial instruments. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

12. Disclosures about the fair value of financial instruments (continued)

The following table presents for each fair-value hierarchy level the System's financial assets that are measured at fair value on a recurring basis as of (in thousands).

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
<u>December 31, 2017</u>			
Guaranteed Investment Contract	\$ -	\$ -	\$ 6,665
Mortgage Backed Securities	-	9	-
Cash and Cash Equivalents	10,685	-	-
Fixed Income	1,203	-	-
Equities	417	-	-
Total	\$ <u>12,305</u>	\$ <u>9</u>	\$ <u>6,665</u>
<u>December 31, 2016</u>			
Guaranteed Investment Contract	\$ -	\$ -	\$ 6,665
Mortgage Backed Securities	-	14	-
Cash and Cash Equivalents	14,406	-	-
Fixed Income	1,086	-	-
Equities	360	-	-
Total	\$ <u>15,852</u>	\$ <u>14</u>	\$ <u>6,665</u>

The following table presents the changes in fair value for the years ended December 31, 2017 and 2016, in Level 3 instruments that are measured at fair value on a recurring basis.

Balance, December 31, 2015	\$ 6,666
Purchases	280
Sales	<u>(281)</u>
Balance, December 31, 2016	6,665
Purchases	280
Sales	<u>(280)</u>
Balance, December 31, 2017	\$ <u>6,665</u>

13. Related party transactions

The System has transactions with related parties for which the System believes the terms and conditions are comparable to terms that would have been available from a third party that was unaffiliated with the System.

14. Commitments and contingencies

The System is involved in various legal actions and claims that arose as a result of events that occurred in the normal course of operations. The ultimate resolution of these matters is not ascertainable at this time; however, management is of the opinion that any liability or loss in excess of insurance coverage resulting from such litigation will not have a material effect upon the financial position of the System.

As referred to in Note 5, the Hospital has begun a series of construction and renovation projects. Contracts related to these projects totaled approximately \$15,241,000 at December 31, 2017. Approximately \$9,324,000 has been paid on these contracts as of December 31, 2017, with approximately \$5,917,000 to be completed in future years.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

15. Subsequent events

Management has evaluated events through the date that the consolidated financial statements were available to be issued, April 13, 2018, and determined that no additional disclosures are necessary other than those already described in Note 2.

16. Community service (unaudited)

As a non-profit, community based health system, the Hospital provides significant programs and health-related services for the indigent and medically underserved in southwest Louisiana, which represents the Hospital's financial commitment to those in our community with inadequate resources or who are uninsured or underinsured. In addition, the Hospital operates an emergency room which is open to the public, 24 hours a day and seven days a week.

Charity Care represents the cost of free or discounted health related services for those who cannot afford to pay for those services and who meet the Hospital's criteria for financial assistance. Under the Hospital's criteria for determining assistance, the Hospital provides full charity care for those whose income levels are at or below 200% of the Federal Poverty Guidelines (FPG). Discounted services are available to those people whose income is above 200% of the FPG and up and including to 500% of the FPG. Charity Care services provided to these people are reported as income in the consolidated statement of operations to the extent of the estimated cost recovery allowed under the Moss Cooperative Endeavor Agreement (Moss CEA). The Hospital also provides some services at a reduced rate that does not cover the costs. For example, the Hospital provides free or significantly discounted vaccinations for children and elderly patients. The unreimbursed Medicaid Costs reported below have been reduced by funds received that approximate the difference between Medicaid payments and the costs allowed under the Moss CEA.

Additionally, the Hospital provides the clinical and financial resources for the Memorial/LSUHSC Family Practice Residency Program, through an affiliation agreement with the Louisiana State University Health Sciences Center – New Orleans, to train 24 family practice residents and also provides the clinical and financial resources for a Radiology Technology and Medical Technology program in affiliation with other state universities. The Hospital is also involved in providing services to the community at large by supplementing professional medical staffing at community clinics and through the provision of support groups, community health education classes, staffing support at McNeese State University School of Nursing, and cash donations to local non-profit organizations.

The Hospital continues to fulfill its obligations under Internal Revenue Service guidelines to participate in Community Health Needs Assessment (CHNA) and has updated its CHNA in 2016. The Hospital has provided a CHNA update in 2017. This report is available on its website at www.lcmh.com.

SOUTHWEST LOUISIANA HEALTH CARE SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

16. Community service (unaudited) (continued)

The following is a summary of the Hospital's estimated costs of community benefits (in thousands):

Programs for the Poor and Underserved:	2017	2016
Charity Care, at cost	\$ 11,818	\$ 22,560
Direct Offsetting Revenue	9,357	18,948
Charity Care	2,461	3,612
Medicaid Patient Care, at cost	72,879	63,505
Direct Offsetting Revenue	64,816	58,132
Unreimbursed Medicaid	8,063	5,373
Community services for the community at large		
Education and research	3,712	3,621
Other	352	326
Total	\$ 14,588	\$ 12,932